

The **GSE** REPORT™

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Major Events

Freddie Mac provides market update for 2004 and announces plans to resume financial reporting “on time” in 2006

- Freddie Mac won't provide timely financial statements until early in 2006, postponing its registration with the SEC until the middle of that year at the earliest, said company executives. Fannie hasn't reported its financial results on time since late 2002, when the company discovered widespread accounting problems that forced it to restate several years of earnings. Freddie Mac has delayed its statements to sort out its accounting problems and revamp internal systems, something Chief Executive Richard Syron said still needs a lot of work.
- In a conference call with investors, management said the company expects to report its 2004 earnings statements by March 2005 and hopes to release its first- and second-quarter 2005 results by the end of August and its third-quarter earnings by mid-November. Management has set a goal of filing its fourth-quarter and full-year 2005 results on time in early 2006. “These are aggressive objectives and we can't guarantee that we are going to hit each and every one of these target dates,” said Chief Financial Officer Martin Baumann. “However, our senior management team is committed to getting this job done right and we believe we have the right people and plans in place to make it happen.” To help the company deal with its accounting problems, Freddie Mac has hired 2,800 consultants from PricewaterhouseCoopers LLP and other firms, equivalent to about 60% of the GSE's 4,800 permanent employees.
- The SEC is reviewing a NYSE proposal to crack down on late filers, which would formalize the agency's existing policy to notify investors and delist firms that are nine months or more late in filing audited financial results to the SEC. While Freddie Mac and Fannie Mae agreed in mid-2002 to register with the SEC, Freddie's accounting problems have delayed its registration until mid-2006. Freddie Mac spokesman Michael Cosgrove said the GSE has fully briefed the NYSE on its future plans to file its financial statements.
- “[Freddie's delay of timely filings is] a little disappointing,” said Paul Miller, an analyst at Friedman Billings Ramsey. “They are dragging their feet. The solid answer is that we have to wait a year and a half to get solid answers” on Freddie Mac's financial results, he said. Mel Miller, chief investment officer for Heartland Financial USA, said Freddie Mac's value to shareholders hinges on whether Syron satisfies investors that he will resume timely financial reporting by the second quarter of 2005. “They'd better meet the expectations for their accounting changes or they'll suffer in the market,” said Miller. David Dreman, chairman and chief investment officer of Dreman Value Management LLC, warned that investors wouldn't easily

forgive late or inaccurate financial results from Freddie Mac. Company executives “have to be very, very careful,” Dreman said. Among investors, regulators, and lawmakers “there is zero tolerance,” he added.

- Freddie Mac’s growth in mortgages and mortgage-backed securities that it holds in portfolio will slow to the low- to mid-single digits this year, said management. The company reported a 2.3% growth rate in its retained portfolio during the first nine months of 2004 to \$660.7 billion as of September 30, up slightly from \$645.5 billion on December 31, 2003. Freddie Mac said most of its portfolio growth stemmed from securities backed by home equity loans, subprime mortgage loans, and other mortgage-related asset-backed securities. “Mortgage-related investment opportunities in fixed-rate products have not been as attractive to us because strong demand from other investors, coupled with lower mortgage loan originations, have generally resulted in unattractive mortgage-to-debt option-adjusted spreads,” Freddie said. Ed Groshans, an analyst with Fox-Pitt Kelton, noted that Freddie Mac’s increased entry into the subprime market is something HUD is encouraging with its new affordable housing rules that push the GSEs to finance more low-income loans. “You’re going to see more (subprime) activity and lower credit quality mortgages coming through,” he said. “I think going forward, you’re going to see the nonprime market become a bigger driver of their mortgage growth.”
- Freddie’s volume of new purchases dropped by more than 42% during the first nine months of 2004 to \$383.8 billion compared to \$668.5 billion during the first nine months of 2003. The volume of refinancings also dropped sharply from \$631.1 billion during the first nine months of 2003 to \$308.7 billion during the corresponding period in 2004. Freddie Mac also experienced a slowing in growth of its mortgage guarantee business with the company guaranteeing \$1.202 trillion in mortgages as of September 30, up just 3.4% over the previous nine months from \$1.162 trillion at December 31, 2003.
- “This will be their slowest retained growth rate in probably 15 years,” said Bruce Harting, a Lehman Brothers equity analyst. “We’re not [fazed] or surprised by what they reported today. This is right in line, right on target...There isn’t pressure on the [GSEs]...to really grow this year.” As Freddie Mac’s accounting concerns are addressed, Freddie Mac’s chairman and CEO Richard Syron must still justify the company’s declining rate of growth, said James McGlynn with Summit Investment Partners. Syron needs to specify “why business has bottomed and why everything is up from here,” said McGlynn. “How will they manage in an environment of fewer home sales?” According to *Bloomberg News*, ten analysts have “buy” recommendations for Freddie Mac, while six analysts rate the stock a “hold.”
- Management also announced that Freddie Mac has discontinued the use of hedge accounting for \$110 billion in notional volume of pay-fixed swaps and \$40 billion in receive-fixed interest rate swaps because the company determined that much of the derivatives were no longer effective hedges and didn’t qualify under GAAP for hedge accounting treatment. While the accounting change doesn’t impact Freddie’s

previously reported results, it will affect the company's regulatory capital said management, adding that they do not believe the change will cause Freddie to become undercapitalized. The accounting change will increase Freddie's earnings volatility going forward, as changes in the fair value of those derivatives contracts will be reported through the income statement rather than on its balance sheet, the company said. Management noted that part of the reason the Freddie Mac is dropping its hedge designation for those derivatives is because the company still does not have automated systems in place to quickly account for everything required under GAAP rules for derivatives. "As a result, we must complete substantial back-end validation and analytical review procedures of our financial results to mitigate our current inability to rely extensively on more automated internal controls," the company said.

- Peter Eavis writes in *TheStreet.com*, "Freddie Mac ... came out with a market update Monday that doesn't put the company in a particularly good light. ... [T]he company didn't come out with any meaningful financial data in its update. All we really got in the way of new numbers Monday were some updated mortgage totals. There's been no income statement or balance sheet for any period in 2004 yet, and there won't be till March 2005. ... Freddie did make a very important announcement: It's discontinuing a special type of accounting treatment for over \$150 billion of derivatives that Freddie uses to protect itself against interest rate swings. The removal of this special accounting treatment means that changes in the value of these derivatives must now be factored into the calculation of very important regulatory capital measures. The removal of this so-called "hedge" accounting shouldn't have a damaging effect on Freddie's regulatory capital, because the company is well capitalized. ... It seems fair to wonder whether the regulator's pressure on Fannie caused Freddie's accountants to revisit its hedge accounting. Hedge accounting has always been a very controversial, easy-to-manipulate area of derivatives accounting, and Freddie's new management is perhaps signaling to the market that it wants nothing to do with a rule that can be so readily abused."
- Analysts said Freddie's changes in hedge accounting would lead to more volatile earnings, and hence capital levels, which could more seriously crimp the company's growth once it works through its accounting problems. (*Dow Jones Newswire*, Dawn Kopecki, 11/01/04; *Bloomberg News*, Al Yoon, 11/01/04; *TheStreet.com*, 11/01/04; *TheStreet.com*, Peter Eavis, 11/02/04; *American Banker*, Jody Shenn, 11/03/04; *Freddie Mac Market Update*, 11/01/04; *Bloomberg News*, 10/04/04)

Freddie Mac holds annual shareholders meeting

- At its annual meeting of shareholders, Freddie Mac's stockholders elected 13 directors to the company's board of directors, ratified the re-appointment of PricewaterhouseCoopers LLP (PwC) as the company's independent auditor for 2004, and approved the company's 2004 stock compensation plan and an amended and restated employee stock purchase plan. Each director was elected to office by at least 92% of the votes cast, while the re-appointment of PwC was ratified by 99% of the

votes cast. The 2004 stock compensation plan and amended and restated employee stock purchase plan were approved by 90 percent and 94 percent of the vote cast, respectively.

- New members to Freddie Mac’s board of directors include Barbara T. Alexander, an independent consultant; Geoffrey T. Boisi, retired vice chairman and co-CEO of JP Morgan Chase and Company; Richard Karl Goeltz, retired vice chairman and CFO of American Express; Thomas S. Johnson, retired chairman and CEO of GreenPoint Financial Corporation; and William M. Lewis, Jr., managing director and co-chairman of Lazard Frères Co. LLC. Freddie Mac chairman and CEO Richard F. Syron was re-elected chairman of the Board and Eugene E. McQuade was re-elected lead director.
- Freddie Mac chairman and CEO Richard F. Syron told shareholders that the company has made much progress in attracting a new senior management team with the GSE’s hiring of Gene McQuade, the former president of Fleet Bank, as president and COO and Patti Cook, a 25-year Wall Street veteran of fixed income markets, as EVP of investments. Syron noted that Freddie Mac has also made important advances in corporate governance, including an orderly transition of about half of the elected board of directors with diverse and seasoned board candidates.
- Syron stated that the Freddie Mac is placing a higher emphasis and focus on the company’s mission of providing the U.S. housing system with liquidity, stability and affordability. To address the affordability of housing, Freddie Mac is developing a number of initiatives to develop new productions and services which will help lift more families out of the subprime market. Syron told shareholders that he wants to see Freddie Mac achieve its affordable housing goals, which will be more challenging in the future. HUD’s higher goals for affordable housing are “a bigger deal than it may seem” because the company has to use “responsible leadership” to manage its “zeal” to meet the goals, while avoiding predatory lending. “This kind of leadership doesn’t mean going after the flashiest short-term numbers,” Syron said. “Managing credit is something we do well,” said Syron. “We also need to look at new ways of how we enhance credits, and in this instance, spread risks more effectively so we could expand our efforts to buy more non-traditional loans while still protecting our shareholder interest,” Syron said.
- Syron told shareholders, “We have also taken a sound and proactive position toward regulatory reform. Reform is necessary and we embrace it. We look forward to working with the Administration and the Congress to put to rest any doubts that our regulator has all that it needs and all that it takes to do the job right. Our aim is a bill next year that improves the regulatory environment and keeps America’s family-friendly system of housing finance the best in the world. Syron added, “What is clear to me – as an economist, former regulator, and lifelong student of public policy – is that it makes no sense to gamble with America’s system of housing finance... As I said, we welcome GSE regulatory reform. But let’s make sure it is reform that truly strengthens our system and builds confidence. So for Freddie Mac,

providing responsible leadership should extend to the public debates about the value and regulation of the GSEs. That's in the interest of a sound, fact-based policy debate. And it is in the interest of our shareholders, as well."

- Speaking with reporters after the annual meeting, Syron said he hopes Fannie Mae quickly resolves questions about its own finances recently raised by OFHEO. "Even though we're a competitor, we regret that that's going on," said Syron. "We wish them, in our own interests, only good will in resolving them absolutely as quickly as they can." (*Freddie Mac Press Release: Freddie Mac Holds Annual Shareholder Meeting*, 11/04/04; *Bloomberg News*, 11/04/04; *Reuters*, 11/04/04; *Freddie Mac Press Release: Prepared remarks by Richard F. Syron*, 10/04/04; *Bloomberg News*, 10/04/04; *Dow Jones International News*, Dawn Kopecki, 11/04/04)

HUD publishes affordable housing goal

- Fannie Mae and Freddie Mac will have to increase their funding of low- to moderate-income homebuyers under a new rule published by HUD, which go into effect on January 1st. The goal for low- and moderate-income homebuyers will increase from the current 50% to 56% in 2008 and the goal for loans in "underserved areas" will increase from the current 36% to 39% in 2008. The affordable area goal will increase from 36% to 39% in 2008. These goals were reduced from HUD's original targets by a percentage point each, because HUD decided to use a different source of data to measure the market's overall performance, said John C. Weicher, assistant secretary for housing and Federal Housing Commissioner. To meet the new goals over the next four years, Fannie and Freddie will need to buy an estimated 400,000 more qualifying loans than the 10 million loans they otherwise would have bought, said Weicher. The rule was developed to encourage the GSEs to match or lead the mortgage industry in targeted markets, said HUD officials.
- In the affordable housing rule, HUD has established specific requirements for the GSEs' counting of mortgages toward housing goals in transactions that provide a seller dissolution option. The agency also prohibited a GSE from "double counting" mortgages that had been counted toward housing goals in previous years, provided new procedures for the treatment of missing borrower income data, and added regulatory provisions to ensure that the GSEs provides accurate data to HUD.
- A Freddie spokeswoman said that while the company was "pleased" that the goals were lowered "slightly from the proposed levels," Freddie still has concerns that the goals would be too tough. "We remain concerned that the new goal and subgoal levels are set far beyond the level of affordable loans that the primary market is likely to produce," she said. "Because of our concerns ... we hope that Congress will continue to make the affordable housing goals part of the GSE regulatory debate."
- Fannie Mae Freddie Mac spokeswoman Sharon McHale said the new goals may be so high that the company will be forced to reduce its funding for other borrowers,

potentially “making it harder for workforce families and working families with children to get a mortgage.” Fannie Mae “will be working with HUD and our housing partners to minimize any unintended consequences for housing that may result from the new goals,” spokesman Charles Greener said.

- On the same day that it issued its affordable housing rule, HUD also asked for comment on ways to address concerns about the feasibility that the GSEs can meet the housing goals during periods of high refinancing volumes. “While HUD believes that the statute and implementing regulations presently contain procedures to address this issue, it is separately seeking specific recommendations from the public about how HUD can more effectively account for high refinance volumes,” said the agency. (*American Banker*, Rob Blackwell, 11/02/04; *Washington Post*, David S. Hilzenrath, 11/02/04; *Wall Street Journal*, Dawn Kopecki, 11/01/04; *Dow Jones Newswires*, John Connor, 11/02/04; *BNA’s Daily Report for Executives*, Richard Cowden, 11/02/04)

Fannie Mae and Freddie Mac

With President Bush’s re-election, the gloves are off on GSE reform

- Emboldened by Republican gains in the House and Senate and re-election of the President, the Bush administration is expected to aggressively strengthen the oversight of Fannie Mae, Freddie Mac, and the FHLBs, and to push for changes far beyond anything contemplated during its first term. “If the administration wanted three major regulatory concessions last year - receivership, mission control, and capital - next year they will want significantly more,” said Peter Wallison, a Resident Fellow with American Enterprise Institute. “As the question of Fannie’s accounting is played out in the next few months, I think the company will continue to lose support in Congress.”
- Fannie Mae and Freddie Mac also lost a key ally in Senate Minority Leader Tom Dashcle (D-SD), who was defeated by Republican challenger John Thune. Republicans have picked up at least six new seats in the House, giving them a 233-201 advantage over Democrats, and also expanded their slim 51-49 majority in the Senate, where the GOP appears to have secured a 55-seat majority in the 106th Congress. As a result of the election, the composition of the Senate Banking Committee will be adjusted from 11 Republicans and 10 Democrats to possibly a 12 to 9 split, giving chairman Senator Richard Shelby (R-AL) a wider margin to pass legislation. Since all committee members up for re-election this month won their races, the only member who will not return to Congress in 2005 is Senator Zell Miller (D-GA), who is retiring. Sources say that the Bush administration’s former secretary of HUD Mel Martinez, the newly elected Senator from Florida, may be appointed to the committee. All of the senior members of the House Financial Services Committee won re-election.

- “Clearly we face a challenging political landscape. But there’s strong bipartisan consensus that our charter provides significant benefits to homeowners and lowers the cost of home ownership,” said Sharon McHale, a Freddie Mac spokeswoman. McHale and Fannie Mae spokesman Chuck Greener both said their companies look forward to working with the administration and Congress next year.
- Washington insiders say the GSEs will be lucky to get the same legislation that the GSEs previously opposed in 2003. Congress and the White House will want, and are in a position, to demand more. The administration is expected to increase the regulatory pressure on the GSEs, by possibly limiting their activities in new markets and appointing long-time critics into key regulatory roles such as Treasury Assistant Secretary Wayne Abernathy or recent Ginnie Mae president Ronnie Rosenfeld as director for a new GSE regulator or as a replacement for OFHEO Director Armando Falcon Jr., should he step aside.
- “The difference between this year and last year is that, in this last year, Congress was trying to move quickly to respond to what it perceived as a crisis,” Mortgage Bankers Association lobbyist Kurt Pfothenauer said, by proposing limited legislation to address immediate concerns over the GSEs’ accounting practices. “Congress has taken another year to get educated on the issues and will approach reform from a more comprehensive policy review. There will be a lot more issues on the table than just safety and soundness...people have become more educated and have more questions about their mission,” Pfothenauer said. “There are legitimate questions, regardless of party, of the GSEs’ ability in promoting affordable housing,” he said. “There’s a growing bipartisan consensus that that’s an area that should be reviewed.”
- “The stall game by Fannie Mae and Freddie Mac is over,” said James Cusser, a bond manager at Waddell & Reed Financial, Overland Park, KS. The GSEs, which have opposed creation of a strong, independent regulator for the enterprises, “now face opponents with a fresh new clock and it will be going on longer than these guys can stall,” said Cusser.
- With campaign pressures behind them, members of Congress, the administration, and the companies are in a better situation to compromise, said industry officials. “What the election does is strengthens [the] Republican majority in the Senate and it may have an impact on the lineup in committees. But also it gives more time for a reexamination, reconsideration of that issue,” said Floyd Stoner, executive director for congressional relations and policy at the American Bankers Association. Industry lobbyist Jim Butera predicted that passage of a GSE bill is a “near certainty” next year, forecasting that it will be “the Number 1 bill coming out” of the House and Senate banking committees.
- The administration could try to limit the GSEs’ investment in higher risk, non-traditional mortgage products, such as subprime loans, adjustable-rate mortgages and interest-only loans. Bank regulators are closely monitoring interest-only loans, which

provide borrowers low, fixed payments for a few years then dramatically increase when principle payments kick in. During 2004, Freddie Mac said that a bulk of its recent portfolio growth stemmed from securities backed by home equity, subprime and other non-traditional loans; Fannie has similar investments but officials from both companies say they represent a small portion of their business.

- Bush's reelection also raises the possibility that the Treasury will move forward with its threat to limit the companies' debt issuances. Calling the Bush administration's bluff, Representative Barney Frank (D-MA) warned there would be a "firestorm" if the administration attempted to limit Fannie Mae and Freddie Mac from issuing debt to fund their operations and growth. "I think they would run into an absolute firestorm if they did that," Frank said.
- "The increased regulation that is in store for them will significantly impair their franchises," said Wallison, a prominent academic and former White House counsel to President Reagan and general counsel at Treasury. "In this environment, it makes sense for Fannie and Freddie to consider privatization." Long-time industry observer Bert Ely, who co-wrote with Wallison a proposal to privatize the companies, said their political risk "will be compounded if more accounting problems emerge at either GSE," which, he said, is likely to happen at Fannie if the SEC forces it to restate its earnings.
- Jim Vogel, a senior vice president at FTN Financial Capital Markets, was one of the few analysts who disagreed with the conventional wisdom that GSE regulatory reform legislation will be enacted with tougher terms than that proposed by the Senate Banking Committee in 2004. The newly-won Congressional seats and "mandates" translate into early action on big picture issues and "GSE reform is not a top 5 priority for Congressional leaders," he argued. "The leadership will look for broad support before scheduling a vote on any 'minor' legislation. They will save political capital for fights that will make the front page. Second, the Treasury will play an important role in shaping tax policy and retirement policy next year. It will be more determined to achieve its GSE goals, but will it have the time to advance them? Third, the GSEs have important Republican support (such as Senator Robert Bennett (R-UT)) along with their traditional Democratic allies. It is not as red and blue as the commentators would like to paint. Finally, in the second half of 2005, replacing Alan Greenspan will be a consuming issue that could distract from GSE questions." Vogel added, "We cannot emphasize enough that assuming the GSEs can regain the world of 1998-2003 represents an enormous bet."
- Merrill Lynch wrote, "The [GSEs] will likely come under increased scrutiny. We think that the Republican Congress will assign a new regulator, and impose stricter capital requirements than those that are in place now. That is likely to be a positive for GSE debt: we don't see a risk to the AAA rating of the existing senior debt. Regulatory changes may pose more problems for GSE equities, although we maintain our buy rating on shares of Fannie Mae and Freddie Mac."

- In its earnings forecast for 2005, Countrywide Financial Corp. executives warned there could be some fallout from the troubles at Fannie Mae and Freddie Mac during President George W. Bush's second term. In a conference call with analysts, company executives said this could have long-term implications for the industry, adding any additional costs to lenders would be passed on to consumers. In an interview with *Reuters*, Dick Bove, managing director for financial services at Puck Ziegel & Co., said Republicans think Fannie Mae and Freddie Mac have outlived their usefulness. "The Republicans have a real opportunity to adjust the position of Fannie Mae and Freddie Mac, and that will impact all of the companies that are heavily dependent on those two agencies," he said. (*Dow Jones Newswire*, Dawn Kopecki, 11/03/04; *National Mortgage News*, 11/08/04; *Mortgage Servicing News*, 11/04; *Reuters*, Mark Felsenthal, 11/03/04; *National Mortgage News*, 11/04/04; *Market News International*, 11/03/04; *Knight Ridder/Tribune Business News*, Gregory J. Wilcox, 11/04/04; *CQ Today Midday Update*, 11/12/04, *Bloomberg News*, James Tyson, 11/04/04; *Wall Street Journal*, Jackie Calmes, 11/12/04)

<p>Treasury Secretary Snow will stay with agency through mid-year and Treasury Undersecretary Roseboro submits resignation</p>
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- U.S. Treasury Secretary John Snow will remain in the president's cabinet at least until the middle of next year and will likely leave Treasury by the end of 2005, said administration officials. Snow will devote his efforts to helping the President fulfill a campaign pledge to simplify the tax code and continue efforts to pass GSE regulatory reform legislation.
- Brian Roseboro, the U.S. Treasury's Undersecretary for Domestic Finance, has resigned from his post with the Bush administration effective December 31st. "I am proud to have been part of the many good works that we accomplished, the bad works we prevented and the challenges met by the Department of the Treasury," Roseboro said in a letter sent to President George W. Bush. "It is now time for me to return to my family." An acting Undersecretary for Domestic Finance, who oversees a wide range of debt management and GSE policy issues, will be named by December 31, said Treasury spokesman Rob Nichols. (*Bloomberg News*, Simon Kennedy, Roger Runnigen, Richard Keil, Brendan Murray, 11/09/04; *Bloomberg News*, Brendan Murray and Simon Kennedy, 11/08/04; *Dow Jones Capital Markets Report*, Campion Walsh, 11/08/04)

OFHEO says Fannie investigation must be curtailed without funding –
as Representative Frank withdraws his support for increased OFHEO funding

- OFHEO may have to curtail its probe of Fannie Mae’s accounting because of a funding shortfall, said OFHEO spokeswoman Stefanie Mullin. “OFHEO will have to dramatically scale back the examination and may lose key expert assistance” from accounting firm Deloitte & Touche LLP should Congress deny the agency its expanded \$59.2 million budget for the fiscal year 2005 that began on October 1, Mullin said. The regulator has already imposed a freeze on hiring, training, and travel, she added. House Appropriations Committee spokesman John Scofield said OFHEO faces a 40% chance Congress won’t approve the higher funding for 2005 during the its one-week “lame-duck” session beginning November 15. OFHEO has operated under its \$39.9 million spending level of fiscal year 2004 under a continuing resolution passed by Congress in October, a figure far below the amount necessary for agency activities, said Mullin. “The uncertainty created by the continuing resolution hinders OFHEO in achieving its mission of effective supervision” of Fannie Mae and Freddie Mac, she said.
- Representative Barney Frank (D-MA) said that he will not support a budget increase for OFHEO until questions raised in a confidential report by the Inspector General of HUD have been addressed. In a letter to colleagues, Frank said that the IG’s report on how OFHEO examined Fannie Mae’s accounting “raises very serious issues which must be thoroughly discussed and addressed.” Frank told House Appropriation Committee members that he had read the report and concluded that OFHEO does not deserve more money. In an interview with the *Washington Post*, Frank said that the issues involve “the role that OFHEO has played” and the report “has major public policy implications.” Since the report has not been made public, Frank said he could not be more specific in his comments. “Once the report is made public and the serious issues it raises have been addressed, there would be time to consider a Supplemental [appropriation] increasing OFHEO’s funding if that were then deemed appropriate,” Frank said.
- “Apparently Mr. Frank is no longer in favor of improved oversight responsibilities over two of the world’s largest financial institutions,” said Dan Gage, a spokesman for Representative James T. Walsh (R-NY), chairman the House appropriations subcommittee that oversees OFHEO’s funding. (*Bloomberg News*, James Tyson, 11/08/04; *Washington Post*, David S. Hilzenrath, 11/11/04; *CBS MarketWatch.com*, Robert Schroeder, 11/10/04; *Daily Report for Executives*, R. Christian Bruce, 11/12/04)

Will heightened competition spur Fannie Mae and Freddie Mac to take greater risks that may endanger taxpayers?

- In the Fall 2004 issue of *Regulation*, a Cato Institute Publication, W. Scott Frame, with the Federal Reserve Bank of Atlanta and Professor Lawrence J. White, New York University write, "...[T]wo emerging and potentially powerful sources of new competition for Fannie Mae and Freddie Mac [are] an expanded mortgage finance program by the Federal Home Loan Bank System and new bank risk-based capital standards that are likely to be implemented in 2006. ...[T]his heightened competition could create incentives for Fannie Mae and Freddie Mac to take greater risks, with potentially unfavorable consequences for U.S. taxpayers. As a result, unless the two firms were to be privatized quickly (which is highly unlikely), enhanced regulatory scrutiny will be in order."
- "The Federal Home Loan Bank (FHLB) System consists of 12 "wholesale" banks that provide finance ...for more than 8,000 banks and thrifts that are members (and also shareholder-owners) of the system. Like Fannie Mae and Freddie Mac, the FHLBs are a GSE, with similar benefits and limits embedded in a congressional charter. They enjoy favorable borrowing rates in the financial markets and they pass on much of that advantage to members in the form of reduced interest rates on advances."
- "In 1997, the Federal Home Loan Bank of Chicago began purchasing pools of residential mortgages originated by members. Termed the "Mortgage Partnership Finance" program, the arrangement left most of the credit risk in the hands of the originator (in return for a credit enhancement fee paid to the originator) while the FHLB received the stream of interest and principal payments and managed the interest-rate risks associated with the pool. The program, and a second one similar to it, has since expanded. All 12 FHLBs currently participate in one or both of the programs. At year-end 2003, the FHLBs collectively held \$113 billion in residential mortgage pools that had been purchased through the programs. The FHLBs are enthusiastic about expanding the programs, so long as they can arrange for the additional capital to support their mortgage holdings. Another potential route for expansion would be for the FHLBs to decide to securitize the mortgage pools and sell the resulting mortgage-backed securities."
- "In 1988, the Basel Committee on Banking Supervision... issued a set of capital guidelines for banks. The guidelines, known as "Basel I," became the accepted standard for most countries. A decade later, the committee issued a draft revision that updated the capital guidelines and greatly broadened their scope. The revision, known as "Basel II," has been revised a number of times since its issuance in 1999 and is currently scheduled to be implemented later this decade."
- "A longstanding complaint about the Basel I requirements is that the required 'risk-based' capital levels for various assets are only loosely related to their underlying risks. That complaint has been especially relevant to prime residential mortgages,

where the credit risks have been appreciably below the 4 percent capital requirement specified in Basel I. The [revised] approach could yield capital requirements for residential mortgages that are in the 1-2 percent range. The 10 largest U.S. banks are likely to be required to use the [revised] approach, and the next 10 largest banks are likely to adopt the approach voluntarily. (The remaining U.S. banks will continue to use the Basel I system.) Those 20 large banks account for about two-thirds of U.S. banking assets and about one-half of residential mortgage assets held by banks.”

- “Accordingly, under Basel II, the 20 banks will have enhanced incentives to retain mortgages in their own portfolios rather than sell them to Fannie Mae and Freddie Mac. The banks will also have greater incentives to compete with the two GSEs in purchasing mortgages from other originators. Because the large banks already account for a sizable fraction of residential mortgage activity, the expansion of competition from those banks could well be substantial.”
- “The new competition and the consequent reduced franchise value have important implications for the safety-and-soundness regulation of the two GSEs. An essential component of safety-and-soundness regulation is the requirement of adequate capital levels on the part of the regulated institution. Adequate capital not only provides a direct assurance that the level of assets will be adequate to cover the institution’s liabilities, but it also provides a disincentive for the owners (or the managers operating on behalf of the owners) to take undue risks.”
- “The reduced franchise value for Fannie Mae and Freddie Mac that will follow from the heightened competition from the FHLBs and the Basel II banks will thus erode their effective capital and increase their incentives for risk-taking -- perhaps through less-than-complete hedging of interest-rate risks, less resources devoted to vetting credit risks, entry into riskier lines of residential mortgage finance, or perhaps even through newly created methods of risk-taking that we cannot imagine today.”
- “In principle, the safety-and-soundness regulatory system established by the OFHEO is supposed to detect and deter undue risk-taking. But the overall capabilities of the OFHEO have recently been called into question, as Congress and the Bush administration have mulled over, and also sparred over, a potential restructuring of the GSEs’ regulation.”
- “In a perfect world, the American polity would realize that the social benefits of continuing Fannie Mae and Freddie Mac (and also the FHLBs) as GSEs fall short of the social costs, and true privatization of those enterprises would readily follow. With the disappearance of the ‘implicit guarantee,’ safety-and-soundness regulation could also disappear and private creditors would address the issues of heightened competition and the incentives for expanded risk-taking.”
- “...[I]n our actual world, privatization of the GSEs is an unlikely event. Consequently, given the continued presence of the ‘implied guarantee,’ the appropriate focus must be on enhanced safety-and-soundness regulation (despite the

paradoxical strengthening of the guarantee that might accompany enhanced regulation).”

- “For all of those reasons, the scenario that we have outlined -- expanded competition, the likely reduction in Fannie Mae’s and Freddie Mac’s franchise values, and the concomitant increased incentives for risk-taking by the GSEs -- should be a wake-up call for heightened scrutiny by the OFHEO or whatever safety-and-soundness regulatory agency replaces it. The failure to heed this call could well prove costly to taxpayers.” (*Regulation*, a publication of Cato Institute, W. Scott Frame and Lawrence J. White, Fall 2004)

AEI’s resident fellow Pollock outlines essential regulatory reforms for GSEs
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- American Enterprise Institute’s resident fellow Alex J. Pollock outlined the essential regulatory reforms for the housing GSEs in the November *Financial Services Outlook*. Pollock writes that from the point of view of economic policy, it is essential that regulatory reforms be pro-competitive through the creation of a single regulator for the housing GSEs that fosters a level-playing field for competitive conditions for Fannie Mae, Freddie Mac, and the 12 FHLBs. Pollock outlines a number of specific characteristics for the GSEs’ regulatory regime needed to promote a competitive secondary market sector.
- Pollock recommends replacing OFHEO and the Federal Housing Finance Board (FHFB) with a new agency, as provided in Senator Shelby’s GSE reform legislation and proposed by the Bush administration. The new regulator would have the ability to view the housing GSE sector as a whole, providing a broad perspective and more balanced bases of comparison of the mortgage market. The new GSE regulator should be headed by a director, rather than the board model of the FHFB.
- Today, the FHLBs have a minimum capital requirement of 4% of on-balance assets, roughly 60% higher than Fannie and Freddie’s corresponding requirement of 2.5%. Factoring in OFHEO’s 30% required capital surcharge for Fannie and Freddie, the FHLBs’ capital requirement is 23% higher than its competitors. Pollock argues that the new GSE regulator should be charged with the responsibility for determining minimum and risk-based capital requirements for all housing GSEs, in which the same risk requires the same capital. Pollock urges Congress to charge the regulator to develop a single, consistent risk-based capital system for the 14 housing GSEs.
- Given the vagaries introduced into financial reporting by FAS 133, Pollock recommends that realized losses (or gains) on derivatives be included in the calculation of regulatory capital and the remainder of accumulated other comprehensive income should be excluded from regulatory capital by the new GSE regulator.

- In structuring its GSE reform bill, Congress should eliminate all government-appointed directors from housing GSEs, which will clarify their relationship to the government and the regulator and will eliminate potential conflicts of interest. The new GSE regulator should have a common approach to the approval of new activities for the enterprises, focused on preserving the GSEs' housing mission and fostering innovation and competition. The GSE regulator should also have the responsibility to develop a sound and equitable approach to interest rate risk among all GSEs. This principal is fundamental and applies of whether the GSEs have the same or different asset mix.
- The Bush administration has consistently argued that receivership powers for the new GSE regulator must be a part of GSE reform legislation. Pollock suggests that Congress simply insert into the GSE charter acts the provision that they are subject to the bankruptcy code, which would entail "effective receivership language" in a straightforward way. In a "perfect" GSE reform bill, taxation should also be made equivalent among the housing GSEs, writes Pollock, which would require applying corporate income taxes to the FHLBs and providing a tax credit for "REFCORP" payments made by the FHLBs to Treasury. FHLB dividends paid to member banks would become normal inter-corporate dividends, providing the FHLB shareholders the normal tax treatment. A change in the tax treatment of the housing GSEs would be a pro-competitive element of reform, removing disparities among the enterprises.
- The new GSE regulator should evaluate the comparative benefits and costs of Fannie and Freddie's affordable housing programs driven by the companies' affordable housing goals and the FHLB's grants, totaling 10% of their profits. Over the short-run, both affordable housing programs could continue, with the new regulator having a goal to "harmonize" the enterprises' affordable housing efforts.
- Pollock concludes that the creation of a single GSE regulator and development of a competitive GSE secondary market sector could lead to the ultimate goal of privatizing all housing GSEs. (*American Enterprises Financial Services Outlook*, Alex J. Pollock, 11/01/04)

High growth housing GSEs a thing of the past
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- David Tice writes in *On Wall Street*, "The days of Fannie Mae [and Freddie Mac] satisfying the tastes of both growth and value managers may have ended. Value managers were attracted to the stock[s'] low PE ratio while the go-for-growth crowd had a fondness for Fannie's [and Freddie's] rapid earnings growth and uncanny ability to 'hit the number.' Given Fannie and Freddie's accounting problems, both points of view are under revision.
- Tice argues that much is at stake if Fannie and Freddie are constrained from doing business as usual. As "quasi-central banks," Fannie, Freddie and the FHLBs have played a central banking role of "buyer of last resort. The GSEs aggressive balance

sheet expansions helped settle frantic markets during the 1994 bond crisis, the 1998 Long-Term Capital Management debacle, the 1992 Y2K scare and the aftermath of the telecom/Internet bubble. The GSEs have flooded the economy with credit, particularly in recent years, with household mortgage debt now about 60% as large as GDP, compared to 43% in 2000. This growth in mortgage debt would not have been possible without the GSEs with their exploding balance sheets.

- Tice argues that housing activity and consumer spending are at risk if the GSEs slow their credit expansion. Should the GSEs face lending constraints, the “odds of a credit bust will certainly increase” writes Tice. “We figured this credit bubble could end under any of a number of scenarios. Rising rates might simply snuff out the demand for mortgages, home equity loans and refis. Or an unexpected external event on the order of the LTCM debacle might prove too much for the Fed/GSE team to handle. But the prospect that the GSE’s would tighten their own credit spigots was a far less likely scenario in our opinion. However, if regulators have their way, it is one that may well come to pass.” (*On Wall Street*, David W. Tice, 11/01/04)

Long-term debt issuance down 27% from a year ago
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- Long-term debt issuance by Fannie Mae, Freddie Mac, the FHLBs, Farm Credit System, Sallie Mae, and TVA totaled \$732.8 billion during the first three quarters of 2004, down 27.4% from the \$1.01 trillion issued during the same period a year ago, said the Bond Market Association (BMA). New issue activity declined in the agency market as total mortgage origination continued to slow, said BMA. In a survey of primary dealers, BMA found dealers are looking for a decrease of agency debt issuance in the fourth quarter based upon expectations of modestly rising interest rates.
- As for the decline in long-term debt issuance through the first nine months of this year, BMA said that “most of the decrease can be attributed to the Federal Home Loan Banks, with issuance decreasing 35.9%, to \$310.1 billion.” The group said Fannie Mae and Freddie Mac also experienced substantial declines in volume, with Fannie’s issuance dipping by 18.9% to \$220.9 billion and Freddie’s volume down 15.6% to \$161.9 billion. (*Dow Jones International News*, John Connor, 11/11/04)

GSEs challenged by new Fed overdraft policy

- Fannie Mae, Freddie Mac and FHLB System officials said it will be difficult coping with the Federal Reserve’s new daylight overdraft policy. “This new policy presents a challenge for us and the industry,” said Alex Kangelaris, vice president in Freddie Mac’s investments and capital market division. “With the new policy in effect, our account must be fully funded. It’s a very, very different process flow that happens today,” said Albert Barbieri, Fannie Mae’s director of Treasury operations. “It’s a

difficult management process for us,” to adapt to the Fed’s policy, said Michael Brown, director of debt and credit services at the FHLB System.

- Under the Fed’s revised payment-systems policy, the GSEs and certain international financial institutions are no longer exempt from the Fed’s daylight overdraft fees starting in July 2006. The GSEs have been exempt from paying these fees for the past 10 years. When the Fed’s new policy goes into effect, GSEs and others will need to make sure their Fed accounts are fully funded by the time payments are due to avoid delay of interest and redemption payments to bondholders.
- Freddie Mac’s biggest challenge is that the company fully balances its Fed account at the end of the day, which will make it challenging to meet the Fed’s 4:00 p.m. ET cutoff time, Kangelaris said. “Everyone needs to think about tools we can use to make this work,” he said.
- When asked if the Fed may raise institutions’ net debit caps, or allowable overdraft balance, as a way of possibly easing the impact of the new daylight overdraft policy, a New York Fed official said that’s not going to happen. “The short answer is no,” said Betsy Irwin-McCaughey, vice president at the New York Fed. “Those caps are really carefully prepared to ensure that Reserve Banks are extending an appropriate level of credit to the participating institutions. Net debit caps are never publicly disclosed and banks are cautioned not to disclose what their net debit caps are,” said Irwin-McCaughey. The Fed expects the necessary infrastructure to be in place to support the new policy by January 2006, she said, which will allow for the systems to be tested before the policy goes into effect on July 20, 2006. (*Dow Jones Newswires*, Deborah Lagomarsino, 11/04/04)

Technology advancements for eMortgages

- To date, the benefits promised by e-signature technology vendors have been huge, while the results delivered have been disappointing. One company, a la mode, announced plans to change this by speeding the adoption of electronic signatures by the thousands. Getting e-signature technology, once available only to the largest brokerages and originators into the hands of small businesses, will drive electronic mortgages and ultimately electronic real estate transactions by “seeding the market” from the ground up, said a la mode Executive Vice President Scott Kinnaird. “We are the first company that will push e-signature technology into the hands of tens of thousands of small businesses, working professionals and mortgage service vendors that interact directly with consumers,” Kinnaird said. “This will change everything concerning the adoption and real use of e-signatures.”
- a la mode recently announced it will offer legally-binding and standards-compliant digital-signing capability to its entire customer base of tens of thousands of real estate agents, mortgage brokers, inspectors, loan officers and appraisers, who use the company’s XSites Network. The majority of the company’s customers are small

businesses connected to its network of Appraiser XSites, Mortgage XSites, Agent XSites and Inspector XSites. The software will be distributed to the entire network via a digital signing toolkit with e-signature included.

- “Fortune 100 companies talk about dipping their toes into e-closings and e-mortgages all the time,” Kinnaird said. “But for years, we haven’t seen the promise fulfilled. Now, thousands of small businesses and even more working professionals have this capability, which will greatly enhance adoption. And when the cost and efficiency benefits are realized by our XSites Network users and their customers, customers will demand nothing less. This is really the last mile in e-closing capability,” Kinnaird said.
- Many analysts agree e-signatures are the vital step toward fulfilling the promise of totally online and paperless mortgage and real estate transactions. “This is a significant step for the entire real estate industry,” said Frank Cook, publisher of *Real Estate Intelligence Report*. “What’s different here is that technology that was once only available to the largest firms and mortgage originators is now available to small businesses and individual brokers and agents,” Cook added. (*PRNewswire*, 10/26/04)
- At the Mortgage Bankers Association annual convention, SwiftView Inc. unveiled SwiftSend eLoanFolder™, a revolutionary electronic folder for collecting, accessing and delivering loan documents online. SwiftSend eLoanFolder is the latest offering in SwiftView’s SwiftSend™ suite, which combines Web-based document delivery processes and electronic folders into an integrated service, allowing lenders to create secure, online electronic loan folders that streamline loan-related communications between internal departments as well as with borrowers and outside business partners. eLoanFolder can be adapted to a lender’s processes anywhere, from application to archiving. And because lenders can print directly to eLoanFolder from any application or server, lenders can capture and store documents electronically before the first piece of unnecessary paper is generated. (*SwiftView Press Release*, 10/25/04)

Fannie Mae

In an end run around OFHEO, Fannie Mae asks SEC to certify its accounting

- *Bloomberg Television* reports, “Fannie Mae wants to bypass its federal regulator. The company is asking the Securities and Exchange Commission to certify its accounting instead. ...OFHEO last month accused the company of improper accounting. Fannie denies that and it says the allegations are hurting the company and the financial markets it uses to finance home loans.” Fannie Mae asked the SEC to rule on its accounting before its financial reports are due on November 15, according to unnamed sources close to the probe. In October, Fannie Mae defended its accounting in a 50-page report to the SEC that wasn’t initially shared with OFHEO, said people familiar with the document.
- At a meeting last month between regulators, OFHEO found out about Fannie Mae’s SEC defense, sources said. SEC enforcement officials called the meeting, attended by representatives of OFHEO, the Justice Department and the Public Company Accounting Oversight Board. After the meeting, Fannie Mae gave OFHEO a copy of Fannie’s accounting report provided to the SEC, said sources. While Fannie Mae said its request for SEC certification of the company’s numbers was unusual, the company said SEC approval of its accounting “would be in the public interest” because the questions about its accounting troubles were causing “great uncertainty” in the mortgage and capital markets, said people familiar with the report. OFHEO spokeswoman Corinne Russell confirmed that the agency received a copy of Fannie’s letter to the SEC. “OFHEO has seen it and discussed it with the SEC, and it does nothing to change OFHEO’s view of our accounting findings,” said Russell, declining to elaborate on the document.
- Fannie Mae’s request for the SEC to certify that its accounting follows GAAP is part of an effort by the company’s CEO Franklin Raines to circumvent OFHEO, said David Gourevitch, a former SEC enforcement attorney. “This appears to be an effort by Fannie to get the SEC to render a decision that is inconsistent with, and which would blunt, the OFHEO investigation,” said Gourevitch. “It’s extremely unusual for the office of chief accountant to offer an opinion in the midst of an ongoing enforcement investigation.”
- An SEC decision backing OFHEO’s determination of Fannie Mae’s accounting might force the company to write down as much as \$8 billion, according to Moshe Orenbuch, an analyst at Credit Suisse First Boston in New York. (*Bloomberg Television*, 11/12/04, 08:10:54 AM; *Bloomberg News*, Robert Schmidt, 11/12/04; *Dow Jones Newswires*, Dawn Kopecki, 11/12/04)
- Fannie Mae has said it will try to release its third quarter earnings by November 15, but has given no guarantees. Market participants doubt Fannie will be able to release

its earnings by that date with the approval of its auditors (KPMG), given that OFHEO has alleged that it has broken accounting rules. While KPMG has certified Fannie's earlier financial results, hedge fund managers with short positions in its stock believe the auditor will not want to expose itself to fines or sanctions by giving further approval ahead of an SEC ruling on the allegations. "Typically, accountants don't sign off on companies under SEC investigation," said John Barnett at Hovde Capital Advisors, a move that could result in an investigation KPMG by the Public Company Accounting Oversight Board (PCAOB). If KPMG does not sign off on Fannie's earnings, the company delay reporting them and miss the SEC's November 15 deadline. (*Financial Times*, Jenny Wiggins, 11/01/04)

- On *Bloomberg News*, William J. McDonough, chairman of PCAOB, said that his group is not investigating Fannie Mae at this time. He added, "There are lots of people in Fannie Mae looking at what's going on. There may be a point we check on the quality of audits they have received." (*Bloomberg Television*, 11/04/04, 2:25 PM)

"Frank's Fallujah"

- On *TheStreet.com*, Peter Eavis writes that meeting the November 15th deadline for filing Fannie Mae's financial results is "Frank's Fallujah." Eavis argues that Fannie Mae's chairman and CEO Franklin D. Raines' days at the company "could be counted on one hand" if Fannie fails to file quarterly results or if this quarterly report fails to include KPMG's statement that the auditor has reviewed the numbers and doesn't see the need for material modifications. Josh Rosner, an analyst with at Medley Global Advisors, believes that Fannie's board hasn't removed Raines because if it fired him now, it would have to pay a severance package. If Fannie Mae indicates that it's going to restate past numbers, the board would have clear cause for getting rid of Raines. Rosner believes a failure to file with the SEC or the filing a report without an auditor's stamp of approval would likely be enough to force the board's hand. If Raines leaves Fannie Mae, it will almost certainly go "hand-in-hand" with a massive restatement of the company's financial results. A Fannie Mae restatement would almost certainly open the door for far-reaching regulatory reforms, which could reduce the company's profitability.
- Eavis notes that Raines' supporters argue that the CEO will survive and Fannie's past accounting will be indicated by the SEC. The supporters' biggest "bogus argument" is that the SEC will come to Fannie's rescue. Some believe that Fannie and OFHEO just have differing views of two accounting rules that could, in the final analysis, be seen to be valid in both cases. They conclude that the SEC will not push for a restatement of past results and is happy that Fannie has agreed with OFHEO to start applying both rules in a way OFHEO approves of. Eavis writes, "[H]ere's why the issue won't pan out this way: According to a person familiar with the SEC probe, Fannie gave a presentation to the SEC [on November 5] that was designed to advance its side of the story. But according to this person, OFHEO also got to attend the meeting, and that would have allowed it to contest Fannie's defense. Another source

says Fannie requested the meeting because it didn't feel the SEC probe was going Fannie's way."

- Eavis argues that it's almost impossible to believe that the SEC agrees with Fannie's implementation of accounting rule FAS 133. The alleged misapplication of this rule appears to be responsible for leaving billions of dollars of derivatives losses out of earnings and capital. The SEC is extremely clear about how this rule needs to be applied, going by a speech given just under a year ago by an official from the SEC's Office of the Chief Accountant, which cautioned companies against misapplying the rule in the way that Fannie is alleged to have done. It's also hard to see KPMG aligning itself with Fannie against the SEC and OFHEO. After reviewing KPMG's handbook for dealing with derivatives accounting, he concluded that any company that stuck by the guidelines of KPMG's handbook would have a very hard time doing its FAS 133 derivatives accounting in the way that Fannie did. He surmised that KPMG had allowed Fannie to go against its own guidelines.
- Eavis writes, "Indeed, there are strong clues that suggest that to be the case. Earlier this year, KPMG worked with ... Impac Mortgage to correct its FAS 133 accounting, and that led to Impac recently restating its SEC filings. KPMG and Impac found that the company was misapplying FAS 133 in very much the same way that OFHEO alleges Fannie misapplied FAS 133. The Impac matter went up the head office of KPMG in the U.S., according to a person familiar with the situation. In other words, either KPMG got its Impac position wrong -- or its Fannie opinion [wrong]. Both cannot be right. KPMG almost certainly checked and double-checked its FAS 133 thinking with Impac, which means it's much more likely to be correct."
- Clearly, Raines has nowhere to turn," writes Eavis. "This is Frank's Fallujah." (*TheStreet.com*, Peter Eavis, 11/11/04)

Change in Freddie Mac's hedge accounting may add pressure to Fannie

- Freddie Mac's disclosure that derivatives contracts with a notation value of \$110 billion cannot qualify for hedge accounting under GAAP may provide ammunition against Fannie's historic use of "short-cut" effectiveness assumptions and put more pressure on Fannie Mae. In a note, Kenneth Posner, a Morgan Stanley analyst, wrote that Freddie's statements "make us reluctant to hope that the SEC will sign off on Fannie's derivatives accounting." According to the OFHEO report on Fannie Mae's accounting, the company characterizes 90% of its hedges as perfectly effective, even though such treatment is usually allowed only in "very limited circumstances." (*American Banker*, Jody Shenn, 11/03/04)

Fannie Mae's capital plan "due" at OFHEO

- The week of November 10, Fannie Mae was required to file a plan for holding extra capital with OFHEO, as part of its regulatory agreement with the regulator. OFHEO said it does not expect to release details of Fannie's capital plan publicly. Analysts expect Fannie will either need to issue stock to come up with an estimated \$4.5 billion in additional capital or shrink its mortgage portfolio to meet its capital requirements. (*Financial Times*, Jenny Wiggins, 11/10/04)

Department of Justice probe of Fannie Mae is "moving slowly"

- Prosecutors from the U.S. attorney's office in the District of Columbia have been busy probing whether Fannie Mae's executives profited from accounting irregularities, sources said, collecting hundreds of boxes of documents from regulators and participating in interviews of a whistle-blower. The inquiry began after OFHEO released a report alleging widespread efforts by company executives to manipulate financial statements to meet Wall Street's earnings expectations. On at least one occasion, the report alleged executives manipulated earnings to trigger millions of dollars in bonuses for themselves. The inquiry is being coordinated with a parallel probe by the SEC.
- The actions of federal prosecutors in the District in the Fannie Mae probe appear to be a sharp contrast to the pace of a long-running criminal inquiry by the U.S. attorney's office in Alexandria, which opened an investigation into Freddie Mac last year. The Virginia prosecutors have neither sought documents from OFHEO nor conducted interviews with current or former employees, according to sources familiar with the probe. (*Washington Post*, Kathleen Day, 11/01/04)

Two shareholder groups file lawsuits against Fannie Mae

- Two shareholder groups have sued Fannie Mae for allegedly misrepresenting the company's financial statements. One suit was filed in a Washington, D.C. federal court on behalf of investors who bought Fannie's common stock between January 13, 2000, and September 22, 2004. The other suit was filed in New York, represents investors who purchased Fannie's stock between October 16, 2003, and September 22, 2004. (*CBSMarketWatch.com*, Robert Schroeder, 11/02/04)

Fannie Mae's "cutting edge" disclosures

- "Having fought his way to the top of Washington's most-powerful company, Raines is keeping his gloves high. A message from the CEO that Fannie Mae posted on its Web site shows Raines isn't about to stop selling Fannie Mae's vision of the

American dream: ‘We listen to investors, shareholders, stakeholders, policy makers and the media,’ Raines says. ‘And as the record shows, we are always willing to do more to keep our disclosures at the cutting edge of best practices,’” writes *Bloomberg Markets* in their cover article, “Fannie Mae’s Fall from Grace.” (*Bloomberg Markets*, James L. Tyson and Monè Fields-White, December 2004)

Much ado about...[*nothing*]?

- *Mortgage Servicing News* writes in an editorial, “Last year, it was Freddie Mac that went through a wringer after regulators found problems with its accounting practices. Now it’s Fannie Mae’s turn. At the time when Freddie Mac’s turmoil erupted, along with a house cleaning that unceremoniously dumped the company’s top executives, MSN expressed regret about the way that accounting scandal had been handled.”
- “Specifically, we felt Freddie Mac might have done itself more harm than good by ushering long-time chairman and CEO Leland Brendsel out the door without so much as a thank you. He had, after all, provided stewardship to a company that helped make long-term, fixed-rate financing available for homebuyers while generating substantial returns for shareholders. We hope that Fannie Mae is able to manage its crisis more smoothly.”
- “First, a couple of points to remember. Fannie Mae, like its secondary market rival, stands accused of trying to manipulate the timing of earnings and losses, not of manufacturing phantom earnings. That’s a lot different than the kind of wholesale accounting fraud that occurred at corporate scofflaws such as Enron and WorldCom, where billions of hidden debt and phantom earnings led to bankruptcy.”
- “Secondly, while the Justice Department has opened a criminal investigation, nobody has - at this point - persuasively made the case that senior management at Fannie Mae deliberately or knowingly violated accounting rules. The corporation’s business is complex and strong oversight is warranted, but we are not convinced that accounting issues identified by Fannie Mae’s regulator rise to the level of criminal wrongdoing or managerial malfeasance. Fannie Mae remains a pillar of the nation’s housing finance system, a system that is the envy of the world and has contributed to a record rate of homeownership.”
- “Is greater scrutiny of Fannie Mae’s accounting practices warranted? Yes, absolutely. Should management be held to account? Again, clearly yes. But a shakeup at this time could easily do more harm than good. Let’s grant Fannie Mae a presumption of innocence before jumping to the conclusion that its regulator is correct in asserting that earnings were manipulated to facilitate bonuses to top management.” (*Mortgage Servicing News*, November 2004)

Fannie PAC “invests” in other PACs

- During the last eight months, Fannie Mae has used its newly formed PAC to pour hundreds of thousands of dollars of contributions into the campaign funds of key congressional leaders. Fannie Mae’s PAC has made more than \$150,000 in contributions to top congressional leaders and at least as much again to those key lawmakers’ leadership PACs, according to records filed with the FEC and reviewed by *The Credit Union Journal*. Since February, the Fannie PAC made campaign contributions to Keep Our Majority PAC (House Speaker Dennis Hastert) \$5,000; Americans for a Republican Majority PAC (House Majority Leader Tom DeLay), \$5,000; Rely on Your Beliefs Fund (House Majority Whip Roy Blunt) \$5,000; Volunteer PAC (Senate Majority Leader Bill Frist) \$5,000; Defend America PAC (Senate Banking Chairman Richard Shelby), \$5,000; Leadership PAC 2004 (House Financial Services Chairman Michael Oxley) \$7,000; Growth and Prosperity PAC (House Financial Services Subcommittee Chairman Spencer Bachus) \$5,000; PAC to the Future (House Minority Leader Nancy Pelosi) \$2,500; and AmeriPAC (House Minority Whip Steny Hoyer), \$5,000, among others. Under campaign law, Fannie Mae’s PAC is allowed to contribute the maximum allowable \$10,000 to an individual lawmaker’s campaign fund and then again to his or her leadership PAC, which can be used for a wide variety of purposes, including contributions to allied candidates. (*Credit Union Journal*, 11/08/04)

Fannie expands its lending for mobile homes

- Fannie Mae is expanding its mobile home-lending program by allowing borrowers to purchase a manufactured home with a down payment of just 5% on a 30-year mortgage. In February, Fannie Mae began a pilot program with 10 lenders that allowed borrowers to finance up to 95% of the value of a mobile home with a 30-year mortgage. The company is now expanding this program for all of the lenders with whom it does business to offer the lower downpayment financing. In the past, borrowers had to have a minimum downpayment of 10% to purchase manufactured housing with a 30-year mortgage. These new standards, which apply only to mortgages on manufactured homes used as a primary residence, apply to all loans delivered to Fannie Mae on or after December 1.
- Encouraging lenders to offer lower-cost financing for mobile homes could also help Fannie Mae to ramp up its purchases of affordable housing in line with new AH goals issued by HUD. Fannie Mae spokesman Alfred L. King said the impact of the new eligibility requirement on the company’s portfolio was likely to be limited, since mortgages on manufactured housing currently account for less than 1% of the GSE’s total business. (*Dow Jones Newswires*, Allison Bisbey Colter, 11/10/04)

Freddie Mac

Department of Justice and SEC probes of Freddie Mac proceed at their own pace

- SEC attorneys, who are conducting a civil fraud investigation of Freddie Mac, have been interviewing former company executives forced to resign last year in connection with accounting errors that resulted in the company's financial restatement. Prosecutors from the U.S. attorneys office in Alexandria, VA have sat in on some SEC interviews but have not asked questions, said sources close to the investigation. Several lawyers who have been following the case said the prosecutors may be waiting for the SEC to conclude its probe before deciding whether to press criminal charges. This strategy is not unusual, they added. The Virginia prosecutors face high hurdles in trying to make a criminal case by trying to explain to a jury what is wrong with a company understating its earnings and trying to prove that executives intentionally falsified financial statements, said the lawyers.
- Justice Department investigators have been active in the investigation of Fannie Mae's former chief lobbyist, R. Mitchell Delk, sources said. An FBI agent has asked former and current Freddie employees about the fundraising activities of Delk, who was ousted earlier this year after Freddie conducted an internal probe of his personal fundraising activities for prominent Republicans, including Representative Michael G. Oxley (R-OH), chairman of the House Financial Services Committee. Freddie Mac referred the results of its Delk probe to the FEC. The outcome of the FEC's probe will determine whether Delk's dismissal will be considered a resignation or a firing for misconduct, which would result in Delk losing at least \$2 million in stock options, according to sources familiar with the matter. (*Washington Post*, Kathleen Day, 11/01/04)

Freddie Mac's stock listing on NYSE is not in question

- Freddie Mac's future as a listed company on the NYSE was never in question despite being bogged down with an accounting scandal that delayed its earnings reporting, said a NYSE official. "We felt throughout this period Freddie was doing everything they could to get public information to shareholders and to the public," said NYSE's chief regulatory officer Richard Ketchum at the Reuters Financial Summit in New York. Freddie Mac has not been current in its financial reporting since accounting problems in 2003 resulted in a \$5 billion earnings restatement, the replacement of five senior executives and a \$125 million civil penalty. The NYSE's "quest for information" from Freddie Mac has not ebbed, said Ketchum. "There obviously is more to understand with Freddie Mac's financials," he said. "But I think the effort ... in the last five months and the resources they've thrown at this - I have a tough time criticizing. This impresses me as an organization that is trying to get as much information public as possible."

- Representative Richard Baker (R-LA), chairman of the House Financial Services subcommittee on capital markets, insurance, and government sponsored enterprises, said in July he was crafting a letter to the NYSE about Freddie Mac's future as a publicly traded company. Baker said he planned to communicate with "those responsible for making those determinations as to what constitutes their judgment in having Freddie [Mac] remain as listed entity." (*Reuters*, 11/11/04)

Freddie Mac chairman Syron says loan limits need to be indexed

- In an interview with *Origination News*, Freddie Mac chairman and CEO Richard Syron said it makes no sense to have one loan amount limit on loans, when in the upper parts of the Midwest \$333,000 buys a nice castle, but in Berkeley, CA., you "can't touch anything." There should be some indexing to housing prices because ultimately the reason for having these programs is to help people at certain income levels, he said. Ultimately Congress should index the loan limits, Syron said, but isn't certain you do it by state or fine-tune the index by MSA.
- When asked about Freddie Mac's emphasis in the subprime and alt-A (credit) markets, Syron said, "On our mission stuff we are in subprime. We are currently working on some pilots in those areas - in subprime and alt-A. Those are not homogeneous markets. Some of that stuff is 'goal rich' yes. It qualifies for affordable housing credits. ... We are in the very early stages of [pilots for] this. We are looking at things from a credit perspective. We have always been extremely, extremely cautious. Our credit losses are about one basis point. And we have been extremely good at managing interest rate risk using derivatives. We are looking at a variety of ways we can manage credit risk. In subprime we have bought tranches that have been triple-A." (*Origination News*, November 2004)

Freddie Mac loses another senior lobbyist

- Clarke Camper, Freddie Mac's vice president for government relations, is leaving the company to become the global head of external affairs at GE Consumer Finance. Camper has been Freddie's acting lead lobbyist since March, when R. Mitchell Delk departed following an investigation into his fund-raising activities. With the reelection of President Bush and Republicans gaining stronger control on Capitol Hill, Freddie is expected to name a Republican to lead its lobbying team. The company has hired the headhunter Korn/Ferry International to lead the search but decided to hold off on hiring their lead lobbyist until after the election. (*American Banker*, Rob Blackwell, 11/08/04)

Freddie Mac is “bringing America home”

- Freddie Mac has launched an institutional advertising campaign based upon “bringing America home.” The GSE told viewers of *Meet the Press*, “At Freddie Mac, we make the unique moments of home possible for a family every seven seconds, because it’s our goal to bring American home.” On the *Chris Matthews Show*, viewers learned “each day, Freddie Mac makes the thrill of home ownership possible for 10,000 families, because it’s our goal to bring America home.” (*WRC-TV*, 11/07/04)

Freddie Mac announces \$550 million environmentally friendly AH program

- Freddie Mac, the Enterprise Foundation and the Natural Resources Defense Council (NRDC) are working together on the Green Communities initiative to build affordable housing that is also environmentally friendly. The five-year initiative is a \$550 million commitment to build more than 8,500 environmentally friendly and affordable multifamily and single-family homes across the U.S. Freddie Mac is participating in the Green Communities initiative by committing to buy low-income housing tax credits that will provide funding for green rental housing developments. (*Freddie Mac Press Release*, 11/02/04)

Freddie Mac announces pilot education program with NAMB

- Freddie Mac and the National Association of Mortgage Brokers (NAMB) announced the launch of a new three-state pilot consumer credit education initiative using Freddie Mac’s CreditSmart® and CreditSmart® Espanol financial literacy curricula. NAMB affiliate organizations in California, Florida and Texas will manage the pilot programs. The pilots will be conducted on a limited basis, with the potential to expand the effort to multiple locations within the three initial states and potentially to other NAMB affiliate organizations in other states. (*PR Newswire*, 11/08/04)

Freddie Mac to test AVM assisted appraisals

- Freddie Mac announced plans to test AVM Assisted Appraisals as an effective replacement for certain traditional appraisals used in first mortgage lending. The GSE also announced plans to improve controls and measures through the use of electronic appraisal data to enable automated quality control. AMCO, the nation’s premier independent valuation solutions company and the creator and holder of patents pending on AVM assisted appraisal products, announced its support of Freddie Mac’s use of such products in the first mortgage marketplace.

- Edward Davidson, Chairman and CEO of AMCO, said “eValu and eView have been providing lenders with safe and sound alternatives to non-traditional appraisals in the [qualifying conforming mortgages] and home equity lending markets for the past three years. By using the best of AVM technology and the judgment and geographic competency of the best local appraisers, AMCO has created a new reality in valuation and credit risk that Freddie Mac’s initiative is building upon. We are proud to be at the forefront of innovation and compliance within our industry.” (*U.S. Newswires*, 11/11/04)

Federal Home Loan Banks

After Fannie and Freddie, the “800-pound gorillas” will target the FHLBs
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- Fannie Mae and Freddie Mac are not the only ones who need to be worried about the recently reelected Bush administration’s efforts to revamp the GSEs’ regulation. Alfred DelliBovi, the president of the FHLB-NY, warned that community banks are also in danger, because the big banks that compete with Fannie and Freddie will use GSE reform legislation to try to steal market share. “There are some 800-pound gorillas on this playing field,” DelliBovi said. “They would not only like to knock out the GSEs but also dominate the market served by community banks. These giants will try to use GSE legislation as a weapon to do exactly that.” While he didn’t mention the banks by name, DelliBovi was clearly referring to large companies like Citigroup Inc. and J.P. Morgan Chase that stand to win if Fannie, Freddie, and the 12 FHLBs are “weakened.” DelliBovi said, “Their principal targets are Fannie and Freddie. But after they have beaten them down, they will turn their attention to the other GSEs, starting with the Home Loan banks. Farm Credit will be next. They will try to use GSE legislation to move their giant operations ever closer to dominating main street banking. They are the competitors we need to watch.” (*American Banker*, Rob Blackwell, 11/08/04)
- Kenneth Guenther writes in *American Banker*, “The well-chronicled accounting problems of Fannie Mae have given this issue a greater urgency. It seems certain that the Federal Home Loan Banks, an increasingly important funding source for community financial institutions, will end up under the same regulator as Fannie and Freddie, considering the position the Federal Home Loan Bank presidents and the industry have taken on the issue. Since the name of the game is limiting the growth of Fannie and Freddie, Home Loan banks could get caught in the same net.” (*American Banker*, Kenneth A. Guenther, 11/10/04)

Federal Housing Finance Board issues SEC registration guidelines

- The Federal Housing Finance Board has issued guidelines to help the 12 FHLBs register their equity securities with the SEC by August 2005. According to the guidelines, the Finance Board will retain jurisdiction over the FHLBs' capital structures and the combined financial reports issued by the FHLBs' Office of Finance. The guidelines also clarify that the structure of the FHLB boards and audit committees do not have to change because of the SEC registration. The guidelines say the three FHLBs that have not already implemented their separately mandated capital reorganizations can wait until after registration to implement the reorganizations. The guidelines note that the FHLBs may "have to invest in new systems and personnel to be able to obtain the necessary certifications and attestations." The FHLBs will have to comply with several Sarbanes-Oxley Act requirements, once the Banks have registered with the SEC, according to the guidelines. Specifically, the FHLBs' chief executives and chief financial officers will have to certify that the Bank has established effective internal controls over financial reporting and provide an attestation by an outside accountant. Finance Board Chairman Alicia Castaneda said the SEC had reviewed the guidance and she expected all of the FHLBs to meet the registration deadline.
- Bob Davis, the lead lobbyist for America's Community Bankers (ACB), said the guidelines would help ease the concerns of some of the FHLBs' members, especially the retaining of key jurisdictions and make it less likely that ACB would litigate the registration requirement. "There is a more rigorous and constructive effort to resolve potential risks and unanswered questions," Davis said.
- *National Mortgage News* reports that ACB has decided to work with Congress to address its concerns about the FHLBs' registration with the SEC, rather than pursue litigation against the Finance Board. "With the re-election of the president and the stronger Republican majority, we think GSE legislation is going to move pretty quickly," said ACB president Diane Casey-Landry. "We believe we are in a good position now."
- At the Federal Housing Finance Board meeting, the board's four members deadlocked on the latest proposal to change the process for nominating public-interest directors of the banks. The two Democrats on the board petitioned for a more open, less political process that included a public solicitation of nominees, while Castaneda and fellow Republican John C. Weicher said changes at this time would be premature. Castaneda intends to select 29 public interest directors to serve on the 12 FHLBs by the end of the year. She said that it is the Finance Board's responsibility to appoint and approve the public interest directors and she expects to complete the process soon. (*American Banker*, Damian Paletta, 11/01/04; *National Mortgage News*, 11/08/04)

FHLB-New York expects to register with the SEC in 2005

- A spokesman for the FHLB-New York said the Bank expects to register with the SEC this year and adopt a capital plan during the second half of 2005. He said the board made a decision to resolve the registration issues before undertaking a capital change. The Bank also said that it expects to reach its “minimum” level of retained earnings this year. Following a depletion of its capital from losses booked on manufactured housing bonds in 2003, the FHLB-New York said it would pay 50% of its net income to retained earnings. Once the Bank reaches its “minimum” level of retained earnings, it would pay 20% of its net income into retained earnings, until it reaches an unspecified “optimum” level of capital. (*American Banker*, Rob Blackwell, 11/03/04)

FHLB-Atlanta and FHLB-Indianapolis announce board elections for 2004

- The FHLB-Atlanta announced the results of the 2004 election for three positions on the board of directors. John Bond, chairman and CEO of The Columbia Bank, Columbia, MD will represent member financial institutions in Maryland. FHLB-Atlanta members also re-elected directors R. Bradford Burnette, chairman of The Park Avenue Bank, Valdosta, GA, and Jerry Williams, chairman, president and CEO of Orion Bank, Naples, FL, who will serve as the board representatives for Georgia and Florida members. (*FHLB-Atlanta Press Release*, 10/28/04)
- The FHLB-Indianapolis announced the results of the 2004 election of directors. The directors elected to the board include Michael H. Price, president and CEO of Mercantile Bank of Western Michigan, Grand Rapids, MI; Timothy Gaylord, President and CEO of Mason State Bank, Mason, MI; Ray D. Tooker, SVP of Macatawa Bank, Holland, MI; Joseph E. Krul, EVP of Standard Federal Bank National Association, Troy, MI; James D. MacPhee, CEO Kalamazoo County State Bank, Schoolcraft, MI; John L. Skibski, EVP and CFO of Monroe Bank and Trust, Monroe, MI; Bernard D. Williams, CEO of Wantigas Federal Credit Union, Saginaw, MI; and Charles L. Crow, chairman, president and CEO of Community Bank, Noblesville, IN. (*FHLB-Indianapolis Press Release*, 10/26/04)

Washington Mutual is new mortgage servicing partner for FHLB-Seattle's MMP

- The FHLB-Seattle announced that Washington Mutual is a new mortgage-servicing partner for the Bank's Mortgage Purchase Program. Member institutions can now sell their mortgage loans to the FHLB-Seattle and the servicing of those loans to Washington Mutual and receive a servicing-released premium for doing so. (*FHLB-Seattle Press Release*, 11/08/04)

Ginnie Mae

Ginnie Mae will launch excess yield securitization in December

- In December, Ginnie Mae is set to roll out a program which allows GNMA II issuers to securitize the excess servicing fees on their portfolios, said agency officials. This program does not apply to GNMA Is. Through this program, a servicer will be able to take a portion of the servicing fee and securitize it, rather than hold the excess on its balance sheet. This new program follows the launch of the agency's Stripped Mortgage-Backed Securities Program in July. The stripped product is created from the interest- and principal-only carve-outs through a grantor trust structure, rather than from a typical REMIC platform, to provide more liquidity for the strips. Freddie Mac and Fannie Mae also have a similar program. (*Asset Securitization Report*, Karen Sibayan, 11/01/04)

Ginnie Mae names Michael Frenz as EVP and COO

- Ginnie Mae has named Michael Frenz as its new executive vice president and chief operating officer. Frenz assumes this new position after serving as Ginnie Mae's vice president of capital markets for the past two years. (*Asset Securitization Report*, 10/11/04)

Sallie Mae

Sallie Mae's privatization grows closer

- As part of its privatization plan, Sallie Mae has wound down its government sponsored enterprise charter and will no longer fund its operations through the GSE. Sallie Mae, formally known as SLM Corp., announced it plans to complete the privatization as early as year-end, almost four years ahead of schedule. As part of the wind-down of the GSE charter, Sallie Mae has been buying back its GSE debt, repurchasing \$1.7 billion worth in a tender offer ending September 30, with plans for additional repurchases over the coming months. The repurchase program has been expensive, costing \$103 million in losses for the first offer, and projected to cost as much as \$127 million in additional losses. Originally chartered by Congress as the Student Loan Marketing Association in 1972 to create a secondary market for guaranteed student loans, Sallie Mae worked with Congress to pass legislation in 1996 to privatize the company and wind down its GSE charter. Sallie Mae has morphed into the biggest originator of student loans in the country and has branched out into new areas, like investing in airplane leases and home mortgages. Some see

the Sallie Mae privatization as a model for potential privatization of the housing GSEs, Fannie Mae and Freddie Mac. (*Credit Union Journal*, 11/08/04)

Bush administration agenda for second term to be Sallie-friendly

- With the re-election of President Bush and the Republicans expanding their majorities in the Senate and the House of Representatives, the GOP will have almost a free hand to put its stamp on national higher-education policy for at least the next two years. In the short term, the administration's agenda will probably be friendlier to for-profit colleges and student-loan companies. Republican proposals to relax certain rules that proprietary colleges must follow to participate in federal student-aid programs and changes in the government's loan-consolidation program that would make it less attractive to borrowers are expected to move forward. As one indication of what the election results mean for the student loan industry, the day after the vote last week, the price of shares in Sallie Mae rose 10.3%. (*The Chronicle of Higher Education*, 11/12/04)

Postal Service

Return to sender on postal reform

- Barring a legislative miracle, postal reform legislation will not be passed by Congress this year. With the convening of the lame-duck Congress in November, lawmakers will turn their attention to unfinished appropriation bills and reorganizing the U.S. intelligence agencies. "In the simplest terms, the clock simply ran out," said Representative John M. McHugh (R-NY), chairman of a special House panel on postal reform and oversight and leading proponent of broad changes in the USPS' operations. McHugh, said much more went right for postal reorganization advocates in this session than in the other eight years in which their efforts fell short. He thinks there is a good chance the new Congress will pass a bill next year.
- McHugh found a partner in Senator Susan Collins (R-MA), chairwoman of the Senate Governmental Affairs Committee, who was as committed to revamping the Postal Service as he was. For the first time, committees in both the House and Senate voted unanimously to approve major postal reform legislation. Neither bill has come to the full floor for a vote. The legislation would grant the USPS more flexibility in the services it offers and the prices it charges for them, while continuing to guarantee delivery six days a week to every address in the nation.
- While the two bills differ in some provisions and the White House has significant objections to provisions in the bills, McHugh said few lawmakers consider the gaps unbridgeable and with more time, he believes a compromise approach could be worked out. President Bush greatly added to the legislative momentum this year by

naming a presidential commission in 2002 to study potential changes to USPS' business model to remedy the Postal Service's bleak financial outlook. "That's a lot different than past years, when our coming up short was predicated more on a substantive issue or lack of will to go forward," McHugh said. "So in a very important way, we did make progress. Obviously, all of us would have liked to send a bill to the White House, but we've come a long way and we remain optimistic that with a fast start in January we can get a bill and do it in a timely fashion so that any kind of major rate increase can be forestalled."

- Collins said she and Representative Thomas M. Davis III (R-VA), chairman of the House Government Reform Committee, recently met with White House chief of staff Andrew H. Card Jr. to discuss strategies for getting a bill that President Bush would sign and obtained a list of measures the administration wants incorporated into the legislation. "It is important that we act to pass postal reform as soon as possible in order to preserve a \$900 billion mailing industry that is responsible for 9 million jobs nationwide," Collins said. "Without substantial reform, it is expected that we will once again see rate increases far in excess of inflation."
- Ralph Moden, senior vice president of government relations for the Postal Service, said USPS will have to file this spring for a 2006 rate hike large enough to cover inflation and perhaps more. This rate increase would be the first increase since 2002, when the price of a first-class stamp rose to 37 cents. Without postal reform legislation, "it will most likely be a double digit [percentage] increase," Moden said.
- George Gould, legislative director of the National Association of Letter Carriers, said he thinks the chances for passage of postal reform next year are good. "It's good politically at this point to make the system viable," Gould said. "The administration and Congress can take credit for the Postal Service avoiding having huge rate increases and for not being able to deliver the products."
- In 2003, Congress provided the Postal Service some financial relief when it passed a law allowing the Postal Service to scale back by billions of dollars its annual payments into its over-funded pension accounts for longer-serving employees. While the measure helped temporarily restore the Postal Service to profitability, it also gave rise to two thorny issues that now complicate efforts to pass the larger overhaul legislation. One issue, while technical but important, is a dispute over whether the Treasury Department or the USPS should pay about \$27 billion in retirement benefits to some workers related to their military service. Historically, Treasury has paid such costs, but the responsibility was shifted to the USPS in 2003 as part of the postal pension legislation. Postal officials want to switch the related retirement benefits back to the U.S. Treasury. Both the House and Senate bills would do so, but the White House opposes such a move because it would add billions to the budget deficit.
- A second issue is the how \$3 billion a year in postal pension savings would be handled, starting in fiscal 2006. Congress allowed the USPS to keep that money in

2004, but required that the savings be deposited in an escrow account in later years as a check on wasteful spending until the postal reorganization could be passed. USPS officials say that unless they gain access to the savings and the larger pension payment issues are resolved, future rate increases will be higher than they otherwise would have to be. The Bush administration is concerned about releasing the money, because that would also add to the deficit.

- The uncertainty surrounding postal reform is bad for large mailers, who are now trying to budget for future mailing expenses. “We’re worried about this notion that mailers are going to be forced to pay a ‘stamp tax,’ “ said Neal Denton, executive director of the Alliance of Nonprofit Mailers, referring to postal rate hikes tied to political disputes about the pension contributions rather than to actual costs. Mailers “are all assuming now that we’re going to get stuck with double-digit rate increases, because it’s been years and Congress still hasn’t gotten postal reform passed.” Denton suggested that Congress consider a two-track approach, releasing the former pension payment money as a short-term fix to hold down mailing rates, while still pursuing the larger legislative package.
- Michael J. Critelli, chief executive of Pitney Bowes Inc. and president of the Mailing Industry CEO Council, disagreed. “If we at this point in time peel off the pension issue from everything else, we will have a very great deal of difficulty reassembling the coalition that has come together behind comprehensive postal reform legislation,” Critelli said. “We need to keep going on the present track.”
- “The chances of getting a postal reform bill passed in new Congress are no greater or less than they were before,” said Gene Del Polito, president of the Association for Postal Commerce, noting his uncertainty about the depth of the White House’s commitment to postal reform. “The question is how much is the White House concerned about postal reform,” said Bob McLean, executive director of the Mailers Council. In earlier discussions with them, he said the White House did not feel these bills reformed the USPS enough, but was unclear why. McLean said that the Mailers Council will be talking to the White House “very soon” about its concerns.
- “I think that with the administration in favor of postal reform and the same players back, we can push for postal reform this year,” added Jerry Cerasale, senior vice president of government affairs for the Direct Marketing Association. He noted that the lack of resolution on the CSRS issue put additional pressure on Congress to resolve the issue quickly. “But since the next postal rate case probably won’t be filed until April, they’ve got time,” he said. (*Washington Post*, Christopher Lee, 11/09/04; *Direct Marketing Business Intelligence*, Larry Riggs, 11/03/04)

President Bush make recess appointments to Postal Board of Governors
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- “On the day that President Bush declared victory, he made two “recess appointments” to the Postal Board of Governors, said the National Association of Postmasters U.S.

in their November 5, 2004 newsletter. As anticipated, the President appointed Carolyn Gallagher and Louis Guilano to serve for one year on the Board, pending Senate confirmation for a full term. While there is no reason to believe that President Bush's desire to enact reform is diminished, the question is whether he will use his "political capital" to pursue postal reform. In fact, a new political problem for postal reform may have emerged. During the presidential campaign, the two largest postal unions took aim at the White House for its position on the CSRS issue and endorsed Senator John Kerry (D-MA) for president. Some postal observers are wondering what proposals will emerge from the White House on postal labor issues, in the wake of the unions' statements and endorsements. "Only time will tell whether there is any Administration backlash," said the National Association of Postmasters U.S. (*PostalWatch.com*, 11/08/04)

USPS may file phased in postal rate increase in 2005
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- In the spring of 2005, the Postal Service is expected to file a rate case with postal rates rising in early 2006, possibly a double-digit increase. The USPS is considering a phased rate increase, said Steve Kearney, vice president of pricing and classification at the Postal Service, which could mean an equal percentage rate increase in each of two years on predetermined dates with single-piece, First-Class rates would be set at whatever the total rate increase is for the two years. "[I]n the best of both worlds, we plan to file a rate case where the rates would be phased in two phases, and, ultimately, we'd like that to become our long-term pattern because we think customers will value the predictability and smaller increases." This approach would require approval from the USPS Board of Governors and the Postal Rate Commission. While the Postal Service has never implemented phased rate increases, Kearney said this approach would help with the USPS's internal budget and cash-management planning. (*DMNews.com*, Melissa Campanelli, 11/08/04)

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