

The GSE REPORT™

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Major Events

According to FDIC, eliminating implicit guarantee of GSEs would **not** weaken banking industry

- Banks and thrifts could easily cope with the changes that would result if Fannie Mae and Freddie Mac lost their implicit government backing, says an FDIC report dated March 1. FDIC's analysis concludes that the initial impact of eliminating any implicit guarantee of GSEs would not significantly weaken the banking industry for two primary reasons. First, the estimated shock to securities values and risk-weighted assets (used to calculate risk-based capital ratios) is less severe than might be expected despite the extent of the exposure. Second, the industry is well situated given current regulatory capital levels to sustain the estimated shock.
- Any government decision on the two GSEs would affect the liquidity and capital of banks and thrifts, which are heavily invested in Fannie- and Freddie-issued securities -- 62% of the industry's securities holdings are GSE-related. But the FDIC report asserts that even though the value of mortgage-backed and other securities issued by Fannie and Freddie would decrease without the implicit guarantee, the loss would not be big enough to threaten liquidity at the large majority of banks and thrifts.
- Also, removing the implicit guarantee would make GSE securities riskier, but not enough to threaten the risk-based capital profile of most banks and thrifts, the report said. Without an implicit guarantee, the value of the Fannie and Freddie securities that banks and thrifts own would drop by about 1.1%, to \$1.04 trillion, the report said. The industry-wide risk-based capital ratio would drop 47 basis points, to 12.75%, and most banks would remain far above the "well-capitalized" threshold.
- "The industry is well-positioned to absorb a widening of yield spreads on GSE-related securities and the elimination of explicit treatment of GSE-related securities" in risk-based capital regulations, the report said. (*American Banker*, Craig Linder, 03/01/04; *FDIC FYI: Update on Emerging Issues in Banking*, 03/01/04)

Freddie Mac ousts chief lobbyist amidst election law probe

- Freddie Mac said that its chief lobbyist, R. Mitchell Delk, had left and would not receive certain compensation pending an investigation by the Federal Election Commission (FEC) into his fund-raising activities. Delk's move came after a week of speculation about the timing and terms of his departure.
- In a press release, Freddie said that it is cooperating with the FEC and will provide the agency with the results of an internal inquiry into Delk's fund-raising. The GSE

has not decided whether to fire Delk or let him resign -- a distinction that will affect his benefits and compensation. Freddie said the decision will be made after the FEC probe was concluded.

- Freddie Mac's spokeswoman Sharon McHale would not disclose how much Delk could lose nor would she release any details of his current separation arrangement. She said it was reviewed by the company's regulator, OFHEO. "Any termination benefits [Delk] may ultimately receive will be subject to formal OFHEO approval," McHale said.
- It is unclear how much money Delk stands to lose. According to Freddie's proxy statement, released last month, Delk was paid \$1.13 million last year in salary, including a \$200,000 bonus that must be paid back if he quits or is fired for "gross misconduct." If he is fired, Delk could lose at least \$2 million in forfeited stock options, according to sources familiar with the situation.
- Delk's exit comes less than a year after the company awarded him a special bonus of \$200,000 to persuade him to stay at Freddie, then being rocked by an accounting scandal. Delk was long viewed as a crucial part of the GSE's efforts to remain on good terms with Congress. But a person who was briefed on the situation said Freddie's new chairman and CEO, Richard F. Syron, decided Delk should leave, after reviewing a report looking into Delk's fund-raising activities.
- Clarke Camper, Freddie's vice president for congressional affairs, will head the GSE's lobbying team for now, and a company spokeswoman said it has hired the headhunting firm Korn/Ferry International to find a permanent successor.
- Most Washington insiders expect Freddie to hire a well-connected Republican, as Delk is, to "offset" the company's Democratic chairman and chief executive, Richard Syron. Several sources pointed to prominent Republican lobbyists like Steve Bartlett, a former Texas congressman and now the president of the Financial Services Roundtable, or Rick Lazio, a former New York congressman and now the head of the Financial Services Forum.
- Delk has been under scrutiny for some time. In August, the *Washington Post* reported that Delk hosted discounted dinners at Galileo, a restaurant where main courses cost between \$25.00 and \$35.00 with Republican House members and lobbyists. Delk held at least 50 fundraising events between 2001 and mid-2003 at which he was charged \$500 for up to 20 dinners, or \$25.00 a plate for a three-course dinner, wine, drink, tax, and tip, the *Washington Post* said.
- Representative Michael Oxley (R, OH), Chairman of the House Financial Services Committee that oversees Freddie Mac, was a guest of Delk's, the paper said. Delk reported his payment for each dinner as an 'in-kind' donation of \$500 or \$750 to the House member he hosted, the *Washington Post* said. Campaign laws during the

period allow an individual to donate up to \$1,000 per election to a candidate in the form of gifts or funds.

- A consumer advocacy group, Public Citizen, filed a formal complaint in October, accusing Delk of “apparent violations” of individual and aggregate contribution limit, reporting requirements, and the ban on corporate campaign contributions. Public Citizen cited group discounts Delk got from local restaurants to host fund-raisers for members of the congressional committees with oversight over Freddie.
- The Freddie Mac board asked the law firm of Covington & Burling to conduct a probe last fall after news reports detailed how Delk had hosted dozens of fundraisers at Galileo at a cost that was far below the rate available to the general public.
- Delk’s attorney, Kenneth A. Gross, a partner at Skadden, Arps, Slate, Meagher & Flom LLP in Washington, said in an interview that Delk’s departure was a “mutual decision” between his client and Freddie Mac. Gross said he had reviewed the information Freddie was giving the FEC and had concluded there was nothing “that would warrant the company taking adverse action against him.” But sources indicated that Delk may have also run afoul of internal politics at Freddie.
- Several sources said that last summer Delk had urged the company’s board of directors not to replace its ousted CEO, Leland Brendsel, with Gregory Parseghian, then its senior vice president and chief investment officer. Delk allegedly argued that Parseghian was tainted by the emerging accounting scandal and would be forced out. (That prediction came true in August). Sources said that after Parseghian took office, he and Joan Donoghue, Freddie’s acting general counsel, began an investigation into Delk’s fund-raising.
- Sources indicated that the negotiation over Delk’s departure was delicate. Freddie has come under fire for paying Parseghian a large compensation package despite his role in the scandal, and sources said the GSE’s officials were concerned about similar criticism when Delk left.
- “Freddie Mac is still knee-deep in terms of getting their ducks in a row,” said Hilary Hayes, an analyst at Victory SBSF Capital in New York, which hasn’t owned shares of Freddie Mac since last year. The company “is still going through a recovery process and any headlines that come up could continuously chip away at any feeling of integrity” for investors, she said. (*American Banker*, Rob Blackwell, 03/12/04; *Bloomberg News*, James Tyson and Albert Yoon, 03/11/04; *Washington Post*, Kathleen Day, 03/12/04; *Wall Street Journal*, James R. Hagerly, 03/12/04; Dow Jones Newswire, Dawn Kopecki, 03/11/04)

FEC fines Fannie Mae and Republican Committees \$132,000 for soft money donations

- The Federal Election Commission (FEC) found that two Republican committees improperly funneled contributions from Fannie Mae to state candidates between 1998 and 2000, fining the three entities a total of \$132,000 to settle the case. The FEC also formally admonished Freddie Mac for not properly designating some of its donations.
- Fannie Mae was fined \$10,000, while the National Republican Senatorial Committee and the Republican National Committee paid \$24,000 and \$98,000, respectively. In its unanimous decision, the FEC said that it “found reason to believe” Fannie Mae violated campaign-finance laws that ban corporate giving to candidates.
- Until two years ago, Fannie Mae and Freddie Mac were allowed to give money to political parties’ building funds, which pay for construction or maintenance of campaign offices. The companies, however, have always been prohibited from donating funds to finance individual campaigns. The two companies were banned from donating to the building funds in 2002.
- The FEC said it found several instances from 1998 through 2000 in which tens of thousands of dollars in Fannie Mae donations were illegally routed to RNC funds that supported state candidates. The Republican Governors Association funneled \$51,470 in contributions from Fannie Mae into an RNC account for state candidates, the FEC said. The governors association wasn’t fined.
- Fannie Mae officials blamed the Republican Governors Association. Company spokesman Chuck Greener said the Republican Governors Association “inadvertently and contrary to the company’s usual practice deposited” the money into another account. He said that in 2001 when Fannie Mae found out what had occurred, it immediately requested -- and received -- a full refund.
- Freddie Mac was cleared of charges that it didn’t properly direct a \$250,000 donation to the RNC’s building fund, which the RNC deposited into a prohibited account. Freddie Mac was chastised for failing to properly document a \$3,000 donation to a National Republican Congressional Committee golf outing.
- “In that one instance, we didn’t say this has to go into the building fund, like everything else,” said Freddie Mac spokeswoman Sharon McHale, adding that the congressional committee properly deposited it into that fund. “They admonished us for not properly communicating that it needed to go into the building fund.”
- The election commission also found the senatorial committee improperly deposited three different donations from Freddie Mac, later refunded, totaling \$130,250 into accounts that help finance campaigns for state Republican candidates.

- The settlement was approved by a 4-0 vote of the FEC commissioners in a closed session February 3. Republican Commissioner Michael Toner and Democratic Commissioner Ellen Weintraub were recused from the case because of their previous legal representation of the party committees. (*Wall Street Journal*, Dawn Kopecki, 03/04/04; *Daily Report for Executives*, Kenneth P. Doyle, 03/04/04)

Fannie Mae and Freddie Mac

Temperature reading on GSE regulatory reform legislation
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- After a week in which key lawmakers disagreed with Federal Reserve Board Chairman Alan Greenspan's call to limit the growth of Fannie Mae and Freddie Mac, the Senate Banking Committee is trying to hammer out language for a bill to establish a new regulator for the GSEs. The committee's behind-the-scenes deliberations were given more urgency by Chairman Richard Shelby (R-AL), who said he plans to have the still unreleased bill marked up by the end of March. The committee is making progress and is working to finalize decisions in a "delicate" process, with outreach to Senate Banking Committee ranking member Paul Sarbanes (D-MD) and others on the committee, a spokesman for Shelby said March 5.
- Shelby said he plans to introduce legislation soon that would create a stand-alone regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. A committee vote is expected by the end of the month. Shelby has broadly outlined a bill, saying the new supervisor should be able to raise minimum and risk-based capital and oversee safety and soundness and the housing mission of the GSEs. He also said the new supervisor should have oversight of any new program activities at the GSEs. But sources said that details on those issues are still being worked out.
- Shelby isn't backing down from his insistence that a new, independent agency handle oversight of Fannie Mae and Freddie Mac. After Treasury Secretary John W. Snow declared again on March 9 that the new regulator should be part of the Treasury Department, Shelby told reporters on March 10 he still favors "an independent regulator, outside of Treasury," and also outside HUD, where oversight of the mortgage financiers currently resides. At a Senate Banking hearing February 10, Shelby publicly supported a new leadership structure for the agency, saying he welcomed a suggestion from Comptroller General David Walker, the General Accounting Office chief. Walker recommended giving the agency a strong executive director backed by an advisory board consisting of the heads of other agencies.
- Shelby will soon meet with Representative Michael Oxley (R-OH), who chairs the House Financial Services Committee, to discuss GSE reform legislation, Oxley and a Shelby spokesman confirmed March 9. The meeting is an extension of Shelby's efforts to achieve broad consensus and support on GSE regulatory reform, a Shelby

spokesman told *BNA* March 9. Oxley referred questions on the meeting to Shelby and a Shelby spokesman said he could not yet confirm a date for a meeting.

- Before taking another look at the issue, the House Financial Services Committee is expected to wait to see whether Senate Banking can pass a bill. Oxley said that most House lawmakers appear to support the creation of a stand-alone agency outside the Treasury Department. Oxley expects that the U.S. Treasury will probably drop its opposition to a regulator of Fannie Mae and Freddie Mac that is not controlled by Treasury, clearing the way this year for creation of a supervisory agency. “I think we’ll end up with an independent regulator. My sense is that Treasury will see the light,” said Oxley.
- At a Mortgage Bankers Association conference, Oxley said that Fannie and Freddie’s affordable-housing goals will be a major point of contention. “The biggest concern I hear from the housing side of things ...is the concern that the housing goals may lose out in this rush to reform,” Oxley said. “That’s really where the rubber is going to hit the road.” Oxley acknowledged Democrats in Congress would have to support the regulatory overhaul for it to pass. “I don’t think you can pass a bill without strong bipartisan support,” he said.
- “There is a lot of momentum for passage of a bill this year,” said Oxley, “certainly more likely than not.” He said that he is optimistic about passing GSE legislation. “At the end of the day, I think we will be successful in getting a bill to the president...If I’m Freddie or Fannie, I want this water torture to stop, and I want to reassure my investors I want to be regulated by a strong independent regulator...Uncertainty about oversight of Fannie Mae and Freddie Mac hurts the companies and the economy.”
- Treasury officials “now accept the fact that they are not going to get” a regulator within Treasury, said Representative Barney Frank (D-MA), the senior Democrat on the House Financial Services Committee. “The consensus now is that the regulator will have to be independent,” Frank said in an interview. Frank said the attention on Fannie Mae and Freddie Mac should also result in requiring the companies to do more to promote affordable housing. He does not believe Congress would pass a regulatory overhaul bill for Fannie Mae and Freddie Mac if lawmakers thought it would weaken housing. Frank said he will “use this crisis to get Fannie and Freddie more deeply into affordable housing.”
- Senator Robert Bennett (R-UT) said legislation to overhaul the regulation of Fannie Mae, Freddie Mac, and the FHLBs will likely clear the full Senate this year. “I think it will be non-controversial enough that it will probably go through,” said Bennett, who chairs the Senate Banking financial institutions subcommittee. “Whether it will be as tough a regulator as Treasury wants -- is still to be determined.” Bennett told reporters he is waiting for Shelby to craft the receivership provision to see whether he can support it. “Let’s wait and see what the language is,” Bennett said. “We are negotiating over that right now.” (*Reuters*, 03/01/04; *Dow Jones Newswires*, Dawn

Kopecki, 03/02/04; *BNA's Banking Report*, Karen Werner and Richard Cowden, 03/08/04; *Bloomberg*, James Tyson, 03/09/04; *Dow Jones*, Rebecca Christie, 03/09/04; *Reuters*, Mark Felsenthal, 03/09/04; *American Banker*, Rob Blackwell, 3/10/04; *CQ Today*, Siobhan Hughes, 03/10/04; *Daily Report for Executives*, Karen L. Werner, 03/10/04; *American Banker*, 03/11/04; *American Banker*, Michele Heller, 03/11/04; *National Mortgage News*, 03/11/04)

Federal banking officials flexing regulatory muscle and tightening grip on GSEs
Treasury's One-Two Punch: Treasury Secretary Snow speaks at ACB about GSEs
Acting Undersecretary Roseboro addresses GSE regulatory reform

- In recent weeks, Federal bank officials have begun to flex never-before-used regulatory muscle to tighten their grip on the government-sponsored enterprises, as Congress grapples with legislation that would strengthen their primary regulator as well as that of the Federal Home Loan Banks. The Federal Reserve recently announced plans to cut off by 2006 the GSEs' access to interest-free loans from the Fed that cover daily interest payments on their debt, which is estimated to cost Fannie and Freddie millions of dollars a year.
- The FDIC then issued a paper highlighting the risk of privatizing Fannie and Freddie to federally insured banks, which hold \$1.1 trillion of their securities. *Although it was not explicitly stated, many bankers took the FDIC study as a warning to rebalance portfolios that have high concentrations of GSE debt.*
- The Treasury Department has one of the most powerful unused regulatory tools in its arsenal - the power to approve or limit Fannie and Freddie's debt issuance. Fed Chairman Alan Greenspan in congressional testimony two weeks ago recommended the companies' debt issuance should be limited. While Snow and Roseboro didn't comment on whether the agency is considering such a move, they voiced the Treasury's concerns about the companies' rising debt levels in a "one-two punch." (*Dow Jones Newswires*, Dawn Kopecki, 03/08/04)

Treasury Secretary Snow speaks to ACB about GSEs

- In a March 9th speech before the America's Community Banker's, Treasury Secretary described the need for GSE regulatory reform and concerns about the GSEs rising debt levels, saying:
- "With their important role helping to fund our mortgage markets we need to be sure that [the GSEs] are operating safely, prudently, and efficiently. That's why I've proposed that that OFHEO (the Office of Federal Housing Enterprise Oversight) and the Federal Housing Finance Board, be replaced by a stronger regulator, better capable of supervising these two entities that have become so large relative to the housing finance market and to the whole financial system of the country."

- “GSEs ...are perceived to have a government guarantee...They have become enormous entities, and they are growing at a very, very rapid rate. The debt levels they are issuing are sizable relative to the economy of the United States. To put it into perspective, the U.S. Government debt held by the public is about \$3.6 trillion; the GSEs now totals about \$2.4 trillion and when you are that big you have potential significant impacts on financial markets.”
- “Our goal at the Treasury Department is to promote the health and strength of the housing finance markets together with the health and strength of the U.S. financial system. In the United States’ economy today, the two are closely related. We also want to ensure that GSEs are living up to the highest standards of corporate responsibility.”
- “We don’t believe in a ‘too big to fail’ doctrine, but the reality is that the market treats the paper as if the government is backing it. ...It’s not a healthy perception and we need to disabuse people of that perception. Investments in Fannie and Freddie are uninsured investments. That is why clear receivership authority is necessary. Because there is investment risk, full and flexible authority for the orderly wind down of affairs of a GSE that gets into serious financial trouble is vitally important for market stability. Blind faith in non-existent guarantees cannot be an acceptable substitute.”
- “The current regulatory structure is not equipped to deal effectively with the current size, complexity and importance of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. We need a strong, credible, and well-resourced regulator with a clear mandate and all the powers of other world class financial regulators. It should oversee all the housing GSEs: Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Although the regulator would have a large umbrella where a number of joint supervisory activities would be conducted, beneath that authority responsibility could be divided, as appropriate in keeping with the different nature of the institutions... regulatory scrutiny for each will be on par, fully comparable, but structurally separate.”
- “The minimum requirements for a credible GSE regulator are:
 - The full box of supervisory tools available to a world-class regulator, as I outlined before congress last fall, including general regulatory authority;
 - The power to monitor the operations of each GSE, including the power to review new activities;
 - The power to set both minimum and risk-based capital levels;
 - The power to place a GSE into receivership, in order to ensure an orderly wind-down of a failed institution. However, only Congress would have the authority to revoke Fannie Mae or Freddie Mac’s charters; and
 - The regulator must be funded through assessments on the regulated entities, and outside of the appropriations process.”

- “The President’s budget recommends that the new regulator be housed in the Treasury Department, where it should benefit from the policy knowledge and expertise of the Treasury. Therefore, Treasury should have ability to review rules and regulations, policy statements, and the regulator’s budget. *GSE reform is pending before the Congress right now. It’s a critical time, legislatively, for details. So it’s important to note that anything less than what I’ve outlined here today as the essential elements of authority for the new supervisor would be inadequate, not credible reform.*” (FDCH Federal Department and Agency Documents, Treasury Secretary John Snow, 03/09/04)

Acting Undersecretary Roseboro addresses GSE regulatory reform

- In a speech to the Mortgage Bankers Association of America, Acting Treasury Undersecretary for Domestic Finance Brian Roseboro said that the Bush administration is continuing to press for tougher regulation of GSEs and is working closely with Congress on the issue. “It is precisely because of the administration’s commitment to the housing sector that we are pushing so hard for GSE regulatory reform,” Roseboro said. “The GSEs’ contribution in assuring financing for home ownership should not be taken for granted. And nor should we take for granted the necessity to insure the safety and soundness of their operations and activities.”
- “With growth in their issued debt tripling since 1996, to \$2.6 trillion, it is only prudent to ensure proper, updated, credible regulatory oversight,” Roseboro said. He reiterated that the administration wants to establish a regulatory regime for the GSEs “comparable to the stature, powers, and resources of other world-class financial regulators.” “Oversight not intended to stifle innovation and opportunity but instead to ensure stability for home owners, future home owners, global fixed-income markets and the U.S. economy,” he said. Further, the GSEs special housing mission should be strengthened to assure they serve the public interest, Roseboro said. “The administration will continue to work closely with the House and Senate leadership on this issue,” he said.
- Speaking with reporters after his speech, Roseboro said the administration is more focused on the powers of a new regulator, rather than its place in the bureaucracy. “From our perspective, location isn’t as important as jurisdiction and what it can do,” Roseboro said. However, he declined to comment on whether the administration will support efforts to create a regulator that isn’t based at the Treasury Department. (Dow Jones Newswires, Deborah Lagomarsino, 03/09/04; Dow Jones Newswires, Rebecca Christie, 03/09/04; Bloomberg News, Brendan Murray and Simon Kennedy, 03/01)

Experts contemplate the prospects for GSE reform and debate the “law of unintended consequences”

- Senator Richard Shelby (R-AL) is hard at work on a bill to rein in Fannie Mae and Freddie Mac, but even before the Banking Committee chairman introduces the measure observers say chances of enactment this year are fading fast.

- Shelby wrapped up five hearings on the issue, including one starring Federal Reserve Chairman Alan Greenspan, who said the GSEs pose big risks to the economy. Greenspan may have made passage harder by adding new ideas -- like limiting the companies' debt issuance -- that have little political support.
- "These are issues that neither banking committee has had a chance to chew on," said Bert Ely, an independent analyst in Alexandria, Va., and a longtime GSE critic. "I don't think the committee members are ready to ignore Greenspan, nor do I think they are ready to move ahead. It was going to be hard enough as it was. This just made it harder."
- Some industry observers say the full-court press from the administration and the Fed will make the GSEs compromise. The two companies may strike a deal to end the risk that Congress will make a disruptive change to their business. "I suspect what is more likely to happen is that Fannie and Freddie are going to say, 'Hey, we better get this bill while we can. Let's cut our losses and get this over with,'" said Alfred DelliBovi, the president of the FHLB-New York.
- Some believe Fannie does not really want a bill and has calculated that the issue could ebb if a Democrat is elected President. But Sheila Bair, a former Treasury assistant secretary for financial institutions in this administration, said the issue will not go away, no matter who wins the election. "The political risk, whoever is in the White House next year, if any of these entities get into trouble ...is tremendous," said Bair. "I think the ...GSEs need to get this monkey off their back."
- Indeed, several sources said Fannie is angling for a bill that does not result in a significantly stronger overseer. "Frank Raines totally wants a bill -- but he doesn't want the bill to do anything meaningful," said one industry lobbyist, who spoke on condition of anonymity.
- Some industry representatives remain optimistic. They said that Greenspan's strong testimony emphasized that there is a problem that has to be addressed, and that lawmakers will not be willing to just let the issue lie. "After this week [of Senate Banking hearings] the odds of getting a bill out of Senate Banking and then the full Senate are higher," said Robert Davis, the lead lobbyist for America's Community Bankers. "I think Alan Greenspan's testimony painted a picture of a potential risk situation that focused attention in a way only he could."
- But Senate passage is just half the battle. The House is not expected to even begin debate on the issue until the Senate is done.
- Edward Yingling, the executive vice president of the American Bankers Association, said the bill's chances ultimately turn on Shelby's bill -- does it give the administration enough of what it wants without losing GSE support? "So far in this Congress ...Shelby and Sarbanes have shown an ability to work together and thread a

needle,” he said. “The key thing will be their bill and the immediate reaction to it. Then you will know if it has a shot or not.” (*American Banker*, Rob Blackwell, 03/01/04)

A debate on the law of unintended consequences

- The credit ratings of mortgage finance giants Fannie Mae and Freddie Mac could suffer if lawmakers go through with a plan to let a regulator -- rather than Congress -- wind down the affairs of either company in a financial meltdown said Victoria Wagner, a Standard & Poor analyst. Giving a new regulator those powers would signal that Congress is distancing itself from the enterprises, who while shareholder-owned, are chartered by Congress to help expand U.S. homeownership by creating a liquid secondary market for mortgages, she said. “That would to us signal that Congress is giving up its control, some of its power, to the regulatory body. If that would ever come down to fruition, we would have to take a look at all of their ratings,” Wagner said. (*Reuters*, Mark Felsenthal, 03/04/04)
- A less-noticed issue in the GSE regulatory reform debate is how to structure the board of the new regulator and how that structure may impact on its daily operations -- and thus its long-term success. Senate Banking Committee Chairman Richard Shelby (R-AL) has indicated that he is preparing legislation to create a regulator with a strong executive director and an advisory board that includes cabinet agency officials.
- Some industry officials said they worry that the agencies would try to impose their own agendas. Conversely, others fear the board would not be powerful enough, leaving no check on the executive’s authority. All sides say the issue is pivotal. “It’s huge,” said Kenneth Guenther, president of the Independent Community Bankers of America. “You can’t have world-class regulation if you have a regulatory structure that doesn’t work. You can’t have good plumbing in the house if the hot-water pipe is connected to the toilet.”
- Senate sources familiar with the matter say that the advisory board would avoid the pitfalls of other regulatory bodies. Though they cautioned that particulars could change before a bill is unveiled later this month, they said current plans are to create a board that is purely consultative, having no role in day-to-day operations, approval of regulations, or congressional testimony. The issue, they say, is to ensure that the executive has enough power. Giving the advisory board some kind of veto power could stall decisions and lead to the kind of infighting among various constituencies that has plagued the Federal Housing Finance Board.
- “What you want is a strong executive director,” said one Senate source, who spoke on condition of anonymity. “When you have an executive board, you’re inevitably asking for problems where you can, in essence, divide and conquer. You have a group of people with different viewpoints, and that can lead to conflict and an inability to act decisively.” Too strong an advisory board could discourage the best candidates for executive director from seeking the job, the source also said.

- “If you are going to have a strong executive, you don’t want to put that person in a situation where on a day-to-day basis they are having to go to cabinet officials to sign off on things,” the Senate source said. That would “limit the pool of people who are interested in taking that role on, and you really want to attract a high-stature candidate.”
- Shelby’s advisory board would almost certainly include representatives from the Treasury Department and HUD. Another likely possibility is a representative of the SEC. The Senate source said it was uncertain what role the GAO might play, but indicated that it would likely be involved in some fashion with the new agency. The Senate source said the agency’s executive director would likely also be the advisory board’s chairman.
- Some outside observers praised the idea of a purely advisory board, arguing that an executive board with members of cabinet agencies could prove problematic. But others disagreed, and wondered if the Bush administration could support such an arrangement.
- Bert Ely, a consultant in Alexandria, VA and a longtime critic of the GSEs, said an advisory board with no power would be of little use, since the executive director could disregard any of its recommendations. “I can’t imagine the administration can be supportive of it,” Ely said. “An advisory board can be ignored or not. I just don’t think the advisory board idea is going anywhere.”
- L. William Seidman, a former chairman of the FDIC and now a commentator with CNBC, said he had mixed feelings as well about a consultative board. “An advisory board is free advice which is probably worth about what you pay for it,” Seidman said. Though he said he preferred a board structure like the FDIC’s -- which includes the Comptroller of the Currency and the director of OTS- Seidman acknowledged that an advisory body “could be helpful in providing a better sounding board.”
- But the Senate source and others said advice from the authoritative officials whom Shelby is considering could help ensure the new agency stays on track. “I don’t think they can be ignored,” the Senate source said. “You are going to have to take their viewpoints into consideration. The board will come up and testify before Congress, which will give them an avenue or a platform to make their concerns public.”
- Richard Carnell, a Treasury official in the Clinton administration and now a professor at Fordham University School of Law in New York, agreed, saying there would be valuable give and take between the executive director and the board. “A blue-ribbon advisory board could provide high-quality oversight and advice,” Carnell said. “The agency head would have incentives to consult and share information with the board. Board members would have incentives to make sure the agency did its job well.”
- Additionally, many industry representatives said they are concerned about the alternative to an advisory board. They said that standard boards can often become

dysfunctional unless the chairman has the necessary stature and authority to command respect.

- “The important thing is that it be a strong regulator,” said Edward Yingling, the executive vice president of the American Bankers Association. “That means in some fashion it has to have a strong, independent leader, whether in the form of a single regulator or a SEC-type model where the chairman does have a lot of authority. “What you don’t want is a board where the responsibility is not clearly ultimately on one person.” (*American Banker*, Rob Blackwell, 03/08/04)

Editorial pages speak out on GSEs

Wall St. Journal editorial

- On March 11, the *Wall Street Journal* wrote that election years are notoriously bad for displays of political backbone, so give Treasury Secretary John Snow credit for holding fast on the regulation of Fannie Mae and Freddie Mac.
- In a March 9 speech, Snow reiterated the White House position that the runaway mortgage giants need proper financial supervision, which means under the pros at Treasury. Any regulator should also have the power to set minimum capital requirements and to take receivership should one of the giants fail. “Anything less than what I’ve outlined here today,” said Snow, “would be inadequate, not credible reform.”
- This is good policy, but it is especially laudable in the face of the lobbying blitz that Fan and Fred have unleashed against the White House. Fannie is running a TV campaign implying that serious regulation would hurt home ownership; no serious economist believes this. The companies have also besieged Congress with campaign cash and strong-arm lobbying. Even some stalwart free marketers are ducking for cover, while Senate Banking Chairman Richard Shelby has already buckled and is proposing a “compromise” for a weaker regulator outside Treasury.
- Fannie Mae CEO (and Beltway powerhouse) Frank Raines is clearly hoping that the Administration will fold under election-year pressure and head for the Shelby exit ramp. Or he’s hoping for a Bush defeat that will bring his Democratic friends back into power. So, Secretary Snow, please keep at it. We taxpayers who are subsidizing Fannie’s high-risk growth and Mr. Raines’s high-flying compensation are grateful. (*Wall Street Journal* editorial, 03/11/04)

Kansas City Star

- On February 29, the *Kansas City Star* wrote an editorial, stating that Federal Reserve Chairman Alan Greenspan has given Congress a timely warning about the “very serious” risk to taxpayers posed by mortgage-finance giants Fannie Mae and Freddie Mac. Lawmakers should take it to heart and tighten supervision of the two federally chartered companies.

- In dealing with any financial risk, the time to act is before a crisis. In the late 1980s, Congress ignored that lesson as the rot spread in the savings-and-loan industry. Lawmakers acted only after a frenzy of irresponsible lending of government-insured deposits led to a full-fledged disaster.
- That bit of history should be kept in mind in considering the rapid growth of Fannie and Freddie. The two are odd hybrids in the financial world. They're "government-sponsored enterprises" but privately owned. Their shares trade on the New York Stock Exchange.
- During a recent appearance before Congress, Greenspan said both appear to be managing their risk well. But he worried about what might happen if interest rates rise suddenly. Since the two companies borrow at short-term rates and make loans at longer maturities, fast-rising short-term rates would quickly erode their profits and their financial position. Thousands of banks hold their debt, so problems would spread rapidly through the economy -- a frightening prospect.
- The Fed chairman supported Bush administration plans to set up a new regulatory authority, which would dictate how much money must be set aside to protect against defaults. Greenspan also suggested curbs on how much the two could borrow to buy mortgages and hold them in their own accounts, rather than package and sell them as bondlike securities. These would be good moves that would put a damper on their breakneck growth. And Congress should answer a broader question: *Why are the federal charters still needed?*
- When Fannie and Freddie were created more than three decades ago, credit availability was spotty. The two giants did a good job of helping to create a national market in mortgage debt. But now they're no longer the only players. Even if Congress, as is likely, retains Fannie and Freddie's status as "government-sponsored enterprises," it's time for closer supervision. Accounting glitches the two reported in recent months underscore that need. Fannie had a "computational error" of more than \$1 billion and Freddie admitted understating income by more than \$4 billion. *The bottom line is that if these companies want to continue benefiting from an implicit taxpayer guarantee, then the price should be greater accountability.* (*The Kansas City Star* editorial, 02/29/04)

The Detroit News

- On March 1, *The Detroit News* wrote that America's two largest home mortgage companies are becoming dangerously big and Federal Reserve Chairman Alan Greenspan is right to worry about them. They dominate the home mortgage market and could endanger the economy if they fail.
- Greenspan asked for two remedies from Congress: A strong, independent agency to regulate the mortgage firms, with the authority to order them to hold more capital in relation to their debt; and a clear, legislative process outlining steps for bankruptcy if

one of them should fail. Without such a process spelled out in advance, Greenspan warned, the political pressure to have the taxpayers provide a bailout would be nearly irresistible.

- Congress should give Greenspan what he seeks. Without it, the nation may face a banking crisis that could dwarf the savings and loan scandal of the early 1990s. (*The Detroit News* editorial, 03/01/04)

Opinion writers speak out on GSE reform:

John Dizard in *The Financial Times*

Andy Serwer in *Fortune Magazine*

Molly Ivins in the *Des Moines Register*

Former HUD Secretary Andrew Cuomo in the *New York Post*

Jerry Howard in the *USA Today*

John Dizard in *The Financial Times*

- John Dizard wrote in *The Financial Times* that ordinarily, Alan Greenspan's testimony to Congress gives Prozac serious competition for medicating the over-anxious. Last week, though, the Chairman's warnings about Fannie Mae and Freddie came as something of a shock. He said that "we assess (systemic risk) as likely if GSE expansion continues unabated." Greenspan's warning was accompanied by one from Gregory Mankiw, the chairman of the President's Council of Economic Advisors, who warned: "Even a small mistake in GSE risk management could have ripple effects throughout the economy."
- "What's most odd about these warnings is that they appeared to come out of the blue. Over the past two or three years there has been a stream of articles, speeches, conference calls, and tedious op-ed columns about the potential systemic risk posed by Fannie and Freddie."
- "Since Greenspan is the master of acting hyper-political while posing as non-political, and since Mankiw is on a very short leash held by the White House's political operators, one has to wonder the following: what do they know that we don't know? Is some buttress in the financial system going to fail soon? Why are the pilot and co-pilot putting on their parachutes? Should we buy some more canned food and ammunition for the country house?"
- "There is also a red herring buried in Mankiw's remarks. He said: "The (GSE) charters do not require the federal government to bail out a troubled GSE." This is true. Furthermore, the GSEs themselves say they do not need a back-up federal

bailout. Their derivatives book, they say, enormously reduces their risk from a rapid increase or decrease in interest rates. Both statements are subtly deceptive because they don't identify the parts of the financial system that would truly be at risk in the event of a serious 'rate shock'."

- "The real threat posed by the GSEs, in the view of Greenspan, Mankiw and their staffs, is that they're just getting too big. Greenspan would like to limit Fannie and Freddie to repackaging mortgages and redistributing them through the financial system. This function gives a "liquidity discount" to mortgage interest costs. What he doesn't like is their trillion dollar purchases of their own paper and the tiny equity bases on which they do that."
- "In the central banking equivalent of a scrawled insult on a bathroom wall, Fannie Mae publishes a series of Fannie Mae Papers, an "occasional series on policy issues." These pour contempt on warnings such as Greenspan's. In one such paper from last October, one of Fannie's distinguished contributors, Christopher Culp, wrote about "myths" he cited as a "concern of central bankers" (no names, please). One was that "Fannie Mae's use of derivatives poses systemic risk." Culp, the author of the recent *Art of Risk Management*, trivializes the risks imposed by the \$811 billion of notional derivative principal Fannie had on its books last June."
- "He does touch on Greenspan's real concern: that the counterparties for those derivative contracts are too highly concentrated among a small number of securities houses and banks. But he does so only to dismiss the problem, writing that 'these concerns play much more on fear than on any actual empirical evidence legitimating the concern.' The problem with Fannie and Freddie's party line is that there is no "empirical evidence" because history has no precedent for their risk concentration. The failure of Drexel Burnham or Long Term Capital Management's problems, which Culp cites, are two or three orders of magnitude smaller than the mountains of GSE paper."
- "Greenspan and Mankiw don't think they'll have to bail out Fannie and Freddie. They think they'll have to bail out the half dozen largest swaps and derivatives dealers who are the big banks and investment dealers. In a rapidly rising interest rate environment, the "gamma", or the rate of the rate of increase in their hedging of their obligations to the GSEs, could, or, if you believe the chairman, will, require the Fed to act as the derivatives counterparty of last resort. The math tells him this could be seriously inflationary."
- "Why the warning now? Here's a thought: the GSEs' purchases of their own mortgage-based securities peaked last summer and have been gently declining since, reducing its requirements for derivatives purchases. However, Fannie has privately been telling bank fixed income securities analysts that they intend to start to increase their purchases, and to achieve double-digit portfolio growth for 2004. It is possible that talk set off the alarm bells at the White House and the Fed." (*The Financial Times*, John Dizard, 03/01/04)

Andy Serwer in *Fortune Magazine*

- Andy Serwer writes in *Fortune Magazine* that “within a matter of 48 hours in late February, Federal Reserve Chairman Alan Greenspan managed to roil the mortgage markets, gouge the stocks of the nation’s two largest mortgage companies, tick off much of Congress, and send ripples of fear through millions of Americans nearing retirement. Which is quite something, since during the nearly 16 years that Alan Greenspan has been Fed chief, he has generally avoided ultimatums, doomsday scenarios, and unequivocal talk. Now, suddenly, it seems he’s all about systemic risk and urgency. Specifically, Greenspan was speaking about the risk posed by mortgage giants Fannie Mae and Freddie Mac [before the Senate Banking Committee], as well as the under-funding of Social Security and Medicare.”
- “The neocon crowd complains that Fannie and Freddie subsidize the poor -- a free-market no-no. They also maintain that financial markets have evolved to the point that the interest rates Fannie and Freddie charge are barely any lower than what could be obtained through the private sector. (Those two points seem to contradict each other, don’t they?)”
- “But Greenspan has focused his attention on the bigness of GSEs. He notes that the markets consider the acronym twins too big to fail -- meaning Washington would be forced to bail them out. If the two did go splat (and I haven’t even mentioned their gigantic derivatives positions), the fallout would make Long-Term Capital look like a Sunday picnic.”
- “Notes one Wall Street source familiar with the workings of the Treasury, ‘Greenspan knows he has a soapbox because of the election. Also he is giving these issues a little more prominence now because there is a little more urgency.’ My take is that Greenspan is speaking his mind without political motivation. In the case of the GSEs, I think he is right on target.”(*Fortune*, Andy Serwer, 03/22/04)

Mathew Ingram in the *Globe and Mail*

- Mathew Ingram wrote in the *Globe and Mail* (Toronto, Canada), “Fannie Mae and Freddie Mac are such warm, folksy names -- they sound like a couple of kind-hearted pensioners sitting on a porch somewhere, sipping lemonade. So why is U.S. Federal Reserve Board chairman Alan Greenspan so worried about them? In fact, the world’s most powerful central banker is so concerned that he put aside his traditional penchant for inscrutable economic commentary and spoke bluntly about the risks Fannie and Freddie pose for the U.S. economy and for the entire American financial system.”
- “That made Greenspan’s comments about Fannie Mae and Freddie Mac even more noteworthy than they might otherwise be -- and even if they had been couched in the usual Greenspan-ese, they would still have been noteworthy. The Fed chairman doesn’t use the term systemic risk that often, and when he does, economists and market-watchers pay attention. That term is usually reserved for events that have the

potential to destabilize the entire U.S. financial system, such as the failure of the hedge fund Long Term Capital Management in the 1990s.”

- “Alan Greenspan didn’t tell Congress that the two GSEs were in danger of failing -- in fact, he said they were managing their risk relatively well. What he did say, however, is that too much of the mortgage market is concentrated in their hands, and that this creates the possibility of a systemic or domino-style risk for the economy. Some estimate that Fannie Mae and Freddie Mac have more than \$1.5-trillion in notional risk on their balance sheets, courtesy of the derivatives they use to hedge their exposure to interest rates and other factors.”
- “That’s several times as much derivative risk as Long Term Capital Management had on its books when it went under in the late 1990s. Some critics say the sheer quantity of mortgages held by the companies -- and the amount of their debt held by banks and other institutions -- means that any potential hiccup could spread through the entire U.S. financial system, with unpredictable results. That’s something that clearly has the Fed chairman concerned. And if Alan Greenspan is concerned, it’s hard for others not to feel just a little queasy as well.” (*Globe and Mail*, Mathew Ingram, 03/01/04)

Molly Ivins in the *Des Moines Register*

- Molly Ivins wrote in her nationally syndicated column “Fannie Mae and Freddie Mac have gone and gotten themselves in big trouble. Fannie and Freddie are the two GSEs that help most of us buy homes. Trouble is, they’ve run themselves into big-time debt -they’ve doubled the amount they owe in just the last five years. When I say big-time, try \$2 trillion. And guess who’s on the hook if these things go under? Congratulations, taxpayers.”
- “Seems to me Fannie and Freddie’s mess is the perfect argument for government regulation, and not just of the two giant mortgage companies. These GSEs have been hedging their debt risks through hedge funds, which are almost entirely unregulated. Greenspan warns that the debt could soon be larger than the federal government’s.”
- “Congress failed its oversight responsibilities by letting the companies get into this mess. The Center for Responsive Politics says Fannie and Freddie contributed \$6.5 million to federal campaigns in 2002. Fannie has hired 14 lobbying firms, and Freddie 26. According to Ralph Nader (a reliable source in these matters, no matter what his political judgment), ‘The board of directors on staff of Fannie and Freddie have always been populated by former officials and political activists from both the Republican and Democratic parties who are given huge pay packages.’” (*Des Moines Register*, Molly Ivins, 02/29/04)

Former HUD Secretary Andrew Cuomo in the *New York Post*

- Andrew Cuomo, Secretary of HUD during the Clinton administration, wrote in the *New York Post* that “Congress is now debating one of the most important corporate-responsibility issues of our time: the status and future of mortgage-finance giants

Fannie Mae and Freddie Mac. The most controversial question is whether to privatize these multibillion-dollar GSEs. But the argument in favor of privatizing is neither politically possible nor good public policy. They should instead be reformed to deliver a public benefit commensurate with their public subsidy.”

- “Having battled these giants before Congress for many years, I believe they are too strong politically and the potential economic consequences too destabilizing. The GSEs will argue that termination of their federal connection could dissuade global investors who rely on the “implicit guarantee” of U.S. government subsidies. With the dollar weakening, this argument has political appeal...Furthermore, privatizing Fannie and Freddie would require the political clout of the president. But it is simply not a White House priority. Nor should it be.”
- “Rather than abandoning [their affordable housing] goal, Fannie and Freddie should be required to do more. HUD or Congress should further raise the affordable-housing requirements, so the public benefit they are supposed to perform - helping working families buy homes - matches the \$15 billion they receive from the American taxpayer.”
- “Congress is also debating whether the current regulator, OFHEO, is the right body to oversee the GSEs or if it is subject to “undue influence” by Fannie and Freddie. (The Treasury Department would take on the job). There are two regulatory functions: financial safety and soundness of the GSEs, and regulation of the extent and nature of their housing mission. Even if Treasury were the more appropriate agency for safety and soundness, HUD should maintain regulation of the housing mission. HUD’s mandate, unlike Treasury’s, is to keep the focus on affordable housing, where the GSEs are already underperforming. Removing oversight from HUD could only further aggravate this problem.”
- “If the fear is Fannie and Freddie’s “undue influence,” congressional leaders should look in the mirror. Congress repeatedly bowed to Fannie and Freddie’s lobbying pressure and rejected budget and reform proposals that several Clinton administration officials and I submitted to support a more effective regulatory structure and to demand more public disclosure of the GSEs’ activities and portfolios.”
- “Fannie and Freddie’s legion of high-priced lobbyists, political action committees, foundation grants, local ribbon-cuttings and patronage are not aimed at HUD, but at the Congress, which determines their financial fate...It is time to quit debating unrealistic and regressive changes and push instead to raise the affordable-housing goals and maximize the opportunity for working families to purchase their own homes. Such a step is not only possible, it would ensure that Fannie and Freddie provide the American people with a needed public service and benefits commensurate with \$15 billion of the taxpayer’s hard-earned money.” (*New York Post*, Andrew Cuomo, 03/05/04)

Jerry Howard in the *USA Today*

- Jerry Howard wrote in *USA Today* that “if Congress follows Federal Reserve Chairman Alan Greenspan’s advice to rein in Fannie Mae and Freddie Mac because they could conceivably one day pose a systemic risk to the nation’s financial system, home buyers had better be ready for a far-less-accommodating home-finance system than the one they have grown accustomed to in recent years.”
- “Acknowledging that Fannie Mae and Freddie Mac are first-class financial institutions that have managed their risks well and that there is nothing on the immediate horizon expected to compromise their good health, Greenspan, nevertheless, wants to limit their portfolio growth, even if it means that such mainstays of the mortgage market as fixed-rate mortgages could be headed the way of the dinosaur.”
- “Applying harsh constraints on the ability of the two GSEs to issue debt and invest in mortgage assets would hit millions of working American families in the pocketbook by reducing the availability of home-financing opportunities and driving up mortgage interest rates.”
- “As Congress moves to enact meaningful regulatory restructuring of the GSEs that ensures their continued financial health, it must protect their ability to follow their federal charter of making homeownership more affordable and available to America’s families. This effort must remain squarely focused on Fannie Mae and Freddie Mac and not, despite Greenspan’s suggestion, be allowed to turn into a referendum on the best housing-finance system in the world.” (*USA Today*, Jerry Howard, 03/05/04)

FM Policy Focus questions the GSEs’ willingness to be regulated

- FM Policy Focus recently published a report on the GSEs’ relationships with their regulators. The report notes that although Fannie Mae and Freddie Mac claim to welcome a new regulator, history suggests that they will resist oversight of their activities. Fannie Mae and Freddie Mac routinely challenge the authority of their existing regulator, OFHEO, demonstrating a disregard both for Congressional intent and the regulator’s authority. The quotes below are taken from comment letters filed by the GSEs, offering just a few examples of challenges the companies have made through the years. This record argues for creation of a strong regulator with clearly defined powers.
 - “[I]t is our view that while OFHEO does have independent enforcement authority with regard to statutory provisions relating to safety and soundness, it does not have that authority with regard to the charter acts themselves; appropriate regulatory oversight concerning the charter acts was commanded by the Congress to be undertaken by the Secretary of HUD, not the Director of OFHEO.” (Fannie Mae Comment Letter dated February 26, 2001 regarding Comments on Proposed

Regulations Governing Administrative Enforcement Proceedings, RIN 2550-AA-6)

- “In other words, under the scheme of the 1992 Act, the authorities of OFHEO are enumerated and specified; the grant of residual, general regulatory authority under the 1992 Act is vested not in the Director of OFHEO, but, rather, with the Secretary of HUD.” “The legislative history of the 1992 Act demonstrates that Congress did not intend to provide OFHEO with the same power that bank regulators have to initiate enforcement action for any conduct deemed to be an unsafe or unsound practice.” (Freddie Mac Comment Letter dated February 26, 2001 regarding Rules of Practice and Procedure, Notice of Proposed Rulemaking, 65 Fed. Reg. 81775 (December 27, 2000), RIN 2550-AA16)
- “Generally, and as expressed above, various parts of the proposed regulatory text provide OFHEO with greater authority than Congress specified in the plain language of the statute. OFHEO simply cannot create authority for itself through this proposed regulation without an appropriate statutory basis.” (Fannie Mae Comment Letter dated July 9, 2001 regarding Fannie Mae’s Comments on OFHEO’s Proposed Prompt Supervisory Response and Corrective Action Rule, 12 CFR Part 1777)
- “[T]he statute does not authorize the additional basis for reclassification, nor is OFHEO otherwise empowered to create that additional basis.” (Freddie Mac Comment Letter dated July 9, 2001 regarding Proposed Prompt Corrective Action Regulations, RIN 2550-AA12)
- “Neither [the 1992 Act] nor its legislative history contains any grant of authority to OFHEO in the area of corporate governance. Given that the 1992 Act provides OFHEO with exclusive authority over very specialized areas, such as ensuring that the companies maintain adequate capital levels, we must respectfully question OFHEO’s legal authority to issue a corporate governance proposal.” “Proposed section 1710.31 exceeds OFHEO’s statutory authority under the 1992 Act...Fannie Mae has been advised by counsel that this provision would not be upheld by a federal court.” (Fannie Mae Comment Letter dated December 13, 2001 regarding Proposed Corporate Governance Regulation, RIN 2550-AA20)
- “OFHEO’s proposed regulations exceed the authority granted by Congress to OFHEO.” “Finally, in addition to exceeding OFHEO’s general powers to promulgate corporate governance regulations, certain aspects of the proposed regulations exceed specific and carefully delineated statutory authority that Congress provided to OFHEO when Congress expressly addressed those issues.” (Freddie Mac Comment Letter dated December 13, 2001 regarding Corporate Governance, Proposed Regulation 66 Fed. Reg. 47557 (September 12, 2001), RIN 2550-AA20)

- “Nevertheless, Freddie Mac does not believe that OFHEO’s statutory authority with respect to [GSE] disclosure is open-ended.” (Freddie Mac Comment Letter dated March 24, 2003 regarding Proposed Regulation: Public Disclosure of Financial and Other Information; RIN 2550-AA25) (*FM Policy Focus Newsletter*, Vol. 1, No. IV)

In the underserved market segments, Wells Fargo challenges the GSEs – says they’re too risk-averse

- Mark Oman, Wells Fargo’s group executive vice president for home and consumer finance, wrote a letter to Representative Barney Frank (D-MA), Ranking Member of the House Financial Services Committee. The letter, dated March 2, accused Fannie and Freddie of hampering “the efforts of Wells Fargo and all of the nation’s mortgage lenders to reach underserved market segments.” How have they hampered those efforts? According to Oman, by being too risk-averse and charging guarantee fees that he said were “excessive” and bore “little correlation to risk.”
- In the letter, which Wells says was sent at the request of Frank, Oman charges that the GSEs’ stringent policies on manufactured home loans and other types of loans to low- and middle-income homebuyers are discouraging the financing of affordable housing. He wrote that Fannie and Freddie insist that Wells retain some of the risk on the “emerging markets” products it sells to them and that they require Wells to pay higher guarantee fees on these loans. He said these requirements had the effect of keeping thousands of consumers out of homes.
- Oman blasted the GSEs’ reluctance to “allow for a layering of risk factors.” For instance, they might buy loans with smaller down payments but not without recourse to the lender, a higher guarantee fee, or both. Through experience, he said, Wells and other lenders have found that “effectively serving the affordable-housing segment frequently requires just this kind of risk layering.”
- On March 4, Fannie issued a terse statement in which it called Oman’s letter “riddled with factual and analytical inaccuracies.” In criticizing Oman’s letter, Fannie also questioned Wells’ commitment to affordable housing by referring to Wells’ image problem over predatory lending. Since last year the Association of Community Organizations for Reform Now has been attacking the lender for abusive practices. “Especially given their record regarding predatory lending practices, we are surprised that Wells Fargo wants to have this debate,” Fannie said.
- (In his letter, Oman said that last month Wells changed its home lending practices “to better meet the credit needs of traditionally underserved communities.”)
- Michael McMahon, an analyst in San Francisco with Sandler O’Neill & Partners LP, took issue with Wells’ demand that Fannie and Freddie take on more risk. He noted that the GSEs have often been accused of taking on too much risk with too much leverage. “I think it’s only appropriate for Fannie and Freddie to require their

partners to share an appropriate amount of risk,” McMahon said. He interpreted the Wells letter as political grandstanding for business concessions. “The GSEs are vulnerable right now” because of Freddie’s scandal and renewed interest in Washington to regulate the two companies more stringently, he said.

- In an interview, Pete Wissinger, the chief executive of Wells Fargo Home Mortgage, insisted that Wells’ motivation was public policy, not business. He said that Wells decided to complain publicly because it wants to draw the industry’s attention. Among its recommendations: a single GSE regulator for safety-and-soundness and mission compliance.”[Congressman] Barney Frank asked us for our view and we made it public because we didn’t want to do it privately,” Wissinger said. He said he hoped that the letter would prompt other lenders to join the fray. “I encourage all lenders to give input on how these markets can be served more effectively,” Wissinger said. “The entire industry should enter the debate and give feedback on how we should do this better.”
- Wells has not been shy about using the public spotlight to disparage the GSEs. Three years ago, CEO Richard Kovacevich complained in *The Wall Street Journal* that Fannie and Freddie were threatening reprisals against Wells for its participation in a lobbying group that sought to limit Fannie’s and Freddie’s power. (*American Banker*, Erick Bergquist, 03/05/04)

Fannie Mae

According to Peter Eavis with *TheStreet.com*, derivatives losses “loom” over Fannie

- Peter Eavis, writing in *TheStreet.com*, poses the question, “Did Fannie Mae grow like gangbusters last year to absorb nearly \$5 billion in losses that resulted from a deficient hedging strategy?”
- Fannie said in its 2002 annual report that it would “bleed an estimated \$4.7 billion of losses on derivatives into its earnings “during the next 12 months,” but somehow Fannie managed to report a strong rise in earnings in 2003. The company reported core business earnings of \$7.3 billion last year, up a solid 14% from 2002’s \$6.4 billion. “It looks like the company added a large amount of new business at a breakneck pace to produce enough earnings to offset the impact of \$4.7 billion in losses. And in pursuing this strategy, it effectively doubled down on a losing bet that interest rates would rise.”
- “When asked for comment, a Fannie spokeswoman said this theory was “fundamentally flawed,” but didn’t say why. She also declined to supply the actual amount of derivatives losses fed into earnings last year, saying that it would be available in its 2003 annual report, which is due out by the end of March.”

- “Here’s the lowdown on the losses. They were booked on derivatives that were entered into to insure against swings in interest rates. Accounting rules dictate that a certain type of derivative loss first gets booked in the balance sheet and then amortized into earnings over time. The line on the balance sheet that shows these so-called cash-flow hedging losses swelled to eye-popping levels at Fannie during 2002. The question that was being asked in some quarters as these losses got higher and higher in 2002 was this: Just how bad would Fannie’s earnings be in 2003, when they would have to contain a good chunk of these losses? “
- “Indeed, that question became all the more relevant when Fannie divulged in its 2002 annual report, published in March last year, that the losses would be approaching \$5 billion. Fannie’s annual said: “We will amortize an estimated \$4.7 billion, net of taxes, out of AOCI and into earnings during the next 12 months.” (AOCI refers to accumulated other comprehensive income, which is the account in equity that contains, among other items, gains or losses on cash-flow hedging derivatives.) During 2002, Fannie’s cash flow hedging losses more than doubled to \$16.3 billion, from \$7.4 billion. Effectively, that meant Fannie didn’t hedge sufficiently for the drop in interest rates that took place that year. Yet 2003 earnings showed little indication that a good chunk of those losses hit the income statement that year.”
- “Assuming that \$4.7 billion of losses were indeed included in 2003’s earnings, Fannie can only have increased its earnings overall by massively expanding its book of business. The growth was astounding. In 2003, Fannie added over \$100 billion of mortgages to its balance sheet, increasing its mortgage holdings by 13% to nearly \$900 billion. To be fair, that growth rate is the same as that of Freddie Mac. But at Fannie the amount of mortgages guaranteed rose by a dramatic 26% last year to \$1.3 trillion, while Freddie’s increase was a much more temperate 7%.”
- Fannie’s robust growth had quite an impact on earnings. Net interest income rose 28% to \$13.6 billion last year, while guarantee fee income leaped 33% to \$2.4 billion.
- “Why does it even matter if Fannie grew to lessen the impact of its hedging losses? Because the company would be doubling down on a losing bet. We know that is happening because the cash-flow hedging losses line in Fannie’s equity didn’t recover for most of 2003. It stayed close to minus \$16 billion for the first nine months of last year, but recovered somewhat to minus \$12 billion in the fourth quarter as interest rates rose.”
- “Think about it: If Fannie’s cash flow hedging losses started 2003 at \$16.3 billion, that number should have declined markedly as the estimated \$4.7 billion of losses stored in the line were removed from the AOCI and amortized into earnings. All else being equal, the \$16.3 billion would have declined by around 75% of \$4.7 billion by the end of September last year, which would have left it at \$12.8 billion. So why didn’t it drop? Most likely because existing and new derivatives positions also went into a loss, keeping the loss in the cash-flow hedging line at close to \$16 billion. The

accumulation of new losses suggests that Fannie continued to bet on interest rates rising, even though it was damaging its shareholders' equity."

- "But don't regulators watch capital and intervene if it gets too low? Not if the company, like Fannie and Freddie, gets to use a capital measure which leaves out the cash flow-hedging losses on the balance sheet. In the case of Fannie and Freddie, this is called "core capital." By basing its leverage calculation on this bizarrely incomplete yardstick, Fannie is able to continue loading up its losses without scaring its feeble regulator, the OFHEO."
- "The deficiency of core capital is well understood in Washington, if not Wall Street. And that is why several members of Congress, as well as the Bush administration, are pushing hard to toughen capital requirements and replace OFHEO with a tougher regulator."
- "Fannie's defenders, who include Wall Street analysts, realtor organizations and homebuilding companies, will respond that core capital should exclude the cash-flow hedging losses because they are on outstanding derivatives that could increase in value in the future as interest rates change. This is absolutely not the case, though. A good chunk of the losses will never be recouped because they are on *closed-out derivatives*. And we can assume that the closed-out losses are monumental at Fannie, because it repeatedly refuses to break out what proportion of its cash flow hedging losses are on closed-out derivatives."
- "In stark contrast, Freddie Mac breaks out losses on closed-out derivatives. In 2002, Freddie reported \$4.4 billion in realized losses, according to its annual report for that year, belatedly released last week after months of financial restatements following its accounting scandals. At Fannie, the realized loss number could be far higher." (*TheStreet.com*, Peter Eavis, 03/03/04)

The drumbeat on Fannie's derivatives losses continues in *The Financial Times* (London),

Fannie responds to *Financial Times*

- Stephen Schurr, writing in *The Financial Times*, said "Fannie Mae paid a net \$25.1 billion on derivatives transactions in under four years -- nearly all of which may represent losses that cannot be recouped, in turn depressing future earnings." The potential scale of the liabilities, which have yet to be recognized in the company's earnings or in the minimum capital adequacy required by its regulator, raise fresh doubts about the financial health of Fannie Mae.
- Fannie Mae acknowledges it has taken losses in its derivatives trading that have not yet been recognized in its earnings, but declines to disclose the amount. The reason, said Jonathan Boyles, vice-president of financial standards and taxes at Fannie Mae, is that "we don't believe it's all that meaningful." A Fannie Mae spokeswoman added

that the company typically held its positions to maturity and as such it did not see the losses as material.

- *The Financial Times*' analysis of Fannie's accounts suggests it may have incurred losses on its derivatives trading of \$24 billion between 2000 and the third-quarter of 2003. That figure represents nearly all of the \$25.1 billion used to purchase or settle transactions in that period. Any net losses will eventually have to be recognized on Fannie Mae's balance sheet, depressing future profits.
- In the *Financial Times*' analysis, Schurr noted that Fannie Mae, unlike sibling government-sponsored entity Freddie Mac, does not disclose the amount of realized derivatives losses in its accumulated other comprehensive income (AOCI). Fannie says that the number is not material to the company's health, but critics of the company's accounting say that excluding the derivatives losses may provide a false picture of the company's earnings and capital adequacy. Because Fannie Mae does not disclose the amount, it is impossible to determine the precise total. However, the company's reports offer several methods to assist efforts to determine a reasonable estimate.
- The total cash flow hedge losses in AOCI are the sum of the realized and unrealized derivative gains and losses. Therefore, one can arrive at the realized losses by subtracting the unrealized amount from the total. While Fannie Mae does not disclose the unrealized figure, the vast majority of its \$1,072 billion derivatives portfolio gets classified as cash flow hedges.
- Fannie Mae breaks down the notional value of its various derivatives positions. *The Financial Times* concluded the best method of estimating the amount of realized cash flow hedge losses is to apportion gains and losses by notional value. When net values are broken down by proportion in this manner, the unrealized cash flow hedge losses would total \$1.1 billion
- At the end of the third quarter, Fannie Mae's AOCI was negative \$24.757 billion on a pretax basis (on an after-tax basis, the total was \$16.092 billion). If AOCI is the sum of realized and unrealized derivatives positions, then subtracting the \$1.1 billion would mean Fannie Mae's total realized derivatives losses would be \$23.653 billion (or, on an after-tax basis, \$15.375 billion).
- Fannie Mae says AOCI is irrelevant to current earnings or capital levels as it provides a misleading view of the company's fiscal health. Jonathan Boyles, Fannie Mae's vice-president for financial standards and taxes, argues that "every financial regulator always ignores the AOCI amount".
- But Fannie Mae's critics say it does matter. Representative Cliff Stearns (R-FL) said in House testimony last year that Fannie complies with Financial Accounting Standards (FAS) 133, which governs derivatives accounting. But Stearns says that, in

correctly applying this rule, Fannie Mae has “used the special hedge accounting rule to defer the billions of dollars in lost shareholder value to the future”.

- The debate gets to the heart of the complex nature of derivatives accounting. To protect the \$1.072 trillion in mortgage assets it owns against interest-rate volatility, Fannie Mae uses derivatives as a hedge. Under FAS 133, Fannie Mae designates these derivatives positions as cashflow hedges. Under cashflow hedge accounting, the fluctuations in market value of Fannie Mae’s derivative hedges are not recorded in the company’s earnings or core capital, appearing instead in the AOCI.
- The AOCI figure includes derivative positions that remain open as well as derivative positions that have been closed or swapped, representing losses that cannot be recouped. AOCI also includes gains in derivative positions that do not appear in the company’s earnings statement. Rather than hitting the company’s earnings and core capital immediately, those gains and losses get stored in AOCI, to be amortized into earnings over the life of the hedge. These derivatives positions are included in the company’s shareholder equity and fair value statements.
- Under FAS 133, companies must record all derivatives at fair value, which records the current market value of derivatives. The FASB calls fair value the “only relevant measure for derivative instruments”. Fannie Mae and its regulator, OFHEO, disagree, saying fair value often results in a distorted picture of the company’s net worth and risk position.
- Dwight Jaffee, a professor at University of California-Berkeley, says AOCI is “a flawed system,” blaming the nebulous accounting due to the accounting rules.
- OFHEO sets the company’s minimum core capital requirement at 2.5% of assets, plus 0.45% of outstanding mortgage-backed securities and off-balance-sheet debt, well below the capital requirements of banks. The company’s core capital consistently meets minimum capital requirements.
- However, shareholder equity and fair value, which include AOCI, would have fallen short of the minimum capital requirement level. Fannie’s shareholder equity was \$16.29 billion in 2002 and its fair value totaled \$22.13 billion, 40% and 19% below the minimum, respectively.
- For 2003, Fannie’s core capital of \$34.41 billion topped the minimum capital requirement of \$31.52 billion; shareholder equity totaled \$22.37 billion. The company will release its annual fair value statement by March 15.
- Critics of Fannie Mae’s accounting demand it publish its fair value statements quarterly rather than annually, like its peer, Freddie Mac. They have also asked Fannie Mae to disclose the amount of derivatives losses it has taken that cannot be recouped but have yet to be recognized in the company’s earnings.

- Next week, Fannie Mae is due to release its annual “fair value disclosure” - a statement of the current market value of its derivatives positions. Observers will be watching to see if the gap between the company’s regulatory capital and fair value has widened further than the \$6 billion shortfall of a year ago.
- Freddie Mac also discloses its closed derivatives positions. Fannie Mae says it has no plans to make any reporting changes but is evaluating its position. Fannie Mae maintains that the losses from cash flow hedging will have no bearing on the capital adequacy required by its regulator.
- However, critics increasingly question whether Fannie Mae’s financial disclosure offers a complete picture of its fiscal health. “They have used the derivative accounting rules for cash flow hedges to defer some losses that they have taken,” said John Barnett, senior analyst at the Center for Financial Research & Analysis, an independent research firm. “They may not be as well-capitalized as they appear to be for regulatory purposes.” (*Financial Times*, Stephen Schurr, 03/09/04; *Financial Times*, Stephen Schurr, 03/09/04; *Financial Times*, Stephen Schurr, 03/10/04)

Fannie responds

- In a statement provided by Jayne Shontell, Senior Vice President of investor relations for Fannie Mae, she said, “*The Financial Times* story by Stephen Schurr is based on a wholly invented methodology that we told the reporter is wrong. His calculation and methodology are flawed and the subsequent implications are wrong. The methodology he employed incorrectly calculated unrealized losses, and as a result, he arrived at an erroneous conclusion. This has resulted in a gross misrepresentation. Anyone who is seriously interested in looking at this should wait for our 10-K filing next week.” (*Fannie Mae Press Release*, 03/10/04)
- In response to Fannie Mae’s press release, *The Financial Times* noted that it “believes it used the best available methodology to estimate Fannie Mae’s unrealized derivatives losses given the company’s lack of disclosure of the actual amount.” When asked for further comment, *The Financial Times* said all questions regarding its methodology should be directed to John Barnett, a senior analyst at the Center for Financial Research & Analysis, who reviewed the newspaper’s methodology prior to publication of the report and was quoted in Schurr’s article.
- “In the absence of disclosure from Fannie Mae, the methodology *The Financial Times* used is the most reasonable way to calculate derivatives losses,” Barnett said, “though the actual figure likely differs from the estimate.” He added, “The best solution would be for Fannie Mae to just come out and disclose what the number is, however.
- Analysts said the report highlighted a gap in Fannie Mae’s financial disclosure that leaves investors guessing about whether the No. 1 mortgage financier has lost money on interest-rate changes, while Fannie Mae called the report a “gross misrepresentation.” In a *Monument Securities*’ report, Stephen Lewis noted that the

market is beginning to wonder whether the [Federal Reserve] and the U.S. Treasury know something about the state of GSE finances that gives cause for concern. It is this feeling that gave credence to *The Financial Times*' Fannie Mae story earlier this week.

- “Regulatory capital doesn’t recognize the AOCI adjustment and that is a serious problem,” said Bert Ely, a financial consultant who advocates privatization of the company. (*Reuters News*, 03/10/04; *Monument Securities*, Stephen Lewis, 03/11/04; *Dow Jones Newswires*, Andrew Wallmeyer, 03/10/04)

Peter Eavis responds to the *Financial Times* inquiry: Fannie should “come clean” on derivative losses

Senator Sununu and Representative Leach agree

- Peter Eavis writes a follow-up column *TheStreet.com*, stating “It’s hard to believe that Fannie Mae can hold out much longer against efforts to make it disclose the amount of unrecoverable derivatives losses it has accumulated on its balance sheet.
- *The Financial Times (FT)* advanced the quest to obtain the mortgage giant’s critical loss number by publishing an article that estimated the losses totaled a *colossal* \$24 billion. While Fannie said the *FT*’s calculations and methodology were “flawed” and that the article had “resulted in a gross misrepresentation,” the company *didn’t* supply its own number for realized derivatives losses on its balance sheet.
- “Given the lack of disclosure by Fannie, it is hard to judge definitively the methodology used by the *FT*. But one thing is clear: The failure so far of Fannie to supply the actual number only leads to the conclusion that it has stored up billions of dollars in losses that it won’t recoup. Of course, the incentive for keeping a big loss number secret is that it protects the careers of the executives at Fannie who may have created the loss and are paid in Fannie stock.”
- Eavis further noted that while Wall Street’s reaction to the *FT* article was muted, it is highly unlikely that the politicians who have prepared legislation to tighten up regulation of Fannie and its rival Freddie Mac will shrug off the *FT*’s findings with the same insouciance.
- “The existence of large amounts of realized derivatives losses at Fannie would expose a massive flaw in capital regulations for Fannie and Freddie and could lead to new, much more stringent capital rules and caps on its growth. In Fannie’s case, tougher capital rules could force the company to issue billions of dollars in stock, which would dilute existing shareholders, while growth restrictions could depress earnings.”
- “Fannie said in its statement that ‘anyone who is seriously interested in looking at this should wait for our 10-K filing next week.’ Its last 10-K filing never contained a number for closed out derivatives. The company still has time to slip one in. By

doing so, it could clear away the mounting speculation about realized losses. As long as the number isn't too ugly, that is." (*TheStreet.com*, Peter Eavis, 03/11/04)

Senator Sununu and Representative Leach agree

- Congress should create a regulator to tighten accounting-disclosure requirements for Fannie Mae and Freddie Mac, Senator John Sununu (R-NH) said after a report was published, stating Fannie Mae lost \$24 billion on derivatives transactions in four years. The report by *The Financial Times* "underscores the need for a strong, independent and professional regulator" of the companies, said Sununu, and "speaks to the size, complexity and sophistication of these financial companies' hedging operations." A new supervisor should "thoughtfully recommend modifications to reporting and disclosure requirements," Sununu said in an interview.
- The report of possible losses at Fannie Mae sends a "clear message -- no institution of any type should be accorded the privilege of lower standards of regulation," said Representative Jim Leach (R-IA). Fuller disclosure of derivatives trading by Fannie Mae would help reduce "the enormous risks inherent in using instruments, which ironically are themselves designed to reduce risk," Leach said in a statement.
- Senator Jon Corzine (D-NJ) has said Fannie Mae should report its assets, liabilities and derivatives at current market values on a quarterly basis instead of just annually. Corzine has introduced a bill that would increase disclosure requirements and strengthen other regulation for Fannie Mae and Freddie Mac. (*Bloomberg News*, James Tyson, 03/10/04)

Fannie's CEO Franklin Raines defends the company
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- In an editorial appearing in *The Financial Times*, Franklin Raines addresses recent criticism of Fannie Mae. Raines writes, "It is important to understand that some of the commentary about Fannie Mae arises from the competitive concerns of some large banking institutions that, without our presence, would be able to charge more for home loans, offer fewer borrowing options and leave the mortgage market for more profitable pastures whenever they want. But the U.S., where home ownership is a national priority, has chosen a policy to encourage Americans to own homes. We have affirmed that a market-based housing finance system, one that relies on the capital markets and provides long-term, fixed-rate low-cost mortgages, is superior to a bank-based system that relies on bank deposits and offers mostly higher-cost or floating rate loans. We also appreciate the ability to raise capital from Europe and round the world to finance homes in America."
- "Fannie Mae is a centerpiece of the market-based US housing finance system and we expand home ownership without a penny of public funds. To many policymakers in Washington who care about housing and its benefit to our economy, Fannie Mae is the bargain of the 20th and 21st centuries." (*Financial Times*, Franklin Raines, 03/02/04)

- In a press briefing in London, Raines said “Congress is looking at regulation, and new legislation will reinforce our role in the housing finance system. We don’t think Congress will take steps that will harm that system,” he said. An election year, he said, “makes it harder. There’s less time members of Congress have available to consider new law.”
- On Greenspan’s remarks before the Senate Banking Committee, Raines said, “[Greenspan] hadn’t said anything that he hadn’t said privately already, so the remarks were not a surprise. He’s calling for fairly radical steps, which appear not to have much support in Congress. Congress is focusing on passing a regulation bill and not on fundamental changes to the charter,”
- Raines added, “We don’t think Congress is going to ask us to downgrade our role. There are some that perhaps would like us to do less, Alan (Greenspan) may be one of them, but we’re not hearing that from members of Congress.” He said, “We would like there to be action [in Congress] because it would reassure investors going forward. We don’t see any other costs of a delay (in passing new law about regulation) other than missing out on that benefit.” (*Bloomberg News*, Jennifer Ryan, 03/01/04)

Ex-Fannie CEO heads Kerry’s VP Search Committee

Current Fannie CEO mentioned as “possible” Vice Presidential candidate

Could presidential politics change the “calculus” for GSE reform?

- Senator John Kerry (D-MA) named former Fannie Mae Chief Executive Officer James Johnson as head of his search for a vice presidential candidate. Johnson, 60, was a managing director in corporate finance at Lehman Brothers Holdings Inc. from 1985 to 1989 before moving to mortgage-buyer Fannie Mae, where he was vice chairman and then chairman and chief executive from 1991 to 1997. Johnson currently is vice chairman of Perseus LLC, a merchant banking and private equity firm based in Washington and New York. (*Dow Jones Newswires*, John Connor, 3/8/04)

Current Fannie Mae CEO mentioned as “possible” VP candidate

- According to Nedra Pickler with the *Associated Press*, “Kerry may consider someone [for Vice President] with economic experience to send a message of fiscal responsibility to Wall Street. Possibilities include Fannie Mae chairman and CEO Franklin Raines, who was President Clinton’s budget director...” (*Bloomberg*, Michael Forsythe and Williams Roberts, 03/03/04; *Associated Press*, Nedra Pickler, 03/03/04)

Could presidential politics change the “calculus” for GSE reform?

- John Connor of *Dow Jones Newswires* questions why Fannie and Freddie would go along with the Bush Administration’s plans for a stronger regulator when the upcoming presidential election could alter the political landscape. “Why should Fannie and Freddie play into a potentially binding hand now by going along with GSE regulatory overhaul legislation that might not be as congenial as it could be?”
- Connor notes that Democrats traditionally are more favorably disposed to housing than Republicans (and, with a couple notable exceptions, more favorably disposed to Fannie and Freddie as well). This thought process could well have additional velocity now that John Kerry (D, MA) has named former Fannie Mae Chairman and CEO Johnson to head up the search for his running mate. Shoot, it doesn’t take much prompting to get the political set talking about the possibility of Johnson as White House chief of staff during a Kerry Administration, or maybe Treasury Secretary (if Franklin Raines, Fannie’s current chairman and CEO, doesn’t get the Treasury post).
- But then again, Bush could beat Kerry and be back for a second term. If so, what price could be paid by Fannie Mae and Freddie Mac if they stalled regulatory overhaul legislation this year in hopes of getting much friendlier treatment from a Kerry Administration?
- Not to ascribe vengeful motivations to anyone, but the suspicion is strong that the folks calling the shots in a second Bush Administration would take off the gloves next year under a scenario where Fannie and Freddie stiffed or were perceived as stiffing a regulatory overhaul bill this year (for the second year in a row). The byword in a second Bush Administration vis-à-vis Fannie and Freddie might be “no mercy.”
- What could that mean on the ground, as they say in military circles? Well, one potential pressure point, while waiting for a legislative consensus to form, might be found in the following language culled from a delayed annual report Freddie Mac released just the other day: “Under the Freddie Mac Act, the Secretary of the Treasury has approval authority over all of our issuances of notes, debentures and substantially identical types of unsecured debt obligations (including the interest rates and maturities on these securities), as well as new types of mortgage-related securities issued subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989.” ...Think about it. (*Dow Jones Newswires*, John Connor, 03/08/04)

Fannie Mae is “bronze benefactor” for the Democratic National Convention
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- According to the *Boston Globe*, the host committee for the Democratic National Convention recently added Fannie Mae to their list of “bronze contributors,” a designation for donors giving contributions between \$100,000 and \$250,000. (*Boston Globe*, Andrea Estes, 03/03/04)

Fannie's Vice Chairman and CFO Howard plans to sell up to 98,200 shares of Fannie stock

- On March 1, Fannie Mae filed an 8-K, in which the Company reported that Timothy Howard, Vice Chairman and Chief Financial Officer of the Company, adopted a Rule 10b5-1 Sales Plan. The Plan instructs his representative to exercise and sell up to 92,800 employee stock options held by Howard that expire in November 2004. The sales will take place between March 17, 2004 and October 7, 2004. Excluding these options, Howard and members of his immediate family beneficially own 240,071 shares of Fannie Mae common stock. Howard also holds additional employee stock options to purchase 620,648 shares of common stock, 222,947 of which are subject to vesting requirements. (*Dow Jones*, 03/01/04)

Fannie Mae speaks out on RESPA

- Fannie Mae joined the mortgage industry in calling on HUD to reissue its Real Estate Settlement Procedures Act (RESPA) proposal for another round of public comment. Fannie Mae supports HUD's effort to simplify the mortgage process and reduce the cost of obtaining a mortgage, general counsel Ann Kapler said in a letter to OMB. HUD is waiting for OMB approval to issue the final RESPA rule. "Fannie Mae also shares the view that RESPA reform must be accomplished in a way that benefits borrowers without imposing undue regulatory burdens or competitive disadvantages on the firms and small businesses that will be affected by the revised regulation," the Fannie Mae general counsel said. However, the RESPA rule needs thorough evaluation and comment before it is finalized, she contends. "Therefore, we urge OMB to work with HUD to republish this regulation to allow for an additional opportunity for consumer and industry comment," Kapler said. (*National Mortgage News Online*, 03/04/04)

Fannie Mae's inflation linked bond "breaks new ground"

- Deutsche Bank Securities of New York persuaded Fannie Mae to try something a bit different: a large-scale bond issue linked to the consumer price index (CPI). The deal, initially planned for \$500m, would be Fannie Mae's first linker in seven years and did not fall neatly into either of two distinct categories: the inflation-linked bonds issued by the treasury known as Tips (which have a specialized, largely institutional audience), on the one hand, and the swath of corporate bonds linked to the CPI issued in recent months, on the other. The latter have tended to be relatively small in size - the largest was a 10- year deal by SLM Corp, a provider of student loans, for \$225m - and aimed at retail investors.
- Rather, Deutsche was aiming for a first: a large-sized agency linker appealing to institutional investors. It was a jump into the unknown. "I don't want to say we were

issuing into a black hole, but there were not a lot of comparisons in the market,” says Sarah Salih, director, debt syndicate.

- As sole lead, Deutsche had structured a deal it thought would appeal to a broad range of investors - offering a spread over Tips but doing away with one of the main disadvantages of the treasury issues: principal accretion. Instead, the bond would pay a coupon, removing the problem, among others, of phantom tax liability - paying taxes on income that has not been received.
- Early response was not overwhelming. In about 350 conversations with clients, there was some enthusiasm about the bond but not a single investor committed to buying. “It was something new; people are always skeptical,” says Ralph Segreti, director, US government trading.
- For Deutsche, the deal was a natural culmination of its success in the agency market combined with its efforts to develop a global inflation franchise (also helped by the development of a CPI swap market in the US). But just because the team could do the bond, it did not necessarily follow that there would be any buyers.
- “It had not been done before so it was really just a group of people saying - we know we can create it - but can we sell it?” said Jeanmarie Genirs, managing director for U.S. agency with Deutsche. “From Fannie Mae’s standpoint it had to take a bit of a leap of faith. It’s something we all believed in collectively but the truth was that until we brought it to the market we really didn’t know if it was going to work.” The risk was that, instead of bridging the gap between two types of market, it might end up falling between the cracks.
- According to Segreti: “Typical treasury investors were telling us they felt the deal would be viewed as expensive - because Fannie Mae trades at 35 basis points over Tips, so why should Fannie Mae inflation-linked trade at 20 over treasuries?”
- As it was, the deal, announced at around 9:00 a.m., was sold out within two hours. “By noon our book was fully subscribed at \$500 million,” said Salih. “Even some of the accounts we were talking to, who were skeptical or even negative on the transaction when we were sounding them out before announcing, came in right away when they saw the momentum gathering around the deal.”
- Orders were still being taken until the end of the following morning on a subject basis - with no guarantee that they would be filled. Then Fannie Mae gave the go-ahead to upsize the deal to \$750 million. By then Deutsche had more than \$1 billion in the order book. Salih said, “I think it could have been much more had we left the book completely open.”
- About 140 investors bought the bond - including corporate bond funds, money managers, central banks and insurance companies, as well as some retail investors. Demand has remained high in the secondary market. “We have traded between \$75

million and \$100 million and right now we are short (of) the bond,” said Genirs, which the team says is not entirely surprising, given the novelty of the product.

- Segreti says that a lot of the investors to whom he spoke said they needed time to analyze the structure because it was new to them. “And by the time they got it done, the books were closed - and they wanted the paper,” he says.
- “A low rate environment with a reflationary monetary policy is a recipe for success for the Tips market and so I think people are looking at inflation- linked products as either defensive bearish plays or, if you believe that rates are on hold for quite a long time, they’re going to be an excellent carry trade,” said Segreti. “And (the Fannie Mae deal) has fed on the success of the Tips program: deals like this were bound to happen.” He argues that the deal will break open the inflation market to a whole new universe of institutional investors - and set a benchmark: “It really did open up the world of inflation protection and inflation hedging, and asset liability matching, to people beyond the treasury world. “I think we’re going to see an inflation credit curve developing, whereas before there wasn’t one; there were these kind of spotty deals out there - there were deals coming and if people had an interest they were getting done - but this definitely marks a sea change in the investment community.”
- Genirs said, “It’s kind of set the benchmark going forward. It used to be Tips or you could look at these retail structures. Now we have something new that kind of bridges the gap.” (*The Banker*, 03/01/04)

Freddie Mac

Freddie’s Proxy raises questions about corporate governance

- Freddie Mac has repeatedly promised to turn over a new leaf, but its latest proxy statement has renewed concerns about its corporate governance practices. The statement disclosed payments of more than \$24 million to a business headed by the spouse of an independent board director, accelerated payments to another director’s lobbying firm, and failure to follow its new guidelines regarding term limits for directors.
- Though none of the practices Freddie disclosed in the proxy statement are illegal, they raise doubts about whether or how quickly it can meet its pledge to correct the flaws that contributed to its accounting problems. According to the statement, Freddie paid Electronic Data Systems Corp., about \$24.1 million last year for services. That flagged a potential conflict for Michelle Engler, who was appointed to the board by President Bush in 2001. Freddie recently nominated her to serve as a stockholder delegate. Her husband, former Michigan Governor John Engler, is EDS’

president of state and local government and its vice president of government solutions for North America.

- Many observers wondered if the revelation meant that Engler should not be considered an “independent” director. And they questioned Freddie’s assertion in its proxy that its chairman and acting general counsel are the only board members with a “material relationship” to the GSE. The spokeswoman said that Freddie’s corporate governance standards for independent directors meet or exceed those imposed by the New York Stock Exchange.
- According to Freddie’s guidelines, which were approved by the board last month, directors are not independent if their or a spouse’s company received from Freddie the greater amount of \$1 million or 2% of the company’s consolidated gross revenues in a fiscal year. By that definition, EDS, which earned \$21 billion last year, would have to do more than \$400 million worth of business with Freddie before it was considered a conflict for Engler. The spokeswoman also noted that Freddie’s relationship with EDS, which involves loan transaction services, predates both Engler’s board service and her husband’s job with the firm. She said neither had any involvement with the contract.
- The proxy statement also said that Powers, Crane & Co. LLC, a New York lobbying firm, was paid \$242,000 in 2003. William Powers, a presidentially appointed director who is leaving the board at the annual meeting at the end of this month, owns the company with his son. The disclosure also said it was paid \$50,000 in 2002. The spokeswoman said Powers was not put on any Freddie committee that required independence and noted that his term was due to expire.
- Observers also raised concerns about Freddie’s slate of 13 directors, which is largely the same as the current board except for the departure of four of the presidential directors, whom the White House did not reappoint or replace. Seven members have served for more than 10 years. Freddie’s new corporate governance guidelines explicitly impose a 10-year limit for non-management directors and a mandatory retirement age of 72.
- Freddie said the guidelines cannot go into effect immediately, because they would disrupt its board too much. The proxy statement’s appendix states “the interests of Freddie Mac and its stockholders strongly support a transition period of service for the eight directors who have served on the board for six or more years.” Four of those directors can be re-nominated for no more than one additional term, and the other four can serve as many as five additional terms, Freddie said. (*American Banker*, Rob Blackwell, 03/04/04)

Citizens Against Government Waste reads Freddie Mac's Proxy and blows a gasket!

- Citizens Against Government Waste (CAGW) blasted Freddie Mac for diverting millions of dollars in generous federal benefits to excessive pay and perks packages for executives, as well as contributions to the two major political parties at a time when the company lags the market in buying up low and middle-income mortgages, is under a financial cloud, and is resisting Congress's attempts to bring accountability and transparency to its financial activities.
- "Ever since the Federal Reserve published its findings that one half of the GSEs' \$10 to \$15 billion subsidy is being absorbed into the bureaucracy at Fannie Mae and Freddie Mac, members of Congress have been asking 'where is all this money going?'" said CAGW Special Projects Director Leslie Paige. "Now we know. While Freddie Mac's executives are toadying up to Congress and claiming publicly that they support a more independent regulator, they are paying millions in bonuses to a hoard of lobbyists to scuttle any real reform behind the scenes."
- Regarding the recently ousted Freddie lobbyist Mitch Delk, Paige notes, "It is amusing to see Freddie Mac's executives trying to wash their hands of Mr. Delk. Both GSEs leverage their lobbying clout and excess profits to ensure that members of Congress will shield the GSEs from any reforms," said Paige. "Given the active executive role in such political activity, it is unlikely that Mr. Delk was acting without his superiors' knowledge."
- At the same time, Freddie Mac has not solved its accounting problems and refuses to give assurances that it will publish quarterly or full-year earnings statements any time soon. Gregory J. Parseghian, Freddie Mac's former CEO, continues to be paid \$375,000 per month as a temporary consultant. He left the company with a \$14.3 million severance package and nearly \$4 million in bonus payments, which were awarded months after Freddie Mac was forced to let him go because of his role in its accounting scandal.
- "Freddie's priorities are crystal clear," said Paige. "Its executives and lobbyists are reaping huge financial bonanzas and using a lot of those profits to kill reforms that would help consumers and protect taxpayers. How many mortgages for low and middle-income families would these millions have helped pay for? The GSEs' activities pose significant risks to our financial system and to taxpayers, yet they operate largely in the dark. Taxpayers and consumers have underwritten this corporate welfare for years and Congress has consistently looked the other way. Enough is enough. Congress must enact a stringent regulatory structure this year to put an end to the GSEs' contempt for consumers and taxpayers." (*Citizens Against Government Waste* press release, 03/04/04)

Warren Buffet warns that derivative accounting *isn't* trustworthy--blasts Freddie Mac's
"shenanigans of mind-blowing size and audacity"

- Derivatives accounting doesn't give investors a clear picture of the risks companies are taking in the market, said Warren Buffett, chairman of Berkshire Hathaway in his annual letter to shareholders.
- Buffett also said investors should have learned something important from the accounting scandal at Freddie Mac last year. Calling Freddie Mac's actions "shenanigans of mind-blowing size and audacity," Buffett said that the scandal proved that derivatives transactions are extremely difficult for outsiders to properly evaluate. Freddie allegedly used questionable derivative deals to shift and smooth earnings -- something that led to its restatement last year of three years of earnings.
- "No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions," Buffett wrote. "Indeed, the more you know about derivatives, the less you will feel you can learn from the disclosures normally proffered you. In Darwin's words, 'Ignorance more frequently begets confidence than does knowledge.'"
- In his note to shareholders in 2003, Buffett said derivatives are "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." (*Bloomberg News*, Mark Gilbert, 03/08/04; *American Banker*, Rob Blackwell, 03/09/04)

Freddie's Ex-CEO Parseghian may be heading back to Wall Street

- According to *National Mortgage News*, Former Freddie Mac chief executive Greg Parseghian, who was forced to resign by regulators, but remains as a consultant to the company, is talking to two New York investment banking firms about employment, industry sources said.
- Some veterans of the mortgage industry who call the Freddie Mac consultant a friend said they feel he has been unfairly tainted by the \$5 billion accounting scandal at the company. It is not known which firms Parseghian is talking to, but industry officials who know him say it makes sense that he would go back to Wall Street where he started his career or start his own investment boutique. (*National Mortgage News*, 03/08/04)

Freddie Mac increases stock dividend 15%

- Freddie Mac increased its quarterly dividend by 15%, raising its common stock dividend to 30 cents a share from 26 cents a share, said Michael Cosgrove, a spokesman for the GSE. The dividend will be paid March 31 to shareholders of record

March 15. A higher dividend “reflects our strong capital base and desire to pay a comparable dividend vis-à-vis other financial institutions,” Cosgrove said.

- Dividend changes don’t fall under an order by the OFHEO for the company to obtain written approval for actions “likely to impair the ability of Freddie Mac to manage the target capital surplus,” such as repurchasing shares, Cosgrove said. Freddie Mac “previewed” the dividend action with OFHEO, and will also file a report to the regulator detailing the impact on the capital surplus, he added.
- In January, Freddie Mac exceeded the increased capital standard of \$32.6 billion with reserves of \$33.2 billion. Under the standard set by Congress, Freddie Mac must set aside 2.5% of on-balance sheet assets and 0.45% of off- balance sheet assets.
- “Freddie Mac is so overcapitalized relative to its minimum levels that they can increase dividends and business activity, and do share repurchases,” said Kyle Cerminara, an analyst at T. Rowe Price Group Inc. in Baltimore. “One or all of those things can happen in the next 12 months.” (On December 31, 2003, T. Rowe Price owned 3.34 million shares of Freddie Mac.)
- “Freddie Mac has a lot of earnings added to their capital account” since it last raised dividends a year ago, said Bruce Harting, an analyst at Lehman Brothers Inc. in New York. “Despite the fact that its accounting is not up to speed, its operations are up to speed.” (*Bloomberg News*, Al Yoon, 03/05/04)

Freddie expects renewed focus in data integrity in 2004

- With the refinancing boom leveling off and portfolio churning expected to ease this year, Freddie Mac thinks that servicers and their business partners will have more time to focus on technology improvements. Janet Eakes, vice president of sourcing operations at Freddie Mac, told *Mortgage Servicing News* that the GSE will be talking to its servicing partners about technology it provides, including EarlyResolution and EarlyIndicator, which help services improve productivity and maximize performance and minimize credit losses.
- Eakes said technology is coming back to the forefront as an industry concern. Heavy lending volume in recent years has prevented many firms from devoting resources into technology issues, but Freddie Mac and Fannie Mae have each made heavy investments in servicing infrastructure. And servicing vendors are creating new tools to help lenders improve data integrity and customer relationship management, she noted.
- Eakes said the development of electronic data standards, such as those promoted by the Mortgage Industry Standards Maintenance Organization, is paying off by creating new opportunities to improve the flow of data and limit re-keying of information. A

Freddie Mac advisory committee of lenders is exploring ways to promote a seamless flow of data from loan origination systems to servicing systems. That kind of technology integration can reduce servicing costs by increasing data accuracy and data accessibility, she said.

- Eakes said that because of cash-out refinancing and the introduction of new mortgage products in recent years, servicers will be keeping an eye on delinquency rates and Freddie Mac “will be monitoring that and preparing for some of the challenges” that the industry may face. She said many of the new technology products available to mortgage servicers focus on “early intervention” to minimize the likelihood that delinquent loans end up in foreclosure.
- In addition, Freddie Mac is working to expand homeownership counseling so that it is available to consumers after origination. “We are focusing more and more on affordable housing, ensuring that we educate the borrower during the servicing of the loan, not just at origination,” she said. (*Mortgage Servicing News*, 03/01/04)

Sources say Ralph Boyd leading candidate for Freddie’s general counsel
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- Separately, several sources said Ralph Boyd, the deputy attorney general for civil rights at the Justice Department, was the leading candidate to be Freddie’s general counsel. Boyd, a former assistant U.S. attorney general who was accused by some advocacy groups of weakening enforcement of civil rights laws, will take over that job as well as the position R. Mitchell Delk had as head of government relations, sources said.
- A spokeswoman for the company would not comment on its hiring plans. Freddie has been without a permanent general counsel since August, when its regulator ordered Maud Mater fired for her involvement in an accounting scandal that forced the government-sponsored enterprise to restate three years’ worth of earnings. (*American Banker*, Rob Blackwell, 03/12/04; *Washington Post*, Kathleen Day, 03/12/04)

Federal Home Loan Banks

Federal Housing Finance Board Chairman Korsmo speaks to ACB

- In a speech before the America’s Community Bankers, Chairman John T. Korsmo of the Federal Housing Finance Board said, “The bottom line: The Finance Board’s transformation into an arm’s length regulator of the Federal Home Loan Banks *has occurred*. While the Finance Board will continue to build its regulatory capabilities, to strive for improved safety and soundness oversight, the Finance Board’s arm’s length status is real, it is in place, and it will guide our actions from here on.”

- Korsmo noted that the Board’s statutory charge is to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner and are adequately capitalized and able to raise funds in the capital markets. The Finance Board also has the statutory duty to ensure that the Banks carry out their housing finance mission. However, Korsmo senses that some still see the Finance Board as part of the system, expect it to be an advocate for the Banks, expect it to respond to a Bank’s arguments against this action or that by automatically agreeing with the argument put forth. He said he can understand how that expectation persists. Again, the old relationship had existed for years, and it was familiar...comfortable.
- Korsmo doesn’t think the Finance Board necessarily and immediately fully appreciated the philosophical change that Gramm-Leach-Bliley represented. For a variety of reasons, action on the capital plans was slow to get under way. And the necessary personnel were not in place to enable the agency to fully perform its safety and soundness obligations.
- When Korsmo took over as chairman in December 2001, there were eight examiners in an Office of Supervision headed by a director with no regulatory background. “How can you function as an arm’s-length regulator when you don’t have any arms?” asked Korsmo. Since December 2001, the Finance Board has taken the steps to arm itself with the additional people to carry out its oversight and regulatory responsibilities. The number of examiners as of today has reached 25, and these 25 average 17 years of examination experience. Examinations now acknowledge the reality that banking is a business of managing risks, and the responsibility of bank supervisors is to ensure the institutions they regulate understand those risks, and that they monitor and control them through prudent risk management practices.
- The Finance Board has added not just examiners, but also staff to address additional supervisory areas, as well, including, for example, mortgage analysts to assist in overseeing the MPP and MPF programs. Another example is the recent creation of a team of four financial analysts, whose full-time duties will be to monitor the portfolios of the Banks and analyze their monthly and quarterly call reports.
- Korsmo noted that the Finance Board now functions in the same fashion as the other federal financial regulatory agencies you all know – the FDIC, the OCC, and, of course, OTS. The Finance Board’s principle statutory responsibility is to ensure that the Banks operate in a financially safe and sound manner, the same mandate given to these other financial regulatory agencies.
- This post-Gramm-Leach-Bliley relationship also means the responsibilities facing the boards of directors of the Federal Home Loan Banks are greater than at any time in the past. To protect the Banks and their housing-finance and affordable housing missions, to protect the investors in these institutions’ debt, and to protect the public who stands behind the Banks and their congressional charters, it is incumbent upon

all of us to encourage the strongest, best practices of corporate governance. On this, regulator and those who are regulated can agree.

- On the issue of SEC registration, Korsmo noted that on September 10, 2003, the Finance Board adopted unanimously a proposed rule to require the 12 Federal Home Loan Banks to meet the standards of the Securities Exchange Act of 1934 by filing current quarterly and annual financial and governance disclosure reports with the SEC. America's Community Bankers filed comments on the proposed rule, as did 22 other individuals and organizations. The comment period closed January 15th, and since then the Finance Board's supervisory and legal staff has reviewed and analyzed those comments and other related information.
- It is possible that, in writing GSE legislation, Congress will include a requirement that the Federal Home Loan Banks register with the Securities and Exchange Commission under the Securities Exchange Act of 1934. As the regulator of the Banks, however, the Finance Board must carry out its statutory responsibilities without being inhibited by or distracted by the possibility of Congressional action.
- As to the broader issue of GSE regulatory reform, Korsmo is uncertain what will happen. Korsmo does not have a position on the structure or placement of a new GSE regulator. That's a policy decision that belongs with the policy-making branch of government. Korsmo does believe, however, and has testified to Congress to the effect that the Federal Home Loan Bank Act provides all the authority and independence needed by a GSE regulator.
- Discussions about GSE regulators might well benefit from a discussion of the government-sponsored enterprises themselves. Consider the dramatic changes that have taken place in the products offered by the Federal Home Loan Banks, Fannie Mae and Freddie Mac over the past decade, the changes in their operations, and the increased risks they have taken on. In shaping a new regulator, Congress should also consider what precisely will be regulated five years, 10 years, 15 years from now. In other words, remedying any shortcomings in the '92 GSE act regulating Freddie Mac and Fannie Mae and/or transferring Federal Home Loan Bank Act authority to a new body will not, in and of itself, reduce or dilute the potential risks posed by the housing GSEs to the taxpayers and the economy.
- Despite his earlier comment conceding no particular insight about congressional action on GSE reform, Korsmo does offer this prediction: There will be no returning to old, pre-Gramm-Leach-Bliley days of a regulator also sharing operating duties over its regulated entities. No one on the Hill is contemplating it; the focus is on moving in the entirely opposite direction.
- Korsmo also feels it safe to say that if a new regulator comes into existence, it will surely continue the evolution under way in the Office of Supervision, in part by retaining the fine men and women who are now supervising the Federal Home Loan Banks. And if the current regulatory arrangement remains in place, the Federal

Housing Finance Board will move forward with its long-term, disciplined drive to strengthen the safety and soundness oversight of the Banks. (*Federal Housing Finance Board Press Release*, Chairman John T. Korsmo, 03/09/04)

Federal Housing Finance Board holds closed briefing on SEC Registration of FHLBs

- On March 10, the Federal Housing Finance Board held a closed meeting to receive a staff briefing on the status of efforts to have the FHLBanks to voluntarily register a class of their equity securities with the SEC. But the Finance Board has no present plans to take final action on a proposed regulation that would require the FHLBs to register with the SEC under the voluntary registration provisions of the 1934 Securities Exchange Act. Carter Wood, a spokesman for Finance Board Chairman John Korsmo, said the contents of the staff briefing eventually will be made part of the public record.
- Alfred DelliBovi, president of the FHLBank-New York, said in a recent message posted on the bank's Web site that the FHLBank's 2003 annual report has been significantly changed to begin the process of meeting SEC reporting requirements.
- "The annual report will be used in discussions with the staff of the SEC in preparation for the anticipated registration of our stock," he said. "We expect our discussions with the SEC to begin shortly after the FHFb finalizes its regulation regarding registration of the stock of the 12 FHLBanks. At this time, we expect that, in the not-too-distant future, the FHFb will enact a regulation formally requiring the FHLBanks to register with the SEC."
- Among other potential factors impinging on the registration issue is the possibility that Congress, in considering GSE regulatory overhaul legislation in the period ahead, could address the FHLBanks-SEC registration matter. (*Dow Jones International*, John Connor, 03/02/04)

FHLBanks seeking higher returns on investments

- The 12 regional FHLBanks are under pressure to find new lines of business because of weak returns in 2003 and earlier, the Cleveland Federal Reserve Bank said in a study released on March 9.
- The Banks, institutions owned by member banks for the purpose of advancing funds for mortgage lending, experienced a drop in average return on equity to 4.1% in the first nine months of 2003 from 4.9% at the end of 2002, the Cleveland Fed said, citing bank data and annual reports. FHLBank return on assets fell to 0.20% on an annualized basis at the end of the September 2003 from 0.24% at the end of 2002, the Fed added. "These persistently weak returns on assets and equity further pressured

FHLBanks to undertake nontraditional lines of business in search of higher returns,” the Fed said.

- The FHLBanks have been begun to invest directly in mortgages and now hold \$108 billion in home loans, more than double what they held a year ago, the regional Fed said. “Mortgage portfolios are expected to be a major source of asset growth in the future,” the paper said. The mortgage buying program -- called Mortgage Partnership Finance -- caused problems for the FHLBank-Pittsburgh and FHLBank-Atlanta last year, contributing to losses of \$6.5 million and \$9 million respectively. The FHLBank-New York lost money invested in securities pooling manufactured housing loans and was unable to pay a dividend to its member banks.
- Carter Wood, a spokesman for the Federal Housing Finance Board, which oversees the bank system, was unable to provide immediate comment on the study. (*Reuters*, Mark Felsenthal, 03/09/04)

Sallie Mae

Sallie Mae fails to keep credit report promises

- Sallie Mae *still* hasn't begun sending loan payment information on millions of borrowers to Experian and TransUnion, two of the major credit bureaus. That's what Boston resident Michael McCarthy discovered recently, when he obtained copies of all three of his credit reports. To McCarthy's surprise, Sallie Mae was not reporting his on-time loan payments to Experian and TransUnion, as the company had promised.
- In the summer of 2002 Sallie Mae decided, without telling its more than 7 million borrowers, that it would report loan information only to Equifax and to Innovis Data Solutions, a small credit bureau. Sallie Mae said it decided to withhold loan data from Experian and TransUnion because those bureaus sell names to companies interested in marketing to Sallie Mae's borrowers. The Fair Credit Reporting Act allows for this practice -- called "prescreening" -- in which lists of consumers who meet certain credit criteria are sold to credit grantors. Critics accused Sallie Mae of trying to hide its borrowers from competitors who might offer better loan deals.
- Amid mounting criticism and threats of legislative action by Senate leaders, Sallie Mae reversed its policy and promised in November to resume reporting repayment history of its borrowers to Experian and TransUnion.
- “Our goal is to ensure that our customers get the credit they have earned,” Rose DiNapoli, Sallie Mae's vice president for government and industry relations, wrote to

Senator Richard Shelby, R-Ala., chairman of the Banking, Housing and Urban Affairs Committee, and Senator Paul Sarbanes (D-MD), the panel's senior Democrat. DiNapoli added: "I am pleased to let you know that following extensive discussions with the other two credit bureaus, Sallie Mae has agreed to resume reporting to them and will provide each with credit information for our customers." That letter was dated November 4.

- But in a letter dated February 16, 2004, Sallie Mae wrote the following to McCarthy: "*Sallie Mae Servicing has submitted an update on your behalf to the four national credit bureaus. However, we will continue to only update Equifax and Innovis on a monthly basis.*" McCarthy was stunned to read that statement.
- The letter sent to McCarthy was in error, said Tom Joyce, Sallie Mae's vice president for corporate communications. Joyce said the company intends to honor its promise. He said the company is implementing a coding system to mask who its customers are to protect their privacy and that is one of the reasons it's taking so long. "There is a lot of work in terms on loading the files," Joyce said. "We are filing and testing the technology. We would have liked to have had this resolved a little earlier but it takes time."
- So when can borrowers expect their data to be included in their credit files at Experian and Trans-Union? "Very soon," Joyce said.
- That's not good enough, complained Edmund Mierzwinski, the consumer program director for the U.S. Public Interest Research Group in Washington. "This is just unbelievable," Mierzwinski said. "Sallie Mae borrowers deserve better. These technical excuses are absurd." (*Saint Paul Pioneer Press*, St. Paul, Minnesota, Michelle Singeltary, 03/03/04)

Postal Service

Senate Government Affairs Committee holds hearings on postal workforce issues

- On March 9, the Senate Governmental Affairs Committee had a hearing to examine postal reform issues. Committee Chairman Susan Collins (R-ME) reiterated her support for universal mail service, particularly for those who live in rural areas. Issues regarding the Postal Service's monopoly or universal service, she said, are matters better left to Congress than to any postal regulatory board. The committee, she noted, was committed to fashioning a bipartisan bill to help ensure the continued viability of the nation's postal service. Collins said she was committed to eliminating the CSRS escrow provision.

- Ann Moore, Chairman and CEO, Time, Inc. told the committee that there is no issue more crucial to magazines and their readers than the future of the postal system. Time, she said, supports the Presidential Commission’s core recommendation for the institution of a mediation process be made a part of reform. Moore said Congress must put in place a rate cap system keyed to inflation to limit “out-of-control postal costs.” Postal rates have outpaced inflation by more than 60 percent in the past two decades, Moore said, and Congress must set maximum rate increases. Within that rate cap structure, however, the Postal Service should be allowed to operate with minimal oversight in setting rates, said Moore. There are no incentives today to contain costs, and mailers are denied predictable rates. Time Inc. is the Postal Service’s biggest customer, and Moore said the Postal Service must establish a predictable, stable rate increase system for consumers. The USPS needs to have its performance specified and measured. Finally, she said, the escrow provision of the CSRS bill should be repealed, as should the assignment of the military portion of postal retiree costs to the Postal Service.
- Mark Angelson, Chairman, President and CEO, RR Donnelley, noted that it costs more to mail a magazine than it does to produce it. Our employees and our customers see, feel, and experience everyday the effects of a postal system that is in need for reform. Reforming the postal system is important to strengthening a sector of jobs that will stay in America. Any piece of legislation that protects the status quo will be unacceptable. Change should be at the heart of reform. The Postal Service must also be able to adapt more quickly to changes in its consumer environment, said Angelson. All companies, Angelson said, have learned they should rely on their core competencies. Delivery, he said, is the USPS’ core competency. All the rest should be left to those that can do it better through worksharing. Despite the successes of worksharing, engaging the USPS in new worksharing opportunities are as difficult as ever. It’s inconceivable, he said, that there haven’t been ongoing adjustments to the Postal Service’s network, given the many changes that have affected the mail. The country’s use of mail has changed, but the USPS hasn’t. The USPS must be allowed to constantly realign its network as necessity demands without political interference. Angelson also urged for the elimination of the CSRS escrow and the military retirement burden.
- Senator Richard Durbin (D-IL) claimed that most of the bulk in an Illinois landfill is paper. A few years ago, he said, he had proposed the idea of providing a postal discount for recycled fiber content. He said he was mystified at the opposition to the notion. Ann Moore responded that Time recognizes the need to be environmentally minded, but the use of recycled content is economically not viable at this time. Durbin said he intended to work to try to accommodate the need to recycle and use recycled content in the Senate’s reform bill.
- Senator Thomas Carper (D-DE) questioned the panel on matters pertaining to the USPS’ governance. Ann Moore responded by noting that the President’s Commission attracted some of the nation’s best. It also ought to be able to do the same for serving for the Postal Service’s governing board. Mark Angelson said that

board compensation should be set at about \$50,000, if the goal were to be comparable to the private sector. Angelson said he would welcome any effort by Congress to ease the worksharing proposition.

- Chris Bradley, President and CEO, Cuddledown, Inc. noted that the company's other key employment related costs was about equal to what the company spends on postage. The only business partner, he said, that isn't working in a 21st century mode (such as extending credit) is the Postal Service. The extension of credit could help stimulate postal business growth.
- Max Heath, Vice President of Landmark Community Papers, testified on behalf of the National Newspaper Association (NNA), which supports postal reform. He said that newspapers use about 60% recycled content. He asked that the newspaper sector remain separate from other classes of mail. The USPS, he said, needs more management control authority. He said NNA favors niche classifications to negotiated service agreements. Volume-based NSAs, he said, are "unwise," since they can place small newspaper competitors at a marked disadvantage. The USPS needs the ability to "right-size" its network. If service standards are established and observed, the PMG should be given this flexibility.
- William Ihle, Senior Vice President, Public Relations, Bear Creek Corp., said that his company would fail to survive without a universal mail delivery system. Reform needs to guarantee universal service, preservation of competitive services, right-sizing the USPS' infrastructure, financial transparency and financial controls. Package delivery should remain within the "core" of the Postal Service's business. Successful private sector competitors don't negate the need for core parcel delivery services. Competition, he said, should control postal parcel rates, not a rate regulator. Even the Postal Service's competitors, he said, use the USPS for parcel delivery in areas that are inconvenient. A few naysayers, he said, should not be allowed to stand in the way of reform.
- Shelley Dreifuss, Director, Office of the Consumer Advocate, Postal Rate Commission, said "the President's Commission Report contains no explicit recommendation for a statutorily required consumer/small business representative, with funds for representation provided by postal revenues. However, the current Postal Reorganization Act does so provide." Any new bill should do so too. Dreifuss agrees with the Association for Postal Commerce that the addition of the word physical, as in physical delivery, acceptance, collection, sortation, and transportation of mail would make it very plain that the Postal Service has not been given license to engage in electronic communication services. (*PostCom, Association for Postal Commerce*, 03/09/04; *CongressDailyPM*, Zach Patton, 03/09/04; *DM News*, Melissa Campanelli, 03/10/04)

Senate Government Affairs Committee holds second hearing on postal workforce issues

- On March 11, 2004, the Senate Committee on Governmental Affairs held a second day of hearings on postal reform. Senator George Voinovich (R-OH) said that there

is a bi-partisan agreement that the Postal Service is important and needs reform. The USPS' debt and retirement related obligations need to be addressed.

- Michael Eskew, Chairman and CEO, United Parcel Service, told the committee that while UPS has been noted as one of the foremost competitors of the Postal Service, the USPS and UPS have made great strides in improving the communication and understanding between the two groups. UPS, he said, is one of the Postal Service's largest customers. UPS is one of the few of the Fortune 500 that has the federal government competing against their core business. In Eskew's opinion, the path to postal reform should focus on core mail services, effective regulation, cost control and financial transparency, a level playing field between the USPS and its competitors. According to Eskew, competitive products will not solve the USPS' troubles. Continued existence of the USPS' monopoly requires effective regulatory oversight. The current rate setting process needs improvement and cost control and proper cost allocation is essential. The USPS should not be allowed to leverage its monopoly advantages into the competitive product area. The USPS has many benefits from its governmental status, other than just the statutory monopoly. He admitted, though, that there are burdens as well that fall on the Postal Service.
- Fred Smith, Chairman and CEO, FedEx, said his company supports the modernization of the Postal Service and supports S. 1285 with some recommended amendments. Further study needs to be given to turning the USPS into a real corporation (government or private), unwinding the monopoly, and harmonizing American postal policy with the changes taking place in Europe. Government and the Postal Service are at a crossroads. Either you need to plan to wind down USPS as its business evaporates, or you can restructure it to make it compete. The USPS, he said, needs "fundamental transformation." Incremental steps to transformation cannot substitute for a comprehensive overhaul. A regulated government monopoly "cannot become a world-class business." The USPS cannot learn to compete unless it is required to compete. Plans should be made to eliminate the Postal Service's monopoly by 2008, as will be the case in Europe. The USPS needs greater flexibility, elimination of compensation caps, and redefinition of the limits of the monopoly. There should be a separation of USPS accounts for competitive and non-competitive products. The Postal Rate Commission should be allowed to phase in the right for private sector companies to have access to letterboxes. Bulk First-Class Mail should be free of the constraint of a uniform rate.
- In response to questions from the panel, UPS Chairman Michael Eskew said that the package business in the U.S. is well-served by the private sector. The USPS, however, is in the parcel delivery business. As long as it is, the playing field needs to be made level. UPS does not doubt that the USPS is needed for all other classes of mail, but UPS already has the ability to provide universal parcel delivery. Unlike the USPS, he said, UPS delivers to the customer's front door. UPS has a very small pilot program in cooperation with the Postal Service in order to effect delivery to mailboxes covered by the Postal Service's monopoly. The markup on competitive products, he said, is more than 50% less than it is on non-competitive products. The

cost burden, he said, is pushed more on the First-Class Mail user. More than 60% of postal costs need to be attributed.

- FedEx Chairman Fred Smith said Congress has two choices: Liquidate the Postal Service as technology encroaches on its primary business or force it to compete. FedEx supports postal modernization, but it also believes that competitive and non-competitive postal products need to be treated differently. The competitive products need to pick up a larger share of postal overhead costs. With appropriate competitive products pricing, the marketplace will determine who should carry and deliver parcels. A good postal board, he said, must be made up of people with a real knowledge of how business works, and the directors must have independence. To function well, the institution it oversees must have transparency. Smith said serious consideration should be given to transforming the USPS into a corporation with an independent board of directors. The U.S., he said, shouldn't go the route taken by some European postal monopolists in taking advantage of their monopoly to compete elsewhere with others.
- Gary Mulloy, Chairman and CEO, ADVO, Inc., told the committee that proper accounting of postal retiree benefits will allow the Postal Service to keep its commitment to its employees and retirees. All pension and health benefits can be paid, now and in the future, and the Postal Service will be able to offers its customers an extended period of rate stability. Extending the current period of rate stability beyond 2006, he said, will allow Advo to be even more aggressive in its expansion plans, because it would have confidence that our largest cost will be contained. "We have the latent ability to create three billion more mail pieces," he said, and "would be able to plan to grow our business in partnership with the USPS. Others in our industry would respond in similar ways." Continued rate stability, he said, would benefit the mailing industry, the Postal Service and the economy as a whole. Stable rates coupled with comprehensive reform, he said, are not a "pipe dream." The committee, he said, can lead the Congress to make them a reality. The Postal Service, he said, can be put on the road to financial health, if Congress fixes the problem of the allocation of benefits earned before 1971, transfers the military benefits back to Treasury and releases a portion of the identified overpayments from the escrow created last year.
- Gary Pruitt, Chairman, President and CEO of McClatchy Company, testified on behalf of the Newspaper Association of America (NAA). Pruitt said that NAA supports many of the recommendations outlined by the Presidential Commission. NAA supports responsible reforms to the rate setting process that can expedite and streamline the process of changing postal rates. "However," he said, "we also recognize that the Postal Service's governmental and public service role precludes it from having the same pricing freedoms as private companies." He said NAA supports reforms to make changing rates less burdensome and more predictable, indexed rate increases, strong independent regulation, worksharing that is appropriately costed and discounted; however, NAA opposes negotiated service agreements. Newspapers, he said, compete with direct mailers (principally

“saturation” mailers) for both types of advertising, but particularly for pre-printed inserts. This competition with other mailers has served as a source of considerable friction between newspapers and the Postal Service. Experience has led newspapers to believe that the Postal Service has unfairly favored its direct mail advertising competitors through pricing strategies and new initiatives targeting the advertising revenues, upon which we depend to support the news and editorial content of our newspapers. Pruitt urged the Committee to be wary of the Postal Service’s plea for pricing flexibility.

- Robert Wientzen, President and CEO, Direct Marketing Association, said that the President’s Commission’s report has noted that the USPS must be empowered to right size its infrastructure, workforce, and service offerings as future circumstances may dictate. These concepts should be first and foremost among those enacted by the Congress, along with the flexible, incentive-based rate-setting process envisioned by the Commission. The USPS, he said, needs pricing flexibility to meet the demands of the market. The Postal Service’s new business model should authorize customized service and rate agreements that offer an economical benefit to the overall system as well as to the parties to such an agreement. Congress, he said, should avoid calls to impose, in legislation, specific instructions to the Postal Regulatory Board to determine the costs of services offered. Reform ought not to mean that the Postal Service and its customers should be placed in a “new, different pricing straightjacket” by requiring that the USPS assign or attribute a specific higher percentage of costs mandated in legislation. Preserving the USPS’ ability to deliver parcels, he said, is essential to the direct marketing industry. A way, he said, needs to be found to depoliticize the rationalization of the postal network. (*Postcom, Association for Postal Commerce*, 03/11/04; *DM News*, Melissa Campanelli, 03/12/04; *Memphis Commercial Appeal*, Bartholomew Sullivan, 03/12/04)

CAGW says road to postal reform must be built on transparency first

- Citizens Against Government Waste (CAGW) today released its reaction after the sixth in a series of postal reform hearings was held by the Senate Committee on Governmental Affairs on March 11.
- “The true state of the United States Postal Service’s (USPS) financial health is as murky and inscrutable as ever. But one thing is clear: the first step toward any serious postal reform must be financial transparency. CAGW has three important words for Congress: audit, audit, audit,” said CAGW Director of Special Projects Leslie Paige. “As in the past, CAGW is calling for a full, operational, top-to-bottom audit that would lift the lid on the postal service’s true financial state. It would be foolhardy of Congress to embark on some of the reform ideas, as dramatic and well-advised as many of them may be, without an audit. Not only are postal regulators and Congress in the dark, postal management itself does not even measure reams of crucial financial data because nobody requires them to. Its regulator, the Postal Rate

Commission, does not currently even have the power to compel the USPS to produce crucial information.

- “Without a complete and accurate picture of the financial operations of this \$70 billion dollar behemoth, how would postal management and postal regulators begin to ‘right-size’ the operation?” asked Paige. “Without the benefit of clear, bottom-line financials, how would Congress begin to distinguish between monopoly and so-called ‘competitive’ products, let alone be sure they are priced properly and overhead for them is correctly allocated? Why should the USPS be permitted to liberally enter into negotiated service agreements (NSA) with favored customers when nobody knows whether these agreements are priced properly, especially when these NSAs could have such a devastating financial impact on non-favored companies operating in the private sector? How can Congress encourage work-sharing agreements without understanding whether the USPS is pricing the discounts in a cost-effective way? How does anyone know whether captive first-class users of the mail have indeed been cross-subsidizing dozens of money-losing commercial ventures?”
- “It would be an egregious error for Congress to bow to the pressure being brought by the USPS and others to cut the agency loose on private-sector entrepreneurs and small business people, especially in the fluid, dynamic world of e-commerce. Instead, Congress ought to be drawing a bright line and getting the USPS out of competitive products altogether. The entire reform agenda, which is ostensibly predicated upon getting the USPS to ‘behave more like a business’ should begin with getting a true picture of the postal services costs, revenues, losses and cost allocation and demanding that this wasteful, inefficient agency improve the performance of its core competency, delivering letter and advertising mail. The first rules of business are to make sure the enterprise is both accountable and transparent, qualities the USPS lacks in abundance. Without them, we are all flying blind.” (*Citizens Against Government Waste* release, 03/11/04)

Two essential elements for postal reform
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- The tempo these days in Washington on postal legislative reform has been picking up pace. Now, more than ever before, key members of Congress seem to have come to the conclusion that the present legislative and regulatory framework for the American postal system needs a significant overhauling.
- As the march toward reform continues apace, those within our industry will get more than an earful on what should or should not be made part of any new law. To the novice, the issues that underlie the postal reform debate may seem incredibly complex, but they’re not. There may be many, but they are interrelated and founded on a few simple principles. For instance, if postal legislative reform is to succeed as a means for ensuring the survival of cost-efficient and universal mail service, then two principles must serve as the foundation of any new law.

- The first is that the definition of costs upon which postal services are based must stem from a clear and definitive measurement of the cost of resources that go into providing service at various levels of access to the postal network. For instance, it's important for policymakers (and the Postal Service) to be able to discern clearly and unambiguously the costs of simple mail delivery as opposed to the costs associated with delivery combined with other upstream services, such as mail collection, initial processing, transportation, downstream sortation, and other such services. A "bottom-up" approach to postal costing is vital for rational postal pricing, the stimulation of new product development, service performance measurement, the wise investment in information technology tools, and the internal management of postal resources.
- The second principle (and perhaps the more important) is that Congress must provide the service with the authority to eliminate whatever redundancies within the postal network may result over time from changes in mailers' behavior or demands of the marketplace. If Congress is unwilling to give the Postal Service an outright grant of such authority, then it must construct as completely as possible an alternative mechanism or procedure that could provide the Postal Service with the tools it needs to eliminate wasteful redundancies and improve the cost-efficiency of mail service.
- These are essentials. If either of these two basic principles is absent from any proposal that is laid before Congress, then the whole legislating exercise won't be worth doing. Congress needs to understand this, and it's up to us to ensure that this important message is not misunderstood or overlooked. (*PostCom, Association for Postal Commerce, Gene Del Polito, 03/08/04*)

Why the USPS should not be a monopoly

- The U.S. Department of Justice recently announced that Oracle's takeover of PeopleSoft violates antitrust law, stating, "We believe this transaction is anti-competitive — pure and simple." Ironically, in the same week the U.S. Supreme Court, in *United States Postal Service v. Flamingo Industries*, decided that the massive U.S. Postal Service is exempt from all antitrust laws. Yet anticompetitive behavior by the Postal Service is more harmful to consumers, competitors and the overall economy than most private sector mergers.
- The Postal Service enjoys a government-enforced monopoly over the delivery of all letters. Yet it competes in a wide and increasing array of businesses in which private firms are already active, including package and express delivery; it has recently ventured into selling a variety of retail merchandise and e-commerce services (most of which are unrelated to postal services).
- A major concern is that the Postal Service will use funds from monopolized delivery services, where it holds customers captive, to under-price in businesses where it faces

competition. Given that the final authority to set rates rests not with its regulator, the Postal Rate Commission, but with the Postal Service itself, that fear is justified.

- Moreover, the best available estimates (given the Postal Service's poor accounting data) indicate that it has earned losses on many products where it faces competition. Under-pricing is thus nearly a certainty.
- Various other concerns have arisen about the Postal Service's competitive activities. In addition to monopoly power, it is exempt from all taxation. It can borrow from the Treasury at government-guaranteed rates. It has the power of eminent domain and is excused from Security and Exchange Commission disclosure requirements. It is not required to pay parking tickets or registration fees on its vehicles. It is immune from antitrust laws and is not subject to Federal Trade Commission truth-in-advertising regulations, meaning that it can assert anything it wishes in ads.
- All those valuable government-bestowed privileges allow the Postal Service to inefficiently and unfairly compete with private firms. The Postal Service is able to force private firms out of business by virtue of its special privileges, rather than through superior management acumen, better labor relations or any business-related skills. It can offer any competitive service it wishes at any time at any price without any regulatory oversight whatsoever.
- This is bad policy. Consumers will be hurt because the costs of those ventures will be passed on to them through higher rates in monopolized activities and because they will face less choice after the Postal Service has forced competitors out of business. Competitors will go out of business, shrink or not start up in the first place in the face of unfair competition from the Postal Service. Finally, state and local governments will lose tax revenue when the Postal Service forces out taxpaying businesses.
- The executive and legislative branches should act. The Postal Service ought to be kept out of competitive activities entirely. Better still, it should be relieved of all government-granted privileges, including monopoly power. This situation is anticompetitive, pure and simple, and it should be changed. (*Stanford Daily*, Rick Geddes, 03/05/04)

Possible hold on funds impedes USPS' planning

- Congress must soon scuttle a planned escrow account to help the U.S. Postal Service plan for its next rate increase, said David Fineman, chairman of the Board of Governors. "It is impossible to set rates without knowing what [the Postal Service's] financial situation will be," Fineman added.
- The Postal Service has promised not to raise rates until 2006, but must start planning for the rate increase later this year. The rate-setting process often takes about 18

months. Starting in 2006, Congress will withhold about \$3 billion annually that the Postal Service is saving through a decrease in its contribution to the Civil Service Retirement System. The law that corrected the overfunding allows Congress to keep those funds in escrow starting in 2006 until the Postal Service explains how it will spend the money.

- The Postal Service told Congress in September that it would use the money to pay for retiree health benefits and pay down debt. But the General Accounting Office said it wants more information on how the agency will improve its infrastructure and work force.
- The Postal Service and mailers fear that if Congress holds on to the escrow money, rates could be hiked up more than 10%, or at least \$.04 on first-class mail. (*FederalTimes.com*, Stephen Losey, 03/03/04)

GAO asks USPS to consider private-sector-style comp system
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- A GAO official says the U.S. Postal Service's workers' compensation costs are out of control, which may require a move toward a private-sector type program. Comptroller General David Walker says the idea merits careful consideration because the current workers' comp approach, "is costly and provides certain perverse incentives." His comments came in a GAO report, U.S. Postal Service Key Elements of Comprehensive Postal Reform.
- Walker told a congressional panel that workers' comp costs have been difficult to control at USPS due to its treatment under the Federal Employees' Compensation Act. The USPS handles more workers' comp claims than any other federal agency, Walker said. Workers' comp in federal agencies is handled according to the FECA.
- The Postal Service reported nearly \$1.5 billion in workers' compensation expenses in FY 2003, Walker said. Its unfunded liability for workers' comp rose \$526 million, to "a record \$7.2 billion at the end of the fiscal year."
- Walker's suggestion to make the USPS' workers' comp program more comparable to the private sector echoed statements by the President's Commission on the Postal Service last July. The commission noted, "Unlike most private sector plans, the FECA imposes no waiting period before benefits begin." It also said there is no maximum dollar cap on FECA payments, so employees eligible for retirement often opt to stay on the FECA rolls rather than retiring. (*Workers' Compensation Monitor*, 03/05/04)

PRC proposes rule change for reporting requirements for nonpostal services

- The Postal Rate Commission proposes amending its rules to establish certain reporting requirements for the Postal Service's nonpostal services and products. The Postal Services' recent expansion of nonpostal services and products has caused various stakeholders to express concerns that those services and products may be cross-subsidized by jurisdictional services. The proposed rule is designed to provide sufficient information regarding the Postal Service's nonpostal services and products to determine the presence (or absence) of cross-subsidies. The data are needed so that the Commission can recommend rates for jurisdictional services that comport with the requirements of the Postal Reorganization Act. Initial public comments are due April 15, 2004 and reply comments are due May 17, 2004 (*PostWatch.com*, 03/05/04)

USPS releases its January financial report

- The USPS has released its financial report for January 2004. According to the January report, year-to-date, revenues were down 1.6% while expenses increased 1.9% over the same period a year ago. Year-to-date operating surpluses or "net profit" decreased by \$806 million or 28% compared to the prior year. (*USPS Financial and Operating Statements*, 01/31/04)

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