

The **GSE** REPORT™

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Major Events

Fannie Mae misses deadline to file 3rd quarter 10Q with SEC and estimates losses to exceed \$9 billion, if accounting changes are required

- In a Form 12b-25 filing, Fannie Mae notified the SEC that it could not meet a November 15th deadline for filing a quarterly financial report because KPMG, the company's independent auditor, was unable to complete its review of the company's third quarter results. Fannie hinted that it may take time for KPMG to sign off on its financial statements, since the auditor's review "is subject to resolution of" the questions pending before the SEC and a separate review of OFHEO's findings being conducted by an outside law firm for Fannie's board of directors.
- In the filing, Fannie Mae also disclosed that it may be required to record \$9 billion of previously unreported losses if the SEC determines that the company's FAS 133 accounting practices were wrong. Such a restatement would erase approximately 38% of Fannie Mae's reported income since January 1, 2001, when FAS 133 took effect. Fannie Mae said that if its hedge accounting under FAS 133 is invalidated by the SEC, the company could be required to retroactively report \$13.5 billion of losses and \$4.5 billion of gains, netting a \$9 billion decrease in earnings and regulatory capital. Fannie also estimated it would book a net cumulative loss of \$26 million, if the SEC determined that its accounting for FAS 91 did not comply with GAAP. In addition, Fannie said that it found a mistake in some of its accounting related to FAS 91, which will increase earnings for 2001 and 2002 and decrease them for 2003. The impact on 2003 will be insignificant and the overall effect of correcting the problem Fannie discovered will be a "wash," the company said. Fannie repeated its rejection of OFHEO's charges that the company improperly applied accounting rules FAS 133 and FAS 91.
- The SEC resolution of Fannie Mae's accounting dispute could be months away, said SEC spokesman John Nester. Missing the SEC filing deadline does not necessarily trigger any regulatory response, which the agency evaluates on a case-by-case basis, said Nester. Analysts do not expect the SEC's decision to be easy. "Up to now, the company has really led people to believe that OFHEO was over-stretching in its interpretation of accounting rules," said Josh Rosner, an equity analyst with Medley Global Advisors. "The fact that they couldn't get their auditor to sign off and they weren't able to file" means the SEC doesn't necessarily think OFHEO was out of line. Mike McMahon, managing director at Sandler O'Neill, said, "I expect some sort of compromise," adding that the SEC has the reputation of Deloitte & Touche and KPMG to also consider as well as its own reputation. The SEC is now in the awkward position of investigating a company that registered with it for the first time in March 2003. "Tacitly they approved Fannie's accounting by allowing them to register with the SEC," McMahon says. "They're right in the middle of this." Peter Eavis, a senior columnist with *TheStreet.com*, believes that the chances of the SEC coming down on the side of Fannie Mae are "slim." He writes, "The SEC

understands FAS 133 extremely well and is fully aware of the ways in which companies misapply it to make their earnings look better than they really are.”

- OFHEO Director Armando Falcon said, “If at some point it turns out that a [Fannie Mae] restatement is necessary and they need additional capital, what we would implement is a capital restoration plan pursuant to our prompt corrective action provisions in the statute.”
- Although the company did not file its 10Q, Fannie Mae released a summary of its third quarter operating results, based upon its current accounting practices. Fannie Mae missed analysts’ earnings expectations by a few cents in the third quarter, reporting core earnings of \$1.86 per share and diluted EPS of \$2.45. Net income fell 9% to \$2.42 billion from \$2.67 billion a year earlier. Fannie Mae’s results for the third quarter of 2004 were primarily driven by a \$900 million reduction in losses on the call and repurchase of debt and growth in guaranty fee income of \$146 million or 24% were offset by a \$634 million or 18% decrease in net interest income, driven by a 31 basis point decrease in net interest yield from 156 basis points to 125 basis points, and a \$333 million decrease in income related to the time value of purchased options. The third quarter’s results also included a \$185 million after tax gain related to the cumulative effect of adopting FASB 149. The net interest margin fell to 0.94 percentage points in the quarter from 1.2 points in the quarter a year ago, Fannie Mae said. The company cautioned that these operating results complied with GAAP “as currently applied by Fannie Mae.”
- In a report issued following the company’s announcement, Merrill Lynch analysts wrote, “Fannie Mae continues to suffer from compressing margins and net portfolio runoff, which we think was generally expected, though it appears the fundamental contraction was modestly more severe than we estimated.” Paul Miller, an analyst at Friedman, Billings Ramsey Inc. said, “The margin may continue to drop to 0.81 points in following quarters.” He added, “The interest margin is a big thing,” for Fannie Mae’s earnings. “We knew it would come down but we didn’t think it would happen this quickly.”
- Now that Fannie Mae has acknowledged that it may have to restate its earnings by billions due to its accounting practices, the tenure of CEO Franklin D. Raines and CFO J. Timothy Howard may soon be over, according to rumblings on Wall Street and in Washington. On *Inside Politics* on CNN, Robert Novak said, “Investors, and the whole Wall Street [are] not happy with the accounting problems at Fannie Mae. They would like to see Franklin Raines, ... former OMB director under Clinton, like to see him go and there’s a talk that Bob Zoellick, the U.S. trade representative could be his replacement.” According to the *Washington Post*, Zoellick is said to be looking to leave or move to another position in the Bush administration. On CNBC’s *Bullseye*, Owen Thomas, chief of reporters at *Business 2.0 Magazine*, said, “...I think the thing that might benefit [Fannie Mae’s] stock the most is if Franklin Raines and Tim Howard decided to leave. These guys have not gone quietly.” On CNBC’s *Street Signs*, host Dylan Ratigan asked Representative Richard Baker (R-LA) if

Fannie's CEO Raines will be forced to resign. Baker responded, "I am awaiting the SEC findings on that; I certainly wouldn't want to pre-judge it. From what I know today, there certainly remains a big question in my mind as to the advisability of current management staying on."

- Writing in *TheStreet.com*, Peter Eavis argues that Fannie Mae may be undercapitalized by as much as \$11 billion, if the company is forced by the SEC to book the \$9 billion charge. Eavis believes that Fannie Mae's \$9 billion estimate doesn't adequately show the full losses that the company may have kept out of earnings by allegedly misapplying FAS 133. He argues, "It is important to understand that the \$9 billion is a *net* figure, made up of after-tax derivative losses of \$13.5 billion and after-tax gains of \$4.5 billion. The before-tax number for those losses is actually \$20 billion." He added, "The key concern for the market is how much capital Fannie now has to raise." In its regulatory agreement with OFEHO, Fannie agreed to increase its minimum capital requirement by 30% to approximately \$41 billion. On September 30, Fannie likely had so-called core capital of \$38.5 billion, said Eavis. Subtracting \$9 billion of net losses would reduce equity to \$29.5 billion, which is \$11.5 billion below the minimum requirement. Among its options for improving its capital position, Fannie Mae could shrink its balance sheet by selling mortgages from its portfolio and slowing its purchases of new loans or by selling preferred stock. David S. Hochstim, an analyst at Bear Stearns, said Fannie easily could cope with a \$9 billion hit, which he called a "worst-case estimate." Fannie Mae would not comment on reports that the company's officials held a conference call on the matter with debt underwriters ahead of company's announcement.
- Fannie's announcement also has lead many to speculate on whether the company will go "dark" and not file quarterly statements for some time. Freddie Mac's restatement delayed its financial results for more than a year and more than three years will have lapsed before the company gets back on track as a timely filer in early 2006. Bert Ely, an Alexandria, DC consultant, predicted that Fannie Mae would go dark for at least two years. Hedge fund manager Lawrence Kam speculated that "we may never see another 10Q from Fannie again." Rosner said he doubts Fannie Mae will be able to issue its 2004 annual reports, since the new SEC rules require the companies to certify both their internal controls and their year-end results. "With the internal control weaknesses that OFHEO has noted, will the company be able to file an annual report? They cannot file without that certification," Rosner said. "Even if the SEC says your accounting is okay, there will be lingering issues of their internal controls." (Federal National Mortgage Association Form 12b/25, 11/15/04; *Washington Post*, David S. Hilzenrath, 11/16/04; *Washington Post*, 11/07/04; *Financial Times*, Jenny Wiggins, 11/17/04; *Wall Street Journal*, James R. Hagerty, 11/16/04; *Dow Jones Newswires*, Dawn Kopecki, 11/16/04; *CBS MarketWatch.com*, Robert Schroeder, 11/16/04; *Bloomberg News*, James Tyson, 11/16/04; *Bloomberg News*, Al Yoon, 11/19/04; *CNBC's Bullseye*, 11/16/04; 18:15:12; *CNN's Inside Politics*, 11/19/04; 15:53:01; *CNBC's Street Signs*, 11/16/04; 18:13:03; *TheStreet.com.*, Peter Eavis, 11/16/04)

Ohio Attorney General files suit against Fannie Mae, alleging securities fraud

- On November 19, Ohio Attorney General Jim Petro filed a class-action securities fraud lawsuit in federal court on behalf of the State of Ohio and all other shareholders of Fannie Mae, alleging the company manipulated earnings to boost its share price and enrich its corporate executives. Petro filed the suit against Fannie Mae and its top executives, CEO Franklin D. Raines, CFO J. Timothy Howard, and senior vice president and controller Leanne G. Spencer, in the U.S. District Court, Southern District of Ohio (Eastern Division) on behalf of the Ohio Public Employees Retirement System, State Teachers Retirement System of Ohio, Ohio Bureau of Workers' Compensation, and all other purchasers of Fannie Mae common stock from October 11, 2000, through September 22, 2004. Petro's complaint alleges that Fannie Mae, Raines, Howard, and Spencer "artificially inflated the company's publicly traded common stock through false public financial statements." Petro said, "These defendants manipulated earnings in a fraudulent scheme to deceive investors about Fannie Mae's true financial state. This deception could cost shareholders billions of dollars. Because these executives were compensated primarily on Fannie Mae's stock performance, this artificially high stock price allowed the executives to get rich at the expense of the company's shareholders." Petro also charged that in violation of SEC rules, Fannie Mae and its officers did not disclose that the company failed to apply generally accepted accounting procedures, lacked sufficient internal auditing controls, and failed to report the volatility of the company's earnings.
- Ohio is seeking lead plaintiff status in its \$40 million securities fraud lawsuit against Fannie Mae. Petro planned to file requests for lead status in federal courts in Columbus, New York and Washington, D.C., said Ohio AG Office spokeswoman Michelle Gatchell. Fannie Mae faces at least 13 lawsuits related to the federal review, said Gatchell. (*PR Newswire*, 11/19/04; *Associated Press*, 11/22/04; *CBS MarketWatch*, Robert Schroeder, 11/23/04)

HUD inspector general's report on OFHEO is released and
Congress decries the IG's findings

- HUD's inspector general (IG) has closed, without any enforcement action, an investigation into whether there was improper political influence at OFHEO. HUD Secretary Alphonso Jackson reviewed the report and returned it to the IG "with the determination that no action was warranted," said HUD spokesman Douglas P. Duvall. In July, Department of Justice prosecutors reviewed the IG's report and decided not to seek charges against anyone at OFHEO. Congress still has the option to take action, said a HUD spokesman. The report concluded that the Director of OFHEO has broad authority to release agency information as he deems appropriate and that OFHEO didn't overstep its legal authority in carrying out the investigations of Freddie Mac and Fannie Mae.

- In April, Senator Kit Bond (R-MO) requested the probe because of his concern that political influence may have tainted OFHEO's investigation of Fannie Mae. The IG's investigation centered on whether OFHEO leaked a letter it had sent to Fannie Mae Chairman and CEO Franklin Raines to the media. The IG's report goes well beyond the question of the agency's media leak and assesses OFHEO's corporate culture and internal tensions over the appropriateness of certain regulatory actions. The report describes OFHEO's management team, embarrassed by the agency's failure to identify accounting irregularities at Freddie Mac, as determined to more aggressively investigate accounting practices at Fannie Mae. The more aggressive approach to the examination process led to divisions with the agency's personnel, according to the report, which quoted some employees as expressing concerns that OFHEO's management had become overzealous in their actions. According to the IG, OFHEO is split between those who favor its past approach as a "collegial" bank examiner to those who would turn the agency into a "much more aggressive regulator." In the report, Deputy Director Stephen A. Blumenthal is quoted as saying he believed that in the past OFHEO was afraid to be a tough enforcer and was more concerned about maintaining collegial relationships with the GSEs they regulated. "Well, that's over now," he told the HUD investigators. According to the report, Blumenthal talked to his staff about how public officials' announcements could hurt Fannie Mae's stock and help make the company "submit to the will" of the regulator. Blumenthal "had taken a publicity-driven approach to oversight," charting how certain events impacted Fannie Mae's share, said the IG report.
- Although the 92-page report was largely ginned up by Fannie Mae's political pressure, it raised the ire of several lawmakers, who are supporters of the GSEs. Representative Barney Frank (D-MA), senior ranking minority member on the House Financial Services Committee, said "The view inside of OFHEO provided by this report is very troubling. The senior management of OFHEO appears to have run roughshod over the judgment of professional staff and seriously compromised OFHEO's credibility as a financial regulator. ... It is clear that a leadership change at OFHEO is overdue." Frank added, the IG's report makes it difficult for lawmakers to trust OFHEO's findings in its examination of Fannie Mae's accounting.
- Bond, who chairs the subcommittee that oversees OFHEO's budget and requested the report, called for Falcon and Blumenthal's resignations. "Falcon's term expired six weeks ago. He should be gone now," he said. "His deputy [Blumenthal], whose conduct has also been severely criticized by many of the career auditors--clearly should step down as well." Bond, who has had a long-running conflict with OFHEO, has requested repeated investigations of the agency, has sought to limit its role and staffing over the years, and had been trying to withhold \$10 million of the agency's proposed \$59 million budget until Director Falcon is replaced. Bond has received thousands of dollars of political contributions from Fannie Mae employees, including CEO Franklin D. Raines, and his son works for Fannie Mae.
- According to the report, Blumenthal alleged that the IG's investigation was "due to the animosity of Senator Bond" and one of Bond's staff members; he questioned

whether there was an attempt, at least on the part of Bond's staffer, to "somehow chill or otherwise interfere with [OFHEO's] investigation of Fannie Mae." The report also includes a suggestion by a senior OFHEO official that the agency might be taking inappropriate political heat "a la the Keating Five in the past" from one particular corner of Capitol Hill. OFHEO officials noted that at the request of Congress the IG has conducted six investigations of OFHEO over the past two years, all of which failed to find any real problems.

- If Falcon were to leave OFHEO before the White House names a permanent replacement, the administration would likely appoint U.S. Assistant Treasury Secretary Wayne Abernathy, the chief architect of the administration's GSE regulatory reform effort last year, to serve as the agency's director on an interim basis.
- In a statement, OFHEO Director Armando Falcon said he is "pleased a determination has been made that I followed the law, acted wholly within my authority as director, and that this is now a closed matter." He added, "We will continue to do the important work of OFHEO and not divert our attention from the serious matters before the agency."
- In a speech before the Women in Housing & Finance, Falcon said the transition of OFHEO from an often criticized, little-respected and under-funded regulator to today has been a difficult one. "We've made much progress and accomplished a great deal," said Falcon about his five-year tenure with the agency. "But, unfortunately, that doesn't come without some criticism or controversy." Falcon and members of his staff have suffered attacks on their professional credibility and personal reputations. "Your motives, your judgment, it all gets questioned," Falcon said. "What's important is that you just stay focused on doing your job, do the right thing and never bow to political pressures. And in this case I think the agency has done this very well." (*Dow Jones International News*, Dawn Kopecki, 11/19/04; *Dow Jones Business News*, John R. Wilke, 11/22/04; *Washington Post*, David S. Hilzenrath, 11/20/04; *Dow Jones International News*, Dawn Kopecki, 11/22/04; *Bloomberg News*, James Tyson, 11/18/04; *Dow Jones Capital Markets Report*, 11/22/04; *Washington Post*, David S. Hilzenrath, 11/18/04; *Dow Jones Newswires*, Dawn Kopecki, 11/17/04; *Bloomberg News*, James Tyson and Al Yoon, 11/22/04)

Congress passes full funding of OFHEO and urges management changes at agency
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- Congress voted to grant OFHEO its full budget request for fiscal 2005 of \$59.2 million, an increase of 48.4%. House and Senate negotiators left out a Senate proposal that would have withheld \$10 million until OFHEO Director Armando Falcon Jr. was replaced. In a report accompanying the omnibus appropriations bill, the conferees urged President Bush "to take swift action in replacing the [OFHEO] director [Armando Falcon, Jr.] and his deputy [Stephen Blumenthal] both in consideration for the very poor decision making of these individuals over the past few

years as well as the serious issues raised by the HUD IG's report of investigations." Spokespersons for OFHEO and the White House declined to comment about the requested management changes.

- Democratic lawmakers will tell their Republican counterparts that the continued tenure of Falcon and Blumenthal would complicate efforts by the Treasury to create a stronger GSE regulator, said Representative Barney Frank (D-MA). "It is clear that a leadership change at OFHEO is overdue," said Frank. Senator Kit Bond (R-MO), who requested the HUD investigation, inserted the request for the removal of OFHEO's leadership in the bill, said Howard Glaser, chief legal adviser to the former HUD secretary, Andrew M. Cuomo.
- As part of OFHEO's funding increase, \$5 million is earmarked for the agency's ongoing special investigations of Fannie Mae and Freddie Mac. The remainder of the increased funding would be used mainly to fund 59 new positions in key areas of OFHEO's oversight operations, including capital administration, the chief compliance office, annual examination activities, the chief accountant's office, legal positions, and other infrastructure for overall management and policy development. (*Washington Post*, 11/23/04; *Bloomberg News*, 11/23/04; *American Banker*, Rob Blackwell, 11/23/04; *Bureau of National Affairs*, Linda Micco, 11/23/04)

Fannie Mae and Freddie Mac

Senator Shelby plans hearings on Fannie Mae's accounting in early 2005
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- On Bloomberg News' *Money & Politics*, Senate Banking Committee Chairman Richard Shelby (R-AL) expressed "great concern" about reports that Fannie Mae would show a \$9 billion loss for the third quarter if the SEC rules that the company improperly accounting for its use of derivatives. Shelby said "There is going to be a political response by the Congress, I believe, and there should be to the problems -- lack of regulations, perhaps lack of good accounting practices at Freddie Mac and Fannie Mae and perhaps the Federal Home Loan Banks, too. Those are problems that we have to address and how do we address them, we address them politically because that's our responsibility. That's what the American people want us to do."
- Shelby was asked if he thought there was a political component of OFHEO's criticisms of Fannie as suggested in the IG's report. Shelby responded, "I don't think so. I think Fannie Mae and Freddie Mac have both had a lot of problems. Fannie Mae is obviously having some now. The SEC is also beginning to look into some of their problems. I think Congress will be looking at it very closely again. I've always advocated that the GSEs do a good job and they serve a purpose but they should be well regulated, they should be well capitalized, and they should have great accounting practices. We ought to know what they're doing because after all,

they are government-sponsored enterprises. (Bloomberg Television, *Money & Politics*, 11/19/04, 14:45:11)

- In an interview with *Market News International*, Shelby said that recent reports about Fannie Mae's accounting irregularities, "confirms that we're on the right track to push comprehensive legislation to strengthen the regulatory structure for GSEs. ... This just confirms it." Shelby said the Senate Banking Committee will explore the most recent reports regarding Fannie Mae. "This new information is something we need to look into," he said. The committee will hold hearings "pretty early [next] year" on issues pertaining to regulatory reform of the GSEs. When asked if the hearings will be held in January when the 109th Congress convenes, Shelby responded, "Not that early." Andrew Gray, the Senate Banking committee spokesman, said Shelby plans to use his original GSE regulatory reform proposal as the starting point for any new legislation. Shelby "was not happy with the changes that were made during markup," said Gray. "He felt it was watered down." (*Market News International*, John Shaw, 11/17/04; *BNA's Daily Report for Executives*, Richard Cowden, 11/18/04)

Representative Baker expects Congress to adopt GSE regulatory reform in Spring 2005

- On CNBC's *Street Signs*, Representative Richard Baker (R-LA) said he believes that Fannie Mae's accounting investigation will ultimately result in Congress passing GSE regulatory reform next year. Baker said, "I think the more important aspect is the effect that this announced [Fannie Mae] investigation [by the SEC] has on the political environment here on the [Capital] Hill. For many years, Fannie and Freddie have enjoyed political protection because of their inordinate skills in deploying their lobbying skills. And this has caused many members [of Congress] to take a second look at these Enterprises and are they really what they've claimed to have been all these years. ... I do believe that [the GSEs have] not met their obligations. The charter that they are given by the Congress requires them to take certain actions to meet social needs. They clearly have underperformed there. They have taken advantage of the taxpayer subsidy. It appears that most of that flows through to the shareholders. And, the most disappointing news of all now is that the accounting that they have utilized for many quarters now appears to at best be faulty and at worst more than that. I think this bad set of circumstances comes in a low interest rate environment when housing is strong and so these revelations are causing the least amount of market disruption possible, but will enable us, I believe, next spring to adopt a regulatory structure that's appropriately funded and, more importantly has market respect and has all the tools that other financial regulators have in order to constrain the growth of these enterprises." (CNBC, *Street Signs*, 11/18/04, 18:13:03)

- US Assistant Treasury Secretary for Financial Institutions Wayne Abernathy said November 18th that regulatory reforms for the GSEs must be achieved in 2005. Restating the Bush administration's insistence on tighter regulation of Fannie Mae and Freddie Mac, Abernathy said that by delaying regulatory reform of the GSEs, "we're continuing to live with a very serious gap in our regulatory system." He added, "What we need to have is a regulator that has adequate authorities." The Treasury's outline of what it requires in GSE regulatory principles has not changed since they were first presented to Congress in last year, said Abernathy. Key reforms include providing the GSE regulator the power to set and adjust the GSEs' minimum and risk-based capital ratios and the authority to place a failing GSE into receivership. "It's clear to us that OFHEO and the Federal Housing Finance Board don't have those authorities," he said. When asked if Treasury would consider mandating a limit of GSE's debt issuance, Abernathy said he would not speculate. "All we've done is verify Treasury's authority in that area," he added. Abernathy described Treasury's GSE regulatory authority principles as "sound" and "timeless," adding that Treasury remains open to any adjustments and additions Congress might want to contemplate. While Treasury has not recently had any significant "sit-down-and chat" sessions with members of Congress regarding GSE issues, the White House and Treasury are having conversations about the regulatory agenda, Abernathy said.
- In reference to recent allegations of accounting improprieties at Fannie Mae, Abernathy said, "Events that have taken place since then, since that testimony [in Sept 2003] have only gone to demonstrate the inadequacies in our current supervisory system." The latest information from Fannie, he said "corroborates that the problem is very serious, the problem is very significant and that it ain't getting better all by itself. This is something to require a legislative solution." He added, "I'm not aware of a whole lot of companies that are having trouble with FAS-133 to the level that Fannie is. It remains an open question whether there is something about the GSE structure itself that "lends itself to having trouble with that particular rule," he said.
- When asked about rumors that he may be selected as the director for the GSE regulator, Abernathy said, "I'm very happy with the job I have now," declining to comment on these rumors. Regarding President Bush's Cabinet reshuffling, Abernathy said, "The music is playing and people are still circling the chairs...I'm sitting in my chair, though, and I'm comfortable there." (*Market News International*, Claudia Hirsch, 11/19/04)

OFHEO's Director Falcon speaks out on GSE regulatory reform

- At a meeting of Women in Housing & Finance, OFHEO's Director Armando Falcon commented on strengthening the regulation of Fannie Mae and Freddie Mac. Falcon, "This is one where we have made some progress but we just haven't achieved the objective yet. I think OFHEO is a world-class regulator, but we just don't have world-class powers. That is why it is so essential to make sure that we close the gap here, to make sure that we have the same powers as every other safety and soundness regulator. These gaps must be addressed. We must ensure the agency is fully empowered so that in a time of crisis the agency will have all the power it needs to fulfill its mission."
- When asked about the possible outcomes on GSE regulatory reform, Falcon said "I think there are three possible outcomes here. One is the status quo, which I think would clearly be a mistake. The second is to maintain the current structure, which is OFHEO as the safety and soundness regulator, just fill the gaps of the agency's powers, give it everything that any other safety and soundness regulator would have. The third option is to establish a new regulator which I think would require combining OFHEO and the [Federal Housing] Finance Board into a single regulator for all the housing GSEs." (*Bloomberg News*, James Tyson, 11/16/04)

Fannie Mae announces (again) its support for a new GSE regulator

- After fighting Congressional efforts to limit its powers, Fannie Mae will now support a bill to create a stronger GSE regulator, said company officials. By positioning the company in support of the GSE regulatory reform effort, management hopes to put Fannie Mae in a stronger position to bargain over crucial details of how the GSE's business would be regulated. Fannie Mae wants to avoid limits on the company's ability to develop new financial products and also wants to be sure that the federal government would give explicit protection to mortgage-backed securities holders if Fannie Mae were ever forced into receivership. "I don't think anyone will have any doubt about our commitment to achieving legislative reform next year," said Charles Greener, Fannie Mae's chief spokesman.
- In the past, Fannie Mae has made similar statements and then torpedoed legislation by fighting key provisions. Last year, Fannie's chief executive, Franklin D. Raines said that the company "looks forward" to creating a new regulator, while at least one of Fannie Mae's offices solicited its grass-roots advocates to actively undercut the administration's plan. Fannie Mae's history makes many lawmakers skeptical that the company would ever support GSE regulatory reform. "It doesn't surprise me that Fannie Mae is saying that it's willing to play nice; that's been its pattern for years," said Michael DiResto, spokesman for Representative Richard H. Baker (R-LA). "But behind the scenes they've always worked to gut any legislation."

- The chief reason for Fannie Mae’s change in tune is OFHEO’s highly critical study of its accounting and management practices, said company officials. As a consequence, the Justice Department and SEC are investigating the company. A stronger regulator would give investors confidence that any such problems have been dealt with, said Fannie Mae executives. Twelve years ago, Fannie Mae made a similar decision to help craft legislation when Congress created OFHEO. Initially, Fannie opposed the creation of the oversight agency. When some of its lucrative ties to government were in jeopardy for largely ideological reasons, Fannie Mae reversed its position and negotiated to limit OFHEO’s powers.
- Another reason for Fannie Mae’s “new attitude” is that the gap has already closed between what lawmakers have proposed in the legislation and what the company and its fellow housing-industry lobbyists are willing to accept. “Over the past year the issues have narrowed significantly as Congress and the administration worked hard on the legislation,” Greener said. “Any remaining issues are bridgeable.” Fannie Mae has good reason to try to rush the acceptance of the latest version of the legislation. Federal Reserve Chairman Alan Greenspan and Treasury Secretary John W. Snow have campaigned for months to place stricter controls on Fannie Mae and Freddie Mac. Earlier this year, the Bush administration complained that the current Senate bill was too weak because it gave too much authority to Congress in the case of receivership. Republicans, who have pressed hardest for the new regulator, will be in a stronger position to pass tougher legislation.
- If Republicans try to incorporate additional restrictions in the legislation, Fannie Mae could reverse course again and try to stall a bill. “Outside the National Rifle Association, they’re probably the strongest lobbying presence on Capitol Hill,” said W. Michael House, executive director of FM Policy Focus. (*Washington Post*, Jeffrey H. Birnbaum and David A. Vise, 11/26/04)

Will former RNC chairman Ed Gillespie be rejoining the GSE fight?

- *National Mortgage News* reports that former RNC chairman Ed Gillespie is stepping down as chairman of the Republican National Committee and is returning to his lobbying firm, Quinn Gillespie & Associates, which works for FM Policy Focus, one of the GSEs’ fiercest critics. “Since [Quinn Gillespie] is a part of the FM Policy Focus team, we expect [Gillespie] to be a part of the team,” said FM Policy Focus director Mike House. (*National Mortgage News*, 11/22/04)

America’s Community Bankers outlines GSE agenda

- In an editorial in *Community Banker*, America’s Community Bankers chairman William M. Zuppe outlined the trade organization’s GSE agenda. Zuppe writes, “ACB established a benchmark in the Senate Banking Committee for regulation and

reform of government-sponsored enterprises. We want the GSEs to have a world-class regulator, one that is fully independent and whose supervision and enforcement powers are like those of the federal banking regulators. We're working to keep Fannie Mae and Freddie Mac on their side of the fence--in the secondary market. And we are actively engaged in maintaining the cooperative nature of the Federal Home Loan Bank System. It is vitally important because of the advances it writes and because, collectively, we own the bank system's stock." (*Community Banker*, William M. Zuppe, 10/01/04)

Fitch Ratings calls for improvement in derivatives disclosure

- In a recent report, Fitch Ratings warns that the complexity of the accounting standards themselves coupled with the relatively low level of transparency associated with derivatives creates a new set of worries for investors and analysts, as interest rates rise and the potential for volatility increases. The hedge accounting standards are complex and difficult both to apply and to understand, said Joe St. Denis, one of the authors of the report. Fitch Ratings believes that there needs to be a significant improvement in the disclosure of the usage of derivatives by companies in order to achieve an acceptable level of transparency on which to base meaningful credit analysis. Without adequate disclosure, the market will have a difficult time understanding the risks associated with derivatives and their effects on financial statements, St. Denis said. It is also very difficult to see whether companies are properly applying the accounting standards for hedging instruments, which can also make for future problems in a more volatile market environment. "The hedge accounting rules are very complex and so it's difficult to see what's going on in most cases," St. Denis said. "There really needs to be more disclosure as to how the rules are being applied." (*High Yield Report*, Savita Iyer, 11/22/04)

Adjusting to the low growth GSEs

- For most of 2004, Fannie Mae and Freddie Mac have restrained their purchases of mortgage loans and mortgage-backed securities. Heated competition from banks and other investors compressed spreads, so the assets have become less attractive for the GSEs. More recently, stringent capital requirements imposed by Fannie's regulator in response to an accounting scandal are also dulling the GSE's appetite for growth. To the extent the capital issue drives Fannie's projected shrinkage, other players could benefit from the company's absence. One potential winner is Freddie Mac, which already holds more capital than the surplus requirement imposed in response to its accounting scandal.
- Michael McMahan, an analyst with Sandler O'Neill & Partners LP, said that to the extent that Freddie and Fannie are restrained in buying loans, lenders would have to sell loans for less. "That will probably push mortgage rates up," he said. "It's an economic law." Some people "may not agree with that, but only in the old Soviet

Union economy did taking away a bid not impact prices.” For the most part, the effect would be small, unless some other factor drives other investors away from the market in droves. “If there was ever a time in which Fannie Mae found itself constrained by a regulatory issue ... now is not necessarily a bad time for that to happen,” McMahon said.

- Andy Pollock, the president and CEO of First Franklin Financial Corp., said if either Fannie or Freddie began pulling back on MBS purchases for capital reasons, other investors would be there to provide liquidity. Investors in Europe, Asia, and elsewhere are active buyers of U.S. mortgage debt, said Pollock.
- Robert P. Napoli, Sr., an analyst with Piper Jaffray & Co., wrote in a research report that Fannie’s zero portfolio growth would result primarily from “historically narrow mortgage-to-debt spreads, the higher mix of ARM loans, and increased desire for mortgage originators to grow their own balance sheets.” The capital issues are playing a role, so there should be some small benefit to other companies pursuing the same assets, he said. If Fannie “had a tremendous growth opportunity out there today, I don’t think they could take advantage of it” because of the capital constraints, Napoli said. Still, “I don’t think” such opportunities exist.
- If aggressive bids from rivals keep Fannie from buying assets, the GSE’s restraint would not necessarily affect pricing, since the GSEs have been playing a smaller role in the market all year. In recent months both Freddie and Fannie have turned to buying adjustable-rate mortgages and senior bonds backed by such loans to expand their portfolios. The shift toward ARMs along with an increasing percentage of nonprime loans has also hurt the GSEs’ securitization businesses and, to the extent they buy these products, their margins. (*American Banker*, Jody Shenn, 11/22/04)

Fannie Mae and Freddie Mac loan caps likely to rise in 2005

- Surging home prices are likely to raise the value of mortgages that Fannie Mae and Freddie Mac can buy in 2005, which would lower borrowing rates for a greater number of home buyers. Currently, Fannie and Freddie can buy loans worth up to \$333,700. Economists expect that ceiling could rise by some 8% in 2005, enabling the GSEs to buy loans over \$350,000 and possibly cut about 50 basis points off of interest rates on mortgages below that level. The loan ceiling, or conforming loan limit, is dictated by a formula in the GSEs’ congressional charters pegged to the 12-month move in the October median home price in a survey by the Federal Housing Finance Board.
- The higher loan limit will give new ammunition to critics, such as Federal Reserve Chairman Alan Greenspan, who see the GSEs’ rapid expansion as a risk to the U.S. financial system. “It’s obviously a factor in Fannie’s and Freddie’s growth - they [would] now have access to a bigger hunk of the mortgage market,” said David Seiders, chief economist for the National Association of Homebuilders. Freddie

Mac said the higher cap is the result of higher home costs. “It just means that many more Americans are able to take advantage of the low-cost funding that we enable,” said Freddie Mac spokeswoman Sharon McHale.

- The increase in the loan cap comes at a politically sensitive time for Fannie Mae and Freddie Mac, both currently facing questions about their accounting and financial reporting. A higher limit would pit the GSEs directly against banks in competition for a larger pool of mortgages and would cut the profits banks can make off those loans, said Mike McMahon, an analyst with Sandler O’Neill. (*Reuters News*, Mark Felsenthal, 11/18/04)

Fannie Mae

OFHEO hires additional accounting expert and defends its Fannie Mae investigation

- According to people close to OFHEO’s investigation of Fannie Mae’s accounting practices, the agency has recently retained Lynn Turner, the former chief accountant of the SEC, to assist with the investigation. (*Wall Street Journal*, John R. Wilke, 11/22/04)
- OFHEO Director Armando Falcon, Jr. continued his public defense of his agency’s investigation of Fannie Mae by dismissing arguments that complex accounting standards are to blame for accounting problems at the company. “I don’t think this is about the complexity of FAS 133,” Falcon said at a Women in Housing and Finance luncheon. “We believe Fannie Mae did understand the rules and didn’t follow them. ... I’m not going to enter into a debate about the accounting rule. The fact is that is the rule. Whether we like it or not, we all have to follow it.”(*American Banker*, Rob Blackwell and Jody Shenn, 11/17/04)

Trust, but verify, Fannie

- In *Active Insight*, George Fisher writes “Questions of accounting and management practices at Fannie Mae and Freddie Mac have been tangled up in politics, which while understandable is slowing progress in their resolution. It can hardly be otherwise because of the semi-governmental nature of these organizations, because of the large amount of money involved, and because mortgage financing has become such a huge segment of the American economy (mortgage debt exceeds government debt). However, the Congress must see past political and partisan interests because of the importance of having these organizations on a sound footing as long-term interest rates rise.”

- “It has not yet been proven that there are substantive problems to be addressed, but between OFHEO’s recent report and years of critical reporting in the financial press there is considerable evidence that a thorough airing is called for. In addition, the fervor of the lobbying campaign mounted by Fannie Mae in particular raises the question of motivation.”
- “Interest rates are going to rise. This has been evident for some time and Mr. Greenspan emphasized the point [recently]. That is going to have negative consequences among over-extended borrowers. However, a gradual, measured rise is unlikely to generate a crisis among American consumers broadly because most of them will successfully adapt (and will likely switch from consumption to saving). Taking on debt when real rates are negative is perfectly rational behavior and that same rationality will be in evidence again as the rate environment changes. Not entirely painless of course, but not a crisis, either.”
- “What might precipitate a crisis, potentially of S&L proportions, would be the failure of a large financial organization. The time is ripe to ensure that Fannie Mae is structured appropriately to weather the coming storm; full transparency into their operation and on-and-off balance sheet structuring is perfectly appropriate. Politics must be set aside in the interests of the country: Fannie and her supporters protest that nothing is amiss. ...let us trust but verify.” (*Active Insight*, George Fisher, 11/22/04)

Market discipline doesn’t work at Fannie Mae
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- In an interview on CNBC’s *Street Signs*, Representative Richard Baker (R-LA) was asked if Fannie Mae has to recognize a \$9 billion loss on its derivatives, would the write-off shake the market? Baker responded, “...Fannie is an amazing enterprise. They can have a house on fire and call it just a home warming party. They are able to describe themselves to the market in very self-assuring ways and I have been amazed. If it had been any other public operating company that announced a multi-year, multi-billion dollar restatement as Freddie Mac had done, you can only imagine the market consequences. So I’m not at all expecting that that news being made final and public would have disruptive effect, but it certainly speaks to my point. And that is that market discipline doesn’t work here. The market looks past the underlying business fundamentals of these Enterprises straight to the U.S. Treasury, knowing if there is difficulty investors will be made whole.” (CNBC, *Street Signs*, 11/16/04, 14:49:49)
- Illustrating Fannie Mae’s lack of market discipline, Jim Cramer writes in *RealMoney.com*, “Big money’s betting that Fannie Mae can’t be taken down. If you can sneeze at a \$9 billion hit -- and a 1.25-point decline in the face of those stories can be dismissed as a sneeze -- you have to believe that this company, somehow, once again, will skate past these problems, too. Fannie Mae’s like a splendid work of fiction. Its books have the imagination of terrific novelists. Its management has no credibility whatsoever. Its regulator reaches conclusions that would make it radically underfunded and would necessitate a gigantic equity offering. And the stock goes

down no more than it would if it were just a garden-variety financial on a bad PPI day. I have to admit that if I were at my hedge fund, I would be buying this stock hand-over-fist, betting that somehow, some way, Fannie Mae would win. The stock simply couldn't trade this strong if the fix weren't in." (*RealMoney.com*, James J. Cramer, 11/16/04)

Fannie Mae's top debt rating affirmed by Moody's

- On November 18, 2004, Fannie Mae had its senior unsecured debt affirmed by Moody's Investors Service at the top Aaa rating with a stable outlook. Moody's is still considering a cut in Fannie Mae's financial strength rating of A-, citing the SEC's investigation of Fannie Mae's accounting practices, the ratings company said in a statement. The stable outlook means Moody's is inclined to leave Fannie Mae's senior unsecured debt rating unchanged. (*Bloomberg News*, Danny King, 11/18/04)

Possible Fannie Mae restatement may give boost to home-equity securitization market

- If Fannie Mae is forced to book as much as \$9 billion of losses on its derivative portfolio, there could be some damping effects on the mortgage bond market, but the home-equity securitization market could get a boost. As a major participant in both markets, Fannie Mae has also been a big buyer this year of home equity loan securitizations, according to market participants. The different impact of the loss partly reflects the options Fannie Mae would face as it would have to increase its capital reserves. It also reflects the attraction of buying home-equity backed debt in a rising interest rate environment. Buying home-equity debt with shorter maturities and a floating-rate structure requires far less hedging, if any, than buying longer-term debt with fixed-rate coupons, analysts said. A lot depends on how big Fannie Mae's actual restatement turns out to be, and many in the market believe that the \$9 billion is an "extreme number, which Walter Schmidt, SVP for FTN Financial, said is a "worst case scenario."
- If Fannie Mae's write-off of \$9 million proves to be accurate, it could cause some weakening in the mortgage bond market, analysts said. "If they end up with a charge that's \$9 billion or close, they would have to produce some liquidity," Schmidt said. One option Fannie Mae would have would be to sell part of its mortgage bond portfolio. "A move of any size could cause some widening," in the mortgage bond market, said Schmidt.
- Fannie Mae has other options at its disposal to boost capital, said Arthur Frank, director of mortgage backed securities research for Nomura Securities International in New York. The agency could issue preferred stock, could temporarily suspend payment of dividends to shareholders, or it could shrink its portfolio by not reinvesting monthly paydowns, he said. "Selling massive amounts of mortgage backed securities," he said, would be "unlikely."

- In the home equity sector, any strictures placed on Fannie Mae's investment programs might actually be beneficial to the market. If Fannie Mae shrinks its mortgage portfolio to add to its reserves, "The logic for maintaining a large presence in the (home equity) sector is stronger now," says Gyan Sinha, securitization specialist at Bear Stearns. Home-equity securities don't require any hedging at all, said Ivan Gjaja, head of asset-backed research at Citigroup, since home-equity securitizations have shorter maturities and carry floating rate notes, making them very attractive in a rising rate environment. Gjaja added that Fannie Mae could even increase its presence in the home equity market. Their structure also makes it "easy to realize the carry advantage," Gjaja said, by borrowing cheaper short-term funds and reinvesting them in longer term, higher-yielding assets.
- If the asset-backed market had been concerned that Fannie Mae may have to reduce its participation in home-equity deals, it would be evident in a widening of rate spreads, said Peter DiMartino, head of securitization research at RBS Greenwich Capital. Instead, interest rate margins in the home-equity sector are set to narrow further, he said. At the September Mortgage Banking Association meeting in San Francisco, Fannie Mae has said that it might have to buy more asset-backed mortgage paper, said DiMartino. (*Dow Jones Capital Markets Report*, Danielle Reed and David Feldheim, 11/18/04)

Fannie Mae named 2004's "Corporate Turkey of the Year"
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- Citizens Against Government Waste (CAGW) named Fannie Mae its 2004 Corporate Turkey of the Year in recognition of how it has cooked the books in its growing accounting and corporate governance scandal. "Fannie Mae has used its special taxpayer-backed privileges and exemptions to leverage itself into a massive mortgage empire with virtually no outside supervision or accountability," said CAGW President Tom Schatz. "Now, it appears the company is showing the feathers we associate with Enron and WorldCom, putting taxpayers at enormous risk in order to receive huge executive bonuses and artificially inflate its stock price. It is unconscionable that Congress has stood by and allowed Fannie's corporate executives to game the system for personal gain, especially in one of the most vital and sensitive sectors of our economy, housing." Schatz concluded, "For using its special taxpayer-granted charter to line its executive's pockets, and for using a Thanksgiving Day Parade of law firms, lobbyists, and advertising agencies to protect its sweet potatoes, rather than using its billions to help struggling families buy homes, Fannie Mae is the 2004 Corporate Turkey of the Year. Fannie is the poster child for corporate welfare. Congress has had numerous opportunities to hunt this game bird in the past and has failed to corral the nation's biggest wild turkey. GSE reform must be at the top of the priority list when Congress reconvenes in January." (*Citizens Against Public Government Waste Press Release*, 11/24/04)

While its mortgage portfolio grew in October, Fannie sees no growth for 2004

- Fannie Mae said the size of its mortgage portfolio increased for a fifth month in October, growing at an annualized rate of 12.2% and bringing its year-to-date overall growth to 2%. Fannie's mortgage portfolio grew by \$8.7 billion to \$913.2 billion on October 31. During October, the company's \$27.1 million of mortgage portfolio purchases included a higher proportion of hybrid adjustable rate mortgages and triple-A Libor floaters, reflecting a continued shift in ARMs and interest-only mortgages. The shift to these mortgages has had a "discernable effect on our net interest yield and net interest margin ... which declined sequentially in each of the past two quarters," Fannie Mae said. The company also said its duration gap was zero in October compared to negative two months in September.
- Fannie Mae's growth for the year will be "close to zero" as the company builds capital to meet a surplus required by its federal regulator and as prices on mortgage securities remained expensive, said Jayne Shontell, a senior vice president of investor relations. "With the current spread environment and the need to achieve the 30 percent capital surplus, it now appears likely that growth in the company's portfolio will be close to zero for 2004," said Shontell. (*Dow Jones International News*, Madeleine Lin, 11/19/04; *Bloomberg News*, Al Yoon, 11/19/04; *Dow Jones News*, Madeleine Lim, 11/19/04)

Fannie Mae funding notes

- Foreign investors appear to be shunning Fannie Mae's bonds, following the announcement its accounting problems. Net foreign purchases of U.S. agency debt, which includes Fannie Mae, slid to \$956 million in September from \$21.2 billion in August, the lowest level in a year, said the Treasury Department. "If this one-month data is the start of trend, it could prove problematic" for Fannie Mae and Freddie Mac, said James Bianco, president of Bianco Research LLC in Chicago. It suggests that foreign investors may be beginning to question the risk of such investments, he added. (*Wall Street Journal*, 11/17/04)
- In November, Fannie Mae elected not to issue benchmark notes, underscoring its low borrowing needs. While the company has opted not to issue callables for several months running, this is the first time Fannie Mae has skipped issuance of non-callable, or bullet, notes since July. (*Dow Jones Capital Markets*, Allison Bisbey Colter, 11/12/04)
- Fannie Mae announced the company's 2005 funding calendar, which is structured to increase its borrowing flexibility. Among changes from 2004, Fannie Mae will reduce its minimum issuance size for new noncallable deals to \$3 billion from \$4 billion and will designate targeted maturities on monthly announcement dates rather than detail them for the year ahead. (*Reuters*, 11/23/04)

Fannie Mae is creating a new deferred compensation plan

- Fannie Mae said that its board of directors has authorized the creation of a new elective deferred compensation plan for its directors and highest-paid employees in response to the American Jobs Creation Act of 2004, which imposes new requirements on deferred pay plans. The new plan isn't intended to boost the value of benefits that employees receive, Fannie said. The highest paid 15% of Fannie's employees are eligible to participate in the new plan, the company said in an SEC filing. According to the filing, eligible employees can choose to defer up to 50% of their base salary and 100% of their bonus and Fannie directors can defer all of their annual retainers and fees. Participating employees and directors "will be unsecured creditors of the company and will be paid from the general assets of the company," said Fannie. Participants in the plan can choose to receive their deferred pay in a single lump sum, up to 15 annual installments or a combination of a lump sum and annual installments for compensation that is deferred after December 31. Janis Smith, Fannie Mae spokeswoman, said the new plan won't change the way the company reports its executives' compensation in its proxy statement. (*Dow Jones Corporate Filings Alert*, David Enrich, 11/23/04)

Fannie Mae adjusts the dividend rate for its variable rate non-cumulative preferred stock

- Fannie Mae announced the next dividend rate adjustment for its Variable Rate Non-Cumulative Preferred Stock, Series J. The new rate will be 4.716% per annum, which is the Swap Rate plus 1.38%. Pursuant to the terms of the Series J Preferred Stock, the dividend rate was initially set as of November 26, 2002, and the rate resets as of November 26 every two years thereafter until any redemption. The Swap Rate is the average rate for two-year U.S. dollar swaps, expressed as a percentage, which appears on the Reuters Screen ISDAFIX3 Page at 11:30 a.m., New York City time, available on the applicable swap determination date (November 23, 2004). The new dividend rate will be in effect from and including November 26, 2004 to, but excluding, November 26, 2006. Holders of record of Series J preferred shares will be entitled to quarterly dividends when and if declared by Fannie Mae's Board of Directors. The initial dividend rate for the Series J preferred shares was 3.78%. Fannie Mae issued 14.0 million shares of the Series J preferred shares with a stated value of \$50 per share and the shares are currently outstanding. (*Fannie Mae press release*, 11/26/04)

Fannie Mae promotes General Counsel Kappler to EVP

- Fannie Mae promoted General Counsel Ann Kappler to executive vice president, elevating her to a title shared by about a half dozen other executive vice presidents at the GSE, who report directly to the company's top four officers: CEO Franklin Raines, COO Daniel Mudd, CFO Timothy Howard and law and policy head Tom Donilon. "[Kappler is] a tremendous general counsel and a terrific asset to the

company,” said spokesman Chuck Greener. Kappler will continue in her role as General Counsel to report directly to Donilon, who is also the secretary of the board, Greener added. Fannie Mae officials said Kappler’s promotion is not indicative of a broader management shuffle, which many have predicted since OFHEO released a scathing review of the company’s accounting practices in September. Company officials said Fannie generally announces its promotions in the fall and that more executive changes are expected in the coming weeks. (*Dow Jones International News*, Dawn Kopecki, 11/18/04)

Fannie Mae to advise South African council on making loans for the poor

- Fannie Mae is advising the Banking Council of South Africa on establishing an agency to help the poor access home loans, said the Johannesburg-based newspaper *Business Day*. The plan would target people earning between 3,500 rand (\$580) and 5,000 rand a month (\$829), who neither qualify for a government housing subsidy, nor for a normal home loan. Up to 35 billion rand (\$5.8 billion) may have to be set aside to finance home loans for the poor, said Banking Council’s CEO Bob Tucker. The agency would buy home loans from mortgage agencies such as SA Home Loans and sell them to banks which would also be able to trade them, *Business Day* reported. The primary risk would lie with the banks, said Standard Bank Group Securitization director AJ Rothman. (*Bloomberg News*, Godfrey Mutizwa, 11/19/04)

Freddie Mac

The shortlist of candidates for Freddie Mac’s head lobbyist shortens

- According to sources, the list of candidates to head Freddie Mac’s lobbying shop is narrowing and the leading candidate is Timothy McBride, who currently heads the Washington office of DaimlerChrysler and was served in the George H.W. Bush administration. Sources said Freddie Mac is close to announcing a decision following a lengthy search for a replacement for R. Mitchell Delk, who resigned in March. In the elder Bush administration, McBride held a variety of positions including assistant to the President for management and administration, deputy assistant to the President, and executive assistant to the chief of staff. From 1985 until 1989, McBride was assistant secretary of commerce for trade development and a personal aide to then-Vice President Bush. In 1995, McBride joined DaimlerChrysler and was vice president for public affairs before becoming head of its Washington office this year.
- It is unclear whether Freddie had made a final decision on its senior lobbyist, and other picks are possible. *The Hill* reported that the position would go to Matt

Schlapp, currently the White House's political director. However, other sources said that they did not expect that to happen. (*American Banker*, Rob Blackwell, 11/24/04)

As Fannie struggles with accounting woes, is Freddie Mac making a comeback?

- With Fannie Mae in the news with serious allegations about accounting irregularities, Freddie Mac has been “pitching” its comeback to the media, as it tried to distance itself from Fannie’s travails. Under a new top-management team, Freddie Mac has begun to repair its relations with regulators and customers and started to regain market share from Fannie Mae. While Freddie Mac’s officials are too diplomatic to gloat about Fannie’s woes, they say the company has some big advantages over Fannie. While Freddie believes all of its bad news has been made public, Fannie has only begun to deal with the allegations. Freddie has mended fences with OFHEO, while Fannie’s relationship with its regulator remains tense. Freddie’s new chairman and chief executive officer Richard Syron says Freddie has begun trying harder to listen to its customers and has personally begun visiting large customers, such as Countrywide Financial Corp. Syron has rallied his staff by playing up the company’s mission of financing mortgage loans for low-income people.
- Freddie Mac still has a long way to go before Syron can declare his mission accomplished. The company still needs to untangle its financial records and upgrade antiquated accounting systems, which will cause Freddie Mac to continue to report earnings on a delayed basis until early 2006. The SEC has said it will likely file civil charges against Freddie Mac for alleged violations of securities law uncovered by last year’s accounting scandal. Syron concedes he has done the easy part of his job: criticizing the mess he found. Now, it is time to deliver better performance, he said. “I’m not criticizing any more,” he says. “I’m coaching, I’m exhorting.” (*Wall Street Journal*, James R. Hagerty, 11/24/04)
- In a speech before the 9th Marcus Evans CFO Summit, Freddie Mac CFO Martin F. Baumann described the changes that he has made at the company to live in a “post Sarbanes-Oxley world.” Baumann said, “Fortunately for me, I work for a CEO and a company that understands [the challenges of Sarbanes-Oxley]. Our Chairman and CEO, Dick Syron, has set out to rebuild public confidence in Freddie Mac. He has set a new tone of candor and integrity from the very top level of the company on down. And he has empowered me as CFO to meet head-on the demands of the post Sarbanes-Oxley world. As a result, I have the authority not only to “fix” our accounting systems and expertise, but to raise them to a new level of transparency and precision that will build public trust and become a model of corporate governance. Just as important, I’ve been empowered not to take on roles and functions that can pose conflicts for CFOs and, at a minimum, distract their attention. ...At Freddie Mac, our substantial investments in accounting remediation are intended to take us beyond just fixing the problems of the past. Our aim is to automate our systems from top to bottom. We’re hiring the right people into critical positions of responsibility. And we’re channeling more energy and resources than

ever into developing leading edge accounting and financial transparency.” (*Freddie Mac Press Release*, Prepared Remarks by Martin Baumann, 11/07/04)

- In a speech before a Merrill Lynch financial services conference, Freddie Mac president and COO Gene McQuade said that a top priority of the company’s management is to centralize technology, administrative and back-office functions to streamline its organization. “Our efforts will really free up our key business managers to focus on their primary job - income generation and customers - and allow the pros to run the infrastructure,” said McQuade. The moves could also cut costs, by allowing Freddie to combine support jobs previously under individual business lines, and improve internal controls, he added.
- McQuade said that Freddie Mac expects expenses of \$1.4 billion to \$1.5 billion in 2004, nearly double what they were three years ago. Expenses are projected to be 11 basis points of the cost of Freddie Mac’s portfolio, approximately 25% higher than average expenses for Fannie Mae and Freddie Mac. The company’s surging expenses are tied to its accounting problems. Freddie Mac will continue to spend heavily on its accounting overhaul, which will cause the company’s expense level to remain high for 12 to 24 months, even though expenses have probably peaked. Freddie Mac currently employs 2,900 full-time consultants and has begun eliminating 20 to 30 consulting jobs a week. (*American Banker*, Jody Shenn, 11/17/04)

Freddie Mac names new EVP for operations and technology

- Freddie Mac has named Joseph A. Smialowski as executive vice president of operations and technology, effective December 1. Smialowski will be responsible for managing Freddie Mac’s largest business operations segment, including all of the company’s mortgage origination and servicing, investment and capital markets operations, and information systems divisions, said the company. He will report to President and Chief Operating Officer Eugene M. McQuade. Previously, Smialowski was executive vice president at Fleet Boston Financial with direct oversight of its information technology, bank operations, corporate real estate, procurement, security and business continuity for Fleet’s business lines in Asia, Europe, Latin America and the United States. (*Reuters*, 11/15/04)

Freddie Mac unwinds \$1.5 billion in MBS
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- Freddie Mac disclosed that a customer unwound \$1.52 billion of mortgage-backed securities this year that the company had created for it. Freddie Mac swapped the securities for the underlying loans in February and October, a company spokeswoman, who would not identify the customer. These securities, which involved multifamily assets, were not created to meet Freddie Mac’s affordable housing goals, she said. The unwinding was disclosed in a footnote to Freddie’s monthly volume summary because it materially sped up the rate at which company’s

securities were liquidating, said the spokeswoman. (*American Banker*, Jody Shenn, 11/23/04)

Freddie Mac's mortgage portfolio shrank in October

- Freddie Mac said its loan portfolio shrank for the second month in October, declining \$412 million to \$660 billion. The drop represents a 0.7% annual annualized rate of contraction. Freddie Mac's loan portfolio has increased at a 2.8% rate during 2004. In September, Freddie Mac said its portfolio would grow in the "low- to mid-single digits" this year compared with 13.8% in 2003, as result of heightened competition by banks and other investors for mortgage assets.
- Together with assets sold from the broker-dealer unit the company disbanded last month, the decline of Freddie Mac's total holdings is even greater, said Jim Vogel, head of agency debt research at FTN Financial, Memphis, TN. The broker dealer unit may be selling in the "mid-teen" billion of dollars of assets, he said. "Layering in the beginning of the liquidation of its broker dealer assets in November, its balance sheet probably has shrunk considerably this fall," said Vogel said. Mortgage securities held by the broker-dealer unit declined to \$13.9 billion in October from \$20.6 billion in September, Freddie Mac said.
- Freddie Mac said it agreed to buy \$14.1 billion of mortgage loans and securities in October, up from \$12.5 billion in September. In October, the balance of mortgage bonds with a Freddie Mac guarantee grew \$3.8 billion to \$1.21 trillion. Freddie Mac said its duration gap was unchanged at zero months in October. The delinquency rate on no-credit enhanced single-family homes stood at 0.23% in October, unchanged from the prior month. (*American Banker*, Jody Shenn, 11/23/04; *Bloomberg News*, Al Yoon, 11/22/04; *Dow Jones International News*, Allison Bisbey Colter, 11/22/04)

Freddie Mac considers a program of Asian currency issues

- Freddie Mac is considering a program of Asian currency issues to guard against future concerns from regional investors over the US deficit and the value of the US dollar. "We do not see any great concern with the US deficit and the dollar at this point in time," Freddie Mac chairman and chief executive Dick Syron told the *South China Morning Post* in an interview. "But if this trend was to continue, and you were to extrapolate if for another year out, or 18 months, it may well be that people would be more concerned. Quite candidly, that is one reason we have talked to people about what their need is for product, and how we can adapt." Currencies identified for prospective issues by Syron included the yen and the yaun.
- Syron was in Hong Kong as part of his first visit to canvass Freddie Mac's Asian investor base since being appointed chief executive of the company. He was

accompanied by Peter Mahoney, the company's vice-president for equity and capital markets investor relations, and Michael Cosgrove, director of Freddie Mac's investment business communications. Their Asian tour began in Tokyo and continued to Seoul, Beijing and Hong Kong. The Freddie Mac team will also visit Taipei and Singapore before returning home. (*South China Morning Post*, Louis Beckerling, 11/15/04)

Freddie to provide identity theft alerts to LP customers obtaining credit information

- Freddie Mac told users of its Loan Prospector automated underwriting system that it would relay identify-theft alerts to those using the system to obtain credit information. While the alerts will be free with single credit files, Freddie said the credit reporting companies would probably charge additional fees for the alerts for merged reports and those costs will be passed on to users. Under the Fair and Accurate Credit Transactions Act, credit bureaus will be required to let consumers attach such alerts to their files effective December 1. If a lender confronts an alert, the identity of the consumer must be verified before extending credit, said Freddie Mac. (*American Banker*, Jody Shenn, 11/23/04)

Freddie Mac teams up with Florida Association of Mortgage Brokers for consumer education program

- Freddie Mac has teamed up with the Florida Association of Mortgage Brokers (FAMB) and the National Association of Mortgage Brokers (NAMB) to launch a new pilot consumer credit education program, using Freddie Mac's bilingual financial literacy curriculum, CreditSmart and CreditSmart Espanol, to help prepare the English and Spanish-speaking communities for the financial responsibilities of homeownership. Van Johnson, FAMB's President, said "This is a fabulous tool designed by Freddie Mac to further the American Dream. We are proud to be selected to deliver this education to our fellow Floridians." He added, "educating consumers about the mortgage process is the best way to ensure that they don't fall prey to abusive lending tactics and NAMB has made such education a top priority." (*Business Wire*, 11/18/04)

Hybrid AVMs gaining acceptance

- Further solidifying the acceptance of hybrid automated valuation models (AVMs), Freddie Mac's director of collateral policy announced at the Valuation 2004 Expo the company's plans to begin testing the purchase of loans using appraiser-assisted automated valuation models (AAAVMs) with its first-tier lenders as early as the second quarter of 2005. Due to growing industry acceptance, valuation technology provider Electronic Appraiser announced the launch of 3111 Controlled Appraisal,

the company's latest solution that offers AAAVMs by combining an appraisal, AVM and PhotoCheck site inspection. By incorporating two human professionals, providing up-to-date Web accessible AVM data, and offering appraisers the option to generate income through AVMs -- all at a lower price, Electronic Appraiser is delivering Uniform Standards of Professional Appraisal Practice compliant AAAVMs in which the appraiser signs off and provides his/her license number. "This is an idea who's time has come, and we're excited to see industry leaders like Freddie Mac paving the way for appraiser-assisted AVMs," said Greg Sullivan, vice president of Electronic Appraiser. "The 3111 Controlled Appraisal is a comprehensive solution that combines the best elements of valuation technology and human expertise for a cost-effective and accurate appraisal." (*Business Wire*, 11/22/04)

Federal Home Loan Banks

FHLB-Chicago delays filing of its third quarter financials – pending a review of its accounting methods for derivatives

- The FHLB-Chicago said its third quarter financial statements will be delayed until it completes an analysis of changes to the accounting methods it uses for certain derivative transactions. The FHLB-Chicago said the changes are the result of recommendations made by KPMG [Fannie Mae's auditor], who was hired by the Bank to review certain accounting processes as required by its regulatory agreement with the Federal Housing Financing Board. The FHLB-Chicago said it's changing the method it uses under FAS 133 to account for certain derivative transactions. The most significant change to its financial statements involves the method of accounting "for certain payer or receiver swaptions under the FAS 133 Derivative Implementation Group Issue G20. "The Bank has decided to discontinue the use of the G20 accounting method for its payer/receiver swaptions and instead directly account for the changes in the value of the swaptions as income or expense in its financial statements," it said. "The Bank is also changing its method of accounting for certain caps and floors under G20. The new method will modify the timing of amortization of premium on the affected cap and floor transactions."
- The FHLB-Chicago said, "This process is expected to be completed in the coming weeks, after which the Bank will determine whether the adjustments have a material impact on prior financial results, and if so, those results will be revised. Based on the analysis completed to date, it is likely that the cumulative effect of these changes will increase prior period net income and will not have a material effect on the Chicago Bank's total capital, as of Sept. 30, 2004." J. Mikesell Thomas, president and CEO of the FHLB-Chicago, said, "The Bank's financial condition is strong, our two core products are profitable and in demand by our members, and we are achieving record levels in our affordable housing and community investment programs. The changes we are announcing today affect principally the timing of certain income and expenses

and demonstrate our commitment to attaining best practice status in our financial controls. We believe that we make highly effective use of derivatives in managing risk, which enables us to provide innovative products and services to our members.”

- The FHLB-Chicago’s delay will mean the publication of the FHLBs’ third quarter combined financial report also will be delayed, said the FHLB’s Office of Finance. The Office of Finance said none of the other Federal Home Loan Banks use the specific hedging strategies now under review by the FHLB-Chicago to any significant extent. (*Dow Jones Newswire*, John Connor, 11/15/04; *Wall Street Journal*, James R. Hagerty, 11/16/04)

FHLB-Seattle net income drops 53% in third quarter

- The FHLB-Seattle reported a 53% drop in net income for the third quarter, as falling interest rates reduced the Bank’s profitability. The FHLB-Seattle said net income fell to \$16.8 million in the third quarter from \$35.5 million a year earlier. Its return on equity plummeted to 2.7% in the third quarter from 5.6% in the third quarter in 2003. The Bank said it didn’t “adequately anticipate the prolonged period of low interest rates” and failed to “efficiently manage the funding and hedging” of its portfolio of investments. While higher rate loans and advances were repaid, the FHLB-Seattle was stuck with longer-term debt that it couldn’t retire ahead of schedule. Following guidance from its regulator, the Bank said it expects to set aside a larger portion of its earnings into retained earnings and to lower the dividend rate it pays to members by at least 50 basis points annually over the next three years. The Bank also plans to shrink its investment portfolio and focus on “mission related assets,” such as wholesale loans to its members and its mortgage-buying program.
- Going forward, the Bank expects “tempered financial performance and increasing regulatory oversight,” said Norman Rice, chief executive of the FHLB-Seattle. Effective December 1, Kelli Bono will step down as executive vice president and CFO for the Bank and Steve Horton, senior vice president and credit officer, will serve as interim CFO. (*Seattle Times*, Melissa Allison, 11/18/04; *Wall Street Journal*, 11/18/04; *Seattle Post Intelligencer*, 11/18/04)

FHLB-San Francisco announces third quarter dividend

- The FHLB-San Francisco announced that the (annualized) dividend rate for the third quarter of 2004 is 3.70%, compared to its second quarter of 2004 dividend of 4.68%. (*Business Wire*, 11/15/04)

FHLB-Dallas announces board election results

- The FHLB-Dallas announced the re-election of A. Fred Miller, Jr., John B. Stahler, and Robert Wertheim as directors of the Bank, who will serve three-year terms as industry directors, commencing January 1, 2005. Miller is president and chief executive officer of the Bank of Anguilla, Anguilla, MS. He joined the Bank's board in 1997 and was elected board chair in January 2004. Stahler, president and chief executive officer of the American National Bank, Wichita Falls, TX, joined the Bank's board in 2002. Wertheim is chairman of Charter Bank in Albuquerque, NM. He joined the Bank's board in 2002. (*PR Newswire*, 11/22/04)

Sallie Mae

The privatization of Sallie Mae, a government sponsored entity
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- Critics who think Fannie Mae and Freddie Mac have it too easy because of their special relationship with the government might want to take look a look at Sallie Mae. Originally founded with a government charter, Sallie Mae agreed in the late 1990s to give up its charter and strike out on its own as a fully private company. The result has been a bigger, more profitable, more dominant company than existed or was even possible when it operated as a government sponsored enterprise.
- Profits at Sallie Mae have soared from \$384 million in 2001 to \$792 million in 2002, and to \$1.3 billion last year. The company's stock price has climbed from less than \$20 a share in early 2001 to more than \$50, while its quarterly stock dividend has jumped from less than \$0.06 a share to \$0.19 over the corresponding period and the stock split three-for-one in 2003.
- Sallie Mae CEO Albert L. Lord, the architect of the company's success, has also done well, receiving \$41.8 million in total compensation, including stock options exercised, in 2003. Sallie Mae's President Thomas J. Fitzpatrick received \$27.8 million in compensation in 2003. Lord and Fitzpatrick ranked second and fourth, respectively, in total compensation in a *Washington Post* survey of executive compensation in the region for the year.
- "Sallie Mae is the Frankenstein that federal law created and let loose on the marketplace," said Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers and a longtime critic of the company. Sallie Mae, with more than 600 employees in the Washington area and 7,000 nationwide, has moved strongly into fields only tangentially related to student loans, including a small mortgage-banking subsidiary. However, its fundamental business makes it important to millions of American families. The rising cost of college tuition and the rising number of young people seeking to go to college have spurred Sallie Mae's growth. Student loan originations have more than doubled nationwide to \$52 billion last year from \$24 billion in 1994. Loans rose to 54% of all

student aid in 2002-03, up from 47% in 1992-93. As a private company, Sallie Mae participated directly in that growth, rather than being limited to buying loans written by other lenders. In 2003, it originated \$12 billion in guaranteed student loans, 23% of the market.

- While there was for many years “a sense that privatization was the ultimate goal” at some point, Sallie Mae General Counsel Marianne M. Keler said in an interview last week, it was only when the company “hit a crisis that we could really convince all of our constituencies, including the federal government, including our investors, our employees, etcetera, that parting company made sense.” The crisis consisted of two parts. First, Congress in the mid-1990s levied a 0.3% fee on the company’s borrowing. “That took away our borrowing advantage,” Keler said. Then President Bill Clinton denounced Sallie Mae and other participants in the guaranteed-loan program—the “middlemen” —as part of the problem of high college costs. Clinton proposed and pushed through Congress the Direct Loan Program, under which the government itself would make student loans and eliminate “middlemen” such as Sallie Mae, which Clinton said were driving up the cost of college loans.
- In 1997, Lord, who wanted to privatize Sallie Mae, won a proxy fight against a management that was content to continue as a government sponsored entity. At his disposal, Lord had a new development in the financial markets: debt “securitization.” In systems pioneered by Fannie Mae and Freddie Mac, lenders were increasingly able to pool loans they owned and sell securities secured by those pools, which enabled the lender to recover a large portion of its loan, allowing it to make more loans while shifting some risks, particularly interest-rate risk, to the buyers of the securities. Debt securitization “made privatization possible for us,” said Keler. “That would never have happened,” otherwise.
- To go private, Sallie Mae faced two significant challenges: where to get new money at competitive rates without its GSE status and how to pay off about \$50 billion in debt it had issued. Under its new leadership, Sallie Mae found it was still able to tap the credit markets for debt and it was able to securitize many of the loans it had bought. “What we had to do was refinance the existing balance sheet and finance all the new business,” Keler said. The process went much faster than expected, said Keler, noting that by early next year the last \$2 billion of GSE debt will be refinanced. Since the proxy fight, the company has expanded its private loan offerings and bought other companies in the student loan industry, which furnish services and collect fees through the life of a loan. Sallie Mae now receives about half its revenue from interest on guaranteed student loans, Keler said, with the remainder from fees (some of which are related to guaranteed student loans) and interest earnings on purely private loans.
- Sallie Mae now directly originates loans to students as well as buying them from other lenders. The company holds some of those loans in portfolio and securitizes others; it services loans and provides technical services for “guaranty agencies,” the nonprofit intermediaries Congress set up to take on some of the default risk that

would otherwise fall on the government. Sallie Mae also has acquired several debt-collection agencies and recently acquired a company that buys defaulted debt and pursues the debtors, keeping whatever it recovers.

- Sallie Mae also uses technology to expand its reach, offering college financial-aid offices computer programs, Web sites and other tools to make it easier for the company to award and manage student aid. Sallie Mae also offers consulting services to colleges, advising them on how best to deploy financial aid and other resources to attract the most desirable students. The company has also set up the charitable Sallie Mae Fund, which among other things has a program designed to encourage students in District public schools to attend college.
- While Sallie Mae is nearly free of its formal ties to the government, its business still is based on a federal program. Congress is scheduled in 2005 to renew the Higher Education Act, which sets subsidy rates for the student loan program. In the past, members of Congress looking for money for other programs have taken bites from the fees the loan industry collects. Sallie Mae and its allies will have to defend the guaranteed student loan program against charges that it is more expensive for taxpayers than the government's own Federal Direct Student Loan Program. Critics have long argued that the guaranteed program is more expensive and is attractive to Congress only because loan guarantees don't show up in the Federal budget as costs right away, while a loan made directly by the government does. To make certain its voice is heard on Capital Hill, Sallie Mae's political action committee donated more than \$800,000 in the 2003-2004 election cycle.
- If Congress seeks additional revenue by trimming loan subsidies, Sallie Mae might be hurt in the short run but helped over time, analysts said. Since Sallie Mae is so large in its field, it wouldn't be hurt as much as rivals with smaller margins. Student lending still "is a very good deal," because loans are 98% to 100% guaranteed by the government, and various subsidies insulate lenders against changes in interest rates, said Matthew J. Snowling, an analyst with Friedman, Billings, Ramsey & Co. "But you have to remember it's such a low-margin business" that the number of banks in the market has shrunk when subsidies were cut. "Whether you like Sallie Mae or not," Snowling said, buying its stock "is a natural hedge against college tuition." (*Washington Post*, Albert B. Crenshaw, 11/22/04)

Farm Credit System / Farmer Mac

FCSA's CEO resigns in wake of collapsed deal with Rabobank

- On November 4, FCS of America (FCSA) announced that Jack Webster had “resigned” as FCSA’s CEO. Webster was the architect of the proposed sale of FCSA to Rabobank, which collapsed on October 21. In a news release announcing his resignation, Webster said, “For this company to move forward, the board and I felt it was in the best interest of this organization to continue to grow under new leadership.” Reportedly, other senior management at FCSA will soon follow Webster out the door. Given divisions within the FCSA board about the Rabobank deal, some FCSA directors may get booted, too, during an upcoming election of directors, writes Bert Ely in *Farm Credit Watch*. “While bankers in the four states (Iowa, Nebraska, South Dakota, and Wyoming) FCSA serves have properly criticized FCSA’s abuse of its GSE status in stealing business from taxpaying banks and other private-sector lenders, bankers should give Webster credit -- had he succeeded in selling FCSA to Rabobank, he would have unleashed pent-up demand among other FCS managers to sell their associations to Rabobank or other private-sector buyers. However, others in the FCS managerial class clearly understood the threat the Rabobank-FCSA deal posed to the FCS, and to their comfortable way of life, which is why they so strongly opposed the deal. Unfortunately, Webster’s departure will cool the appetite of FCS executives to sell out.” (*Farm Credit Watch*, Bert Ely, November 2004)

FCS over-reserved for loan losses?

- According to the news release announcing the FCS’s financial results for the third quarter of this year, FCS institutions are over-reserved for loan losses. In April, the FCA directed the FCS institutions to study their methodology for determining their allowance for loan losses. According to the FCS news release, “these studies will be completed during the fourth quarter of 2004 and reductions in the allowance for loan losses will be recognized at that time. The resulting reductions in the allowance for loan losses are expected to be significant.” One unnamed association completed its loan loss study during the second quarter and then booked a \$27 million negative provision for loan losses, said Bert Ely. On September 30, FCS institutions had \$2.02 billion in total allowance for loan losses, representing 2.42 times non-performing loans (non-accrual loans, accruing restructured loans, and loans past due more than 90 days and still accruing). “Although not intended, the forthcoming reduction in loan-loss reserves provides stark evidence of FCS’s blatant cream-skimming,” said Bert Ely in *Farm Credit Watch*. “Far from meeting the credit needs of farmers and ranchers who cannot obtain credit elsewhere (that is, credit-challenged borrowers), the FCS increasingly funds America’s financially strongest farmers and ranchers, those least in need of a government financing subsidy. A substantial reduction in loan loss allowances will further boost the FCS’s already excessive capital ratio,

which was 16.6% on September 30, up from 16.2% at the end of last year. It is high time FCS executives begin paying higher dividends rather than hoarding capital that FCS's owners -- its farmer and rancher members -- could put to good use." (*Farm Credit Watch*, Bert Ely, November 2004)

Is FCS arbitrating its GSE status?

- FCS enhances its profitability by borrowing at GSE interest rates and invests those funds at substantially higher rates. While the FCS does not disclose this number, it probably is earning at least a 30 or 40 basis point spread on investments funded by GSE debt, said Bert Ely. "This abuse of the FCS's GSE status has been growing -- from the end of 2001 to September 30, FCS investments grew by 50% while its loans rose by 15%, he said. "The FCA has proposed regulatory changes that would permit FCS institutions to increase their investments from 30% to 35% of loans; at September 30, investments equaled 24.7% of loans. The FCA should kill this proposal." (*Farm Credit Watch*, Bert Ely, November 2004)

Farmer Mac makes its semi-annual report to Congress

- In its semi-annual report to Congress, Farmer Mac provided information on its program activity and financial condition as of June 30, 2004, and the first half of 2004. Farmer Mac's on- and off-balance sheet program-related activities declined to \$5.6 billion from \$5.8 billion at year-end 2003, representing a reduction of 2.5%. Long-Term Standby Purchase Commitment volume outstanding totaled \$2.4 billion, up 1.8% during the first half of 2004. Standby volume represents 42.4% of all program activity and dominates the corporation's off-balance sheet guarantee business. Post-1996 Act Farmer Mac I loan volume purchased or guaranteed that was 90 days or more past due, in foreclosure, in bankruptcy, or Real Estate Owned (REO) was 1.4% of all post-1996 Act Farmer Mac I loan volume outstanding, compared to 1.6% at June 30, 2003. REO was down \$6.3 million from yearend 2003. The reported allowance for losses decreased 1.2% to \$21.8 million at June 30, 2004, compared to \$22.1 million at December 31, 2003. Charge-offs on loans net of recoveries during the first half of 2004 were \$3.5 million, compared to \$2.3 million over the same period in 2003.
- Farmer Mac's net worth increased 6% to \$226.1 million from \$213.3 million at yearend 2003. Farmer Mac's recently announced stock repurchase of up to 10% of Class C common stock and the \$0.10 per share quarterly dividend payment will impact the future growth of net worth from retained earnings. Farmer Mac's statutory minimum core capital requirement was \$136.4 million, while its core capital available to meet this requirement was \$226.3 million. Farmer Mac's risk-based regulatory capital requirement was \$49.3 million and its regulatory capital available to meet this requirement was \$247.5 million. Farmer Mac remains in Enforcement Level I with core capital and regulatory capital, exceeding statutory minimum and regulatory risk-

based capital requirements, respectively. Non-program investments remained relatively stable at 29.1% of Farmer Mac I program assets including Standbys and totaled \$1.6 billion at June 30, 2004. Net income available to common stockholders for the 6-month period ended June 30, 2004, was \$9.8 million, a 41.7% decrease over the same 6-month period in 2003. (*Farm Credit Administration, Semiannual Report to Congress on Federal Agricultural Mortgage Corporation as of June 30, 2004, 11/24/04*)

Postal Service

House and Senate postal reform bills “lack substantial reform,” says the White House

- The Bush administration has provided House and Senate postal leaders an outline of what it expects to see in a postal reform bill. The outline states, “The administration believes that the Postal Service, not ratepayers, must continue to be responsible for its pension costs connected with military service credit for postal employees under the Civil Service Retirement System. ...The House and Senate provisions for making funds available to the Postal Service by abolishing the existing statutory escrow requirement in 2005 must be altered so there is no adverse budget impact. ...The Administration is deeply concerned about the proposals to delay collection of escrow funds for two years, effectively allowing the USPS to delay a rate increase by using those funds for operations. Each year of this delay costs taxpayers more than \$3 billion and this short-term rate stabilization ensures that true, long-term postal reform is not enacted.” The White House said that the House and Senate postal reform bills “lack meaningful reforms in the area of transparency to prevent cross-subsidization of competitive products with monopoly product revenue; and flexibility, especially with respect to cutting the high cost of labor (76% of revenue).”
- The Administration asked that reform provisions be included in the postal reform legislation which:
 - Require SEC-like financial disclosure by the USPS;
 - Require the USPS to produce product-by-product financial statements;
 - Require the USPS to include all on –and-off balance sheet liabilities in rates, including retiree health and workers’ compensation;
 - Require the Postal Service Competitive Fund to bank, borrow and invest with Treasury (at market rates), rather than in the private market;
 - Allow the Postal Regulatory Board to determine whether materials submitted by the USPS are deemed confidential and exempt from public disclosure;
 - Eliminate provisions that would reduce flexibility to negotiate work sharing agreements; and
 - Provide flexibility for the USPS to optimize its process and distribution network. (*PostalWatch.com, 11/19/04*)

Largest postal rate increase in decades on the horizon?

- The Postal Service is expected to start seeking approval for an increase in postage rates of at least 10% early in 2005, increasing the price of a first-class stamp from \$.37 to at least \$.41. Rates charged for all business mailings are likely to go up 18% to 22%, depending on the volume of pieces shipped and the amount of presorting handled by the senders. The size of the expected new rate increase stems partly from the demise of proposed postal reform legislation that would have allowed the USPS to take advantage of about \$3 billion a year in pension-fund savings resulting from a change in how it contributes to a federal retirement fund and relieved the Postal Service from future pension payments to certain postal workers who served in the military. The higher postal rates will likely take effect in early 2006. (*Wall Street Journal*, Nicole Harris, 11/24/04; *Kiplinger Business Forecast*, Kathy Rowings, 11/15/04)

USPS continues on its “productivity path”

- The Postal Service reduced 21 million work hours in fiscal year 2004 versus fiscal year 2003, which resulted in a reduction of more than 21,000 career employees said Postmaster General John Potter. The Postal Service will continue its efforts to improve productivity and save billions of dollars over the next several years by streamlining mail operations, trimming redundant facilities and upgrading processing equipment, said Potter. Over the next three years, the Postal Service will plan the reforms, called Evolutionary Network Development. It does not yet have estimates on savings, costs or closings. These reforms will supplement the sweeping changes outlined in the Postal Service’s 2002 transformation plan, under which the USPS reduced its debt, improved mail-processing automation, developed ways to electronically track mail as it is processed and delivered, and cut the work force by more than 70,000. Potter said the cuts have so far saved \$4.3 billion, placing the Postal Service well on its way to meeting its goal of saving \$5 billion by September 30, 2006. (*PostalWatch.com*, 11/16/04; *DMNews.com*, Cary H. Baer, 11/23/04)

President Bush to nominate Hammond to remain on Postal Rate Commission

- President Bush announced that he intends to nominate Tony Hammond to continue in his role as a commissioner of the Postal Rate Commission (PRC) for a six-year term expiring October 14, 2010. Hammond, who currently serves as vice chairman of the PRC, was appointed by the Senate in November 2002 to serve as a commissioner for a complete a term that expired October 14. Hammond previously owned and managed T. Hammond Co., a private consulting firm based in Arlington, VA and also served as senior vice president of direct marketing firm Feather, Larson & Synhorst. (*DMNews.com*, Melissa Campanelli, 11/19/04)

TVA

Congress approves changes to TVA's governance

- Congress has approved sweeping changes in the management of the Tennessee Valley Authority (TVA), which will expand the utility's board from three full-time members to nine part-time members and require the TVA to comply with the SEC's financial disclosure requirements. The new board will choose a chairman and a chief executive officer, who will oversee all TVA operations. In 1997, Senate Majority Leader Bill Frist (R-TN) began pushing for governance reform for the agency after TVA raised electric rates for the first time in a decade. Frist said the reforms will have a broad impact on TVA, which serves some 8.3 million customers in Tennessee and parts of Kentucky, Mississippi, Georgia, North Carolina, Alabama and Virginia. "For more than seven decades, TVA has played a vital role in the lives of all Tennesseans," Frist said. "However, its board structure has not kept pace with its development into one of the nation's largest electric utilities. These reforms will help to increase accountability and oversight, which will be good for both TVA and for its ratepayers."
- Under the plan, President Bush will continue to nominate members to TVA's board, who will now serve five-year terms rather than the current nine-year terms. Board members will receive annual pay of \$45,000, which will be adjusted for the cost of living and the chairman will be paid \$50,000. [Currently, TVA board members are paid \$136,900 with the chairman receiving \$145,600.] The TVA's CEO cannot serve as a member of the board and must have "senior executive-level management expertise" in "large complex organizations." The board is strongly encouraged to consider someone with "strong financial skills" and expertise in the electric utility industry. The legislation doesn't change the terms of TVA's three current board members. Current TVA Chairman Glenn McCullough's term expires May 18. Remaining directors Bill Baxter and Skila Harris would become part-time, until their remaining terms expire in 2011 and 2008, respectively. The changes to the TVA board would take place May 18 or when three new board members are confirmed by the Senate, whichever comes first.
- The legislation approved by Congress also includes a measure that will require TVA to meet the financial disclosure requirements of the SEC, which will make the federal utility subject to the same disclosure requirements as other publicly traded companies, including filing annual and quarterly financial reports to the SEC. The change also would subject TVA to possible SEC enforcement actions.
- Some have criticized Frist's actions, calling the TVA changes a political power play by the majority leader. "I can't for the life of me see how it helps either TVA or the ratepayers," said Representative Roger Wicker (R-MS), a former TVA Congressional Caucus chairman. "In my humble opinion, the majority of members in the TVA

region have grave doubts about this change and were either compromised or muscled by the Senate majority leader.”

- Senator Lamar Alexander (R-TN) called the reforms the “most important change to TVA’s structure in the past 45 years,” which will improve executive decision-making in TVA. “A \$7-billion-a-year business needs a chief executive officer,” said Alexander, chairman of the TVA Congressional Caucus.
- Harold DePriest, president of EPB, Chattanooga’s public power distributor, agreed. “We think it’s a good form of government,” DePriest said. “It’s very similar to what all of us as distributors are used to.”
- Two top TVA directors said they anticipate “smooth sailing” when the 71-year old New-Deal-era agency transitions next year to a new governing board. “We’re making sure that information continues to flow smoothly ... that TVA’s business operations won’t in any way be interrupted,” said TVA Chairman Glenn McCullough. “This will be a seamless transition,” he said.
- “This will be great for TVA’s future,” TVA director Bill Baxter said. “It will increase the breadth of expertise at the board level. And it will provide a more logical structure. Everybody will have one boss. That will be less confusing, less cumbersome, quicker, more responsive. And these are the characteristics that TVA will need as it transitions to a competitive marketplace.” Baxter, who will remain on the board as a part-time member, predicted the transition “will be very smooth.” Both officials said they don’t expect a new board would change the location of its power operations with 3,000 TVA employees in Chattanooga, TN and its administrative headquarters with 1,000 employees in Knoxville, TN. The agency has 12,500 to 12,800 employees, said TVA spokesman John Moulton. TVA, which is funded entirely by ratepayer dollars, has some \$23 billion in debt.
- Longtime TVA observer, Stephen Smith of the Southern Alliance for Clean Energy, predicts a less-than-smooth transition. “I think it’s probably going to be a challenge because first of all you have people like Baxter and some of the others who want to stay on and are going to be relinquishing power. The existing board has so much power.” He said they may have “difficulty letting go.” Smith predicted Baxter will seek to convince the new board to make him chairman. Baxter sought to shrug off questions about whether he is interested in becoming chairman, saying it “is up to the new board.” (*Associated Press*, 11/21/04; *Chattanooga Times Free Press* (TN), Andy Sher, 11/22/04; *Dow Jones Newswires*, 11/23/04)

Keeping TVA on its toes

- In an editorial, the *Chattanooga Times Free Press* writes, “If the change [in TVA’s governance] doesn’t have advocates of the agency’s mission on their toes, it should. As the traditional form of governance falls away, it will be up to newly appointed

board members and the chief executive officer they appoint to set TVA's future course. The looming question is whether the new governance structure will lead to a fundamental change in the agency's operational goals and mission. The outcome, for better or worse, remains to be seen."

- "For more than 70 years, TVA's controlling board members have paid allegiance to TVA's charter mission of promoting the use of electricity and providing flood control, navigation, and economic, agricultural and industrial development in the TVA region. While its emphasis and mix of activities have changed over the decades with the needs of the Tennessee Valley, the agency largely has adhered to its role as a nonprofit, public utility focused on providing low-cost power to ordinary ratepayers, who receive their TVA power from 158 local, independently managed, publicly owned distributors."
- "Environmentalists reasonably fault TVA for delaying cleanup of its heavily polluting coal-fired power plants, its failure to protect water quality in its dam-and-reservoir system along the Tennessee River and its promotion lately of mountain-top removal for coal mining. Public service advocates also fault it for abandoning energy conservation and reducing public access to its vast store of public lands. Yet TVA largely has served the public well by reining in costs, significantly reducing its stunning public debt and holding the line on rate increases."
- "The chief issues facing the new board members and CEO to be appointed this year revolve around debt reduction and how the agency will cope with the anticipated opening of TVA's service area to competitor utilities in the next few years. Will it shed public services, alter its rate structures (industrial vs. residential), protect ratepayer-owned transmission and generating investments, or court customers outside its traditional service areas if its boundaries evaporate?"
- "At stake, essentially, is TVA's future role: Will it remain a steadfast nonprofit, service-oriented public utility focused on the Tennessee Valley, or change its character by readying itself for conversion to a private utility or dissolution -- the long-held goal of Republican foes? In short, the change in the utility's governance structure is not nearly as important as the vision of the people selected to run the agency, their commitment to TVA's charter mission, and the goals of the Republicans who appoint them." (*Chattanooga Times Free Press*, 11/23/04)

NC Attorney General plans to sue over TVA's coal powered plants

- North Carolina Attorney General Roy Cooper announced he intends to sue the TVA, contending that several of its coal-fired power plants contribute to North Carolina's dirty air. TVA officials say the suit lacks merit because they have greatly reduced emissions and are on course to cut them further. Cooper has also petitioned the EPA to order TVA and other utilities with coal fired power plants to reduce their emissions in accordance with the Clean Air Act. The EPA has asked for more time to respond

to Cooper's petition. Given EPA's delay, Cooper announced he plans to sue the EPA to force it to require reduced emissions from coal-fired power plants in 13 states that he says pollute North Carolina's air. He sent a letter to the EPA, serving notice he will sue in federal court to compel the EPA to act. The letter, as required by law, gives the EPA 60 days to act or deny the request. (*News & Observer*, Dane Kane, 11/20/04)

- In an editorial, the *News & Record* (Greensboro, NC) writes, "States suffer from one another's secondhand smoke. For North Carolina, aging coal-fired power plants operated in neighboring states by the Tennessee Valley Authority bear some of the blame for our poor air quality...For years, the TVA has hidden behind a technical smoke screen. "Grandfather clauses" allow plant renovations that evade tough federal emissions regulations. Cooper...charges that the TVA runs some plants without required permits or fails to determine if control monitors should be added after equipment modifications. North Carolina has been in the forefront demanding that coal-fired energy generators meet stringent clean air standards. The [North Carolina] 2002 Clean Smokestacks Act exceeds federal guidelines. In addition to tough enforcement, it directs state officials to seek interstate agreements to reduce pollution through legal action, if necessary. That's exactly what Cooper is doing. More power to him." (*News & Record*, 11/21/04)

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