

The **GSE** REPORT™

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Major Events

Fannie Mae forfeits \$6.5 million in “criminally derived” gains in mortgage fraud case

- In a consent order filed with the U.S. District Court in Charlotte, NC, Fannie Mae agreed to forfeit \$7.5 million in “tainted money” to the U.S. government. The Department of Justice (DOJ) had sought \$6.5 million plus about \$1 million in interest from Fannie Mae for accepting millions of dollars that the GSE knew had been pilfered from Ginnie Mae. The consent agreement only settles Fannie Mae’s financial liability to the U.S. government in the case and doesn’t prohibit the government from taking further action against Fannie Mae in the future. Other victims in the mortgage scheme, including individual homeowners and other companies that were subsequently defrauded, can file separate claims against Fannie Mae. Fannie Mae spokesman Chuck Greener said, “This agreement brings a swift, appropriate and cooperative end for the United States and Fannie Mae in this matter.”
- In a sealed ruling issued on October 7, the U.S. District Court in Charlotte, NC ordered Fannie Mae to forfeit \$6.5 million in “criminally derived” gains received from First Beneficial Mortgage Corp (First Beneficial), which defrauded Ginnie Mae out of more than \$30 million. Judge Lacy Thornburg directed the Federal Reserve Bank of New York to temporarily freeze the \$6.5 million of “tainted funds” in Fannie’s account and ordered both First Beneficial and Fannie to preserve evidence, turn over documents, and provide witness testimony to federal law enforcement officials investigating Fannie’s role in the mortgage fraud. “The United States has substantial evidence that high level officials of Fannie Mae had direct knowledge that the funds Fannie Mae receive[d] ...were fraudulently obtained from Ginnie Mae” by First Beneficial’s owners, James McLean and his wife, Macy, Assistant U.S. Attorney Paul Taylor told the court.
- Fannie Mae’s dealings with First Beneficial date back to 1994, when the company trained James and Macy McLean to become Fannie-authorized lenders through a special program giving extra assistance to minority- and women-owned mortgage businesses. In 1998, Fannie started having problems with First Beneficial when a \$1 million portfolio of its home-equity, manufactured-housing and other loans started going bad and Fannie attempted to recoup its losses by collecting on the FHA insurance. After FHA informed Fannie that First Beneficial never purchased insurance on these loans, Fannie forced McLean to buy back the loans. “This was not voluntary. ...We requested, or really demanded, repurchase of the ineligible loans,” testified Fannie Mae representative Natin Dave, who worked with minority financial institutions. Although McLean said he couldn’t come up with the money, he wired Fannie \$964,000 several weeks later, after finding Ginnie Mae as a new investor for the loans.
- Fannie Mae then discovered new problems with First Beneficial’s mortgage loans. “We really started to question the expertise at First Beneficial to really do business in

the secondary market and underwrite properly,” said Stan Smith, Fannie’s vice president of single family operations. Fannie temporarily suspended First Beneficial from doing business with the company. After inspecting some of the collateral properties securing their loans, Fannie discovered few of the properties had houses on them of any kind, despite documentation to the contrary. Without that collateral, Fannie determined that a “good number” of the properties were worth just 25% of the value of the loans that First Beneficial had sold to the company. While Fannie’s underwriting guidelines required loan-to-value ratios of about 80%, the loan-to-value ratios on many of the First Beneficial mortgages were estimated at around 400%. Moreover, the McLean family and a few friends were listed as borrowers on multiple applications - a red flag for fraud.

- McLean “understood how serious this issue was, that Fannie Mae under no circumstances would be doing any more business with him, and that it was very, very important that we find a way to get Fannie Mae’s money back,” testified Smith at the McLeans’ trial, adding that First Beneficial needed to find other investors. “We wouldn’t publicize any suspension, so no one would know that he had been suspended. We wouldn’t advertise that fact,” he said. Smith also testified that many investors will ask if a lender’s ever been terminated or suspended by Fannie. If so, “that raises a lot of red flags on the part of other investors as to what were the situations that caused that,” Smith said.
- Although McLean offered to repurchase all of the \$35 million of loans his company had sold to Fannie, the company directed McLean to buy back only the “most egregious loans,” resulting in McLean’s repurchase of \$8.7 million of loans from Fannie in several transactions between September 1998 and February 2000. On December 18, 1998, Ginnie Mae transferred \$4.9 million to First Beneficial; two hours later, the mortgage broker wired roughly the same amount to Fannie Mae, testified Cathleen Whiteman, a special agent for the IRS. Whiteman said she discovered a similar pattern with another set of transactions totaling \$1.7 million.
- “Prior to Fannie Mae receiving these transfers, Fannie Mae officials were aware that the source of these funds was Ginnie Mae, and that the McLeans had re-paid this money to Fannie Mae simply by re-selling the fraudulent loan packages to Ginnie Mae and thereby defrauding that entity,” said HUD Inspector General special agent Mark Heinbach in a sworn affidavit in October 2004. “Fannie should have been a better citizen in advising the respective regulatory agencies of the potential fraud that existed here,” said Kenneth Donohue, Sr., inspector general HUD. “The coordination between these agencies is paramount to make sure these cases don’t happen or don’t get worse.” Donohue estimated that losses to Ginnie Mae would have run roughly \$7 million if Fannie reported the McLeans’ fraud when it was first detected. He noted that First Beneficial’s scheme was the largest and most significant criminal mortgage case ever pursued by HUD and that the McLeans and several of their “investors” received some of the stiffest prison sentences ever handed down in a white collar case. The defendants’ prison sentences ranged from two to 21 years on multiple

charges, including money laundering, wire fraud, bank fraud and conspiracy to defraud the U.S. government.

- In October, HUD asked the DOJ to try to recoup some of Ginnie's money from Fannie Mae after trying for several months to settle the matter out of court. While prosecutors haven't filed any criminal charges against Fannie, they haven't entirely ruled out filing such charges. The forfeiture is technically a criminal matter, law enforcement officials said.
- In a December 1 letter to Fannie Mae chairman and CEO Franklin Raines, House Financial Services Committee Subcommittee chairs Richard H. Baker (R-LA), Sue W. Kelly (R-NY) and Robert W. Ney (R-OH) asked Raines to explain to Congress why the GSE did not alert authorities when it discovered that \$35 million in bonds in its portfolio were backed by First Beneficial's fraudulent loans. Further, Raines must tell Congress why after Fannie discovered the fraud, the loans were then sold to Ginnie Mae. "We are very concerned that the U.S. taxpayers may have been put at risk when certain loans were sold to Ginnie Mae after many of the same loans were determined to be fraudulent by executives at Fannie Mae," said Representatives Baker, Kelly, and Ney. The Representatives' letter requests that Raines respond to their questions by January 14. (*Dow Jones International News*, Dawn Kopecki, 11/30/04; *Dow Jones International News*, Dawn Kopecki, 12/01/04; *Washington Post*, David S. Hilzenrath, 12/01/04; *Dow Jones International News*, Dawn Kopecki, 12/02/04; *New York Sun*, Roderick Boyd, 12/03/04; *Dow Jones Newswires*, Dawn Kopecki, 12/08/04)
- Paul Muolo writes in *National Mortgage News*, "Thanks Fannie Mae. Just when housing finance reporters thought they could take it easy during the holiday season, the mortgage giant's name has surfaced in regard to a new/old swindle -- this one involving \$6.5 million in funds that Fannie got from a scamming mortgage banker based in North Carolina... How come you haven't been reading about this in the press? Because prosecutors have sealed the record. Why would they do this? According to court records, to prevent the \$6.5 million from being 'transferred to other accounts or locations.' Who could potentially move the money in question? I would assume Fannie. To boot, three key subcommittee chairmen are steamed and want an explanation. Could a congressional hearing be next? Stay tuned..." (*National Mortgage News*, Paul Muolo, 12/06/04)
- "When Citizens Against Government's Waste (CAGW) named Fannie Mae the 2004 Corporate Turkey of the Year, we had no idea just how fowl the situation really was," said CAGW President Tom Schatz. "Now, it appears that Fannie Mae officials knowingly allowed a group of scam artists at First Beneficial to unload bad loans on Ginnie Mae in order to make their money back, but never bothered to inform any law enforcement authorities that these lenders were ripping off the taxpayers. Fannie Mae essentially lent a helping hand to a mortgage scheme which has cost taxpayers \$30 million. ...In the bad loan scandal, there's no amount of backpedaling that can hide the wrongdoing. What remains to be resolved is which officials knew about the

illegal activity, when did they know it, and how did they hide it? Nonetheless, Fannie Mae CEO Franklin Raines and his colleagues will probably make yet another trip to Capitol Hill to try to put some spin on this latest outrage. This is the pattern at Fannie Mae. As long as Fannie executives can fatten their own bottom lines and their own compensation packages, taxpayers are just collateral damage. If this latest revelation doesn't light a fire under members of Congress to immediately act on a reform package upon their return in January, they should all be ashamed of themselves." (*PR Newswire*, 12/01/04)

- Arthur J. Prieston, the chairman of Prieston Group, a mortgage-fraud prevention firm, said, "With all the news about accounting issues, as well as predatory lending issues, mortgage fraud has taken a back seat" in thinking about risk at the GSEs. The case "is a perfect example of how in many instances the GSEs are relying upon the repurchase remedy as a risk management tool" rather than actually trying to reduce fraud, said Prieston. (*American Banker*, Jody Shenn, 12/10/04)
- Reacting to Fannie's court-ordered forfeiture of \$6.5 million, Richard Nacht writes, "Can you say 'Arthur Andersen?' Explain to me why Fannie only has to give up its gains - why don't they have to pay a penalty and why aren't the executives associated with the fraud being held to task." (*The Mortgages Weblog*, Richard Nacht, 11/30/04)

OFHEO announces new conforming loan limits for 2005

- OFHEO announced a 7.8% increase in the upper limit of single-family home mortgages that will be eligible in 2005 for purchase by Fannie Mae and Freddie Mac. The threshold for "conforming loans" will increase from its current level of \$333,700 for single-family mortgages to \$359,650. The single family conforming loan limit is increasing roughly \$26,000 in 2005 compared to \$10,000 in 2004. The loan limits are adjusted annually based upon the change in the average home price published by the Federal Housing Finance Board (FHFB) in its Monthly Interest Rate Survey (MIRS). OFHEO also announced a new loan limit of \$460,400 for two-unit dwellings; \$556,500 for three-unit dwellings; and \$691,600 for four-unit dwelling. It also revised the limit for specially designated high-cost areas, including Alaska, Guam, Hawaii, and the U.S. Virgin Islands to \$539,475. In 2005, the limit for second mortgages will be \$179,825 and in high-cost areas it will be set at \$269,725, said OFHEO.
- OFHEO also determined that both Fannie Mae and Freddie Mac had used incorrect figures that failed to incorporate methodological changes in the MIRS, which the FHFB adopted in January 2003. OFHEO's February 20, 2004, Supervisory Guidance SG-04-001 expressed its concerns about the procedures Fannie and Freddie used in computing the upper loan limit and required the GSEs to reduce the limit for 2005 by \$2,300 to adjust for the incorrect calculations in 2004

- The newly increased limit could make it possible for an additional 340,000 families to purchase homes, said Freddie Mac. “Freddie Mac estimates that total mortgage interest savings for a borrower with a typical 30-year fixed-rate mortgage at the new conforming loan limit is as much as \$24,800 over the life of the loan,” said the company. Fannie Mae estimated the number of potential new homeowners at 271,524 as a result of the revised mortgage limit. Although the higher loan limit takes effect January 1, 2005, lenders typically begin offering the higher conforming loans as soon as the adjustment is set, providing time for the loans to be funded in 2004 and sold to Fannie and Freddie early in the new year.
- The increase in conforming loans will help the real estate market as it enters a year that probably will have the first decline in sales since 1999, said David Lereah, chief economist of the National Association of Realtors. “Raising the loan limit makes homes more affordable in the middle segment of the market,” he said. “It will bring people into the buying market who might not otherwise be there.” Lereah predicted that sales of existing homes are likely to fall 3.7% to 6.3 million in 2005 from a record 6.55 million in 2004.
- In higher-priced regions of the country, the GSEs’ higher conforming loan limits provide little relief, since many borrowers must use jumbo loans to afford even a modest house. Politicians in California and elsewhere have begun calling for higher conforming-loan limits in their states. The California Association of Realtors said the increased limit announced by OFHEO isn’t enough for most home buyers in the state, where the median home price is \$460,000, up 21% from a year ago. (*Bureau of National Affairs*, Richard Cowden, 12/01/04; *Wall Street Journal*, James R. Hagerty, 12/01/04; *Washington Post*, Kathleen M. Howley, 12/01/04; *Asset Securitization Report*, Karen Sibayan, 12/06/04)
- OFHEO also announced that the average price of a single-family home financed through Fannie and Freddie surged 12.97% over the 12 months ended September 30, the largest 12 month increase in 25 years. The sharp rise in home prices eclipsed the previous 12-month record set in the second quarter and “shows further acceleration from already rapid increases,” said OFHEO Director Armando Falcon. A slowdown in mortgage refinancing may also have contributed to the climb, said OFHEO’s Chief Economist Patrick Lawler. It appears that in mortgage refinances where home owners did not extract cash, appraisals may have tended to underestimate home values, Lawler said. The greater use of automated appraisals and other low-cost valuation methods might have contributed to the understated appraisals. (*Dow Jones International News*, Dawn Kopecki, 12/01/04; *Reuters*, 12/01/04; *American Banker*, Jody Shenn and Will Wade, 12/02/04)

Fannie Mae and Freddie Mac

Congress' desire to replace OFHEO's leadership may fuel GSE reform

- Following the release of HUD's Inspector General critical report on OFHEO, Representative Barney Frank (D-MA) and Senator Kit Bond (R-UT) asked the Bush administration to replace Armando Falcon, Director of OFHEO. Frank recently told *Bloomberg News* that he and fellow Democrats have no political leverage to oust Falcon. "It's up to HUD. The question is what can we do? Nothing," said Frank. When the Bush administration comes "to Congress looking for legislation for a new regulator, then I think we will have some leverage," Frank added. Then, the White House is "going to have to take Congressional views into account," he said. When asked about the possibility that the nomination of a new OFHEO director by the Bush administration might not precede the creation of a new regulator by Congress, Frank responded, "It is reasonable that you don't know who you are going to appoint because you don't know who is going to take the job until you know what the job is. But people can give assurances, so that's one of the things I would certainly look at: what kind of people you have in mind." (*Bloomberg News*, James Tyson, 12/06/04)
- Financial Services Capital Markets ranking member Paul Kanjorski (D-PA) said the Committee is likely to consider legislation to overhaul the regulatory structure of the housing GSEs. Kanjorski said there is a "great need" to replace the GSEs' current regulators with a "strong, independent" regulator. "I don't think anything's going to come out of Congress that doesn't have that feature in it," he added. (*National Journal's CongressDaily*, Molly M. Peterson, 12/03/04)
- Wall Street analysts said the HUD IG's report casting the OFHEO's management in a negative light slightly increases the chances that a GSE regulatory reform bill will pass in 2005. The report, which tarnishes the reputation of the OFHEO among members of Congress, may increase support for transferring GSE regulation to the Treasury, say some analysts. JPMorgan Securities said, "The release of this report showing the lack of professionalism exhibited by the OFHEO reinforces our view that there is likely to be growing bipartisan consensus in the House and Senate to enhance the regulatory structure of the GSEs." Analysts said that this would also increase the chance of a compromise from both sides of Congress on some of the more divisive issues. JPMorgan analysts said that while the HUD report does not have direct implications on the ongoing SEC investigation of Fannie Mae's accounting, the report's conclusion that OFHEO actions were politically motivated could bolster the GSE's defense relating to unresolved FAS 133 issues. "We continue to believe there is a lot of grey area in FAS 133 and the main discrepancies appear to be a difference of opinion between auditors," said JPMorgan analysts. (*Asset Securitization*, Karen Sibayan, 11/29/04)

Federal Reserve Chairman Greenspan wants limits placed on GSE debt-issuance

- According to *The Wall Street Journal*, Federal Reserve Chairman Alan Greenspan is pressuring the White House to incorporate in GSE regulatory reform limits on the debt that Fannie Mae and Freddie Mac could hold or issue unrelated to their mortgage mission. In total, Fannie Mae and Freddie Mac currently approximately \$4 trillion in mortgages.
- *The Wall Street Journal* also writes, “Despite continuing legislative and regulatory battles, which flow from the firms’ accounting scandals, both [Fannie and Freddie] plan to scale back their vaunted lobbying and image consultants. Critics say the talk is itself a public-relations ruse.” (*Wall Street Journal*, Jackie Calmes, 12/10/04)
- Standard and Poor’s warns that Fannie Mae and Freddie Mac risk losing their AAA debt ratings, if legislation is passed altering the relationship between the government and the companies. Fannie and Freddie “owe” their AAA credit ratings to their status as GSEs, which “implies” that the U.S. government will support the companies if they run into trouble. (*Financial Times*, Jenny Wiggins, 12/10/04)

Freddie Mac’s CEO Syron warns of unintended consequences of GSE regulatory reform

- At an affordable housing symposium sponsored by the National Association of Homebuilders (NAHB), Freddie Mac chairman and chief executive Richard Syron warned attendees of the potential for unintended consequences resulting from regulatory reform for the GSEs. “Reform is necessary and we embrace it. There’s only one possible loss in this debate ...if we ignore the tremendous benefits the system generates,” Syron said. “Can we improve the GSEs? Absolutely. But we have to do it carefully and we have to weigh very carefully the law of unintended consequences.” Syron repeated his concerns that the GSEs’ affordable housing requirements through 2008 set by HUD may be too aggressive in the later years. “We expect to meet [these goals]. We’re going to do everything possible to do that,” Syron said. “When you raise these things far enough and far enough and far enough, they become predatory and you’re not doing people a favor,” he cautioned. “Even if we find a way to meet it, you know, and take some of the public heat off us, we’re not doing the right thing. It’s an issue that’s out there in the future,” he said. “Our critics can’t have it both ways. They can’t demand that we meet ambitious goals and at the same time strip away what makes us unique and treat us as if we were just another couple of private-sector financial institutions,” said Syron “Because those type of changes would make it all-but-impossible for us to serve our mission. And they would harm our partners just as they would harm the families we serve.”
- “...We are committed to working closely with the Home Builders and other valued partners throughout [the legislative debate on the GSEs]. ...And, we hope, as well, that in this debate we will earn a good share of your confidence and support,” Syron

told the NAHB audience. "...We stand with housing- and everyone who wants to build it, finance it and make it affordable for all. And we hope you will stand with us, as well." [In October, NAHB CEO Jerry Howard told *The American Banker* that his trade organization was "reevaluating" its support for Fannie, following the disclosure of the GSE's accounting problems. He added that the NAHB was forming a task force to look into the matter and didn't expect the group to make any policy changes until at least the first two weeks of 2005.].(*Dow Jones International News*, Dawn Kopecki, 12/08/04; *Reuters*, 12/08/04; *Freddie Mac Press Release*, Prepared Remarks for Richard F. Syron, 12/08/04; *American Banker*, Rob Blackwell, 10/01/04)

President Bush asks Treasury Secretary John Snow to serve in his second administration

- Ending widespread speculation of changes at the Treasury Department, President Bush asked Treasury Secretary John Snow to serve as the department's secretary in his second term in office. "I was deeply honored by the action of the president in asking me to continue," Snow said. "I look forward to working with him on an agenda to keep the economy growing."
- As the administration's second-term takes shape, there will likely be a number of changes in top Treasury posts overseeing international affairs, tax policy and the GSEs. Treasury Undersecretary for Domestic Finance Brian Roseboro will be resigning at the end of the month after a longer-than-expected 3 1/2 years at the department. According to *The American Banker*, a top candidate to succeed Roseboro is Kevin Warsh, a special assistant to the president, said people following the process. Such an appointment would be consistent with other moves taken by President Bush to place close White House aides in key positions elsewhere in government. Assistant Treasury Secretary for Financial Institutions Wayne Abernathy, the department's point man on GSEs, is being considered to fill in as the director of the OFHEO on an interim basis, if not permanently, should the current director, Armando Falcon, leave. It is believed that Abernathy will fill in permanently as the GSEs' regulator, only if Congress passes GSE regulatory reform legislation. (*Bloomberg News*, Simon Kennedy, Richard Keil, Art Pine, Brendan Murray, Alison Fitzgerald, Michael McKee, Peter Cook, and Vivien Lou Chen, 12/09/04; *Dow Jones International News*, Deborah Lagomarsino and Elizabeth Price, 12/09/04; *Dow Jones News Service*, Joseph Schuman, 12/10/04)

RNC Chairman Gillespie to assist FM Policy Focus with communications
in GSE regulatory reform debate

- Republican National Committee Chairman Edward Gillespie will personally work on communication efforts for FM Policy Focus, after he leaves his current post on January 18 and rejoins his firm, Quinn Gillespie & Associates, said the coalition's director Michael House. Gillespie "is one of the best strategic minds" in Washington,

who has an unusual “ability to know how you position yourself and your strategy for moving legislation,” said House. FM Policy Focus hasn’t discussed details of Gillespie’s role, House added. (*Bloomberg News*, James Tyson, 12/02/04)

A lone voice in Mansfield, OH asks, “Where’s the punishment for Fannie and Freddie?”

- In a Letter to the Editor of *The News Journal*, Jeanette Swigart writes, “... [T]he *News Journal* printed an article September 25 with the headline ‘Fannie Mae may see shakeup.’ ...Freddie Mac ‘disclosed in June 2003 that it had understated profits by some \$4.5 billion for 2000-02 in an effort to smooth earnings.’ These CEOs are already millionaires. Greed is rampant. The list of the companies of these crimes is endless. Freddie Mac’s crimes were two and three years ago. Where is the punishment? Not one word printed about punishment for Rite Aid, Pharmore, Enron, World Com. The list goes on and on, and that’s because there is no punishment. So they fine them a few million dollars. That’s a drop in the bucket. I’m sure they are shaking in their shoes.” (*The News Journal*, Jeanette Swigart, 11/24/04)

The Shadow Financial Regulatory Committee addresses privatization of GSEs

- In their analysis of the financial services agenda for the second Bush Administration, the Shadow Financial Regulatory Committee said, “The Committee has in the past endorsed the privatization of Fannie Mae and Freddie Mac. Recent events at Fannie Mae have emphasized the importance of this step in reducing or eliminating taxpayer risks, and increased the likelihood that privatization will be considered during the administration’s second term. Although the Committee has not made a particular privatization proposal, it believes any privatization proposal developed or endorsed by the Administration should be designed to increase competition in the secondary mortgage market.” (*Shadow Financial Regulatory Committee, Statement No. 212*, 12/06/04)

The culture of subsidies inflate housing costs

- In the *Washington Post*, Steven Pearlstein asks, “What two things do a college education, health care and housing have in common?” He continues, “One is that the price of these things has been rising at least twice as fast as other prices. The other thing is that they are all subsidized by government. This is no coincidence. As most economists will admit, the subsidies are deeply implicated in the rapidly rising prices -- so deeply, in fact, that it calls into question whether they do very much for the people they are supposed to help.”
- In the world of homeownership, now synonymous with “the American Dream,” Pearlstein writes, “The mortgage interest deduction already costs the Treasury \$62.6

billion a year, supplemented by billions more in implicit subsidy provided via Fannie Mae, Freddie Mac and the regional Home Loan Banks. To a large degree, however, this money has rewarded those already with homes while making it harder for everyone else to afford one. How is that? Imagine there are two identical houses offered for sale on the same street, the only difference being that one comes with a monthly rebate of \$250. Which house would you be willing to pay more for? Obviously the one with the rebate. How much more? Up to \$249 a month, which at today's interest rates works out to roughly \$50,000. The home mortgage deduction is no different than a monthly rebate. Over time, its effect is to boost the price of the house until it incorporates most of the subsidy. And the more the house appreciates, the bigger the tax deduction, creating a dynamic of ever increasing house prices. What all of this suggests is that in a competitive marketplace, government efforts to help people pay for vital services can be self-defeating if they are not properly designed. That's something to consider during what are likely to be heated debates on ...tax reform." (*Washington Post*, Steven Pearlstein, 12/01/04)

Securities Industry Association urges FASB's advisory council to reform FAS 133, as debate about complexity of accounting for derivative instruments continues

- In light of serious accounting problems at Fannie Mae, Marc Lackritz, the president of the Securities Industry Association, urged significant changes to six-year-old rules on accounting for derivative instruments. Speaking at the quarterly meeting of the Financial Accounting Standards Board's advisory council, Lackritz cited "the sad state of affairs" with respect to FASB Statement No. 133, the standard for derivatives and hedge accounting. "I think it's a disaster," he said, referring to the application of the rules that many consider to be the "poster child for accounting complexity." Lackritz said, "I think it really needs to be revisited, and sooner rather than later."
- In a November letter to FASB, Lackritz referenced the findings of the September 20 report by OFHEO, and noted that if the hedge accounting practices scrutinized by SEC accountants are judged to be inappropriate, Fannie Mae would have to record a net cumulative after-tax loss of approximately \$9 billion stemming from its derivatives transactions. Lackritz said, "Nine billion here, nine billion there. You're talking about some real money." (*Bureau of National Affairs*, Steve Burkholder, 12/03/04)
- In *The Pipeline*, Andrew Davidson points out that the accounting rules for derivatives only bring confusion to the presentation of financial results. Davidson writes, "FAS-91 is a particularly insidious rule. It creates prospective uncertainty about past amortization of premium and discount. FAS-91 requires that firms show the same level of income as a percent of amortized balance (or internal rate of return) over the life of an investment. As actual and forecast prepayments change, firms must recalculate the amount of amortization taken to date. For premium loans slower forecast prepayments lead to gains and faster forecast prepayments lead to losses. As forecasts rise and fall the same premium is added and subtracted from income over

and over. Maybe FAS-91 was supposed to be the start of the move to mark-to-market reporting. But it isn't that at all, at most it is the mark of premium to a non-market rate. If a loan becomes a market value discount, you would still need to mark up the premium if prepayments slow, even while the value of the loan is declining."

- Davidson continues, "Much has been written about the flaws of FAS-133, foremost is that FAS-133 provides disparate treatment for assets, liabilities and hedges (derivatives). While the financial accounting system needed unification, FAS-133 served to further divide the balance sheets of financial institutions. FAS-133 introduces such great uncertainty, that many firms have decided not to hedge appropriately rather than face the burdens of FAS-133 bookkeeping or the draconian punishment of potential ineffectiveness. ...In our view, flawed accounting such as FAS-91 and FAS-133 will lead to sub-optimal behavior. Faced with such twisted rules, firms will seek first to avoid the uncertainty created by the rules. This will lead to techniques like smoothing, threshold levels and hedging to models rather than to markets."
- Davidson concludes, "As a natural consequence, management will set up levers to control the accounting results. At first management will seek to modify the accounting results to match what they believe are the true economics of the firm. At some point, however, the temptation to manipulate earnings to hide the true economics of the firm may become too great to resist. Management generally believes that they are adding value, accounting results that do not support that view are viewed with skepticism. When the rules are not economically based, it becomes extremely difficult for management to distinguish between adjusting accounting results to better reflect the true economics of the firm and manipulating earnings to hide the true condition of the firm. Clearly rules that are in place need to be followed, and flaws in the rules are not a justification for earnings manipulation. But these flawed rules should not be allowed to remain a permanent fixture of the accounting landscape. Firms should actively oppose these flawed rules. Complacently accepting FAS-91 and FAS-133 is a disservice to management and investors." (*The Pipeline*, Andrew Davidson, 11/04)
- Writing in *Barron's On-line*, Alex J. Pollock, a resident fellow of the American Enterprise Institute writes, "Looming large in the accounting woes of Fannie Mae and Freddie Mac is Financial Accounting Standard 133, which prescribes accounting for derivatives -- for the hedging that is essential to manage a portfolio of residential mortgages financed by debt. Apparently, neither Fannie nor Freddie strictly followed the rules as promulgated by the Financial Accounting Standards Board, and everyone agrees they should have done so. At the same time, virtually everybody also agrees that the FAS 133 rules are extremely complex, convoluted and difficult to apply. They have given rise to more than 800 pages of interpretations -- and they often cause accounting treatment to diverge from economic reality."
- "In fact, the FAS 133 rules tend to make financial statements less clear, less transparent and less understandable for investors. The questionable character of FAS

133 is the” ghost at the feast of their accounting scandal,” writes Pollock, created by a collision of two major government-sponsored efforts: Leveraged mortgage finance on one hand, and the elaboration of detailed top-down accounting rules on the other. To date, the force of the government-sponsored FASB idea is prevailing over the government-sponsored mortgage finance idea in the Fannie Mae and Freddie Mac accounting scandals.”

- “With the effects of FAS 133, are investors in Freddie’s debt and equity better informed or just baffled? The most probable answer is that they are baffled -- this must particularly be true for ordinary retail investors. ... We can conclude that just as the accounting travails of Fannie and Freddie point to the need for GSE reform, the performance of FAS 133 needs to be reexamined before the court of knowledgeable financial opinion. Without doubt it has made accounting more convoluted and expensive. Has it made the results of hedging activities clearer in exchange? Almost everybody in the mortgage business thinks the answer is no.”
- “This issue deserves a formal review. The FASB may not wish to undertake one, with 15 years of past commitments and reputational capital at stake, and other battles in process. This is why the Fannie dispute is heading to the SEC, but only regarding whether Fannie was following the rules, not whether the FAS 133 rules themselves are sound. The best guardian of good financial reporting remains informed and informative disclosure. Disclosure relevant to hedging activities could be improved by adopting the ‘two sets of books’ approach, as the best of the limited set of alternatives. Fannie, Freddie, other GSEs and any company whose financial results are heavily influenced by activity in derivatives markets should publish statements that follow FAS 133 to the last detail, as well as that can be determined.”
- “Then they should add a second set of books which represents, to the best of their judgment, the economic reality. Along with this must come candid and sophisticated management discussion. This will not yield uniformity, nor should it. In the multiplicity of perspectives, there will be more information and greater likelihood of approximating the relevant facts. FAS 133 will be put into a Darwinian market competition for the preferences of financial decision-makers. That is where it belongs.” (*Barron’s OnLine*, Alex J. Pollock, 11/29/04)

Fannie and Freddie face increasing competition in the MBS market
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- Fannie Mae and Freddie Mac have something else to worry about these days— increasing competition from commercial banks in the mortgage backed securities market. Large banks, such as Countrywide Financial and Wells Fargo, are buying mortgages to hold or repackage as mortgage securities and making a big inroad into the GSEs’ mortgage-backed securities market share. Issuance from banks accounted for over 50% of total new MBS in the third quarter of 2004 at \$249.4 billion, according to *Inside MBS & ABS*, a publication of *Inside Mortgage Finance*, while Fannie Mae, Freddie Mac and Ginnie Mae issued \$222.9 billion. That’s the first time

private label MBS issuance exceeded that of the three GSEs combined. “If this shift is an actual structural change and not a temporary one it will hurt [Fannie Mae and Freddie Mac] big time,” said an analyst at Fox-Pitt, Kelton Inc.

- Changes to the product mix of loans, including more sub-prime, Alt-A security mortgages, and interest-only hybrid adjustable-rate mortgages, is causing a structural shift that has benefited private banks. Alt-A and sub-prime mortgages are considered riskier than traditional “prime” loans due to looser loan requirements and reduced documentation requirements. Freddie Mac does not buy individual sub-prime loans because these loans do not meet its underwriting standards. Fannie Mae purchases some of these loans, but not the “riskier” ones, said a company spokesman. “The sub-prime market is still active and growing, so it comes as no surprise that [the private issuers] would be growing as well,” said Freddie Mac spokesman Douglas Robinson.
- With housing prices appreciating in recent years, a larger percentage of hybrid ARM loans are “jumbo” in size, above Fannie Mae’s and Freddie Mac’s buying limit. “Fannie and Freddie have been shut out of a [jumbo mortgage] market that has grown significantly over the past year as home values soared in value,” said Art Frank, director of MBS research at Nomura Securities International. The shift in product origination, coupled with home price appreciation, has placed a significant portion of the secondary market “out of reach” for Fannie Mae and Freddie Mac.
- “Fannie Mae’s loss of MBS market share only confirms our view about its earnings,” said the Fox-Pitt analyst, who asked not to be identified. “Fannie Mae is going to focus on garnering and protecting its capital base in order to meet a targeted 30% capital surplus as required by its regulator rather than growing its retained [mortgage] portfolio in the near term,” he added. Jonathan Gray, an analyst at Sanford C. Bernstein & Co, is forecasting continued slow growth in 2005 for Fannie Mae and Freddie Mac in both earnings and assets. “It’s the other side of the coin when it comes to the private banks,” he said. “If Fannie and Freddie are going to be growing slowly, the rest of the market is going to be growing fast.” (*Reuters News*, Julie Haviv, 12/01/04)

Agency debt finishing strong at year’s end
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- Agency debt securities appear to be heading into a strong finish for the year, surviving an accounting scandal at Fannie Mae and heightened regulatory scrutiny of the GSEs, according to market players. Aided by limited supply, agency/Treasury bond yield spreads have tightened to levels not seen since before Freddie Mac’s accounting revelations in 2003, said market participants. “Supply is all but non-existent,” said Mark Mothner, agency trader at Bank of America Securities, adding that the spread could come in even further if debt issuance remains scarce. Jeanie Genirs, managing director and head of agency trading at Deutsche Bank, said, “Some of our GSE valuations today are the richest they’ve been in the last four years.”

- Foreign and domestic demand for agency bonds is also on the rise, while political and headline risk appears to have receded as a market factor, said traders. The market has “more than weathered” a variety of signals from Washington that stricter GSE regulation is on its way, if not legislatively, then through actions by host of other federal agencies, Mothner said. “Accounts, both domestic and overseas, have all but no fear of any headline risk that’s going on.”
- “Perhaps the debt market has matured on all these headlines to the point where political risk has now become equated with a greater likelihood of improved regulation, which is good for investors,” said Michael DiResto, spokesman for Republican Representative Richard Baker, who serves as chairman of the House subcommittee that oversees Fannie, Freddie and the FHLBs. “The better regulated these entities are, the more secure are these investments,” DiResto added. (*Market News International*, Claudia Hirsch, 12/05/04)

Fannie Mae and Freddie Mac shift to short-term debt which carries risk
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- After a decade of rapid growth financed almost exclusively by debt, Fannie Mae and Freddie Mac have slowed their growth amid increased scrutiny from OFHEO. Changing market conditions are also making it less attractive for the GSEs to purchase mortgages and repackage them for resale, which reduces the companies’ funding needs. As a result, Fannie and Freddie have sharply reduced issuance of the long-term notes that have been the mainstay of their debt programs. Instead, Fannie Mae and Freddie Mac have relied more heavily on shorter-term and floating-rate debt to meet their funding needs, which has allowed the companies to raise money more cheaply than they could with long-term, fixed-rate debt. Short-term and floating-rate debt also provide a better match for non-traditional mortgage products, such as adjustable-rate mortgages, that Fannie and Freddie have been buying as the origination of long-term fixed-rate mortgages has declined.
- The GSEs’ issuance of larger amounts of short-term and floating-rate debt makes the companies more vulnerable to rising interest rates, since they must continuously return to the market to refinance its debt. It also appears that issuance of long-term debt by the GSEs may be slowing faster than their purchases of fixed-rate mortgages, indicating that they are covering some longer-term funding needs through the use of short-term debt. According to the Bond Market Association, Fannie and Freddie issued substantially less long-term debt during the first nine months of the year, with Fannie’s issuance down 18.9% to \$220.9 billion and Freddie’s down by 15.6% to \$161.9 billion. The GSEs’ loan portfolios have been shrinking, but not by nearly as much. Freddie said that it expected growth of its retained portfolio to be in the low- to mid-single digits for the year, down from a growth rate of 13.8% in 2003. In December, Fannie said it expects growth in its mortgage portfolio to be flat for the year, compared with a 13.1% growth in its portfolio in 2003.

- At Fannie Mae, the funding shift has been more dramatic. In November, Fannie cancelled two previously scheduled long-term debt auctions and issued \$1 billion of three-year floating-rate notes that are callable after one year through an unscheduled “reverse inquiry” deal, in which investors told the company they were interested in purchasing debt with certain terms. According to FTN Financial Capital Markets, 84% of Fannie Mae’s long-term debt issuance so far in the second half has been securities with a maturity of between two and four years, up from 66% in the first half of the year. These figures are for gross issuance and don’t take into account any debt that has matured or been retired. Fannie declined to comment on its funding policy.
- According to FTN Financial Capital Markets, 55% of Freddie’s long-term debt issuance in the second half has been bonds with a maturity of between two and four years, up from 46% in the first half. According to Freddie’s vice president for debt execution and assistant treasurer John Radwanski, the reduction in long-term debt issuance over the past year has been largely tailored to match changes in its mix of assets. “We didn’t issue that much long-term debt in the second half, but we did in the first half, and that volume covered us in terms of our duration needs,” he added. Freddie’s ultra-short term debt - its discount notes and reference bills - currently represent just 26% of total funding, which is at the low end of the normal range, said Radwanski.
- While the GSEs’ can use hedges to deal with any mismatch between the duration of debt in their loan portfolios, there’s no way to guarantee that Fannie and Freddie will be able to issue short-term or floating-rate debt so cheaply in the future, even if official interest rates remain relatively low. The yield spreads on agency debt over Treasuries have approached their narrowest levels in two years, despite the GSEs’ recent accounting woes, due to limited supply of agency debt securities. If investor demand dries up and pushes spreads of both short-term and long-term agency debt wider, Fannie and Freddie would be forced to quickly refinance large amounts of debt at unfavorable rates. “You can’t hedge away the rollover risk,” said senior agency and treasury strategist at Banc of America Securities Gerald Lucas. “It’s a risk all companies face if they have an over-reliance on the front end” of the yield curve, he added. While Fannie and Freddie would face the same rollover risk if they issued a larger proportion of long-term debt, they wouldn’t have to refinance it as quickly as they would their short-term or floating-rate debt. (*Dow Jones Newswires*, Allison Bisbey Colter, 11/30/04; *Market News International*, Claudia Hirsch, 12/05/04)

Fannie Mae

John K. Wulff elected to Fannie Mae's Board of Directors

- Fannie Mae's Board of Directors has elected John K. Wulff to join its Board to fill the unexpired term of Anne Mulcahy, who resigned in October. The Board has also appointed Wulff to the Audit and Compensation Committees. "We welcome John Wulff to our Board and look forward to benefiting from his expertise," said Ann McLaughlin Korologos, Chair of the Board's Nominating and Corporate Governance Committee. "John brings a solid base of corporate board experience and an interest in the mission of Fannie Mae."
- Since December 2003, Wulff has served as the non-executive Chairman of the Board of Hercules Incorporated, a manufacturer and supplier of specialty chemical products. Wulff also was a member of the Financial Accounting Standards Board from July 2001 until June 2003. From January 1996 until March 2001, he was the chief financial officer of Union Carbide Corporation. During his 14 years with Union Carbide, Wulff also served as vice president and principal accounting officer and controller. From April 1977 until June 1987, Wulff was a partner with KPMG and predecessor firms. (*PR Newswire*, 12/09/04)
- *The Financial Times* wrote, "Fannie Mae appears to be preparing for the worst. The mortgage finance giant, which may have to restate its earnings if the SEC finds it has abused accounting rules ...took the unusual step of appointing a financial expert to its board. ...Wulff is a former KPMG partner and has also served on the Financial Accounting Standards Board, so his expertise will no doubt be highly valued at Fannie, which is battling to get the Securities and Exchange Commission to look kindly upon its accounting interpretations. Wulff also brings other experience to the table that Fannie may need to take advantage of: how to handle a financial restatement. Last month, Hercules said it would restate some of its earnings results after finding problems with its tax accounting." (*The Financial Times*, 12/10/04)

OFHEO sets stage for showdown with Fannie Mae

- OFHEO recently set the stage for a possible showdown by withholding a required capital adequacy classification for the month of September, a classification required quarterly in order for the mortgage finance firm to operate. In a statement issued by OFHEO, the agency said that since Fannie Mae finds that it can't complete its formal quarterly report to the SEC on November 15, the regulator "has determined not to provide a monthly capital classification for Fannie Mae at this time." Up until now, the monthly classification has been a routine event, confirming that Fannie has met its statutory requirement for capital. A source confirmed that the statute requires that

Fannie's capital adequacy be confirmed four times a year, apparently setting a deadline in two months for compliance. (*Market News International*, 12/05/04)

Portales Partners, LLC analyzes Fannie Mae's potential for restatement and reduced EPS

- In a November 16th report published by Porter Partners, LLC, analyst Mark B. Agah rates Fannie Mae's shares a "SELL." Agah writes, "In the words of the long-time sports broadcaster, Keith Jackson – 'WHOA, NELLIE!!' For the first time, Fannie Mae quantified the potential effect of an earnings restatement, which could total \$9 billion (aftertax). ...Fannie Mae's estimate of these losses is just that – an estimate. Our analysis has shown the range to be \$5 billion -\$15 billion so the \$9 billion number comes as no surprise. However ...Fannie's aggregate losses on cash flow hedges total \$20.4 billion since the beginning of 2001 when FAS133 was adopted. Therefore, management's estimate could potentially be too low, and pre-tax losses from these cash flow hedges could approach \$20 billion (making the \$9 billion number too low). Fannie has also been layering SWAPs on top of SWAPs (closing hedges by entering into the opposite position). Derivatives used to close out existing derivatives positions do not qualify for the short-cut method under FAS133, which Fannie was applying. This layering and the corresponding inappropriate accounting makes the actual number very difficult to gauge (think of Freddie Mac's ongoing restatement)."
- "...[In the event of an earnings restatement,] the hit to regulatory capital is tremendous and earnings power could fall below \$6 per share (2005 consensus is \$7.97; Portales estimate is \$7.45). ...If we assume the \$9.5 billion is a good estimate and that the SEC does find against Fannie, the company's capital would fall to approximately \$28.5 billion. ...Current minimum regulatory guidelines, with the 30% excess capital mandate from OFHEO, call for Fannie to carry \$40 billion in capital. Fannie would be roughly \$12 billion shy of its minimum capital requirement. According to the company's Q2'04 10Q, Fannie does have authorization for an additional \$5.9 billion in preferred stock, which would still put the company in a \$6 billion capital-deficient position. We suspect Fannie would attempt to issue common shares, diluting current shareholders, and sell assets to boost its capital."
- "The potential restatements will have a profound effect on the company's regulatory capital, putting Fannie below the minimum by approximately \$12 billion. Again, while the market may perceive that Fannie is providing investors with a worst-case scenario, we believe the restatement could be above their \$9 billion figure. In order to assure minimum capital standards are met, Fannie Mae will likely have to take aggressive measures. We estimate the company could raise \$8 billion in combined common/preferred and sell up to \$150 billion in assets. These moves will dilute shareholders and reduce EPS to below \$6 per share. **The SEC has the final say, but we suspect the findings will result in a restatement.** The bad news for Fannie Mae is that the SEC senior accountants typically have no political agenda, and they will provide an unbiased investigation into the application of FAS133. The other negative

is a drawn-out investigation, which could last well into 2005 and weigh on FNM shares.”

- “The macro-environment is also behaving badly, with the company’s [net interest margin] under pressure and profitable balance sheet growth opportunities becoming scarce. Major restatements at a time when industry fundamentals are deteriorating could be a very bad combination for Fannie. Other issues to consider are potential management changes (or management credibility issues at the very least), widening debt spreads (and worsening funding costs), and increased regulatory/legislative pressures from the potential restatement.” (*Porter Partners, LLC Analyst Report for Fannie Mae PR4-No 196*, Mark B. Agah, 11/16/04)

The director of Fannie’s Follies deserves to go

- David Pauly writes at *Bloomberg.com*, “Fannie Mae should fire Chief Executive Officer Franklin Raines -- no matter the outcome of investigations into whether the company fiddled with its earnings. The U.S. government, which created Fannie Mae in 1938 to make more mortgages available to home buyers, should then cut its ties with both that company and ...Freddie Mac, prodding them to break up into less-risky parts.”
- “In recent years, [Fannie Mae and Freddie Mac] catered more to their shareholders than to home buyers, hurting both in the process. By taking on riskier loans to keep profits growing, Fannie and Freddie exposed stockholders to losses and provided more liquidity than home buyers needed, helping overheat the housing market. Tougher regulation -- particularly a permanent increase in the capital Fannie and Freddie must keep in reserve for losses on bad loans -- would reduce their risk. Breaking up the companies would help even more. Fannie Mae could spin off at least two companies, giving each a third of its mortgages and a third of its \$940 billion in debt. Freddie Mac could split in half and divide its mortgages and \$666 billion in debt in two. ...Five companies would increase competition for mortgages as well as spread the risk. Competition would be enhanced further if the government ended its relationship with the mortgage companies. Eliminating the notion that the U.S. all but guarantees the companies’ debts would let banks compete for mortgage funds on equal terms.”
- “While Raines insists he and his company are innocent, smoke has been emanating from Fannie Mae. Armando Falcon, head of [OFHEO], which regulates the government-chartered companies, said Fannie Mae’s accounting misdeeds were ‘a continuous effort,’ including an instance where earnings were inflated to ensure executives got bonuses. A former accounting employee said the company harassed him after he complained about policies. And Fannie Mae agreed to increase its required capital by 30 percent more than the required amount and to change the way it accounts for hedges against its mortgage holdings.”

- “Raines, who was director of the U.S. Office of Management and Budget from 1996 to 1998, will be a hard man to push. But he must go, and Fannie Mae should search for his successor outside the company. Freddie Mac had to do that last year after replacing CEO Leland Brendsel with insider Gregory Parseghian -- who then was found to have been implicated in the accounting subterfuge.” (*Bloomberg.com*, David Pauly, 11/29/04)

The accounting spin cycle

- J. Edward Ketz writes on *SmartPros.com*, “I don’t know about you, but I am getting bored because accounting frauds plod on. So they lied and cheated at Fannie Mae. Ho hum! Like that’s such a big surprise. [OFHEO] released its report not too long ago on Fannie Mae. ... We now learn some sordid details about how the executives at this government-sponsored entity pulled feats of accounting magic. These tricks were more of the same bag of tricks: recognizing revenue early or late, as needed to maximize management bonuses, and juggling derivatives contracts whichever way was more beneficial to these executives. The managers are just acting like the greedy, narcissistic, egos that they are. I am not going to delve into the mechanics of the book cooking that Franklin Raines and the other crooks engaged in. The recipes are old and insipid. Someday the diners are going to wise up and try a different restaurant. ... Fannie Mae wanted to deceive us about her economic history. She did. And Franklin Raines and his associates led us down this path. By hiding behind the complexity of accounting rules, he is demonstrating that he will accept no responsibility for the sins of Fannie Mae. Let’s watch the investment community and see whether it will grow in wisdom.” (*SmartPros.com*, J. Edward Ketz, 12/04)

Smithsonian Institute selects Fannie’s CEO Raines to serve on Black History Museum Council

- The Smithsonian Institution has selected a roster of high-profile corporate leaders, including media empress Oprah Winfrey and the chairmen of American Express, Merrill Lynch, IBM, Time Warner and Fannie Mae, to lead the effort to establish the country’s first comprehensive museum on African American life. The Smithsonian Board of Regents appointed 19 executives to the founding Council of the National Museum of African American History and Culture, scheduled to open in 2013. The museum is expected to cost between \$300 million and \$400 million, which will be paid equally by government and private sources. (*Washington Post*, Jacqueline Trescott, 12/08/04)

Fannie Mae is ranked in the top 20 private sector employers in Washington, DC

- According to the *Washington Post*, Fannie Mae ranks as the fifth largest private sector employer in the Washington, DC area with approximately 5,000 employees. (*Washington Post*, 12/09/04)

Fannie Mae Foundation study shows affordable housing shortage is worsening in DC

- A study released by the Fannie Mae Foundation and the Urban Institute shows the rising prices are worsening the affordable housing crunch in the Washington metropolitan area, particularly for low and moderate income workers. The region's wages have risen 9% on average from 2000 to 2002, while the median home price went up 37% over this period. While the local economy in the area is strong, the high home prices are forcing workers to live further away from their jobs, prolonging commutes. The report's recommendations for improvement include promoting dense development and requiring affordable housing be built in the most popular housing markets. (*Associated Press*, 12/09/04; *Fannie Mae Foundation Press Release*, 12/09/04)

Freddie Mac

Freddie Mac board member resigns as TIAA-CREF trustee over violation of SEC rules

- Stephen A. Ross, a Freddie Mac board member and MIT finance professor, and William H. Waltrip, the former chairman of Technology Solutions, resigned effective November 30 as trustees for TIAA-CREF, the nation's largest institutional investor, amid pressure by the SEC. In a filing with the SEC, TIAA-CREF disclosed that Ross and Waltrip had formed a business venture in 2003 with Ernst & Young LLP, the company's independent auditor, in violation of SEC auditor-independence rules. Ernst entered into an agreement with a company owned by Waltrip and Ross, called Compensation Valuation Inc. (CVI), for which Ross was chief executive and majority owner, and provided \$1.33 million in financing to CVI. Under the agreement, Ernst would jointly sell CVI's valuation services for corporate stock options. Ernst notified TIAA-CREF management and the SEC about the independence violation August 9, 2004 and CVI ceased operations on August 20, 2004. CVI was later dissolved on November 1. However, some members of the TIAA-CREF board weren't told about the auditor-independence problem until December 1, the day before TIAA-CREF submitted its SEC filing on the matter. The SEC's enforcement division has opened an inquiry into the events surrounding the violation, say sources close to the investigation. (*Wall Street Journal*, Jonathan Weil and Joann S. Lublin, 12/03/04; *Associated Press*, Michael J. Martinez, 12/03/04; *Wall Street Journal*, Jonathan Weil and Joann S. Lublin, 12/06/04)

Freddie Mac plans to reshape role of its top lobbyist

- As Freddie Mac searches for a successor to its chief lobbyist Mitch Delk, the company is redefining its top lobbying position, seeking to return it to a traditional government-affairs post without the broad influence over communications strategy that Delk had, said sources familiar with the negotiations. The change reflects the growing influence of Hollis McLoughlin, hired in April as chief of staff to Freddie Mac's CEO Richard Syron. McLoughlin has assumed many of the responsibilities for strategy that had been handled by Delk, sources say, and he has played a large roll in determining who will fill the scaled-back lobbying position. Tim McBride, a DaimlerChrysler lobbyist, is a leading contender to succeed Delk. He is a friend of McLoughlin from their days together serving in the presidential administration of George H.W. Bush, according to lobbyists with knowledge of the search. McBride is also a friend of Nels Olson, the headhunter at Korn/Ferry International who is leading the search. McBride's weakness for the position is that he knows little about housing and banking and may take time to settle into the job.
- Other candidates on Freddie's short list include Kurt Pfothauer of the Mortgage Bankers Association; Dan Berger of America's Community Bankers; Joe Seidel at

Credit Suisse First Boston; Terry Haines, a former staff director at the House Financial Services Committee and currently a lobbyist at Alexander Strategy Group; and Matt Schlapp, the White House political director. All of these candidates have strong Republican credentials, having worked for the GOP either on the Hill or in an presidential administration.

- Freddie Mac's decision to scale back the role of its chief lobbyist has taken some candidates out of the running, such as Mitch Bainwol, head of the Recording Industry Association of America and a former chief of staff to Senate Majority Leader Bill Frist (R-TN). Bainwol's name was considered at one point, said a lobbyist familiar with the search, but his name was dropped after the company opted to create a less powerful position. (*The Hill*, Josephine Heam, 12/01/04)

Freddie Mac's CEO Syron outlines steps the GSE is taking to provide affordable housing

- In a speech at the Workforce Housing Symposium sponsored by the National Association of Home Builders and Freddie Mac, the company's chairman and CEO Richard F. Syron discussed the progress that Freddie Mac was making on its initiatives to provide affordable and workforce housing. Freddie Mac has launched a major initiative called Project Greenlight, which includes new mortgage products that green light more loans; a redesigned A-minus program that lifts more families out of the subprime market; new outreach tools that expand the pool of potential borrowers; and broader access to all of the GSE's affordable products through its automated underwriting service.
- As their next step, Freddie Mac will introduce a new mortgage suite called Home Possible, which will provide a new level of credit flexibility for affordable housing programs. Home Possible will make Freddie Mac's lowest downpayment mortgages available for more eligible families with lower credit scores. The program will also make available more types of loans for purchasing a wider range of homes. To make it easier for families to buy a new construction home, Freddie Mac is making its automated underwriting decisions "good" for six months rather than four, which will give homebuilders extra time to complete construction without risking the loss of a qualified buyer. Freddie Mac is also testing a new type of "high-touch servicing" on affordable loans, which makes counseling services available to homeowners at any time – not just on the brink of foreclosure.
- Another area Freddie Mac is emphasizing is the needs of working families through the Workforce Home Benefit program, a "soup-to-nuts," customizable program that dozens of employers are using to offer mortgage assistance to as many as 175,000 working families. Through Home Possible, Freddie Mac is now making its most flexible loan terms available to working families.
- Freddie Mac is also focused on increasing the supply of affordable housing, particularly through multifamily housing. Through an initiative with homebuilders

and the AFL-CIO Investment Trust, Freddie Mac and its partners are going into a dozen high-cost market areas and creating 10,000 new apartments targeted for working families earning an average wage. Through a new program that supports small loans, Freddie Mac is also expanding its multifamily business to reach the entire market. The company is also investing more aggressively in low-income housing tax credits to create and preserve apartments for low-income families. Freddie Mac has also delegated underwriting on certain affordable loans to experienced lenders, a move that will finance thousands of additional apartments next year.

- Freddie Mac's other major effort is reaching out to more families who may be interested in homeownership through counseling, education and outreach. With its partners, the company is helping consumers build a good financial record; dispelling myths about the mortgage process; teaching families how to detect and deter predatory lending; and helping them adjust to paying the mortgage. Freddie Mac is using a new version of Loan Prospector with a select number of lenders and housing counselors to decide whether families are financially ready to apply for a loan. Most of these families are minority, first-time homebuyers who would not ordinarily be in the system. About 30% of those who have gone through the process are ready for homeownership. (*Freddie Mac Press Release*, Prepared Remarks for Richard F. Syron, 12/08/04)

Freddie Mac's appetite grows for adjustable rate loan products

- Freddie Mac is finding attractive pricing on adjustable-rate mortgages, including subprime interest-only loans, said Patricia Cook, the company's executive vice president for investments. "Agency and AAA-rated non-agency ARM products currently represent an increasing percentage of our total purchases" for the retained mortgage portfolio, she said. "These products provide attractive risk-adjusted returns." Returns on fixed-rate products are not as attractive because of investor demand, she added. Cook said, "We permit IO mortgages to be included as collateral backing non-agency AAA securities in which we invest" on the investment side. In the case of subprime asset-backed securities, Freddie makes certain that the loans comply with its anti-predatory lending guidelines, which limit prepayment penalties to three years and ban mandatory arbitration clauses. The company also requires higher levels of subordination, a company spokesman said. (*Mortgage Servicing News*, 12/04)

Freddie Mac's board approves changes to compensation for outside directors

- The Board of Directors of Freddie Mac approved changes to the cash and stock compensation paid to directors who are not employees of the company ("outside directors") for their services as directors, effective January 1, 2005. The annual retainer for the company's lead director remains unchanged at \$100,000, while the

annual retainer for other directors is increased from \$50,000 to \$60,000. The company's per meeting fee will increase from \$1,000 to \$1,500. The annual retainer for Committee Chair, other than audit committee, increases from \$5,000 to \$10,000, while the audit committee chairman's annual retainer increases from \$10,000 to \$20,000. The per meeting fee for audit committee members increases from \$2,000 to \$2,500, while the fee for other committee meetings increases from \$1,000 to \$1,500. Fees paid for director recruiting increase from \$1,000 to \$1,500 per interview.

- The Board of Directors also approved a revised policy under the 1995 Directors' Stock Compensation Plan (the "Directors' Plan") effective January 1, 2005. Under the revised policy, future awards of stock options and restricted stock units will vest at the rate of 25% over four terms, instead of at the rate of 20% over five terms. The allocation of awards under the Directors' Plan for newly elected and newly appointed outside directors during their first two terms will also be modified. Prior to the revision, newly elected and newly appointed outside directors during their first term received initial grants of options to purchase Freddie Mac common stock with a value of approximately \$300,000 and restricted stock units with a value of approximately \$130,000, but during their second term were not eligible to receive any grants. Under the revised policy, newly elected and newly appointed outside directors during their first term will receive initial grants of options to purchase Freddie Mac common stock with a value of approximately \$150,000 and restricted stock units with a value of approximately \$65,000 (the same values as for other outside directors) and will be eligible to receive the same grants in their second and each subsequent term.
- The Board also modified the terms of all outstanding nonqualified stock option agreements under the Directors' Plan. The modification permits outside directors to pay the exercise price of an option by delivering shares of Freddie Mac common stock acquired through the exercise of an option during the preceding six months. Previously, shares acquired by exercising options had to be held at least six months before they could be delivered to pay the exercise price for an option. The modification permits vested options to be exercised on a net share basis, through which the person exercising options receives Freddie Mac common stock with a dollar value equal to the difference between (i) the exercise price of the options plus tax withholdings, if any, and (ii) the market price of the common stock. (*Freddie Mac Supplemental*, 12/04/04)

Freddie Mac declares quarterly dividends
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- Freddie Mac's board of directors declared a quarterly dividend rate on the company's voting common stock of \$0.30 per share and declared quarterly dividends on its preferred stock. The fourth quarter dividends will be payable on December 31, 2004 to stockholders of record as of December 13, 2004. (*Freddie Mac Press Release*, 12/03/04)

Freddie Mac debt is popular in Asia

- Freddie Mac said Asian investors purchased a record 40% of its \$3 billion five-year reference note sale in early December. Foreign investors accounted for 48% of the notes, which pay an interest rate of 4% and were priced to yield 0.305 percentage point more than the U.S. Treasury's five-year note, said Freddie Mac spokesman Michael Cosgrove. Investors in Asia accounted for 13% and 29% of Freddie Mac's last two five-year note sales, he added. Foreign demand was "so strong," said Jeanmarie Genirs, head of U.S. agency trading and underwriting at Deutsche Bank Securities, that the Bank sold a "very high" 65% of its allocation to international investors. The increase in demand from Asia comes amid increasing concern that a drop in the U.S. dollar to its lowest level in almost five years against the Japanese yen and to a record low versus the euro will dampen the appeal of dollar-denominated securities. Federal Reserve Chairman Alan Greenspan said last month that foreign investors would "at some point" begin diversifying into other currencies amid a growing U.S. deficit. (*Bloomberg News*, Al Yoon, 12/03/04)

SVP of Multifamily Corbiere named most influential by *Multi-Housing News*

- Freddie Mac's senior vice president of multifamily Adrien Corbiere was named by *Multi-Housing News* as one of the most influential executives in the multi-housing industry. Corbiere joins Donald Trump on this year's list of honorees, who stand out for their vision and ability to shape multi-housing's present and its future. Corbiere stands out in the industry for introducing a number of recent innovations and, last year, setting a new multifamily funding record of \$22.6 billion for 500,000 apartment units across the country. (*Freddie Mac Press Release*, 12/03/04)

Federal Home Loan Banks

The Federal Housing Finance Board enters into regulatory agreement with FHLB-Seattle

- The Federal Housing Finance Board has entered into a written agreement with the board of directors of the FHLB-Seattle, which addresses certain shortcomings in the Bank's governance, risk management and financial performance, which were identified during a regular examination and a subsequent review by the Finance Board in 2004. The written agreement is designed to address these shortcomings and to enhance the FHLB-Seattle's business planning and capital management. The agreement calls for independent reviews of the Bank's board oversight and management, and its risk management. Under the agreement, the FHLB-Seattle must also submit to the Finance Board an "acceptable" three-year business and capital management plan. As part of that plan, the Bank will establish, subject to the Finance Board's review, capital stock, retained earnings, and dividend policies appropriate for the Bank's business strategies. Other provisions of the agreement include monthly progress reports to the Finance Board; a limitation on the growth of the FHLB-Seattle's acquired member assets; and a limitation on the amount of certain investments held by the Bank. (*Federal Housing Finance Board Press Release, 12/10/04*)

"Don't undercut the GSEs in tightening their supervision"

- In a Letter to the Editor in *The American Banker*, John L. Von Seggern, President and CEO of the Council of FHLBanks, wrote, "[I]n your November 19 issue, [*The American Bankers'* article] "Powers and Marching Orders for a Strong New GSE Regulator" emphasized the need for a single 'world-class' regulator for the government-sponsored enterprises. However, it also suggested that this new regulator and the legislation by which it is to be created should raise the question as to whether the 'statutory lines of credit to Fannie, Freddie and the Home Loan banks' should be retained. Let's be frank here. Creating a new 'world class' GSE regulator is a laudable and worthwhile goal, but trying to chip away at the GSEs' charter in the process is really an attempt to undermine the GSEs. The Council of FHLBanks supports the purposes of S1508, the Federal Housing Enterprises Regulatory Reform Act of 2004, because it would accomplish the stated goal of creating such a regulator for all the GSEs without shredding the FHLBank charter. The Federal Home Loan banks have existed for over 70 years and are a critical funding source for community banks and the neighborhoods they serve. Let's keep this debate focused on needed enhancements to the regulatory structure to ensure the GSEs can fulfill their vital housing finance mission without undercutting their charters and in turn shortchanging American consumers." (*American Banker*, John L. Von Seggern, 12/03/04)

FHLB board elections

- The FHLB-NY has added Ronald E. Hermance, Jr. to its board. Hermance is the president and CEO of Hudson City Bancorp Inc., Paramus, NJ, holding company for its \$18.7 billion-asset Hudson City Savings Bank. (*American Banker*, Christopher Wood, 12/09/04)
- The members of the FHLB-San Francisco have elected David A. Funk to serve a three year term from January 1, 2005 to December 31, 2007 as an industry director. Funk is director and president of Nevada Security Bank, Reno, NV and serves as the national director of the Independent Community Bankers Association and state chairman of the American Bankers Association. (*Reno Gazette-Journal*, 11/24/04)

Farm Credit System / Farmer Mac

FCSA agrees to pay Rabobank \$10 million to terminate merger

- Farm Credit Services of America (FCSA) has agreed to pay Rabobank a \$10 million fee to terminate its proposed merger with the Dutch cooperative. The merger agreement called for a “termination fee and expense reimbursement of \$13.5 million payable by FCSAmerica in certain circumstances.” Through negotiations, this fee was reduced to \$10 million and structured as four installments of \$2.5 million over the next year to settle all outstanding issues, the companies said. In July, FCSA agreed to sell itself to Rabobank for \$600 million, touching off a storm of protest over whether the government-sponsored lender should be able to sell itself to a private company. The proposed merger led to a counteroffer from AgStar Financial Services of Mankato, MN, protests from Farm Credit Services shareholders, and a congressional hearing. On October 21, Farm Credit Services told Rabobank it wanted to terminate the deal and declined the AgStar offer. Jack Webster, FCSA’s president and chief executive officer, resigned on November 4. Gene College, the lender’s chief financial officer, has been serving as the interim president and CEO, while the Board searches for a new chief executive officer. FCSA’s annual meeting is scheduled for December 15. (*American Banker*, Ben Jackson, 12/02/04; *Bureau of National Affairs*, Marcia Kass, 12/04/04)

FCS system needs to be modernized for the 21st century

- Writing in the *St. Paul Pioneer Press*, Mike Krutza, president of FCS Financial Services (WI) and Marc Knisely, president of the Farm Credit Services of Minnesota Valley, warn that the FCS system needs to be reformed to better serve the farmers’ needs in the 21st century. Krutza and Knisley wrote, “Now that the [FCSA-

Rabobank] deal is off the table, we urge those who debated it to step back and see it for what it was: A symptom of a larger issue. This debate isn't just about a big foreign bank's designs on small farms in America's heartland. It's about how dramatically those rural economies and communities have changed, and how much they need a modernized Farm Credit System to prosper in the 21st century."

- "When Congress established the Farm Credit System in 1916, it did so because lenders were unwilling to work with the nation's 32 million farmers due to the substantial risk involved. Congress saw a vital need for rural America to have steady access to capital, and the system was founded with a public purpose that has since grown into its mantra: to make loans to agricultural producers 'in good times and bad.' However, rural America has changed (only 2 million farmers remain), and an outdated Farm Credit System is ill-equipped to help. We're proud of the system's legacy of nurturing rural America, but we fear its future and mission are at risk under the weight of outdated legislation. For example, most Farm Credit institutions generally can lend only to farmers, ranchers and those operating small businesses directly related to production agriculture. As a result, roughly 95 percent of those who live in rural America can't utilize a system originally designed to help them prosper. The system can make home loans in towns of 2,500 or less population, but fewer than 18 percent of Americans live in towns that small vs. 36 percent 50 years ago."
- "Farm Credit's own leaders have asked Congress for help in keeping it relevant. In testimony to a House Agriculture subcommittee, Farm Credit Administration chairwoman Nancy Pellett declared that the system's governing statute 'does not accommodate many of the market conditions and economic forces, nor reflect the rural America, that exist today.' Ken Auer of the Farm Credit Council made a similar point: 'Farm Credit should have the flexibility -- either through changes in regulatory restrictions or changes through federal law -- to meet those changing needs.'
- "Still, positive reforms seem uncertain. In fact, in response to the Rabobank proposal, several Congressional members proposed changes to prevent cooperatives from leaving the system -- ever. It's an approach that treats a symptom and ignores underlying causes, and the real reasons, behind leaving the system. Instead, lawmakers should help explore how to keep the system relevant and strong to benefit communities that count on us. John Blanchard of the American Banker's Association expressed similar concerns, stating that Farm Credit institutions should not be denied their democratic right to exit the system, if that is what a majority of the stockholders wish to do."
- "A prosperous America must rest on a healthy, prosperous agricultural base. Farm Credit was founded to sustain that base, and that remains our vital public purpose. We're flesh-and-blood, storefront embodiments of our government's commitment to supporting rural life. We lend to small farmers, beginning farmers and struggling farmers. We lend to those who need us, even in some cases where pure economics say we shouldn't. We're close to our communities, invested in their aspirations and

eager to see them thrive. But if we preserve the system as-is, we are doomed to keep shrinking in number, merging and leaving communities where we'd rather stay and serve. Roughly 100 lending cooperatives remain today, vs. nearly 5,500 in 1935. We're no longer living in Grandpa's rural economy, so we should not expect Grandpa's Farm Credit System to sustain that economy 'in good times and bad.' But with Congress' help, we can adapt the system to serve the realities of 21st century rural life, and the profound interdependence of farmers and other rural dwellers, agricultural and non-agricultural."

- "With Congress' help, we can go our mantra one better, and serve rural America 'in changed times, with modern tools -- as rural America's customer-owned partner.'" (*Saint Paul Pioneer Press*, Mike Krutza and Marc Knisley, 12/05/04)

Dallas Tonsager sworn in as new member of FCA board

- The Farm Credit Administration said that Dallas Tonsager has been sworn in as a new member of the FCA's three-member board. Tonsager, former executive director of the non-profit South Dakota Value-Added Agriculture Development Center, was nominated by President George W. Bush on November 15 and confirmed by the Senate on November 21 to serve the remainder of a six-year term expiring on May 21, 2010. "Tonsager brings to his position on the FCA board extensive experience as an agricultural leader and producer in South Dakota," said the FCA. (*Dow Jones Newswires*, Deborah Lagomarsino, 12/02/04)

FCA board approves stricter governance requirements rule

- The Farm Credit Administration board unanimously adopted a proposed rule for stricter corporate governance for FCS institutions. The rule was drafted in response to the Sarbanes-Oxley corporate governance law, which does not cover FCA. "Why do we need a governance regulation?" ask board member Doug Flory. "To ensure consistency and compliance."
- The proposed rule addresses the boards of directors, committees of the board, board-appointed directors, and compensation disclosure. The proposal would help improve board expertise through training and annual performance evaluations and would require FCS institutions to identify specific board member qualifications to assist the board in its "management oversight, planning, policy direction, and fiduciary responsibilities," said the FCA. The proposal adds banks to the list of institutions that must provide an annual meeting information statement to stockholders and requires more information on nominee qualifications. The proposal also provides guidance on the size, independence, responsibilities, and resources available to nominating committees. Under the proposed rule, each FCS bank and association would be required to have an audit committee made up of at least three "well-qualified" board members with at least one member having financial expertise and at least one

member being an outside director. The proposed rule would also increase the minimum number of outside directors to two for all institutions with assets in excess of \$150 million and would require that at least one outside director be a “financial expert.” The proposed rule also provides the process for the removing for cause of directors through shareholder vote, FCA said.

- The proposed rule expands the disclosure requirements for potential conflicts of interest to include senior officers, and requires disclosures of business interests by all persons in positions of authority, not just directors. The proposal requires individual disclosure of compensation paid to all senior officers, including cash and noncash compensation. Senior officer compensation would have to be disclosed in the institution’s annual report and available to the general public. In connection with the proposed rule changes, FCA also is asking for public comment on whether the rules dealing with waiver of the statutory bank director compensation should be amended and, if so, how. Nancy Pellett, FCA board chairman, said that the proposed rule is “in concert” with the agency’s regulatory agenda and “not overburdensome.” The proposed rule will be published in the Federal Register with a 60-day comment period. (*Bureau of National Affairs*, Marcia Kass, 12/10/04)

Postal Service

Representative Davis urges Congress to pass postal reform

- On December 7, Representative Tom Davis (R-VA) urged members of Congress to pay attention to the urgent issue of postal reform, which will provide the USPS increased flexibility to compete in a communications and delivery marketplace. Davis said, “Early next spring, the Postal Service will file for a rate increase, to be implemented in 2006. Unless Congress acts, that rate increase will be one of the largest in history--at least 15%. Reforming the Postal Service is a crucial responsibility. Each year, the labor and infrastructure costs facing the Postal Service rise, while the volume of mail continues to fall. This is a ‘death spiral’ that can only be reversed by Congressional action. We have the framework for responsible, comprehensive Postal Reform in the form of legislation that will force the Postal Service to act more like a business, while also resolving two issues related to the Postal Civil Service Retirement System Funding Reform Act of 2003. I urge my colleagues to come back next year ready to pass meaningful Postal Reform.” (*Remarks before Congress by Representative Tom Davis (R-VA)*, 12/07/04)

Postal reform and job “prospects”

- Kevin Gallagher writes in the newsletter for the Association of Postal Workers Union, “Gene Del Polito, head of a mailers’ coalition, put out a positional statement the day after the Presidential election saying that it is time to commit to meaningful reform – that the current Postal Reform bills do not address the real problems of the Postal Service – that the Postal Reform bills need to be reworked into something the mailing industry wants – which is easily understood to mean increasing the massive postage discount program for presorted mail.”
- “[The Mailers’ Coalition, the Direct Marketing Association, and the Alliance of Nonprofit Mailers] have begun political action – pushing what they want in Postal Reform bills – immediately after the November 2nd election. The political and public campaign to change the current Postal Reform bills is already high and will get much louder and stronger throughout the winter and spring. They want [the postal workers’] wages, retirement, and health benefits reduced through Congressional legislation and they want bigger postage discounts for presorting mail. They also want to have the ability to open mailbox delivery to anyone so that they can establish their own processing and delivery system to completely bypass the USPS. In your corner – fighting for you [the postal worker]– is only one group, your Union. And the opposition is large, well financed, and politically connected. Despite all of this, your Union will be fighting the fight of our lives – of YOUR lives - to protect you. ...If our Union loses this fight – we all lose.” (*Association for Postal Workers Union*, Kevin Gallagher, 12/04)

The “coming postal plague”

- Writing for the *Association of Postal Commerce*, Gene Del Polito writes “...[T]he direct mail industry is about to feel the effects of a bubonic plague of its own. Only in this instance, the plague will take the form of double-digit postal rate increases. Nonetheless, to many businesses whose interests are tied to the vitality of mail, the effects could be equally devastating. As in the case of 14th century Europe, this postal plague could bring the lives of many businesses to an end. The adverse effects will be felt not only by the Postal Service, but also by the hundreds of businesses across the United States that are in the business of using mail or supporting others in the use of mail for business communication and commerce. Unlike the plague of the 14th century, we know what will cause the 21st century’s postal plague. It will be the saddling of unnecessary postal burdens on the shoulders of mailers because of the imposition of an escrow of postal retirement reform savings. The only question is: Can we do anything to prevent this?” (*Association of Postal Commerce*, Gene del Polito, 12/04)
- David Asman reports on *Fox News* that rising postal rates “...means that a lot of businesses are going to be hit hard by another cost increase, which of course they’ll

pass on to the rest of us. And it probably means that a lot of folks are going to stop buying as many stamps and send e-mails instead. So even though the post office gets more money per stamp, they may end up with less revenue in the long run. In fact, the post office's revenue for first-class stamps fell by more than \$100 million in the first half of this year. Now usually when a company can't move a product, they put it on sale. They don't increase the price. But that's our post office." (*Fox News*, David Asman, 12/02/04)

- While a postage-rate hike could be months away, financial services trade groups are preparing to lobby for minimal rate increases and postal reform. The Postal Service is expected to apply to the Postal Rate Commission for a rate increase in the first quarter, said Irving D. Warden, an associate general counsel with the American Bankers Association (ABA), as part of a process that can take up to 10 months, while the USPS and 75 to 100 business trade associations present their cases to the Commission. Warden said the two big issues this year will be the basic rate for postage and the work-sharing agreements between companies and the postal service. Another wild card is postal reform legislation. "If there's legislative action on the Hill, it could go anywhere from minimal effect to all bets off," Mr. Warden said.
- In November, the Financial Services Roundtable (FSR) urged the White House to pass a "stopgap" measure that would let the postal service redirect money it had put into the Civil Service Retirement System to pay for operating expenses. The move could cut 2 cents from any proposed hike, said the FSR. "This short-term solution will also allow Congress and the administration additional time to achieve comprehensive postal reform that fully addresses the concerns of all parties." (*American Banker*, Hannah Bergman, 12/09/04)
- William Burrus, President of the American Postal Workers Union, said "Recent media reports about the price of a first-class stamp going up to 41 cents overlooked a simple truth: the increase could be avoided or mitigated if high-volume mailers paid their fair share. While individuals and small businesses currently pay 37 cents to mail a first-class letter, corporate mailers often pay as little as 9 cents. Over the years, the mailing industry has established and expanded so-called "work-sharing discounts" for mailers who pre-sort their mail, but the discounts far exceed the costs the USPS would incur if it sorted the mail itself. This corporate welfare drains billions of dollars in revenue from the Postal Service every year, forcing the USPS to raise postage rates and leaving individual mailers and small businesses to make up the difference." (*PostalWatch.com*, 12/08/04)

USPS 2004 profit falls as 1 st class mail declines

- The Postal Service said its profits for fiscal year 2004 dropped 56%, as first-class mail volume fell for the third straight year. Net income for the year ended September 30 was \$400 million, excluding a \$2.7 billion gain from a change to retirement funding, down from profit (excluding a gain) of \$900 million in 2003. Revenues

were little changed at \$69 billion in 2004. Net income in fiscal 2004 was \$3.1 billion, including a \$2.7 billion gain created by a change in the agency's funding of its retirement system. The gain helped the agency reduce its debt by \$1.8 billion.

- Total mail volume in the fiscal year ended September 30, 2004 grew 4 billion to 206 billion pieces. Most of the growth was in standard mail, a less profitable USPS product. First Class mail declined by 1.1 billion pieces, falling for the third straight year. Revenue from first class mail fell \$700 million to \$36.5 billion, while standard mail sales rose by \$900 million to \$1.8 billion.
- Under Postmaster General John Potter's leadership, the Postal Service has cut jobs, work hours, and other costs in a bid to reduce expenses by \$5 billion over a five year period. The USPS is ahead of schedule, reducing expenses by \$4.3 billion in three years through a reduction in workforce of 68,000 employees since 2002. Over a four year period, the Postal Service has reduced its debt by \$9.5 billion. With declines in first-class mail volume hurting the agency's profitability, Potter has warned that postal reform legislation for the Postal Service is crucial to its future. "Our biggest challenge is the loss of first-class mail," he said. "That decline is going to continue because people are going to migrate to payment of bills, and perhaps even receipt of bills, through the Internet, and some personal communications too. That's progress. We aren't going to stand in the way of progress."
- "Up through 2000, the Postal Service would count on moderate growth in its revenue due to growing mail volume," Chief Financial Officer Richard Strasser said in an interview today. "Since then, we haven't had the same kind of growth and revenue has changed very little. That's why the business model needs to be changed so we can grow the business." Strasser added that the Postal Service next year is expected to post a loss of about \$195 million. The agency could possibly break even, if cost cuts and an increase in standard mail volume are realized, he said. (*Bloomberg News*, Kim Chipman, 12/07/04; *DMNews.com*, Scott Hovanyetz, 12/08/04; *E-Napus Legislative Newsletter*, 12/03/04)

Postal service strike for the holiday season?

- Drivers for Mail Contractors of America (MCA), a truck drivers' union which serves as contract employees for the USPS, has authorized a strike affecting about 500 workers in MCA terminals in Kansas City, KS; Jacksonville, FL; Des Moines, IA; Greensboro, NC; and Memphis, TN. MCA said they will consider striking during the holiday season because the Postal Service has eliminated benefits for its workers that had been obtained in past collective bargaining agreements. A spokesman for the USPS said the strike would not hinder mail delivery. "While we hope a strike doesn't take place, we're making arrangements for alternative transportation should it become necessary," said spokesman Richard Watkins. "We don't anticipate a delay in holiday mail, either domestically or to our troops overseas." (*PostalWatch.com*, 12/08/04)

TVA

Critics say the Pottery Barn rule applies to TVA reform-- "If you break it, you own it"

- After sweeping changes in TVA were tacked on to the omnibus spending bill in November, some members of Congress and others question what impact the TVA changes will have. "I have never been in favor of the changes that have been proposed," said Representative Bill Jenkins (R-TN), a former TVA board member. Jenkins added, "Once it's done, what we need to do is hope that the right kind of people will be appointed to this board. You can make anything work." Former TVA Chairman Craven Crowell said proponents of the change "better hope it turns out well," citing the "Pottery Barn rule"--that once you break it, you own it. [Using this logic, would anything *ever* change?]
- Dr. Joseph Carcello, cofounder and research director at the University of Tennessee's Corporate Governance Center, said TVA is moving to a model that "just about every corporation and certainly every large corporation in the country follows." He added, "It's not a perfect model, as we've seen in the last three or four years. "Sometimes boards are asleep at the switch. Sometimes they don't have good information. Management sometimes intentionally leaves them in the dark." Carcello said the success of the TVA's reforms depends a great deal on "who gets on the board." The presidentially nominated TVA board will consist of seven members, who undergo Senate confirmation. Current TVA directors Bill Baxter and Skila Harris, whose terms have not expired, will join the new board. The new board assumes control of TVA on May 18 or when the new members are sworn in, whichever occurs later.
- TVA, the nation's largest utility, serves 8.5 million people in Tennessee and parts of Alabama, Mississippi, Kentucky, Georgia, North Carolina, and Virginia and reports total revenues of approximately \$7.5 billion. The government sponsored entity faces stiff challenges threatening its survival, including heightened competition stemming from the deregulation of the utility industry; clean air regulations and the high cost of retooling its infrastructure to meet federal clean air standards; and a nagging \$25 billion debt. "The question of whether TVA's challenges and problems are structural or not is very debatable," said University of Tennessee historian Bruce Wheeler. "The philosophy and the whole mission of TVA is something that may have to get rethought." Senate Majority Leader Bill Frist's TVA reform plan doesn't go that far. (*Chattanooga Times Free Press*, Andy Sher, 12/07/04; *Associated Press*, Duncan Mansfield, 12/06/047)

Hometown values at work?

- The City of Memphis could soon ask state legislators to change the way local residents pay their utility bill. According to the City's 2005 legislative agenda,

Memphis Light Gas Water (MLGW) may soon be able to charge rates based on the customer's income. MLGW officials say their intent is to help those who are low-income and have difficulty paying their utility bill. Some city council members are concerned that something else might be in the works. E.C. Jones, Memphis City Council member said, "I can assure you, the intention is: We're going to lower certain individual bills and pass it on to other people." MLGW officials said that they have not yet worked out how they would pay for a rate reduction. The bill has not actually been written yet and is subject to approval of the Memphis City council and then the Tennessee General Assembly. (WMC-TV, Memphis, TN, 12/04/04)

- According to MLGW's annual report, the utility purchases power from TVA and resells the power to residents of Memphis, TN and Shelby County. MLGW is the nation's largest three service municipal utility that is governed by a president and five member board, all of whom are appointed by the Mayor of Memphis. "While sticking to our hometown values, MLGW still manages to provide world-class service," said the utility in its 2003 annual report. [This may not be the type of reform that Senator Frist (R-TN) had in mind for TVA's utility customers.] (*Memphis Light Gas Water 2003 Annual Report*)

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