

The **GSE** REPORT™

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Contents of GSE Report™

Major Events

- [Rising Interest rates may alter Fannie Mae's earnings outlook \(p. 3\)](#)
- [Ex-Freddie Mac CEO reaches deal in stock option case \(p. 3\)](#)

Fannie Mae and Freddie Mac

- [Treasury Secretary Snow unwittingly owned – and lost – on GSE bonds \(p. 4\)](#)
- [Oxley's "to-do list" doesn't include GSE reform \(p. 6\)](#)
- [IMF backs Bush administration on GSE regulatory reform \(p. 7\)](#)
- [Fannie Mae CEO Raines and Freddie Mac SVP "hopeful" that GSE reform bill will pass \(p. 8\)](#)
- [Partisans getting "testy" in GSE trenches \(p. 8\)](#)
- [GSEs have just the right mix pf the "big and dangerous" to generate one spectacular financial crisis \(p. 9\)](#)
- [NY Fed President Geithner says that Fannie and Freddie are the "arms race" in finance \(p. 11\)](#)
- [Global market for derivatives grew 43% over past six months \(p. 12\)](#)
- [Wall Street firms seeking lengthy transition to Fed's new payment system \(p. 12\)](#)
- [U.S. housing economists warn restraints on GSEs could imperil housing growth \(p. 13\)](#)
- [GSE rumblings on presidential politics \(p. 14\)](#)

Fannie Mae

- [Fannie Mae inquiry widens \(p. 15\)](#)
- [Readers respond to Barron's May 17th story on Fannie's accounting \(p. 15\)](#)
- [Citizens Against Government Waster names Fannie CEO Raines "Porker of the Month" \(p. 16\)](#)
- [Fannie Mae is breaking into the auction-rate securities market \(p. 17\)](#)

Freddie Mac

- [Financial Services subcommittee asks OFHEO to clarify why the agency is concerned about the pay of Freddie's top executives \(p. 19\)](#)
- [Freddie Mac plans to release 2003 earnings by end of June \(p. 19\)](#)
- [Freddie's mortgage portfolio shrinks for sixth month \(p. 20\)](#)
- [Freddie's SVP – Investments & Capital Markets discusses counterparty risk \(p. 20\)](#)
- [Christina Seix resigns from Freddie Mac's board \(p. 21\)](#)
- [Freddie Mac spends \\$15.9 million on lobbying Congress in 2003 \(p. 21\)](#)
- [Freddie's general counsel focuses his attention on lobbying \(p. 21\)](#)
- [Freddie Mac Foundation appoints two new board members and elects CEO Syron Chairman \(p. 22\)](#)

Federal Home Loan Banks

- [Representative Frank seeks to ease FHLBank membership rules \(p. 22\)](#)
- [Fannie and Freddie's "headline risk" driving Asian investors to FHLBank debt \(p. 24\)](#)

Ginnie Mae

- [Federal Housing Finance Board conducting joint study with HUD on housing goals \(p. 25\)](#)

Farm Credit System / Farmer Mac

- [GAO says Farmer Mac needs higher capital requirements and tougher regulation \(p. 25\)](#)
- [CoBank's acquisition plan? \(p. 27\)](#)

Postal Service

- [Senate Governmental Affairs Committee unanimously approves Postal Reform legislation \(p. 28\)](#)
- [Less than letter-perfect postal reform \(p. 29\)](#)
- [Postmaster General Potter warns that postal reform contains "costly" problems \(p. 30\)](#)

Major Events

Rising interest rates may alter Fannie Mae's earnings outlook

- Speaking at Fannie Mae's annual meeting, CFO Timothy Howard said "The dynamics of the interest rate market are likely to change again ...and if warranted we will update 2004 guidance at the end of the second quarter."
- Franklin Raines, Fannie Mae's chairman, acknowledged controversy about regulation of the company, but did not speak directly to worries that Fannie may need to restate earnings. The need to assign mark-to-market value to assets creates volatility in earnings but tends to even out over time, Raines told shareholders. Prior to the meeting, shareholders were telling reporters that they wanted Raines to assure them he will avoid an earnings restatement at Fannie Mae. Completion of OFHEO's accounting review at Fannie Mae will help remove roadblocks to the company's stock price, said Jayne Shontell, a senior vice president of investor relations. "There is a lot of uncertainty around the GSE stocks right now stemming from the Freddie Mac restatement and the review of Fannie Mae," said Shontell.
- Answering a question on whether Fannie Mae can be viewed as a "growth company" when U.S. housing demand is forecast to fall in 2004, Raines said housing demand is likely to grow 8% to 10% on average in coming years. "If we can grow at that pace, we are growing faster than the economy," he said. "By the end of the decade there will be 13 million to 15 million new American households needing homes. Some 1.8 million new homes need to be constructed each year to meet that demand." Steve Ashley, a Fannie Mae board member, said the face of the U.S. mortgage market is set to change radically. "There is an untapped market of millions of minority families" that need access to home ownership, he told shareholders. (*Bloomberg News*, Al Yoon, 05/25/04; *Reuters*, Ros Kransy, 05/25/04; *Dow Jones*, Michael McHugh, 05/25/04)

Ex-Freddie Mac CEO reaches deal in stock option case

- Former Freddie Mac chief executive Leland Brendsel and OFHEO have reached an agreement involving the distribution of about \$4 million worth of Freddie stock options that are set to expire June 2. The agreement will allow Brendsel to exercise his options by June 2 and Freddie Mac to hold the money in escrow pending the outcome of Brendsel's lawsuit. The agreement was outlined in a federal court, where Brendsel is suing OFHEO for blocking the release of about \$53 million in cash and stock-based compensation after he left the company last June in the midst of an accounting scandal. Brendsel's lawyers at Williams and Connelly had argued he would forfeit those options if he was not allowed to exercise them by the deadline.

- During the hearing at the U.S. District Court for the District of Columbia, Judge Richard J. Leon asked for additional information from each side. “The court believes at this point that neither side, to date, has adequately addressed OFHEO’s authority with regard to the payouts,” he said. Leon requested additional information on the legislative and legal basis involving OFHEO’s authority to freeze Brendsel’s assets. Brendsel’s lawyers argue that his employment contract with Freddie Mac predated OFHEO’s 1992 creation. Among other things, Leon said he wanted to know “what is the legal basis for the lack of procedural safeguards accorded to the plaintiff.” Leon has scheduled another hearing on the matter for July 6. The case will likely not be resolved until 2006. (*Dow Jones International News*, Jennifer Corbett Dooren, 05/27/04)

Fannie Mae and Freddie Mac

Treasury Secretary John Snow unwittingly owned-- and lost -- on GSE bonds

- Treasury Secretary John W. Snow unwittingly held more than \$10 million of debt securities issued by Fannie Mae, Freddie Mac and the Federal Home Loan Bank. When Snow’s bond holdings were recently discovered by the Treasury Department during the preparation of his annual financial disclosure form, the Secretary quickly sold the securities, taking a loss of \$477,467, to avoid a conflict of interest.
- Treasury officials said that prior to taking office on February 3, 2003, Snow instructed his financial advisors to purchase \$10.87 million of U.S. Treasury bonds. Instead, his advisors purchased on February 3 and February 4 of that year \$10.9 million of GSE debt. “I was under the mistaken belief, based upon discussions with, and instructions to, my then outside legal and financial advisors that the money used to purchase these GSE debt instruments had been used to purchase United States Treasury instruments,” Snow wrote in the letter. He did not discover the mistake until May 10 when preparing his annual financial report, although Snow had received several statements from his financial advisors that detailed his holdings, said a Treasury spokesman. He “simply did not look at” the financial statements sent to him, the spokesman said. Snow “views this as something that is very regrettable. It is upsetting,” added the spokesman. Snow directed his financial advisors to sell the GSE debt on May 14.
- When asked in a radio interview on KMOX-AM (St. Louis, MO) what lessons he has learned from his recent discovery that he had owned GSE bonds rather than U.S. Treasuries for 15 months, Snow responded “Well, mistakes get made. As soon as we discovered the mistake, we corrected it. It’s just one of those things that happens from time to time, and it’s now been rectified.”

- Snow’s financial advisor, Jeffrey C. McCutcheon told reporters he was asked last year to buy more than \$10 million of Treasury bonds for Snow, but invested the money instead into debt issued by Fannie Mae, Freddie Mac, and the FHLBanks without telling him. McCutcheon, a former senior vice president for corporate human resources at CSX Corp. where Snow was formerly the CEO, told reporters that he viewed the GSE debt as a better investment. “Because of the higher yield on GSE debt, I had essentially just purchased the same laddered portfolio using the GSE debt instead of Treasury debt,” he said. “There were an awful lot of things going on at that time with the secretary. Evidently, I never communicated that detail to him.” McCutcheon said “I was aware of the difference between GSEs and Treasurys, and I was operating just to get the highest yield.” He added “I had no reason to believe it would be a conflict” for Snow.
- On the morning of February 3, 2003, the day Snow was sworn in, McCutcheon said he arranged for a broker to purchase 10 GSE bonds. The transactions were to be completed before Snow was sworn into office, he said. “It was my sincere intent to have all of those executed on that day,” McCutcheon said. As it turned out, nine of the 10 transactions were completed February 3, but one went through February 4. McCutcheon said he doesn’t know why all 10 GSE bonds weren’t bought February 3, saying it was an issue with the broker. He declined to give the name of the firm that executed the transactions. “It simply failed to get executed by the broker,” McCutcheon said. “As I understand it, even the fact that the one occurred the following day did not present a conflict of interest,” he said. McCutcheon said he handled the portfolio as a personal favor to Snow, not as an employee of CSX. “It’s common when you are busy as a CEO to ask trusted friends to help you out,” he said. “That is really the capacity I was operating in.” McCutcheon said he has periodically updated Snow on his holdings through phone calls and statements but did not recall ever discussing the GSE transactions with Snow.
- The transaction became a “hot-button topic” in Washington, when the Treasury disclosed that Snow had bought and sold GSE debt while in office. Many questioned whether Snow’s purchase and sale constituted an ethics violation, because he was actively promoting the White House’s effort to rein in the GSEs. A Treasury spokesman said Snow did not realize he owned the debt until recently and sold it shortly thereafter to avoid the appearance of impropriety. Some observers said the incident was an example of how investors often do not know the difference between Treasury debt, which the government explicitly backs, and GSE debt, which is not explicated, backed by the government.
- Kenneth R. Schmalzbach, the assistant general counsel and designated Treasury ethics officer, wrote in a May 18 memo that Snow’s financial dealings complied with all ethics laws and concluded that his actions did not have a direct and predictable effect on the GSE debt. In view of recent events, Schmalzbach will review any future changes to Snow’s investment portfolio, said a Treasury spokesman Womack Kolton, making a blind trust for Snow’s assets unnecessary.

- At Snow's request, Treasury's Office of Inspector General (IG) is also investigating whether Snow's ownership of the GSE bonds created a conflict of interest. Treasury's IG is reviewing "his ownership of those securities during a time that he was advancing the administration's positions on issues that affected Fannie Mae and Freddie Mac," said Rich Delmar, counsel to Treasury's IG. "Obviously we want to get this done as quickly as we can, consistent with following all the leads," Delmar said.
- If McCutcheon had followed Snow's orders and arranged for U.S. Treasuries to be purchased by the time Snow was sworn in and that's what happened, there would be no problem. But if McCutcheon had done what he was told and there was a similar hitch whereby some of the U.S. Treasuries had been bought after Snow was sworn in, Snow would be in hot water. Snow is barred as Treasury secretary from buying or selling U.S. Treasury securities while in office. "I was aware that the Treasury purchases would need to be completed before he was sworn in," McCutcheon said.
- Snow is still saddled with an investment in a venture capital fund he promised to liquidate early last year. According to his latest financial disclosure form, Snow still has an investment valued at between \$250,000 and \$500,000 in DLJ Venture Partners II, which has indirect investments in a company offering accounting services from India and in a cable company scarred by scandal. A Treasury spokesman said Snow has unsuccessfully tried to sell his share of the venture capital fund. "He's made every effort to divest his interest," Treasury spokesman Rob Nichols said. "The hold-up is, no one will buy it." As a limited partner in the fund, Snow doesn't control the investments made, Nichols said. "Any suggestion that this impacts his credibility is nonsense." Snow's financial disclosure forms for 2003 show that his assets were valued between a range of \$43 million to \$128 million, down by nearly half from 2002. (*Dow Jones International News*, Deborah Lagomarsino, 05/27/04; *American Banker*, Rob Blackwell and Michelle Heller, 06/01/04; *Dow Jones International News*, Deborah Lagomarsino, 06/04/04; *Reuters*, Jonathan Nicholson, 06/02/04; *Washington Post*, David S. Hilzenrath, 05/27/04; *American Banker*, Rob Blackwell, 05/27/04; Dow Jones Newswires, Deborah Lagomarsino, 06/04/04)

Oxley's "to-do list" doesn't include GSE reform

- House Financial Services Committee Chairman Michael G. Oxley (R-OH) said his legislative agenda for next year includes deposit reform and insurance regulation, but *off* his list altogether is regulatory reform for Fannie Mae and Freddie Mac. While Oxley is interested in a reform bill, he told a group of *American Banker* editors that he blames the Bush administration's broad reform demands for stalling it. Oxley said, "I think the votes were there," for a bill the committee was poised to vote on last October, but backed off after the administration pulled its support. He noted virtually all the Republicans on the panel and at least half the Democrats would have supported the bill creating a new regulatory agency inside Treasury to supervise Fannie Mae and Freddie Mac. At the time the fight was over how much control the Treasury

should have over a proposed new regulator. Now other obstacles to reform have emerged, including the administration's desire to give the new regulator receivership powers and impose limits on the GSEs' growth. Oxley dismissed speculation that Fannie and Freddie had foiled the bill. "The division there was so great once you started getting it beyond the change in regulator that it became virtually impossible to get a bipartisan bill," Oxley said. "Honestly, I don't think they wanted a bill in the first place for whatever reason," he said. "They have decided they are going to go the regulatory route. Having been around here for 23 years, I finally reached the point where I just thought it was such a moving target, we couldn't get there."

- Oxley made it clear that he thinks the issue requires congressional action, saying "There is no way you are going to get a world-class regulator without legislation. We were absolutely determined to do a good bill that had bipartisan support and created a new regulator and independent of the Treasury, independent of the White House, independent of the Congress. That was a worthy goal, but you don't live in a perfect world and there are differences of opinion as to what you want to try to accomplish here, but in this case I think the perfect became the enemy of the good and we missed a chance to really make the first real reform in GSEs."
- While the bill is likely to be revived next year, Oxley predicted it will not move unless the administration compromises or another crisis occurs at one of the GSEs. If the Democrats recapture the White House, legislation is even less likely next year, Oxley said. "I would think the ardor to reform GSEs would be far less in the Kerry administration than the Bush administration." Oxley says he is confident that President Bush will be reelected, and that Republicans will maintain control of the House and Senate. Besides running his own campaign, Oxley said he would work hard to help the President and other fellow Republicans win in Ohio, which is a swing state. Oxley noted that his disagreement with the administration over the GSE issue is an isolated incident and not a sign of a wider rift. (*American Banker*, Dean Anason, 05/25/04; *American Banker*, 06/04/04)

IMF backs Bush administration on GSE regulatory reform
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- The International Monetary Fund (IMF) backs the Bush administration's efforts to overhaul regulation of Fannie Mae and Freddie Mac. In its annual assessment of the U.S. economy, the IMF wrote, "The Administration has raised justifiable concerns regarding the large and increasing share of mortgage-backed securities held by the main government-sponsored enterprises. The growth of these institutions has concentrated interest rate and mortgage prepayment risk, and the Administration's proposal to overhaul the current supervisory regime and establish an independent regulator with powers to set capital requirements and put a GSE into receivership, if needed, warrants legislative support." (*Dow Jones International News*, John Connor, 05/25/04)

Fannie Mae CEO Raines and Freddie Mac SVP “hopeful” that GSE reform bill will pass

- At Fannie Mae’s annual meeting of shareholders, Fannie Mae chairman and chief executive Franklin Raines said he is hopeful that a regulatory reform bill will eventually pass. Raines reiterated that Fannie Mae supports a bill to create a strong regulator to oversee the housing GSEs. Despite widespread speculation that such legislation is dead, at least for this year, Raines said that Fannie Mae would continue pushing for it. “I’m optimistic that this process will work its way through to completion,” Raines said. “It may not be possible to predict the time frame, but we have a very big interest in seeing that this effort is successful, and it will continue to be a key focus and priority of Fannie Mae.” But “these things take time,” he said. “They raise complex issues, and they also generate strong views.” (*American Banker*, Rob Blackwell, 05/26/04)
- Speaking at a Sanford Bernstein investor conference, Raines was asked if the “political heat would drop in temperature” if Democrat John Kerry was elected in November. “I don’t believe our issues are partisan and I don’t believe termination (of proposed legislation) will depend on the occupants of the White House and Congress,” Raines responded. He also noted that the GSEs have had their ups and downs with both Democrat and Republican administrations. (*Dow Jones Newswires*, Jennifer Corbett Dooren, 06/03/04)
- At a Citigroup agency debt investor conference, Nazir Dossani, Freddie Mac’s senior vice president for investments and capital markets, said that “much of the rhetoric surrounding Freddie Mac and Fannie Mae appears to have taken on a life of its own.” He told the group of investors that “we understand that such headline risk and media noise is not comforting to long-term holders of our securities. “But we are confident that a consensus is emerging and that sensible, bipartisan regulatory reform will be enacted,” Dossani added. “The question is not ‘if’ but ‘when’ we will see such legislation.” (*Dow Jones Newswires*, John Connor, 05/27/04)

Partisans getting “testy” in GSE trenches

- With no prospects for enacting legislation this year to address regulatory reform for GSEs, lawmakers are shifting their focus to the Bush administration’s regulatory efforts, including a “controversial” HUD proposal to set higher affordable housing goals for them. The proposed goals, which would require Fannie Mae and Freddie Mac to finance more mortgages for low- and moderate-income homebuyers, have drawn concerns from both Republicans and Democrats. “It is clear this is an issue that will have a profound impact on America’s housing policy,” House Financial Services Housing and Community Opportunity Subcommittee Chairman Bob Ney (R-OH), said. “I intend to pay careful attention to this proposed HUD rule, as I know everybody else will be, to make sure there is no adverse impact on the well-functioning housing market in the United States.” While he agreed that the GSEs

should serve more families, Ney said he is worried that the rule could have an adverse impact on middle-income homebuyers. “My concern is that this proposed rule could force the GSEs to set higher interest rates for mortgage refinancing, which is what we do not want,” Ney said.

- Financial Services Housing and Community Opportunity Subcommittee ranking member Maxine Waters (D-CA) raised another concern by noting that HUD allowed its “bonus point” incentive program to expire last December. The program, giving the GSEs extra “points” for financing mortgages for certain targeted markets, were used in the calculation of the GSEs’ performance in meeting their affordable housing goals. “If you are going to take away the points and redefine how they can reach the goals, I am not sure that you are really serious about expanding the goals and having them reach them,” Waters said.
- House Financial Services ranking member Barney Frank (D-MA) told *CongressDaily* he will continue pushing for Congress to “ramp up” the affordable housing goals as part of a broader GSE bill. “In the legislation, which I wish the administration would stop blocking, I think we need to increase the goals, but also refine them,” Frank said. “I am not in favor of going forward the way HUD has proposed going forward.”
- On another front, Treasury claims it has authority to limit the issuance of debt by Fannie Mae and Freddie Mac. According to sources, the Bush Administration’s threatened administrative crackdown on Fannie and Freddie will get “rolling” this summer, which will take the GSE wars to a new level. Freddie Mac Chairman and Chief Executive Officer Richard Syron isn’t convinced that the Treasury has such authority, since its power in this area has been narrowly defined.
- While waiting for the balloon to go up, other partisans are getting a bit “testy” in the GSE trenches. Representative Frank (D-MA) recently told an analyst at Sanford Bernstein & Co. LLC, as the analyst summarized it, that “the Administration was engaged in the corporate equivalent of character assassination where the GSEs were concerned” and that Frank “believed that the Administration was intentionally targeting the companies’ stock prices to pressure them into ‘throwing in the towel’ and accepting the administration’s regulatory reform bill.” (*National Journal’s CongressDaily*, Molly M. Peterson, 06/01/04; *Dow Jones Capital Markets Report*, John Connor, 05/28/04)

GSEs have *just* the right mix of the “big and dangerous”
to generate one spectacular financial crisis

- Susan Lee writes in the *Wall Street Journal*, “Almost everybody knows that Fannie Mae and Freddie Mac, the two leveraged hedge funds pretending to be housing-finance companies, are big and dangerous. And every time there’s a change in interest rates, lots of investors hold their breath until Fannie and Freddie file their next financial statements.” In a recent speech by William Poole, the head of the

Federal Reserve Bank of St. Louis, discussed how vulnerable the financial system is to risks created by Fan and Fred. He pointed out that financial institutions should know better than to lend long and borrow short. Fannie and Freddie, which have debt maturing in one year at 34% of their total assets, must roll over \$30 billion of maturing obligations a week. “Given their thin capital cushions, Fan and Fred can look mighty shaky,” Lee writes.

- Fannie Mae and Freddie Mac depend on the market believing that their debt enjoys government backing which enables the GSEs to issue debt at interest rates just above Treasuries to fund purchases of higher yielding mortgage-backed securities. Since the GSEs borrow short and lend long, they face a mismatch in maturities leaving them open to interest-rate risk, which they hedge with derivatives called interest-rate swaps.
- The federal government insists that it does not guarantee the GSEs’ debt, which the Bush administration’s aggressive attitude over the past year appears to have successfully reinforced. Just recently, Standard & Poor’s announced that instead of evaluating Fannie’s and Freddie’s senior debt under the assumption of government backing, S&P will rate that debt more on the basis of their current financial conditions.
- Lee writes, “...What would happen if the market itself came to believe that the government would not bail out Fan and Fred? What might be the consequence of the market’s understanding of the real risk involved in buying their debt? The market’s first response would be to demand higher interest rates to cover the increased risk. As Fan and Fred came to roll over their short-term debt, they would find themselves forced to pay higher interest rates that, in turn, would zoom up the cost of their debt. A higher cost of debt, of course, would reduce the spread between their assets and liabilities...It’s almost impossible for Fan and Fred to hedge against this event because of something called basis risk. Basis risk is a standard problem in hedging strategies where the good being hedged is not identical to the good specified in the contract. Take, for example, the swaps used to hedge against a rise in interest rates. Fan and Fred enter into swap contracts in which they pay a fixed rate and receive a floating rate. So if interest rates go up, the amount they receive also goes up. But floating rates are based on the London Interbank offering rate. The risk is that if Fan’s and Fred’s cost of debt goes up, it will exceed the Libor rates they receive on their floating rate swaps. Thus, Fan and Fred are exposed to a certain amount of risk even with their hedging strategy: They will have to absorb the increased cost of interest payments on their debt, thereby reducing their earnings.”
- “A second problem could very well be impaired access to the credit market. Without the government guarantee, the risk associated with Fan and Fred debt would ratchet up, and there might not be enough willing buyers at any price. Not all of their short-term paper could be rolled over, and they would have to liquidate assets to redeem maturing obligations. Meanwhile, as soon as Fan and Fred became suspect, liquidity in the mortgage-backed securities market would decline. At the least, the market

would assume that Fan and Fred, under stress, will not be buying huge amounts of these securities. Or, worse, the market would anticipate that they'd have to unload securities in order to redeem maturing obligations -- especially after their liquidity reserves are exhausted. Either way, the market would try to get ahead of Fan and Fred by dumping mortgage securities. The value of MBSs would head south. Count this as a major pressure on Fan's and Fred's assets and therefore on their capital positions. And oh, as a major disruption in the mortgage market as well."

- "...[J]ust to top off this poisonous brew, consider what would happen if the market viewed Fan and Fred with serious suspicion. Counterparties to their enormous derivative book might demand collateral. Posting collateral would, in turn, deplete their reserves. Of course, some debt holders (and investors) could cash out; but not all can exit the market at the same time. A rush to the door would make Fan and Fred obligations illiquid in a matter of days. And, if your hair isn't standing on end yet, remember those inadequate capital positions -- Fan and Fred might pass quickly from paralyzing illiquidity to insolvency."
- "Now for the reassuring part. This insolvency scenario unfolds with a lot of assumptions and conditionals. It might turn out that the market behaves in a stately fashion, only gradually recognizing that the government guarantee doesn't exit. Such a dignified process might give Fan and Fred time to adjust their financial arrangements and avoid total disaster. And, it should be noted, Mr. Poole isn't suggesting that any of this bad stuff will happen. In fact, he emphasizes that he doesn't have any information indicating that "a crisis is at hand."
- "But ignoring the risk that Fan and Fred pose to the financial system isn't quite the answer, either. Their combined securities -- direct and guaranteed debt -- are larger than the federal government debt, and widely held. Simply put, they have just the right mix of the big and dangerous to generate one spectacular financial crisis." (*Wall Street Journal*, Susan Lee, 06/04/04)

NY Fed Reserve President Geithner says that Fannie and Freddie are the "arms race" in finance
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- In a speech before the Economic Club of New York, New York Federal Reserve President and CEO Timothy F. Geithner identified a number of "challenges" in the financial services industry, among which is "the degree of concentration in some core financial intermediation functions," specifically at Fannie Mae and Freddie Mac. "The two largest government-sponsored enterprises in the mortgage market now hold 36% of Agency mortgage-backed securities, as compared with less than 10% at the end of 1993," Geithner said. "The exposure of banks to these GSEs, primarily through holdings of the GSE debt funding these MBS positions, is as a consequence very large." He also noted that the two GSEs "now account for essentially all of the market for the clearing function for government securities and agencies, as well as for tri-party repo activity" and that "a relatively small number of institutions now account

for a large share of activity in the over-the-counter derivatives business generally, as well as in certain categories of risk-transfer instruments.”

- Geithner also pointed at hedge funds, referring to “parts of the financial system that are not subject to direct supervision and regulation of their capital and leverage ratios.” He said hedge funds, whose assets under management have doubled to \$750 billion since 1998, “can play a beneficial role in the U.S. financial system.” However, he warned, “intermediaries providing credit to hedge funds need to ensure that the terms and conditions of their provision of credit -- including the contingent credit that is an increasing feature of prime brokerage arrangements -- appropriately reflects the risks involved.” (*Federal Reserve Bank of New York Press Release*, Timothy T. Geithner, 05/27/04; *The Main Wire*, Steven K. Bronz, 05/28/04)

Global market for derivatives grew 43% over past six months

- The Bank for International Settlements reported that total derivative contracts reached \$170 trillion by mid-2003, up from \$127.5 trillion a year before and \$142 trillion six months ago, representing a 43% annual rate of growth during the last six months and 33% during the last year. Total contracts along with \$38 trillion in outstanding positions in exchange-traded futures and options bring the total size of the global derivatives markets to \$208 trillion. Randall Dodd, proprietor of the Derivatives Study Center in Washington, is concerned that the derivatives market is expanding at rates far higher than the growth of the underlying economy, suggesting that most trading in derivatives is more gaming than bona fide risk management. (*Dow Jones International News*, John Connor, 05/25/04)

Wall Street firms seeking lengthy transition to Fed’s new payment system
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- Wall Street firms are requesting a lengthy transition to the Federal Reserve’s new payment-systems policy for GSE, but the Fed doesn’t appear sympathetic. Earlier this year, the Fed said that it plans to implement changes in its payment system in 2006, which will require GSEs to pay up front for any cash payments the Fed makes on their behalf, eliminating billions of dollars in cash-management “wiggle room” for Fannie Mae, Freddie Mac and the FHLBanks. Comment letters on the Fed’s plan show that the industry is resigned to the changes, but many hoped to delay the transition.
- Richard Jones, the Atlanta Fed’s senior vice president and general counsel, responded “The Federal Reserve Bank of Atlanta views the entities involved...as sufficiently sophisticated and endowed with the needed incentives to organize an efficient transition to the new payment-system rules without further guidance,” Jones added that the Atlanta Fed sees no need for a phased-in approach. Jones’ letter recommends that the new policy take effect in July 2006, as proposed, with no further Fed action.

- Several major market participants warned of big disruptions if Wall Street can't get ready in time. "Such changes should come about gradually so as not to be disruptive to the market and to minimize the possibility of increased systemic risk resulting from an abrupt change," wrote Kathleen Voight, vice president of funds flow at State Street Corp, a major institutional money manager and securities transaction processor. Some warned that the changes could lead to payment delays that would unsettle market rhythms. "This may affect customers' expectations and behavior, which could impact the financial markets globally as a whole," wrote Jane Buyers Russo, managing director at J.P. Morgan Chase, Inc., one of the two major clearing banks for government securities.
- Fannie Mae, Freddie Mac and the FHLBanks will be most affected by the Fed changes because they are large issuers of debt. Neither Fannie nor Freddie submitted a comment on the plan and both have said publicly that they plan to work with the Fed on the transition. Other GSEs have weighed in, supporting the calls for a phase-in period. "It is our view that a phased approach would likely reduce the potential for significant, unintended payments-system mishaps," wrote the Federal Farm Credit Banks Funding Corp. The FHLB system said changes could affect the GSEs' core missions if the transition isn't smooth. "We would like to work with the Board to understand the alternatives that can be pursued ... with minimal impact on the capabilities of the FHLBanks to achieve their housing mission," wrote John Darr, managing director of the FHLBs' Office of Finance. Although several commenters called for a Fed-sponsored task force, the Fed so far has not taken any further action on the proposal, nor has it met with any issuers. (*OsterDowJones Commodity Wire*, Rebecca Christie, 05/25/04)

U.S. housing economists warn restraints on GSEs could imperil housing growth
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- On behalf of the Homeownership Alliance, economists from Fannie Mae, the National Association of Home Builders, the Independent Community Bankers of America, and Freddie Mac, published a forecast for America's housing industry, predicting a decade of steady house price rises and homeownership expansion in the U.S., but warned that restraints on the housing GSEs could imperil those gains. The economists forecast annual home price appreciation averaging 5% over the next 10 years. The economists anticipate that changing demographics, including immigration and population growth, along with tight inventory and building constraints will fuel demand over the 10-year period 2004-2013, even as interest rates rise. The economists said mortgage debt outstanding would grow 8.25% a year over the next 10 years and U.S. homeownership rate would top 70% from its current level of approximately 68%. Despite a recent appreciation in home prices propelled by a period of low mortgage interest rates, the economists do not anticipate a housing bubble collapse or even substantial reversals in regional markets. "The likelihood of a decline in home prices at the national level is quite remote. Even at a local level,

demand-supply conditions today are such that there are few, if any, markets that exhibit bubble characteristics,” they said.

- The economists warned that the housing market could be “dampened” by restrictions on housing GSEs. “Certain proposed changes in the regulation of government-sponsored enterprises could impair their ability to fulfill their secondary market role,” the economists said. (*Reuters*, Mark Felsenthal, 05/26/04)

GSE rumblings on presidential politics
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- Representative Barney Frank (D-MA), the ranking minority member on the House Financial Services Committee, told an analyst that the political climate surrounding Fannie Mae and Freddie Mac would improve instantly if Senator John Kerry (D-MA) wins the presidential election. On the other hand, Frank said a win by President George W. Bush in November would lead to a continuation of the administration’s attacks on the government-sponsored enterprises, or worse. Frank’s comments were reported by Rebecca Wolfe of Sanford Bernstein & Co., LLC, a subsidiary of Alliance Capital Management L.P., in a Bernstein Research Call report. (*Dow Jones, John Connor*, 05/28/04)
- Analysts Henry Dickons and Charles Reinhard of Lehman Brothers published a report that picks stocks likely to benefit from a Bush or Kerry win in November, The analysts write, “Government-sponsored Fannie Mae and Freddie Mac almost certainly would benefit from a Kerry win. These businesses have been under attack by doctrinaire conservatives. Fannie Mae is down 10% this year.” (*Chicago Tribune*, Bill Barnhart, 05/25/04)
- Russell Peralman, senior writer from *Smart Money* magazine said on *CNN FN*, “Fannie Mae and Freddie Mac [are] a big issue with republicans. They feel that they have an unfair advantage with mortgages. They don’t like the accounting chicanery that goes on in Freddie Mac. That is not a big issue for democrats. So we think that Fannie Mae will benefit [from a Kerry presidency]. We think that Fannie Mae is just undervalued to begin with. We think that it will have a much bigger advantage with Kerry.” (*CNN FN*, 05/24/04)

Fannie Mae

Fannie Mae inquiry widens

- Compensation of Fannie Mae's top executives is drawing scrutiny from regulators and lawmakers amid concerns that incentives may have encouraged overly aggressive accounting. OFHEO is examining Fannie Mae's "earnings per share challenge option grants" as part of its broader investigation of Fannie's accounting methods, according to people familiar with the matter. Lawmakers in the House of Representatives have asked OFHEO for further information on the compensation received by high-ranking officials at Fannie Mae and Freddie Mac.
- Armando Falcon Jr., the director of OFHEO, declined to confirm any specific issues involved in the investigation. Executive compensation was a central issue in OFHEO's separate investigation of Freddie Mac, said Falcon, adding "A big part of our review of Freddie Mac involved incentives created by compensation structures. So, you can't conduct an investigation of a company and not look at that issue."
- In January 2000 all Fannie Mae employees received the challenge options grants, linking the goal of doubling its per-share earnings by the end of 2003. Franklin Raines, chairman and chief executive, received 213,548 of the challenge options grants, while the other four top officials received more than 50,000 options. Fannie Mae's 2003 earnings per share of \$7.29 easily exceeded the Company's target of \$6.46 for the EPS challenge options, which became exercisable in January. OFHEO has said its investigation may require Fannie Mae to restate earnings, which could require top executives to return performance-based compensation based on revised numbers.
- Fannie Mae declined to comment on specific issues related to the company's compensation. In its annual report to shareholders, Fannie Mae says its compensation philosophy is based on pay for meeting long-term performance goals and comparable compensation with similar businesses.
- Separately, Representative Cliff Stearns (R-FL) and Representative Janice Schakowsky of (R-IL) wrote to Falcon this month seeking more details on the compensation of top officials at Fannie Mae and Freddie Mac. (*Financial Times*, Stephen Schurr, 05/28/04)

Readers respond to *Barron's* May 17th story on Fannie Mae's accounting

- In its May 17th cover story, *Barron's* reported that Fannie Mae is on shaky ground regarding how it records billions of dollars of losses and presents its financial appearance to Wall Street. To avoid recording a loss, Fannie Mae has used a "series

of legal mechanisms” to transfer negative numbers to its balance sheet under “accumulated other comprehensive income” (AOCI), which allows Fannie Mae to “burn off” losses over time.

- In a Letter to the Editor, Brett Crawford responded to *Barron’s* story by writing, “Let me thank you for the opportunity to purchase additional shares of a world-class financial company at a lower price. Jonathan R. Laing’s article about Fannie Mae (“Swept Away,” May 17), recognizes the complexities of accounting for derivatives, but fails to accurately describe the problem. The problem isn’t that Fannie Mae reports large unrealized losses in hedging derivatives, but rather that it can’t simultaneously report the equally large and offsetting unrealized gains in the underlying securities actually being hedged. Investors who don’t read the footnotes only see one side of the coin. The article describes large losses in the non-mortgage portfolio, primarily in manufactured-home loans and aircraft-lease paper. The numbers presented, while large in absolute terms, are small relative to Fannie Mae. The recent \$250 million write-down reduces shareholders’ equity by approximately 1% and current earnings by 3%. Double the losses and the company can still easily shoulder the burden. The article derides Fannie Mae’s asymmetrical exposure to future interest-rate increases. With rates at historic lows and a myriad of sound reasons why inflation and therefore rates will likely rise, management would be acting irresponsibly to assume otherwise. Shareholders and creditors alike should sleep soundly, knowing that Fannie Mae is well-protected.”
- Avner Mandelman writes in a Letter to the Editor, “Jonathan R. Laing’s article about Fannie Mae’s accounting was simply brilliant. The murky one-line items, the obscure accounting stratagems, the Soviet-type bookkeeping and self-dealing of state enterprises, abetted by the nomenklatura, all this was explained clearly. However, the impact on the market of Fannie’s going straight may be more than just on its own stock. Here is why: Fannie and Freddie Mac have to finance \$1.5 trillion a year, about 16% of the U.S. gross domestic product. It could be a problem that is beyond the Fed’s ability to handle. Why couldn’t the Fed print the problem away? It’s too darn big, that’s why. The Fed simply can’t handle Fannie’s and Freddie’s debt, if the market refuses to take it. If Fannie and Freddie have to pay higher rates for their short-term paper, it would drive all rates higher. Short-term rates are now made in the market, not by the Fed. (*Barron’s Online*, Jonathan R. Laing, 05/17/04; *Barron’s Magazine*, 05/31/04)

<p>Citizens Against Government Waste names Fannie Chairman Raines “Porker of the Month”</p>

- The Citizens Against Government Waste (CAGW) writes that “increasingly deluged with questions about its operations, accounting practices, and lobbying activities, Fannie Mae’s Teflon image is wearing off.” CAGW notes that OFHEO recently ordered Fannie Mae Chairman Franklin Raines to recalculate losses on some of the bonds it holds in its \$1 trillion portfolio, including \$8 billion in securities backed by

mobile homes and another \$300 million backed by aircraft leases. Meanwhile, Fannie Mae is resisting efforts by HUD to increase low and middle-income housing goals for the GSEs. While the GSEs spend millions of dollars on ads to improve their image and tout their commitment to helping low-income families purchase homes, Fannie Mae and Freddie Mac have consistently lagged the private market in catering to that population and fulfilling their Congressional mission.

- *Despite* ongoing Congressional and regulatory investigations, calls for tighter oversight, and sub-par performance in meeting its low-income housing mission, Fannie Mae's Board of Directors saw fit to boost Raines' compensation by 50% in 2003, to \$17.1 million. Raines' compensation package included \$196,000 in private jet travel and more than \$37,000 in tax counseling and accounting services at Fannie Mae's expense.
- CAGW points out that the GSEs have unique taxpayer-backed advantages, including tax exemptions and lines of credit at the U.S. Treasury, plus an implied taxpayer-backed guarantee, together worth about \$20 billion annually, according to CBO's most recent numbers. About one-third of that corporate welfare subsidy — or \$6.7 billion — is retained by GSEs' executives and their stockholders. While Raines publicly states that he is “fully supportive” of a stronger regulatory regime, Fannie Mae, under Raines' leadership, has spent millions of dollars on an army of lobbyists and public relations professionals to weaken and obstruct any attempts at reform on Capital Hill.
- “For administering and defending an impenetrable and questionable accounting regime, for heavy-handed meddling in the legislative process to protect the company's congressionally-protected status and its lavish corporate welfare program, and for potentially subjecting taxpayers to a massive bailout, CAGW names Fannie Mae Chairman Frank Raines its Porker of the Month for May 2004.” (*U.S. Newswire*, 05/26/04)

Fannie Mae is breaking into the auction-rate securities market
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- Fannie Mae, the largest provider of credit enhancement in the multifamily housing sector, is breaking into the “burgeoning” auction-rate securities market. During the week of June 7, the New York City Housing Development Corp. (HDC) will be selling \$130 million in 30-year, multifamily housing revenue bonds with a \$112 million tax-exempt, auction-rate series, carrying the long-term, triple-A credit enhancement from Fannie Mae. The balance of the HDC's \$130 million deal is federally taxable.
- The HDC deal incorporates a different type of credit enhancement from Fannie Mae. In the past, Fannie Mae has enhanced fixed-rate housing bonds with its triple-A rating and, as the use of floating rate debt has grown in popularity, the GSE has offered enhancement and liquidity - letters of credit or standby purchase bond agreements -

for conventional variable-rate demand obligations (VRDO). As auction-rate securities have grown in popularity, Fannie Mae is offering to enhance the product, which unlike VRDOs, does not require liquidity, making this structure very popular in the marketplace.

- To date, none of the traditional credit enhancers in the housing sector have agreed to back auction-rate products, but have instead structured such deals without enhancement or carried bond insurance. Fannie Mae believes it is time for the agency to diversify into enhancing auction-rate securities and said it expects other agencies, such as Freddie Mac, to follow suit. “Moving into auction-rate securities allows us a more natural diversification of our book of business,” said Daniel Cunningham, national director of the Fannie Mae’s national affordable housing team. “From our conversations we’ve received affirmation that auction-rate securities is where variable-rate, tax-exempt investing is going.” Cunningham said Fannie Mae is “looking at several deals. This one materialized fairly quickly. Once this one goes through, more people will see it as acceptable.”
- According to Thomson Financial, the volume of multifamily housing bonds sold in the auction-rate mode grew to \$1.3 billion last year from a mere \$135 million in 2002, while across the municipal market, auction-rate volume was up 75% to \$45.2 billion last year over the year prior.
- HDC president Emily Youssef said that having Fannie Mae as an enhancer in the market is significant because “it broadens the market of who can buy our bonds. Fannie Mae trades really well. Having them accesses another group of investors.” To date, Youssef said the HDC has completed one other auction-rate deal, which it sold through its double-A, open resolution credit and so did not require credit enhancement. (*The Bond Buyer*, Michael McDonald, 06/02/04)

Freddie Mac

Financial Services subcommittee asks OFHEO to clarify why the agency is concerned about the pay of Freddie Mac's top executives

- The House Financial Services Subcommittee on Commerce, Trade, and Consumer Protection asked OFHEO to clarify why it is concerned that the pay of Freddie Mac's top executives may have encouraged them to understate earnings by \$5 billion from 2000 until 2002. In a May 13 letter, the Subcommittee told OFHEO to explain by the following week how compensation for 20 executives at Freddie Mac and 23 at Fannie Mae "posed or continue[s] to pose an actual or potential conflict of interest." Referring to Fannie Mae, the subcommittee said it is "necessary to look at these issues as a prophylactic matter." Representative Cliff Stearns (R-FL) and subcommittee chairman, and Representative Janice Schakowsky (D-IL), the ranking minority member on the committee, signed the letter.
- In December, OFHEO said top Freddie Mac executives manipulated financial statements in order to reduce volatility in earnings. "Compensation of senior executives at Freddie Mac, particularly compensation tied to earnings per share," contributed "to the improper accounting and management practices of the enterprise," OFHEO Director Armando Falcon said in written testimony to the subcommittee on January 28. "Actions shifting earnings from one quarter to future periods helped ensure that earnings-per-share goals, and consequently the bonuses paid upon them, would be achieved," Falcon said.
- OFHEO spokeswoman Corinne Russell and Freddie Mac spokeswoman Sharon McHale didn't return calls for comment.
- The subcommittee told OFHEO to provide the names, titles, and job descriptions for the 20 Freddie Mac executives and 23 Fannie Mae executives whose salaries the regulator detailed in a letter on February 2. It also requested "the necessary explanation and analysis" on how compensation may create incentives that led to improper decisions in accounting and other areas. "We request your assistance in better focusing your response," said the letter to OFHEO. (*Bloomberg News*, James Tyson, 05/27/04)

Freddie Mac plans to release 2003 earnings by end of June

- Freddie Mac says it is working toward releasing its quarterly and annual financial results for 2003 by the end of June. "That is our goal," Freddie spokeswoman Sharon McHale said. Freddie Mac has not provided guidance on when the 2004 first-quarter results will be released. (*National Mortgage News Online*, 06/02/04)

- Peter Eavis writes in *RealMoney* that when the GSE's 2003 results are released, "a back-of-the-envelope calculation suggests that [Freddie Mac] could be worth \$72 a share, which is 25% above current levels. Interestingly, applying the same valuation approach to its rival Fannie Mae clearly shows that this other large, government-sponsored enterprise is substantially overpriced, and its stock would have to drop by half to be appropriately valued." (*RealMoney*, Peter Eavis, 05/27/04)

Freddie Mac's mortgage portfolio shrinks for sixth month

- Freddie Mac said its loan portfolio contracted for a sixth straight month in April. The portfolio, which provides about two-thirds of the company's profit, shrank by \$4.1 billion at an annualized rate of 7.8% to \$631.5 billion, Freddie Mac said. Freddie Mac (and Fannie Mae) "still need mortgage-backed securities to cheapen at least 10 basis points on a sustained basis to resume double-digit annual growth in the third quarter," said James Vogel, head of agency debt research at FTN Financial in Memphis, Tennessee.
- Freddie Mac also said its duration gap was unchanged at zero months in April. The GSE also reported its single-family non-credit enhanced delinquency rate was 25 basis points in April, down from 27 basis points in March. (*Bloomberg News*, Al Yoon, 05/26/04; *Reuters*, 05/26/04)

Freddie's SVP –Investments & Capital Markets discusses counterparty risk

- In a speech at the Citigroup Agency Debt Investor Conference, Nazir Dossani, Senior Vice President –Investments & Capital Markets, discussed how Freddie Mac manages the GSE's exposure to the creditworthiness of their counterparties. Dossani said, "...distributing interest-rate risk using derivatives creates another kind of risk – namely, exposure to the creditworthiness of the counterparty with whom we are doing business. We have made extraordinary advances in the past few years in our management of derivative counterparty risk. We have a highly diverse, numerous set of counterparties, and the credit ratings of these counterparties are also quite high. We require collateral posting for all net exposures from all but the highest-rated counterparties, and for most of these parties we are obtaining collateral on a "T+1" basis, meaning our exposures are collateralized basically on an overnight basis. And, most important, we have synthesized our management of interest-rate and counterparty risks. We have developed our systems to the point that our operating managers and traders have a real-time understanding of our exposure to a given counterparty. This enables us to execute interest-rate trades in a manner that often permits us to reduce our net exposure to a counterparty at the same time." (*Freddie Mac Press Release*, Nazir Dossani, 05/20/04)

Christina Seix resigns from Freddie Mac's board

- Freddie Mac announced that Christina Seix resigned from the company's board of directors due to a potential conflict of interest. A board member since 1990, Seix is also been chairman and chief executive of Seix Investment Advisors Inc., an investment management firm, which is being acquired SunTrust Banks, Inc. Following completion of the transaction, Seix will be a senior officer of SunTrust Banks, said Freddie Mac spokeswoman Sharon McHale. "SunTrust is a Freddie Mac customer, so that would potentially create a conflict of interest," McHale said.
- Following Seix's departure, Freddie Mac board will have 12 members. "The board, through its nominating committee, will conduct a search for a new board member to replace her," McHale said. On March 31, Freddie Mac shareholders elected 13 board members, including 11 current members. (*Reuters*, 05/28/04)

Freddie Mac spends \$15.9 million on lobbying Congress in 2003

- According to the nonpartisan PoliticalMoneyLine, General Electric and Freddie Mac led U.S. companies in 2003 lobbying expenditures, which reached a record \$2 billion for the year. GE spent \$17.2 million and Freddie Mac \$15.9 million on lobbying, according to disclosure records. (*Washington Post*, 06/02/04)

Freddie Mac's general counsel focuses his attention on lobbying

- This spring, Freddie Mac hired Ralph Boyd, Jr., a recent veteran of the Bush administration as its general counsel. The GSE's choice was a clear signal that the troubled company, under fire from regulators and legislators, needed more than just a lawyer. Boyd's political connections as a former top appointee in the U.S. Department of Justice will come in handy as he oversees both lobbying and legal matters for Freddie Mac. "The expectation is that I will certainly be one of the faces of Freddie Mac, both to Congress and to the public," says Boyd, who joined the company in April.
- Joan Donoghue, Freddie Mac's acting general counsel, has assumed the newly created position of principal deputy general counsel, responsible for the day-to-day operations of the 85-attorney law department. By delegating duties to Donoghue, Boyd has more time to spend on his second area of responsibility—lobbying for Freddie Mac. Given the GSE's governance lapses, concerted oversight of lawyering and lobbying is necessary at Freddie Mac, Boyd says. "There needs to be the impression that this is a modification," said Boyd. Freddie Mac's image was further tarnished when top lobbyist R. Mitchell Delk resigned in March after the FEC opened an investigation into his fund-raising activities. Lobbying has become even more crucial for Freddie Mac, as it faces criticisms from U.S. Department of the Treasury

secretary John Snow, Federal Reserve Board chairman Alan Greenspan, and members of Congress, who are currently considering GSE regulatory reform legislation, endorsed by the Bush administration.

- Boyd's role in the GSE's lobbying could mark a turning point in Freddie Mac's approach to lobbying, says Richard Carnell, a Fordham University law professor and a former assistant secretary for financial institutions in the Treasury Department. According to Carnell, Freddie Mac has historically been less heavy-handed in its lobbying than Fannie Mae. "At Fannie Mae, there are mostly political people at the top, people who they figured could be heavy hitters," Carnell notes, including Fannie Mae chairman Franklin Raines served as director of the OMB under President Bill Clinton. By picking Boyd, a recent veteran of the Bush administration, Freddie Mac seems to have embraced the Fannie Mae's political strategy. "Given Freddie's recent troubles," Carnell says, "it makes sense to have a general counsel who is squeaky clean and can help rebuild credibility on Wall Street and in Washington." (*Corporate Counsel*, Lily Henning, 06/01/04)

Freddie Mac Foundation appoints two new board members
and elects CEO Syron chairman

- The Freddie Mac Foundation board of directors elected Freddie Mac Chairman and CEO Richard F. Syron chairman of its board. Michelle Engler, an attorney and trustee of Investor Series Trust and Freddie Mac board member and Dwight P. Robinson, senior vice president, corporate relations for Freddie Mac, were also appointed to the Foundation board of directors. Engler is also the wife of former Michigan governor John Engler. (*Freddie Mac Foundation Press Release*, 06/03/04; *Washington Business Journal*, Jeff Clabaugh, 06/03/04)

Federal Home Loan Banks

Representative Frank seeks to ease FHLBank membership rules

- Representative Barney Frank (D-MA) is floating a plan that would make it easier for commercial banks to belong to more than one FHLBank. Commercial banks, and thrifts and unitary thrift holding companies are not allowed to belong to more than one of the FHLBanks, while a bank holding company may have separately chartered subsidiaries that belong to different FHLBanks. "I've proposed a compromise that ...we should ask" the Federal Housing Finance Board "to accept multimemberships in the limited situation ...that when there is an acquisition, the acquired bank should be allowed a multiple membership for the purpose of allowing the acquired bank to stay in the regional system it has been in," Frank said. "With all the other concerns about mergers, if the bank that is being acquired has to tell the people in its area, 'Oh,

by the way, a consequence of this merger is the [region's] affordable housing program is going to lose money,' then you're going to have more resistance.”

- In January, Frank brokered a deal in which Bank of America agreed to keep Fleet's membership in the Home Loan Bank of Boston by taking out a special charter, whose sole purpose is to make it a member of the Boston Home Loan Bank.
- Frank said that because unitary thrifts cannot hold more than one charter, he is “trying to find a way for this to happen” in Sovereign's acquisitions in New England. Sovereign belongs to the FHLBank-Pittsburgh, while the Massachusetts banks belong to the FHLBank-Boston. If the rules are not changed, “revenues to the Home Loan Bank [of Pittsburgh] will be generated in New England and used for affordable housing in Pennsylvania,” Frank said.
- A spokeswoman for Sovereign said it supports Frank's proposal. A spokesman for the FHLBank-Pittsburgh did not comment on the plan, but referred a reporter to the Bank's 2002 comment letter sent to the Finance Board, advocating multidistrict membership. “Permitting an institution that combines with another member to maintain the membership of the member that is acquired is in the best interest of the bank system,” the letter said. A spokesman for the FHLBank-Boston said its board has not taken a position on the idea.
- Sheila Bair, a former Treasury Department official, expressed concern about Frank's proposal. “I don't think you can do it from a statutory standpoint,” said Bair, now a professor at the University of Massachusetts Amherst. “The statutory language is fairly explicit, and my interpretation is that it doesn't allow for multidistrict membership. You'd have to get a statutory change.” Blair first articulated that position in 2002 on behalf of the Bush administration, when she was the Treasury Department's assistant secretary for financial institutions. Her successor, Wayne Abernathy, reiterated that position last year before the Senate Banking Committee, noting that a “plain reading” of the law “finds little room to conclude that the Finance Board has the legal authority” to approve a multidistrict arrangement. Abernathy indicated that if Congress wanted to change the law, the Treasury would not stand in its way. “There are compelling arguments on both sides of the question with regard to the advisability of multidistrict membership,” he said. “It is to the Congress that these arguments should be offered and where any change in the statute will have to be made.”
- Frank would not say if he will push for legislative change if he cannot achieve his goals through regulation, because he is “in the process of negotiation.” Bair suggested that instead of trying to change the law, “an alternative would be just for the Federal Home Loan Bank of the surviving institution to work out an arrangement with the Federal Home Loan Bank of the acquired institution to retain affordable housing program contributions.”

- Proponents of multidistrict membership said linking the debate to affordable housing could make it more viable politically. “What Barney Frank has done is reduced” the debate “to what the real issues are, which is making it possible for Home Loan banks to be responsive to local needs after consolidation,” said Alfred A. DelliBovi, the president of the FHLBank-New York. (*American Banker*, Michele Heller, 05/27/04)

Fannie and Freddie’s “headline risk” driving Asian investors to FHLBank debt
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- Overseas investors, particularly Asia, have grown “fond” of bonds issued by the FHLBanks, while turning their backs on Fannie Mae and Freddie Mac debt. This trend reflects the increased political and regulatory scrutiny of the Fannie and Freddie that the FHLBank has managed to evade so far. Asian investors have “become increasingly comfortable with FHLBank debt, particularly because they offer fewer headaches from negative headlines,” said Paul Garavente, an agency trader at Nomura Securities International.
- The proof comes in the FHLBank’s latest bond sale, a \$3 billion, 10-year global bond priced on May 22, with 34% was purchased by Asian investors--the highest percentage ever registered for an FHLBank 10-year global debt offering. Domestic investment in the bonds was also strong at 56%, while European investors accounted for 9% of the deal.
- In contrast, demand for Fannie Mae’s \$4 billion five-year benchmark note sale that week saw very light buying out of Asia of only 11%. Asian investors bought 18% of Freddie Mac’s \$4 billion three-year reference note in April. Historically, Asian investors used to purchase between 20%-30% of bond offerings by Fannie Mae and Freddie Mac, dealers said.
- “Overseas, FHLBank is certainly benefiting at the expense of Fannie and Freddie,” said Peter Loftus, first vice-president and senior portfolio manager at HSBC Bank USA. “They (overseas investors) have grown weary of all the negative headlines surrounding Fannie and Freddie and so have I.” He added, “FHLB has amazingly managed to go under the radar amid this ongoing negative news. These headlines aren’t ending anytime soon.” Loftus, who manages a \$1.5 billion fixed-income portfolio, said he recently sold some of his Fannie Mae and Freddie Mac holdings in favor of FHLB debt. Loftus’ agency holdings total \$250 million.
- The FHLB partly attributes its success in Asia to its ongoing marketing campaign there. Bank representatives visited the region earlier this year to meet some first-time investors and to renew contacts with others it had previously visited, according to Mike Ciota, spokesman for the FHLB’s Office of Finance. Another reason could be structural, Ciota said. “It is likely that as a cooperative, we are viewed as less risky.” (*Dow Jones Capital Market*, 05/26/04)

Ginnie Mae

Federal Housing Finance Board conducting joint study with HUD on housing goals

- FHA/VA has lost market share to rivals Freddie Mac and Fannie Mae. Therefore, writes Karen Kibayan in *Asset Securitization Report*, “it is probable that the credit profile of the average FHA/VA borrower has declined and moved closer to subprime collateral.” Robert Young, an analyst at Citigroup, said “The decline in GNMA market share suggests that the credit quality of the typical FHA/VA borrower has changed over time - that is, borrowers with better credit have migrated to conventional programs.” Thus, FHA/VA pools could consist of lower-credit borrowers, manifesting through delinquency rates, which have increased in the last several years while GNMA’s market share has declined. In terms of prepayment speeds, increased delinquencies should boost speeds on discount mortgages. Further, if home prices were to weaken, this would probably increase the frequency of assumptions and limit the ability of FHA/VA borrowers to trade up, Citi said. In this instance, Citi predicts that the associated increase in delinquencies serves to counteract this effect, especially during the first couple of years of seasoning. (*Asset Securitization*, Karen Kibayan, 05/24/04)

Farm Credit System/Farmer Mac

GAO says Farmer Mac needs higher capital requirements and tougher regulation

- David D’Agostino, GAO director of financial markets and community investment, testified in a House Agriculture Committee hearing that the Federal Agricultural Mortgage Corp. (Farmer Mac) needs stronger capital standards and tougher regulation because of the risks in its investments. Stricter regulation “is especially important given Farmer Mac’s increasing risk portfolio” and its holdings of “non-mission related assets,” said D’Agostino. “Farmer Mac risk management systems have not kept pace with its increasingly complex portfolio,” she added. Last October, GAO said in a report to Congress that Farmer Mac must improve its corporate governance and methods for reducing risk.
- D’Agostino said GAO has recommended to Farmer Mac that it re-evaluate its current strategy of holding agricultural mortgage-backed securities (AMBS) in its portfolio and issuing debt to obtain funding. “[B]ecause Farmer Mac has elected to retain nearly all its AMBS in its portfolio instead of selling them to investors in the capital markets, [GAO] could not ascertain the depth and liquidity of the secondary market for AMBS, which is unknown even in good market conditions,” D’Agostino said. She said that during 2003, 80.8% of Farmer Mac I loans--agricultural and rural housing mortgage loans that do not have primary mortgage insurance provided by the

Department of Agriculture--were made within 10 financial institutions. While GAO found that Farmer Mac had improved in fulfilling its mission of providing a secondary market for agricultural real estate and rural housing loans and increasing agricultural mortgage credit, GAO pointed to the concentration among few institutions as a reason for Congress to set "clearer mission goals" for GSE.

- "Holding relatively high proportions of non-mission investments invites speculation that GSE status is being used to generate what amounts to arbitrage profits," testified Gregory Zerzan, the Treasury Department's deputy assistant secretary for financial institutions. "Farmer Mac continues to maintain the highest percentage of non-mission investments among all the GSEs," Zerzan said. As of December 31, Farmer Mac's investment portfolio accounted for 25% percent of its total assets, he added. From 1996 to 2003, Farmer Mac's portfolio grew more than 10-fold from \$150 million to \$1.7 billion, Zerzan said.
- Zerzan also suggested that Congress should take another look at whether Farmer Mac is really needed. "While Farmer Mac's role in agricultural mortgage markets has increased, whether Farmer Mac's increased business activity contributes to achieving a significant public purpose remains an issue that Congress should evaluate," he told the Committee. Zerzan said Farmer Mac's broad mission statement makes it difficult to gauge how well the GSE is meeting its goal of providing a secondary market for agricultural real estate markets. While Farmer Mac has supported farm lending by buying loans from farm lenders, there is "no active secondary market" in Farmer Mac agricultural mortgage-backed securities, said Zerzan. "If the goal of creating Farmer Mac was to create another specialized agricultural lender, as opposed to developing a viable secondary market for AMBS, then Farmer Mac has been more successful in achieving its mission. Whether such an activity constitutes a meaningful public mission is one (issue) that Congress should carefully consider."
- Treasury is scaling back its limited oversight of Farmer Mac, Zerzan said, adding that Treasury had monitored the GSE's financial condition during a transition period to new capital requirements, in a joint effort with the FCA. Treasury will still keep an eye on Farmer Mac but would like to distance itself somewhat from FCA, he added. "Having FCA provide an advance copy of [periodic financial] report[s] for Treasury to review, or having Farmer Mac or FCA continue to reference a joint monitoring arrangement with Treasury, may inadvertently provide the false impression that Treasury exercises some form of oversight of, or responsibility for, Farmer Mac," Zerzan said. "Treasury plays no such role."
- Zerzan said Treasury has not changed its view of Farmer Mac's line of credit with the Treasury as set forth in its 1997 opinion, saying the line of credit probably couldn't be used to fulfill guarantees on Farmer Mac securities owned by Farmer Mac or its subsidiaries. That view still holds, he added. "Investors in Farmer Mac securities should rely on the underlying credit quality of Farmer Mac when making investment decisions, not on any potential access to a line of credit with Treasury," Zerzan said.

- Farmer Mac executives testified that Farmer Mac is meeting its goals, managing its risk appropriately, and generally operating in a safe and sound manner. “Farmer Mac is accomplishing its Congressional mission of increasing the availability of long-term mortgage credit to farmers and ranchers at stable interest rates by providing greater liquidity and lending capacity to agricultural lenders through a secondary marketing arrangement for qualified mortgages,” said Farmer Mac’s chairman Fred Dailey and CEO Henry Edelman, in a joint statement. “The non-mission related assets are very high quality assets and we are very comfortable with those,” Edelman told reporters during a break in testimony. “They represent a rapidly diminishing percentage of our total business.”
- Farmer Mac executives testified that Treasury’s view of the line of credit shouldn’t have an adverse impact on investors. “No issue has been raised as to the availability of Farmer Mac’s statutory Treasury line of credit relative to AMBS held by parties other than Farmer Mac,” Dailey and Edelman said. “If Farmer Mac were coming under pressure to fund its guarantee obligations, it would sell to third parties any AMBS it held long before it needed to access the Farmer Mac Treasury line of credit,” said the Farmer Mac executives.
- FCA Chairman Nancy Pellett said her agency will continue to strengthen its oversight of Farmer Mac. “I believe we are well positioned to address any challenges to ensure Farmer Mac has the capability to remain successful in the future,” Pellett testified. (*Bloomberg News*, James Tyson, 06/02/04; *Dow Jones Newswire*, Rebecca Christie, 06/02/04; *Daily Report for Executives*, Marcia Kass, 06/03/04)

CoBank’s acquisition plan?

- Bert Ely reports in *Farm Credit Watch (FCW)*, “In an April 1 article in the *Denver Business Journal*, appropriately headlined ‘CoBank quietly grows into a giant,’ CoBank CEO Doug Sims boasted that ‘I think this bank will continue to grow...It will be significantly bigger five years from now than it is today.’ What was most puzzling about the article were several references to acquisitions. For example, a \$200 million preferred stock issuance last November ‘boosted CoBank’s financial flexibility for making acquisitions.’ Sims stated that ‘We always are looking [for acquisitions], but nothing on the plate that I can talk about.’ He also said “CoBank could ‘easily’ acquire an entity with \$2 billion to \$3 billion in assets.” Being rather puzzled as to what types of acquisitions CoBank could make (other than merging with another Farm Credit Bank), *FCW* has asked FCA ombudsman Carl Clinefelter what legal authority CoBank has to make acquisitions outside the FCS. *FCW* looks forward to hearing from Clinefelter regarding CoBank’s acquisition authority. (*Farm Credit Watch*, Bert Ely, 05/04)

Postal Service

Senate Governmental Affairs Committee unanimously
approves Postal Reform legislation

- The Senate Governmental Affairs Committee unanimously approved S. 2468, a bill to overhaul the Postal Service for the first time in three decades, giving the USPS greater rate-setting flexibility and the ability to respond to market forces more like a private business. In a 17-0 vote, the committee approved the bill largely based on a postal reform bill written last year by Senator Thomas Carper (D-DL). Carper said that S.2468 improves on his previous bill in the area of health benefits for postal retirees. A similar postal reform bill (H.R. 4341) was approved in May in the House Government Reform Committee. House and Senate aides said they expect floor votes on the bills sometime in June.
- Governmental Affairs Committee Chairwoman Susan Collins (R-MA) said she hopes “the comprehensive bipartisan legislation we have drafted would put the Postal Service on stronger financial ground.” She also noted the numerous bipartisan cosponsors, as well as broad support for the bill among postal employers and supervisors, commercial mailers and postal competitors.
- After accepting a manager’s amendment from Collins that made minor changes to the underlying legislation, the committee approved on a 9-8 roll call vote, an amendment from ranking member Joseph Lieberman, (D-CT), limiting the Postal Service’s ability to offer work-share discounts to mailers. The Lieberman amendment was the only serious sticking point in the committee’s consideration of the bill. Work-share discounts are incentives offered to postal customers who perform tasks that otherwise would be done by the Postal Service. The underlying bill would prohibit work-share discounts that exceed the savings seen by the Postal Service with five exceptions. The Lieberman amendment would strike the exception for a catchall provision allowing the Postal Regulatory Commission to approve excessive discounts. The amendment also would amend an exception that allows excessive discounts for new postal products and services. The amendment provides a four-year sunset provision. Carper supported Lieberman’s amendment, saying it would “close a loophole in our bill.” Lieberman said his amendment would facilitate an easier conference on the bill, since the House Reform Committee’s postal bill includes the same four-year time frame. Collins argued that the underlying bill would sufficiently limit the work-share discounts for new services, because it already would require them to be phased out over time. “The Lieberman amendment is very prescriptive, and it would eliminate the flexibility that has already been demonstrated as beneficial for both the Postal Service and its customers,” she said. Ultimately, the committee approved the Lieberman amendment on a party-line vote, with only Senator Arlen Specter (R-PA) who voted by proxy, going against his party.

- The committee accepted by voice vote an amendment offered by Senator Richard Durbin (D-IL) calling for a GAO study to determine the feasibility of offering postal rate incentives to mailers who use a certain amount of recycled paper. By voice vote, the committee also accepted an amendment from Senator John Sununu (R-NH) to move the responsibility for developing accounting standards for pricing competitive mail products from the Postal Service to the Treasury.
- *Direct Magazine* reports that “Mailing groups were optimistic the Senate Governmental Affairs Committee’s unanimous passage of its postal reform bill would finally translate into legislation this year, even with a controversial amendment about ending postal worksharing discounts.” “This is as far as we’ve ever gotten,” said Neal Denton, executive director of the Alliance of Nonprofit Mailers. “As one senator said, this is a once in a generation opportunity.” (*CongressDaily*, Zach Patton, 06/02/04; *Alliance Report*, 06/03/04)

Less than letter-perfect postal reform
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- James L. Gattuso writes in a WebMemo at the Heritage Foundation, “The good news is that [postal reform bills H.R. 4341 and S. 2468] would implement some welcome changes in the way the U.S. Postal Service operates. The bad news is that they fall short of the kind of real transformation that is needed and would saddle taxpayers with billions in postal costs. Congress can and should deliver more than this disappointing package.”
- “[T]he House and Senate bills fall far short of the comprehensive reform that is needed, and they would in some ways would make the current situation worse. Among the problems:”
- “The bills provide for billions in new subsidies for the Postal Service. The legislation relieves the Postal Service for paying some \$27 billion over the next few decades in pension benefits due to postal retirees for prior military service. These obligations, however, are Postal Service costs, triggered by retirees’ postal employment, and part of the total compensation paid to employees for postal work. Taxpayers should not be saddled with this burden.”
- “The bills keep in place—or even expand—political restrictions on USPS’s ability to cut costs. For instance, the Postal Service would continue to be banned from closing post offices because they run a deficit. Moreover, the bills ignore a proposal by the President’s reform commission to streamline the closure of other facilities through a process similar to that used to close unneeded military bases. The bills also would limit the ability of the Postal Service to use “workshare” agreements, under which private users take over some mail processing functions in return for lower rates.”

- “While the bills whittle away at several of the special privileges enjoyed by USPS, they barely scratch the most important one: the statutory monopoly that makes it illegal for anyone else to deliver letter mail. This monopoly should be repealed. Short of that, there are a number of important changes that could be made. The President’s postal reform commission, for example, proposed giving the Postal Regulatory Commission authority to determine the extent of the monopoly, rather than let the Postal Service itself define its own monopoly’s limits.”
- “Many elements of the postal reform legislation now pending in Congress are welcome steps in the right direction. Yet, it falls far short of the comprehensive transformation of the mails that USPS requires—and American consumers deserve.” (*Heritage Foundation Webmemo #514*, James L. Gattuso, 06/01/04)

<p style="text-align: center;">Postmaster General warns that postal reform contains “costly” problems</p>

- In a speech, Postmaster General Jack Potter said that he anticipates the need for a rate increase in 2006 that will be “over and above” previous USPS forecasts. Unless further legislative changes take place to the Civil Service Retirement System (CSRS), a provision in the CSRS legislation could result in the need to generate \$3 billion in the next rate filing beyond forecasts, said Potter. While the 2003 legislation corrected the overpayments, it also put in place a requirement for the Postal Service to place the savings in escrow beginning in 2006 and the law transferred responsibility for military retirement benefits of postal employees from the Treasury to the Postal Service, adding a \$28 billion obligation.
- Potter is counting on postal reform bills introduced in both the House and Senate this month, both of which include language that would eliminate these burdens being placed on postal ratepayers. However, Potter expressed concern about other provisions of the bills, such as the requirement that the USPS to prefund health benefit retirement obligations. “Our evaluation indicates the costs could be as high as \$3.9 billion in 2006,” he said, “or a 6.5% rate increase over and above our forecast.” Potter is also concerned about the provisions dealing with pricing flexibility in competitive and noncompetitive product lines. “The language will likely result in added costs being shifted to packages,” he said. “That could result in significant upward price pressure, which could put \$2.5 billion in contributions we gain annually from our package services in jeopardy. That loss of contribution would have to be borne in higher rates on other classes of mail.”
- Potter had promised that postal rates will not increase until 2006. If the USPS has to prepay those benefits, he said, the cost will *add* just over 2 cents to whatever increase would have been necessary in the current 37-cent first-class rate. (*Catalog Age*, 05/26/04; *Washington Post*, Randolph E. Schmid, 05/27/04)

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