

The **GSE** REPORT™

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Major Events

Atlanta Federal Reserve study urges Congress to privatize the GSEs

- Top economists argue in a newly released Fed study that Fannie Mae and Freddie Mac should be privatized, saying the GSEs are unnecessary for the U.S. housing sector and pose risks to the financial system. “The United States has too much housing (and not enough of other goods and services), and federal sponsorship of Fannie Mae and Freddie Mac exacerbates the problem,” said Scott Frame, an economist for the Atlanta Fed, and New York University economist Lawrence White in the Fed study. “Moreover, Fannie Mae and Freddie Mac do not do an especially good job of focusing on the low-and moderate income first-time buyer,” they said. The GSEs impact on mortgage rates is marginal and there is little evidence that the companies improve the efficiency of the mortgage markets, wrote Frame and White. If the GSEs were privatized, mortgage rates would probably rise 20 to 25 basis points, they said. “Complete privatization of the two companies would be the first-best outcome,” they conclude.
- Frame and White concede that the privatization Fannie Mae and Freddie Mac appears unlikely in the current political environment. Accordingly, the authors recommend “second best” measures to deal with the GSEs’ risk. First, government officials should clearly say the federal government would not bail out either GSE in a financial crisis, the authors said. They also urged that Fannie and Freddie be forced to focus more on lower-income housing. The economists recommend that the GSEs’ regulator, OFHEO or its successor, be given broader authority to approve new activities, adjust minimum and risk-based capital requirements and receivership authority. Stronger regulatory oversight would serve to reduce the taxpayers’ exposure to GSE risk. As Fannie and Freddie grow and become a more pervasive influence in the U.S. financial markets, the economists conclude that constructive “second best” measures deserve serious consideration, if privatization of Fannie Mae and Freddie Mac is not politically viable. (*Dow Jones International News*, Dawn Kopecki, 10/21/04; *Reuters*, 10/20/04; *Federal Reserve Bank of Atlanta Working Paper 2004-26*, W. Scott Frame and Lawrence J. White, October 2004)

St. Louis Federal Reserve study concludes GSE executive compensation should be in GSE reform

- The safety and soundness regulator of Fannie Mae and Freddie Mac “should have a greater ability to constrain executive compensation” at the two GSEs, according to a new study prepared by two economists at the Federal Reserve Bank of St. Louis. OFHEO’s authority to actively participate in the setting of executive compensation at the GSEs would be fitting either as part of an enhanced supervisory regime or as part

of a transition to privatization, said the study written by economists William Emmons and Gregory Sierra of the St. Louis Fed's supervisory policy analysis staff. "Prudent public policy requires greater supervisory control over executive compensation at the GSEs, which would follow a precedent set in banking," it said. While borrowing limits and higher capital requirements in principle could help counter the most obvious signs of aggressive risk-taking by the GSEs, these types of restrictions are unlikely to prevent "stock- and option-fueled" management from reaching risk return trade-offs to maximize shareholder wealth, according to the study. The crucial task from a public policy perspective "is to recalibrate managerial incentives to decrease the large risk appetite by the owners of a highly leveraged institution that is perceived by many capital markets participants to enjoy a government guarantee of its liabilities," the study said. "Thus, corporate governance - and executive compensation arrangements in particular - should be an important component of the reform agenda," added the study.

- As the debt holder's and taxpayer's representative, the GSEs' regulator must be admitted to their boardrooms in a way that is atypical of an ordinary publicly held company, said the study. "This intrusion into the board's oversight of executive compensation plans is justified given the GSEs' public purposes and their large potential costs to taxpayers," it said. The study noted that recent amendments proposed by OFHEO to its corporate governance framework for the GSEs' would require compensation to be "reasonable and appropriate," rather than merely "reasonable and comparable," as is now the case. "Authority for OFHEO to participate actively in setting GSE compensation would be fitting as part of a transition to privatization," it concludes.
- "In the wake of OFHEO's investigations into Freddie Mac's and Fannie Mae's accounting practices, there are signs that GSE owners and directors have begun to appreciate how important executive compensation arrangements are in establishing the firms' cultures and setting an appropriate 'tone at the top,'" the study said. Since there is no guarantee that GSE shareholders and directors will follow through, "prudent public policy requires greater supervisory control over executive compensation at the GSEs, which would follow a precedent set in banking," the study concludes. (*Dow Jones Newswires*, John Connor, 10/27/04; *Federal Reserve Bank of St. Louis*, Working Paper 2004-06, 10/26/04)

Rabobank deal called off, following backlash from FCSA shareholders

- The unprecedented attempt by Dutch banking cooperative Rabobank Group to buy a part of the Farm Credit System of American (FCSA), collapsed amid a backlash by shareholders and farm-state politicians. FCSA of Omaha, NE announced its directors called off their three-month-old agreement to sell to Rabobank, which sweetened its offer by 25% several weeks ago to \$750 million. FCSA executives blamed sibling institutions for stirring up opposition to the merger. "I'm very disappointed. This could have been a great opportunity," said Jack Webster, CEO of FCSA, who

supported the merger so the institution could offer more services than allowed under the mission approved by Congress.

- Cor Broekhuysen, who heads Rabobank's operations in the Americas, said his company is willing to consider other U.S. acquisitions. "We're open to discussions with anybody," said Broekhuysen.
- Separately, FCSA's directors rejected a takeover proposal by AgStar Financial Services, a Farm Credit institution in Mankato, MN. AgStar's bid, whose terms weren't disclosed, was made in August with the support of system executives who wanted to see the FCSA concern stay within the banking network.
- The Farm Credit System (FCS), created by Congress 88 years ago to lend to agricultural interests exclusively, is the largest lender to U.S. farmers, controlling \$60 billion in loans, or one-third of total farm business debt. Many FCS leaders felt Rabobank's proposed deal would encourage other members of the system to consider going private. While FCS has the advantage of being able to raise funds more cheaply than commercial banks because its bonds hold quasigovernment status in the minds of many investors, its members are blocked from offering many services, such as taking deposits and lending to nonagricultural businesses. The fight caught the attention of Congress, which held hearings at which some legislators expressed concern.
- Shareholders who opposed the merger organized a group called Farmers for Farm Credit, which launched a Web site and met with FCSA's directors in late September. Many in the group complained that FCSA agreed to sell for too little and, using its own experts, valued the lender at \$1.8 billion. "We have a lot of questions about how the board came to its original decision," said Alan Dillman, a Morrill, NE, farmer and co-chair of the group. Morrill and others in the group are considering whether to seek the ouster of Webster, FCSA's CEO who championed the deal. Webster said he intends to stay in the post.
- Some observers argue that it's time for FCS to cut its ties to the federal government and the Rabobank offer marks natural evolution. Bert Ely writes in Farm Credit Watch, "FCS fears about the proposed Rabobank deal were legitimate because this deal, even though it was not consummated, clearly demonstrated that rural America no longer needs the FCS. Rabobank was willing to pay a substantial premium, to assume FCSA's loan book without any government subsidy. Instead, as a private-sector, fully taxed lender, Rabobank would have funded those loans in the capital markets. For decades, the FCS has contended that it stands ready, at all times, to lend to those farmers and ranchers that banks and other private-sector lenders supposedly will not serve. The Rabobank offer clearly shows the falsity of this argument. The Rabobank offer confirms what bankers everywhere know to be true -- FCS increasingly uses its substantial tax and credit subsidy to skim off the cream of agricultural credits, those borrowers least in need of an interest-rate subsidy, while also pressing to expand its lending to non-farm borrowers. If this were not the case,

why was Rabobank willing to purchase the FCSA loan portfolio for a substantial premium?”

- Ely continues, “The Rabobank offer so rattled the FCS managerial class that they are pushing Congress to repeal that portion of the Farm Credit Act that would have permitted FCSA to sell itself to Rabobank. In effect, FCS managers want Congress to deny FCS members the democratic right to take the associations they own out of the FCS if they can get a better deal elsewhere. FCS managers want Congress to cement the FCS into rural America even though it no longer is needed. The FCS managerial class, working through its trade association, the Farm Credit Council (FCC), has used the Rabobank offer to support its case that the FCS needs broader off-farm lending powers. In a news release commending the collapse of the FCSA-Rabobank deal the FCC stated: ‘We believe this episode highlights the challenge facing [the FCS] as it works to fulfill its mission. Agriculture is evolving and the needs of farmers, ranchers, and rural communities are changing. [FCS] should have the flexibility -- either through changes in regulatory restrictions or through changes in federal law -- to meet those changing needs.’”
- Ely concludes, “Note how the FCS is trying to broaden its mission, to serve all of rural America (and possibly beyond), and not just farmers and ranchers. This mission expansion would take the FCS far beyond what Congress intended when it created the FCS in 1916. The FCS now seeks, with the full support of FCA Chairman Nancy Pellett, to expand its already substantial authority to engage in non-agricultural lending. This objective was quite evident at an FCA public hearing last year. Simply put, the FCS wants to lend to anyone anywhere for any purpose. The FCC will aggressively push this objective in the next Congress. Bankers and others concerned about the FCS need to oppose broader FCS lending authorities.” (*Wall Street Journal*, Scott Kilman, 10/22/04; *Financial Times*, Jenny Wiggins, 10/21/04; *Dow Jones Newswires*, Deborah Lagomarsiono, 10/21/04; *Farm Credit Watch*, Bert Ely, October 2004)

Fannie Mae and Freddie Mac

GSE reform “prospects” in 109 th Congress
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- While Congressional efforts to strengthen GSE oversight will be revived in 2005, it remains unclear whether more talk will result in passage of legislation to reform the regulation of government-sponsored enterprises, said aides to key Congressional members at a Mortgage Bankers Association conference. “GSE reform will remain a focus in the 109th Congress,” said Cindy Chetti, a senior aide to Representative Michael Oxley (R-OH), chairman of the House Financial Services Committee. The details of what GSE regulatory reform legislation will look like will depend largely on how the elections in the House and Senate fall, she added. “The numbers in the

House and Senate are very close and it's difficult to get anything done in Congress without consensus," she said.

- "I expect my first agenda item will be reforming the regulation" of the GSEs, said Mark Calabria, senior aide to Senator Richard Shelby (R-AL), chairman of the Senate Banking Committee. "I am hopeful we get a bill out. That is at the top of our agenda," he added. "My position, and of [Committee Chairman Richard] Shelby, is one of strong support in the mission of the GSEs," Calabria said. "We don't necessarily have faith in what we hear from regulators and that does not give us comfort." Regardless of the outcome of the presidential election, Calabria believes that GSE regulatory reform will move forward in the 109th Congress, noting "I don't think safety and soundness is a partisan issue." He added, "The folks over at the Treasury bureaucracy will stay the same," pointing out that many of the career staff at the regulatory agencies that oversee the GSEs aren't political appointees who will change if Senator John Kerry is elected president.
- "Everyone agrees to strengthen and improve the regulator," said Scott Olson, an aide to Representative Barney Frank (D-MA), the top Democrat on the House panel that oversees Fannie Mae and Freddie Mac. "There is frankly not a lot of disagreement between the parties on the Hill that there is a desire to strengthen and improve the regulation. One could be relatively optimistic that there could be consensus next year." However, Olson said he is "not optimistic" on an immediate consensus when the subject of GSE reform is revisited after Congress convenes next year. Olson also noted that Democrats would like to see Fannie and Freddie commit more money to manufactured housing, affordable housing and subprime lending. "They are designed to do a role and that is to serve an area that's not being served, an area the market isn't serving," he said.
- While a Kerry win might give Democrats more leverage in strengthening the GSEs' affordable housing mission, panelists agreed that toughening the companies' oversight would remain a top priority. Lawmakers still don't have complete confidence in OFHEO as a regulator, Calabria added. "There's a lot of concern on the Hill about the kind of job OFHEO's done, and what the [Federal Housing] Finance Board are doing. Quite frankly, we don't necessarily have faith in what OFHEO and the Finance Board say," Calabria said, adding he was expressing his personal views which didn't necessarily reflect the views of the Banking Committee. (*Dow Jones Newswires*, Dawn Kopecki, 10/26/04; *Reuters*, Richard Leong, 10/26/04; *Bloomberg News*, Al Yoon, 10/25/04)
- In comments at the Florida Bankers Leadership Dinner, Treasury Secretary John Snow underscored the importance of the GSEs in the housing market and stressed that they require a strong regulator to maintain market stability and their safety and soundness is critical to the overall well being of the banking industry. "With a strong regulator, I think the markets would be less nervous," Snow said. He also welcomed calls for establishing strong standards on risk capital and measures to ensure that GSEs aren't over-extending themselves. (*Dow Jones Newswires*, Rod Alvarez)

- In a panel session at the Mortgage Bankers Association’s Conference, HUD’s assistant secretary of congressional relations Steve Nesmith said the administration will also push Congress to create a “world class” regulator for Fannie, Freddie and the FHLBs. “No matter who is in the White House, there will be GSE reform, said Nesmith. He also sought to dispel the myth that the Bush administration wants to strip Fannie and Freddie of their federal benefits and treat them as private corporations. “Let’s put it out there, the big elephant in the room. A lot of people believe we want to privatize the GSEs. That’s not what the administration wants to do,” said Nesmith. (*Dow Jones Newswire*, Dawn Kopekci, 10/26/04)

The GSE reform debate: two different debates taking place through two different lenses
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- Howard Glaser, former chief of staff for former Clinton administration HUD Secretary Andrew Cuomo and former lobbyist for the Mortgage Bankers Association, said there are really two different debates taking place in Washington, DC through two different lenses. Congress is debating the GSE issue in terms of the scope and power of its regulatory agency. Fannie Mae and Freddie Mac are also focused on the regulator’s powers and structure in this debate. Glaser said there is “broad consensus for a stronger GSE regulator, although there are some differences and important details.” The second filter, which focuses not on the regulator, but on the characteristics, the benefits and the obligations of the GSEs, is the debate that the Bush administration and conservative think tanks have been pressing.
- Glaser concludes that the reason GSE regulatory reform efforts failed this year is that the administration and Congress were not debating the same issue. Chairmen Shelby and Oxley stuck to a “fix the regulator” approach, while the administration pushed more “organic GSE changes.” When the parties couldn’t agree, they reached a stalemate. According to Glaser, the \$64,000 question is will Shelby and Oxley move toward the White House position? Have widespread failures of internal controls leading to multi-million dollar accounting problems caused by management failures at many levels been enough to shift the debate from one about the regulator to the regulated? [If not, *why* not?] Given Congress’ lack of action following the Freddie Mac scandal, Glaser believes that Congress will remain focused on the GSE regulatory problem rather than the structural problems of the GSEs. Glaser also notes that it’s hard to argue that OFHEO remains “the sick man of regulatory agencies,” given the agency’s recent performance in reviewing the accounting practices of Fannie and Freddie. He notes, “[T]here are people here scratching their heads on the Hill saying, ‘Why do we need to fix OFHEO again?’” [If that’s really the sentiment on Capital Hill, why didn’t Congress increase OFEHO’s funding in the Continuing Resolution –paid by the GSEs and “budget neutral”—to facilitate the completion of the Fannie Mae special examination?] (*Prudential Equity Group LLC Research*, Recent Events Surrounding FNM and OFHEO 10/13/04)

MBA supports “strong, well-funded, well-managed” GSE regulator

- With regard to GSE regulatory reform, Mortgage Bankers Association chairman Michael F. Petrie said that the big issue his organization will tackle next year is GSE regulatory reform. Petrie said, “Our position is that we want a strong, well-funded, well-managed regulator. We’re not going to pick where it should come from. We want to make sure the regulator has a clear message on mission, and that we make sure that they perform their mission and that there isn’t what we call “charter creep” into the primary market. There is a distinct secondary market and a distinct primary market where we both operate. ...[W]e want a strong, safe, secondary market.”
- To support the MBA’s efforts, Petrie said, “we’d like to grow Morpac, our political action committee. As a matter of fact, we’re going to reach a milestone this year of \$1 million. We’re going to grow to \$1.3 million in a cycle.” (*American Banker*, Christopher Wood, 10/26/04)

Are lawmakers willing to take the risk of a GSE disaster occurring on their watch?

- In the *New York Law Journal*, associate professor Clyde Mitchell writes, “Freddie and Fannie are in trouble and steps need to be taken to fix their accounting and management problems. The Office of Federal Housing Enterprise Oversight also has problems with its image and probably this won’t be remedied without the establishment of a new regulator with adequate powers that can command respect. This in turn requires the passage of legislation along the lines of S1508 (which will not be an easy task and probably will not happen in this Congress). My bet: we will have a new regulator in 2005.”
- “*The Wall Street Journal*, in a scathing editorial, “Review & Outlook -- Fannie Mae Enron” on October 4, concluded that: “Fannie Mae isn’t an ordinary company and this isn’t a run-of-the-mill accounting scandal. The U.S. government had no financial stake in the failure of Enron or WorldCom. But because of Fannie’s implicit subsidy from the federal government, taxpayers are on the hook if its capital cushion is insufficient to absorb big losses. Private profit, public risk. That’s quite a confidence game -- and it’s time to call it.” I agree. Any Congressman who fails to get the seriousness of this message and to support meaningful GSE regulatory legislation will be accountable to the American taxpayers in the event that a disaster occurs on their watch.” (*New York Law Journal*, Clyde Mitchell, J.D., 10/20/04)

Federal Reserve Board Governor Bies says GSEs are taking on
interest-rate risk to promote their growth

- Federal Reserve Board Governor Susan Bies said Fannie Mae and Freddie Mac were taking on interest-rate risk as a way to grow earnings and need stronger regulation. Answering questions following her speech to a symposium sponsored by the Connecticut Law Review, Bies said Fannie Mae and Freddie Mac were promising shareholders growth rates in the teens, even though the GSEs already held half the mortgages in the country. “How much bigger can you grow your earnings if you’re dominating in market share?” asked Bies. “They’re promising it by taking on risk. They’re taking on risk by (holding) their own mortgage-backed securities (on) their balance sheet, buying each other’s mortgage-backed securities ... and they’re taking on interest-rate risk.” (*Reuters*, 10/21/04)

FDIC Chairman says banks’ exposure to GSEs is not excessive

- In a speech before America’s Community Bankers Annual Convention, FDIC chairman Don Powell said that federally insured banks and thrifts appear to have an acceptable level of risk exposure to Fannie Mae, Freddie Mac and the FHLBs. FDIC-insured institutions hold more than \$1 trillion in mortgage-backed securities, primarily those issued by Fannie Mae and Freddie Mac, and they had borrowed about \$533 billion through FHLB advances as of mid-year 2004, said Powell. “[O]ur view based on the conclusions examiners are reaching and the results of offsite analyses is that insured institutions are not exposed to excessive risk as a result of their interaction with the GSEs under currently foreseeable scenarios,” he said. While regulators have had some concerns about banks and thrifts leveraging advances or getting involved in FHLB structured advances without understanding or managing risks, Powell said, “[F]or the most part, institutions are using advances responsibly as part of their overall funding strategies.”
- Powell also noted calls for the GSEs regulatory reform to expand regulatory powers given the GSEs’ size, changing business conditions and the widespread perception of their having a federal safety net. He suggested that the bank regulatory framework could provide a suitable model based on independence from politics, budget autonomy and strong supervision and enforcement powers, including the ability to set capital requirements and appoint receivers if needed. (*Dow Jones Newswires*, Campion Walsh, 10/18/04)
- While GSE critics have argued that Fannie Mae and Freddie Mac present a threat to the banking industry, some argue that the “threat” of GSE debt is overplayed. With the banking industry’s assets totaling nearly \$10 trillion, debt securities guaranteed by GSEs account for more than 10% of those assets. On June 30, 2004, FDIC-insured institutions held \$317 billion of direct obligations of all GSEs and \$872 billion more of MBSs backed by GSE guarantees, according to the FDIC. In aggregate, the GSE

obligations represents about 158% of the industry's Tier 1 capital. Representative Richard Baker (R-LA), a longtime GSE critic, has been "making hay" of the fact that roughly 40% of insured institutions hold more GSE debt than Tier 1 capital. Many observers conclude, however, that the FDIC depository system is not particularly vulnerable to a GSE stumble.

- Even Bert Ely, an Alexandria, VA banking consultant and vocal critic of Fannie and Freddie, said the GSEs' threat to banks and thrifts has been exaggerated. Financial problems at the GSEs pose a much larger problem for equity investors than for debt investors, he said. "There are several lines of defense before you get to MBS and the senior debt: common equity, preferred stock, subordinated debt," Ely said. "The likelihood that one of these companies would be so insolvent that there would be a loss imposed on senior creditors is relatively remote."
- Jim Vogel, an analyst at FTN Financial Capital Markets in Nashville, TN, said picking the GSEs as the first domino to fall probably inverts the equation. "In general, the GSEs own extraordinarily low-risk assets, and they own the cream of the crop of the low-risk assets. It's the banks that have the great concentration of the high-risk assets," Vogel said. "If you are thinking about what could go wrong with the single-family housing industry, the banks are going to suffer based on their own direct exposure before they suffer based on the indirect exposure to the GSEs." (*American Banker*, Todd Davenport, 10/18/04)

Chairman Greenspan is right – it's time to privatize Fannie and Freddie

- *The National Review* writes, "Fannie Mae is the nation's biggest mortgage provider, with \$1 trillion in assets. A new report says that it has been cooking its books. The Department of Justice has opened a criminal investigation. Were Fannie Mae a normal company, enforcing the relevant laws would be enough. But Fannie Mae is a public-private partnership. Translation: All kinds of government subsidies help it make a profit; if it ever fails, taxpayers will be on the hook. It has become such a large player in housing markets that its failure would also disrupt those markets. For that reason, and to avoid the risk of a massive taxpayer bailout, Alan Greenspan has been recommending that Fannie be privatized. The revelation that its management has been more interested in enriching itself than in serving its supposed public purposes -- and may have broken the law -- is evidence that Greenspan is right." (*National Review*, Roman Genn, 10/25/04)

HUD Secretary Jackson says Fannie and Freddie lag the market
in serving affordable housing market – and GSEs respond

- In a speech before the Mortgage Bankers Association, HUD Secretary Alphonso Jackson said "Fannie and Freddie are doing a good job of opening doors to

homeownership to the underserved. The question is: Is it good enough?" Jackson added, "On average, the GSEs don't do as well as other lenders in the private market" and need to do a better job serving the AH market. Jackson said HUD will publish the final low-income housing goals for Fannie and Freddie, which will dramatically increase over the next four years the volume of mortgages financed by the GSEs for minority and lower income borrowers.

- Fannie's CEO Franklin Raines and Freddie's CEO Richard Syron criticized HUD's proposed housing goals in speeches before the Mortgage Bankers Association . The GSEs have said HUD's revised housing goals will decrease the number of loans they can buy or guarantee for middle-class and wealthier borrowers. Raines said that HUD's new rule sets "false" goals and "doesn't do any good to establish housing goals that (encourage) us to stop serving middle class." Steve Nesmith, HUD's assistant secretary of congressional relations, responded, "I don't believe that's true," adding that neither Fannie or Freddie nor their allies have provided any data to support that theory. (*Dow Jones Newswire*, Dawn Kopecki, 10/26/04)
- In an interview with *The American Banker*, Mortgage Bankers Association chairman Michael F. Petrie said that his organization "want[s] to make sure that from a standpoint of ...affordable housing goals, that those are appropriately set and we can meet them together. To put undue pressure on Fannie and Freddie to meet unrealistic goals means that the mortgage banker is going to end up with the pressure and the attendant risk of pushing too far. So what we want to make sure is that the goals reflect the marketplace and that Fannie and Freddie perform the goals. ... We believe that HUD has inappropriately sized the market. We think the market is 51% and they say it's 52%. But yet they ratchet it up over the next five years up to 57%. And to create concrete numbers without adjusting for market size - we don't think that is correct. We think if they're going to say that it's 52% next year, the year after that they should, instead of going to 53% automatically, at least look at the market, decide if it's 53% or maybe it's 51% - maybe it's still 52 - and then stick to that. Like we said, by ratcheting these goals up, basically the risk of this will be borne by the mortgage banker. So you can't regulate who takes the risk in the affordable-housing goals. The only thing you can regulate is how many loans they're supposed to do. The transference of risk to the mortgage banker is one of the things that's a bad byproduct to this whole process. We're against inappropriately sizing the market, because the risk will be transferred to us." (*American Banker*, Christopher Wood, 10/26/04)

When all else fails, shoot the messenger:

Representative Frank urges release of HUD's Inspector General's review of OFHEO and requests OFEHO to waive privacy rights;

Representative Meeks requests hearing on IG's report on OFHEO

- Representative Barney Frank (D-MA), the ranking Democrat on the House Financial Services Committee, is urging HUD and a Senate subcommittee to immediately release the preliminary findings of an investigation examining the conduct of OFHEO, as the agency probed Fannie Mae's accounting practices. Moreover, Frank wants individual employees of OFHEO to waive their privacy rights and consent to the release of the IG's report examining their conduct.
- HUD's IG Kenneth Donohue told Frank that he has provided a copy of the report to Frank's committee, and to the Senate Banking Committee. Donohue said privacy rules do not permit him to release a copy to the general public, even if the names of the individuals mentioned in the report are redacted. "Further, to date, the OFHEO personnel, about whom the report of investigation pertains, have not provided to OIG [Office of Inspector General] written consent to disclose it," he said in a letter to Frank. OFHEO spokeswoman Stefanie Mullin said Director Armando Falcon has not yet seen a letter Frank sent OFHEO asking that "those individuals identified in the report provide the OIG with written consent to disclose the report and that they be afforded an opportunity to respond." HUD hasn't provided OFHEO a copy of the report and neither the agency nor its employees have been provided an opportunity to respond to the report's findings.
- Frank said he is "troubled by a recent press account" that HUD's Office of Inspector General (IG) and Senator Christopher Bond (R-MO) are refusing to release the report to the public. Bond, a long-time Fannie ally whose son works for Fannie Mae, accused OFHEO in an April letter to HUD's IG of improperly disclosing to *The Wall Street Journal* details of a disciplinary letter the agency sent Fannie Mae in February directing company's officials to improve its automated accounting systems. Bond chairs the Senate Appropriations subcommittee that oversees OFHEO and HUD's funding.
- In separate letters sent to Bond and HUD, Frank said, "If the OIG report contains official findings that OFHEO did something wrong, those findings should be publicly disclosed and publicly discussed." Frank added, "Just as I argued in similar circumstances that OFHEO's report on possible problems at Fannie Mae should be made public, a similar principal should be applied to the report about OFHEO. If the information contained in the media account is correct that this [HUD] report has been shared with others outside [Bond's] office, one would assume that the report is already redacted or that Privacy Act concerns are not paramount."

- Bond’s office, which received the “much-hyped” report several weeks ago, has provided limited access to a handful of senators, according to *The Wall Street Journal*. Lawmakers are tightly guarding the “politically charged” report, fueling speculation in Washington about its contents. Bond’s office has refused to release the report, citing privacy concerns raised by the HUD investigators who conducted the probe, which is still on-going. “After consulting with the HUD Inspector General, we have concluded that we should not release any copies of the Report of Investigation to outside parties until the investigation is considered closed and all Privacy Act concerns are addressed,” Bond spokeswoman Leanne Boyer said.
- HUD’s Inspector General’s office also denied Freedom of Information Act Requests by *The Wall Street Journal* and *Dow Jones Newswires*. FOIA officer Patricia Sanders said HUD is prohibited from releasing the IG report, citing privacy act concerns and FOIA exemptions, allowing government officials to withhold “records or information compiled for law enforcement purposes,” the release of which would likely interfere with enforcement action.
- The IG’s probe of OFHEO “smells like something political,” said Representative Gregory Meeks (D-NY). “This administration talks during the presidential campaign about homeownership being at an all-time high when it’s Fannie Mae that they can thank for that,” said Meeks, who is encouraging lawmakers to sign a letter urging committee chairman Representative Michael Oxley (R-OH) to subpoena HUD for release of the IG’s report on OFHEO. In a letter to dated October 26th Oxley, Meeks has asked the committee chairman and other members of the panel to call for a hearing on the IG’s report on OFHEO during the week beginning November 15, said Jameel Johnson, Meeks’ chief of staff.
- Representative Paul Kanjorski (D-PA), the second ranking democrat on the House Financial Services Committee, said “...[W]e have to have the Congress exercise its oversight and get the report out there in full public view. ...What we don’t want is overzealous regulators driven by political considerations. That is the worst of all worlds, particularly for the financial services industry. I’m not suggesting it exists, but we have to make sure it doesn’t exist under our committee’s jurisdiction. I would not suggest there is anything that smacks of partisanship at this point. But we all have to be on our toes, given how this administration has operated.”
- Representative Artur Davis (D-AL), a member of the Financial Services Committee, urged the IG to release its report on OFHEO. “The report should be released,” Davis said. “I think now that the report has been completed, members of Congress should have the opportunity to review it.” He added, “I don’t think this is a partisan issue. All partisan motivations aside, OFHEO has exceeded the role of a neutral regulator. There are significant questions over OFHEO’s conduct. If there is a concern that OFHEO has acted improperly, we need to know that before they complete their investigation of Fannie Mae.”

- House Financial Services Committee member Representative Mel Watt (D-NC) said “[Senator] Kit Bond has no more justification to have this report than any member of the financial services committee or any other member of the House or the Senate. To say the inspector general should do its job away from the spotlight is reasonable, but when it becomes a piece of paper, a document, and a report, it is hard to argue with integrity that other members of Congress shouldn’t have the report. If government funds have been spent to do an investigation and one member of Congress has the report, it seems to me that all members of congress should have it.” With regard to the IG Report on OFHEO, Watt said, “I don’t know whether it casts doubt on OFHEO. It could shore up OFHEO for all I know. I know a number of people are raising questions about OFHEO’s motivations. I’m not interested in casting doubt on OFHEO or shoring them up. I am not out to get OFHEO. I am out to have the public believe that people are acting with integrity and OFHEO is not subject to political influence.” (*Dow Jones Newswires*, Dawn Kopecki, 10/22/04; *Bloomberg News*, James Tyson, 10/22/04; *Bloomberg News*, James Tyson, 10/26/04; *Dow Jones Newswire*, Dawn Kopecki, 10/29/04; *Bloomberg News*, James Tyson, 10/28/04; *Bloomberg News*, James Tyson, 10/27/04)

OFHEO releases research report on Fannie Mae and Freddie Mac
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- Armando Falcon, Jr. Director of OFHEO issued a research report, “Mortgage Markets and the Enterprises in 2003.” The agency’s research report covers developments in the housing sector and primary mortgage market, the secondary market activities of the GSEs, and the financial performance of the GSEs in 2003. The report’s appendix also provides historical data on the GSEs, loan limits, mortgage interest rates, housing activity and regional and national home prices. The full text of the report is available on OFHEO’s website at <http://www.ofheo.gov/media/pdf/MME2003.pdf>. (*OFHEO Press Release*, 10/29/04)

Fannie and Freddie spend \$11.7 million to lobby Congress in first half of 2004

- Fannie Mae and Freddie Mac spent \$11.7 million during the first half of 2004 to lobbying *against* increased oversight, including a Senate plan for a tougher regulator which stalled in April. According to the Washington-based *PoliticalMoneyLine*, the two GSEs spent more than any single company to influence policy makers. Fannie Mae paid 19 lobbying firms a total of \$4.99 million, up 31% from the first half of 2003, said *PoliticalMoneyLine*. Freddie Mac paid 27 lobbying firms \$6.7 million, or 13% more than the first six months of 2003.
- The appearance of Freddie and Fannie near the top of the lobbying list is “somewhat surprising,” said Kent Cooper, co-founder of *PoliticalMoneyLine*. “You’ve got a public trust-type function going on, and yet they’re spending money for lobbying the

legislature that, in essence, created them,” he said. “You would think organizations created by Congress wouldn’t need to lobby Congress.”

- “We’re still in the midst of the accounting situation and certainly while that is going on it requires us to spend a great deal of time keeping members and their staff up to date,” said Freddie Mac spokeswoman Sharon McHale. Much of the lobbying focused on briefing lawmakers on Freddie Mac’s plan to restore timely financial reporting early next year, she added. Fannie Mae spokesman Chuck Greener declined to comment.
- Fannie and Freddie hired Patrick Cave as a lobbyist after he quit in January 2003 as assistant Treasury secretary for financial institutions. Fannie Mae paid Cave’s firm, the Federalist Group, \$200,000. Freddie Mac paid it \$340,000, according to *PoliticalMoneyLine*.
- Fannie Mae chief lobbyist Duane Duncan leads a team of several government veterans from Treasury and Congress. He is a former chief of staff for Representative Richard Baker, a Louisiana Republican who since 2000 has proposed legislation tightening oversight of Fannie Mae and Freddie Mac. Fannie Mae hired Lendell Porterfield and Raymond Cole, former aides to Senator Richard Shelby, an Alabama Republican and chairman of the Senate Banking Committee, which sets policy affecting the company. It also enlisted Steve Ricchetti, a deputy chief of staff in the Clinton administration.
- Fannie Mae in December started a political action committee that raised \$624,590 as of August 31, according to *PoliticalMoneyLine*. Funded by voluntary contributions from company executives, the group may contribute up to \$5,000 per election to Congressional or presidential candidates. Fannie Mae had disbanded a PAC in 1993, the year after Congress launched OFHEO.
- Fannie Mae’s political action committee has contributed to “leadership PACs” -- war chests that lawmakers use to support their allies’ election campaigns -- to the tune of \$38,750 for Democrats and \$49,500 for Republicans, *PoliticalMoneyLine* said. The company donated \$5,000 to a PAC of Representative Michael Oxley of Ohio, a Republican and chairman of the House Financial Services Committee; \$1,000 to a PAC of Senate Majority Leader Bill Frist of Tennessee; \$2,500 to a PAC of Senator Jon Corzine, a New Jersey Democrat; and \$2,500 to a PAC of House Minority Leader Nancy Pelosi, a California Democrat, *PoliticalMoneyLine* said.
- Fannie Mae must constantly monitor and contain political risk, chief executive Franklin Raines told the Prudential Financial Services Conference in an October 2000 speech. “Having a Congressional charter and two full-time regulators means political and regulatory risk are a daily fact of life for us, and we manage it with the same focus and intensity that we apply to our other risk,” Raines said. “We’re pretty good at managing through whatever is the risk du jour.”

- “Lobbying is an important way for us to educate and inform Congress about who we are and our role in the national housing market,” said Sharon McHale, a spokeswoman for Freddie Mac. “The fact of the matter is that other large financial institutions, including our critics ... spend substantially more than we do on lobbying because they give through numerous different ways,” such as trade associations, McHale said. FM Policy Focus, a rival financial services industry group started to keep the two companies from expanding their businesses, spent \$1.5 million on lobbying during the first half of this year. (*Bloomberg News*, James L. Tyson, 10/21/04; *Bloomberg Markets Magazine*, James L. Tyson, 10/26/04; *Washington Post*, David S. Hilzenrath, 10/25/04)

Presidential politics in the air?

- Senator Max Baucus (D-MT), ranking Democrat on the Senate Finance Committee, referred the documents related to Treasury Secretary John Snow’s possible conflicts of interest stemming from his investments in GSE debt to the Justice Department for “review and appropriate action.” Six months ago, the Treasury Department disclosed that Snow held about \$11 million in bonds of Fannie Mae, Freddie Mac, and FHLBs, which were all under his regulatory authority. At the time of disclosure, Snow insisted that the investments were made by accident and the GSE securities had been sold at a \$478,000 loss. Treasury ethics officials concluded that Snow’s ownership of GSE bonds at a time he was lobbying for tougher regulation of GSEs wasn’t a conflict of interest. A statement released Friday by Baucus contained no new information about Snow’s activities.
- The Treasury chief’s spokesman Bob Nichols said, “Given the timing of this press release...it is easy to understand why some will think this is politically motivated.” Nichols added, “The secretary is committed to the highest ethical behavior. The department’s ethics office found no conflict of interest had occurred” in May. The Treasury Department inspector general’s review has not yet concluded.
- A spokesman for Baucus declined to say why the documents were referred at this time. Under Senate rules, the documents cannot be released to the public without the consent of Senate Finance Committee Chairman Charles Grassley, R-Iowa. Grassley’s spokeswoman, Jill Gerber said, “The Treasury inspector general is reviewing this and we don’t plan to take any further steps until the Treasury inspector general has completed its review.” (*CBSMarketWatch.com*, Corbett B. Daly, 10/15/04, *Dow Jones Newswires*, Deborah Lagomarsino, 10/18/04; *Reuters*, Anna Willard, 10/15/04; *America Banker*, Rob Blackwell, 10/18/04)

One more feat of daring: cut GSEs' servicing to 12 basis points

- Before retiring, Countrywide Financial's chairman and CEO Angelo Mozilo would like to accomplish "one more feat of daring"- convincing Fannie Mae and Freddie Mac to slash their minimum servicing fee, according to *National Mortgage News*. While Fannie and Freddie have set a minimum servicing fee of 25 basis points, Mozilo thinks a 12 basis point servicing fee sounds about right. While 25 basis points may seem like a fair arrangement, he said "That 25 basis points is an asset we have to hedge against. It costs us and the industry hundreds of millions of dollars a year." While Mozilo has discussed the issue with Fannie's CEO Raines and Freddie's CEO Syron, he said, "So far the answer has been no." However, he believes that in time, the GSEs might possibly see the light. "If the GSEs cut the minimum to 12 basis points, costs could come down dramatically for the consumer," he said. "Given what these two firms have been through lately" in regard to their accounting problems, "I think they're beginning to open their eyes." (*National Mortgage News*, Paul Muolo, 10/25/04)

Fannie Mae

Fannie discloses the SEC's formal criminal investigation of company

- In an 8K filing with the SEC, Fannie Mae disclosed that the SEC has opened a formal investigation into the company's accounting practices, which enables the SEC to subpoena information and to file charges against the company or executives if they fail to comply. Separately, Justice Department prosecutors and the Public Company Accounting Oversight Board are also conducting a review of OFHEO's report on Fannie Mae's accounting practices.
- In an interview with *Bloomberg News*, former SEC chairman Arthur Levitt answered questions about what triggers a formal SEC investigation [at Fannie Mae]. Levitt said, "...[C]learly the [SEC] commission has found something that warrants their looking further, warrants their being given subpoena power." To launch a formal investigation, the SEC staff has "to find evidence of fraud," said Levitt. "They've got to find evidence that leads them to believe that there is some fraudulent activity going on." He added, "They think they have something. Now, not every formal investigation results in a lawsuit or an indictment, but it's clear that this issue is so high profile, and what they have found thus far warrants going further. It's clear that Fannie Mae didn't go to the SEC merely to get a pass from OFHEO."
- Former chief accountant for the SEC Lynn Turner said materiality was a main factor in determining whether the SEC triggered a formal investigation. Turner said that

what the SEC is “going to be looking at is the fact that management and KPMG both ascertained that they had a \$400 million error back there, half of which was booked. It wouldn’t be viewed as an error and booked if it wasn’t. And the fact that that KPMG left the other \$200 million on the score sheet also factually indicates that there was an error. Even though you had about \$3 billion in income, the fact that \$200 million made the difference between where these executives got a sizable bonus or not is actually one of the criteria in Staff Accounting Bulletin 99 for assessing materiality. So, I think it makes a strong case that this is material, and yet you had management who knew about it, you had auditors who were fully aware of it, and people intentionally chose not to book it and go ahead and pay bonuses to people. That will be a very strong sign to the SEC that they need to go and dig deeper, that not everything was working the way that it should.”

- Fannie Mae recently announced its plans to delay releasing its third-quarter financial results; the company spokesman didn’t indicate if the SEC and other inquiries were behind the decision to delay the company’s earnings release. It is unclear if Fannie Mae will file its official earnings report on time with the SEC either, as company officials said they would “actively seek” to file earnings by Nov. 15. Former SEC Chief Accountant Lynn Turner said the delays suggest Fannie’s auditor, KPMG LLP, may be refusing to sign off on the company’s financial statements until after regulators conclude their review of the GSE’s accounting. “Given KPMG’s past track record of not signing off on financial statements until investigations are done, I would not be surprised if they were to tell Fannie they were not in position to approve the [third-quarter] financial statements until the investigation is complete,” Turner said. SEC rules require the external auditor to review all of the company’s financial statements before filing with the commission. While some companies file statements without auditor approval, Turner said it is “highly unusual” and in violation of SEC regulations. KPMG spokesman Tom Fitzgerald said the firm couldn’t comment on Fannie Mae’s earnings delay as a result of client-confidentiality reasons, referring calls to Fannie. Edwin Groshans, equity analyst at Fox-Pitt, Kelton, said, “[The earnings delay] raises more questions. If Fannie did nothing wrong, why can’t it file?” Fannie Mae chairman and CEO Franklin D. Raines said his company is working with the SEC so that it can report its third quarter earnings on time. When asked by reporters if Fannie Mae expects to file its quarterly financial report before the November 15th deadline, Raines said “We’re trying hard to do that.”
- Turner believes the SEC will take months to conduct a thorough investigation of Fannie Mae’s accounting, before drawing any conclusions. He said, “The SEC, I don’t think, will jump to any conclusions one way or the other until they’ve had a chance to conduct an in-depth and thorough investigation and get to the bottom of the issues and numbers.” Turner also said Fannie Mae executives have been trying to downplay some of the accounting issues highlighted by OFHEO as mere differences of opinions over complicated financial issues. “The issues are more black-and-white than Fannie Mae would lead you to believe,” he said, adding that OFHEO’s accountants at Deloitte & Touche (D&T) are the industry’s leading authorities on many of the issues in the report. D&T has a number of former SEC people in their

national office who have actually dealt with specific types of issues and transactions while they were at the SEC, said Turner, leading him to conclude that the accounting firm has given very good counsel to OFHEO. He added, “[D&T] doesn’t have an opinion out there that they have to defend, so they’re in a position that they can give that unbiased opinion to OFHEO. ...So, I suspect they’re doing a pretty good job for OFHEO here, and that’s one reason I don’t think you’re going to find these gray accounting issues ...where KPMG and Fannie have one viewpoint and OFHEO has another. I think they’re going to find that they’re more black-and-white than that.”

- In talking with one of Fannie Mae’s major credit rating agencies, Turner also learned that Fannie Mae’s description of their accounting for derivatives was significantly different from what had been reported in the OFHEO report. These discrepancies raise serious issues of creditability, he said, which will not help Fannie Mae put this behind them fairly quickly. Turner added, “When the OFHEO report comes out, that wasn’t consistent with what Fannie was telling the rating agencies, which would tell me that, quite frankly, there are probably more issues in that derivatives portfolio.”
- When the company announced the SEC’s formal investigation, Fannie Mae’s stock price “slipped” in the marketplace. “[The SEC investigation] is going to put pressure on [Fannie’s] stock...,” said Ed Groshans, vice president of Fox-Pitt, Kelton in New York. “The SEC would not lift [the probe] to formal if it did not think something warranted it. There are a lot of questions swirling around the validity of their capital, the validity of their accounting, and the validity of their earnings.” The inquiry’s elevated status, he said, “lends credence” to OFHEO’s report, which accused the company of misusing accounting methods to smooth earnings and boost executive bonuses. Groshans said the news also puts pressure on Fannie Mae chairman and CEO Franklin Raines. (*Dow Jones International News*, Dawn Kopecki, 10/20/04; *CBSMarketWatch.com*, William L. Watts, 10/20/04; *Bloomberg News*, 10/20/04; *Financial Times*, Jenny Wiggins, 10/18/04; *Prudential Equity Group, LLC Research*, Recent Events Surrounding FNM and OFHEO, 10/13/04; *Reuters*, 10/27/04)

Fannie Mae hires Huron as its forensic auditor
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- Fannie Mae’s board of directors appointed Huron Consulting Group, founded by a team of former Arthur Andersen accountants, as its forensic auditor to investigate allegations of accounting manipulation by its regulator. OFHEO required Fannie to hire an independent law firm and auditor to research OFHEO’s findings. An attorney for the board at the law firm of Paul Weiss, Robert Parker, said Huron was their final choice and OFHEO spokeswoman Corinne Russell confirmed that the agency approved an auditor. Chicago-based Huron is a financial and legal advisory firm, which specializes in forensic examinations of companies faced with large-scale accounting problems. The publicly-traded Huron has more than 600 employees and eight offices in the U.S. (*Dow Jones Newswires*, Dawn Kopecki, 10/22/04; *Bloomberg News*, James Tyson, 10/22/05)

Fannie's accounting – simple issues or not?

- In an interview, SEC Chairman William H. Donaldson said that the accounting issues the SEC must address in its investigation of mortgage funding giant Fannie Mae are “not black and white.” Donaldson said, “This is not a simple matter; it’s not black and white.” Donaldson’s comments contrasted with OFHEO Director Armando Falcon’s recent testimony that Fannie Mae committed “clear violations of accounting principles.” Before a House subcommittee, Falcon testified, “We feel very strongly that these are black and white accounting issues. These are not issues of interpretation. They’re not issues where reasonable people can disagree.”
- Laura Cox, an adviser to Donaldson, said the SEC chairman was not contradicting Falcon. The context for Donaldson’s comment was that the issues “are extremely complicated,” said Cox. The SEC will be the final arbiter of whether Fannie must restate past financial statements. (*Washington Post*, David Hilzenrath, 10/23/04)

SEC's “options” in its Fannie Mae investigation

- About the only thing on which all sides can agree is that the SEC, as the final arbiter of GAAP, must resolve a brutal dispute between Fannie Mae and OFHEO regarding the company’s interpretation of FAS 133 and FAS 91. When and how the SEC can do that remains a mystery. Some observers, including securities lawyers, suggest that the SEC has at least four options for resolving concerns that Fannie Mae’s accounting, which run the gamut from backing Fannie entirely to siding with OFHEO.
- Fannie officials appear hopeful that the SEC will provide a more “neutral venue” than OFHEO. The SEC is under immense pressure, since its decision will send a critical message to other companies that have used accounting similar to Fannie’s. “People will be paying attention to this -- there is no question about that,” said Ira Kawaller, the founder of Kawaller & Co. LLC, which specializes in derivatives. “The concern is ‘Could this happen to me?’”
- Most observers say the SEC basically has four choices in their review of Fannie Mae’s accounting. By backing Fannie Mae’s accounting practices, the SEC could essentially say that Fannie Mae appropriately documented its derivatives for hedge accounting and that no restatement is needed. While this position would anger Fannie critics, it could please companies that also have a significant number of derivatives hedges and worry about some or all of them being declared invalid at some point.
- If the SEC backs OFHEO findings about Fannie Mae’s accounting, the SEC could say that the company inappropriately used a shortcut to qualify for derivatives hedging and is no longer entitled to use any hedge accounting method. This would be

the worst possible outcome for Fannie Mae, which would have to restate past earnings. If the SEC takes this hard-line approach, it would be saying that because Fannie did not use a long-haul approach to qualify derivatives and it lost the chance to qualify for hedge accounting.

- Alternatively, the SEC could back OFHEO, but not require Fannie Mae to restate its earnings. Some expect the SEC to agree with OFHEO's insistence on long-haul accounting treatment and conclude that other changes are correct, but must only be made in the future. In this scenario, Fannie Mae would not have to restate its earnings. There is recent precedent for SEC in pursuing this approach. Earlier this year, OFHEO said that Fannie Mae was not accounting correctly for impairment of its manufactured housing portfolio. The SEC ruled that Fannie should account for such impairment OFHEO's way, but did not require the company to restate earnings.
- A fourth option for the SEC is to require Fannie Mae to restate its earnings, but not the kind OFHEO has suggested. OFHEO has said that Fannie should have applied the long-haul treatment to its derivatives but lost that chance when it took the shortcut. The SEC could say that OFHEO was right to question the shortcut method, but conclude that Fannie could recalculate its derivatives using the long-haul method. In its regulatory agreement with OFHEO, Fannie agreed to change its accounting for future periods and to calculate what its balance sheet would have looked like in past periods had it used the long-haul method. The SEC could "solidify" that recalculation, which could be considered a restatement if it would have had a material effect on Fannie's historical financial results. Derivatives experts are uncertain what the effect of such a recalculation would be. On one hand, Fannie might have to restate its earnings, something that is never good for a publicly-traded company. On the other hand, such a restatement would probably be less significant than the one that would result from OFHEO's suggested method. However, the SEC would be running a risk with this decision, since it would be sending a message to other companies that there is little downside to using the shortcut method, even if it later proves to have been inappropriate.
- At the recent House Financial Services subcommittee on OFHEO's report on Fannie Mae, the company's chairman and chief executive, Franklin Raines struck a "confident tone" when discussing the SEC. Raines said, "The SEC has been enormously cooperative with us in our process of becoming a registrant. They were very helpful in that process, in reviewing our initial documents, and giving us feedback. So, they have bent over backwards to be helpful. ...They have also worked with us on sticky accounting issues. And we, like other companies, have presented accounting issues to them and asked them for a judgment as to what the appropriate accounting is, and, again, they have been very responsive in giving us answers. We, of course, have implemented the answers that they have given to us." Fannie has talked to the SEC through various channels since OFHEO aired its allegations, said Raines. "It is my desire now -- as it would have been my desire before the report came out -- that these accounting issues simply go to the body who can solve them.

Then we will have the answer. We won't be having a debate about who is right and who is wrong." (*American Banker*, Rob Blackwell, 10/19/04)

Fannie Mae may have had the one-liners at the House Financial Services subcommittee hearing but OFHEO had the facts

- At the October 6th House Financial Services Subcommittee hearing on Fannie Mae, the news media and Washington pundits were focused on which side [Fannie Mae or OFHEO] had the loudest or best insults. At the hearing, Fannie Mae executives could not and did not dispute the facts of the accounting maneuvers they used at the hearing; they only offered the opinion that the SEC would rule in their favor. "But what was revealed in the hearing is only likely to increase the chances that the SEC rules against Fannie Mae," writes Mark Haefele in *TheStreet.com*.
- During the first three hours of the hearings, only a few simple but important pieces of information came out. Under oath, OFHEO director Armando Falcon added some force and emphasis to the findings outlined in the OFHEO report. He said Fannie Mae's accounting is wrong, must be fixed and believes that the SEC will see it that way. Falcon hinted that more instances of cooking the books for executive bonuses were likely to be revealed as OFHEO continues its investigation. Fannie Mae CEO Frank Raines and CFO Tim Howard testified under oath that there is nothing wrong with Fannie Mae's accounting, and they believe the SEC will see it their way. Both sides agreed the SEC would be in charge of deciding if Fannie Mae's accounting needs to be restated.
- After hours of back and forth, something happened at the hearing that the reporters missed. Things had gotten very boring for those looking for heated rhetoric, but very interesting for those scrutinizing the accounting details that will govern Fannie Mae's fate. Haefele writes, "Representative Patrick Toomey (R- PA) used his question time to draw out CFO Howard on how Fannie Mae interpreted accounting rule FAS 91. Accounting rules do not allow a FAS 91 reserve, and OFHEO charged that Fannie Mae created an undisclosed FAS 91 reserve that was used to smooth earnings. To Toomey's surprise, Howard didn't dispute OFHEO's description of this reserve and how it worked. He simply noted Fannie Mae's auditor, KPMG, eventually signed off on it, and predicted that the SEC would agree that it was fair play. In fact, Howard didn't even try to minimize the impact this undisclosed reserve had on managing Fannie Mae's earnings. Instead, he 'made the judgment' that smoothing out some of the volatility FAS 91 caused in quarterly earnings was necessary because 'it preserves the integrity and the quality of our published financial statements.'"
- Haefele continues, "...The significance of Howard's testimony is difficult to overstate. Even before Howard testified, it was unlikely the SEC would side with Fannie Mae. OFHEO had revealed an undisclosed FAS 91 reserve that distorted earnings in a manner inconsistent with GAAP. The arbitrary application of this reserve in 1998 resulted in a \$200 million audit difference, which KPMG flagged.

This \$200 million difference in earnings was the difference between no bonuses for Fannie Mae executives and maximum bonuses. Howard's testimony only raises the stakes. Howard demonstrated complete understanding of the issue, confirmed OFHEO's description of Fannie Mae's accounting process and, furthermore, emphasized how the FAS 91 reserve had a meaningful impact on the earnings management he was trying to achieve. This will be a tough nut for the SEC accountants to swallow. Howard would have the SEC agree with his judgment that a fanciful interpretation of FAS 91 to include an undisclosed discretionary reserve was somehow beneficial for investors, while ignoring the uncontested fact that his machinations were extremely beneficial for himself and other executives." (*TheStreet.com*, Mark Haefele, 10/18/04)

- *Credit Union Journal* writes, "But the purpose of the [House Financial subcommittee] hearings seemed clear, according to many in the audience. That is to expand the debate on reforming the secondary market beyond the humble proposals that were easily defeated this year, much because of heavy lobbying by both Fannie and Freddie. That proposal would have simply eliminated OFHEO and created a new oversight agency for the two companies in the Treasury Department, with a little bit more authority. The Democrats at the hearing wrongly charged it was the Bush Administration that killed the reform bid this year. That is not so. It was the lobbying by the two companies, which are widely believed to have the most powerful lobbying teams in Washington. The next Congress, however, is likely to seek even greater reforms, such as strict restrictions on what the two companies may do and even the possibility of a full privatization of the government chartered enterprises. That is what the hearing was all about." (*Credit Union Journal*, 10/18/04)

While Fannie says it did nothing wrong, criminal indictments could be on the way
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- James J. Cramer writes in the October 18th issue of *New York Magazine*, "Fannie Mae, it seemed, turned a roller coaster into a ski lift. No one on Wall Street likes a roller coaster. You shoot up and plunge down again and again until you return to where you started, sick to your stomach, woozy, and, unless you are a kid, vowing never to return. But a ski lift? One solid, beautiful quarter on top of another, ever rising, no looking back, with terrific views and lots of new highs? Nothing like it."
- "Truly nothing, it turns out, and certainly not Fannie Mae. When I first got in the business, Fannie Mae was a stock no one would own. What was the point of buying shares of a company chartered by the federal government to help the housing market, a quasi-public entity that had to take one for the team, the American homeowner, whenever rates fell or rose dramatically? Backed by a sort of wink-wink guarantee from the Feds, Fannie bought mortgages from banks and got them off the banks' books, so the banks could make still more loans without worrying about inventory. Fannie then sold those loans in buckets, for a profit, provided it could manage the interest-rate risk so it wouldn't get stuck holding too many of them."

- “For years, Fannie’s quarterly earnings would shock you, both high and low, and like the proverbial sickening coaster, they produced a stock that went nowhere. But in the nineties, after Tim Howard took over as chief financial officer, Fannie Mae started reporting smooth, positive earnings—earnings usually reserved for classic growth companies like Coca-Cola or Pfizer, even though, beginning in 1998, interest rates began to rise and fall like waves at a football stadium—a process much too hard for most mortals to game.”
- “For those of us who have managed interest-rate risk, for those who have created, sold, or bought complex derivatives, Fannie’s earnings seemed too good to be true. Who could be that smart? Who could deliver great results no matter how fast the prepayments came in when rates went down, no matter how quickly the mortgage market dried up when rates went up? Who were these geniuses?”
- “As always, when someone gets it right when everyone else gets it wrong—as WorldCom did versus AT&T, Verizon, and Sprint, as Nortel did versus Lucent, as Enron did versus everyone in the natural-gas merchandising business—you hear jealous carping. “They’re cooking the books,” traders would tell me. “They’re lying to make the number,” bond merchants would whisper. When the whispers grew to a din, I invited Frank Raines, the gentlemanly CEO of Fannie Mae, on Kudlow & Cramer, where he responded to critics by saying that Fannie Mae would never manipulate anything, that it would never jeopardize its mission because homeownership was too important to trifle with. To drive home the point, Fannie bombarded the airwaves with saccharine ads about poor folks getting homes because of the good deeds of this great company. Fannie, well connected in Washington, given the millions it has doled out in lobbying, and worshiped on Wall Street, given the billions it has paid in underwriting fees, became too big and powerful to question. The roller coaster turned ski lift kept climbing.”
- “Until last month. When we found out that Fannie Mae may have hidden losses—perhaps \$11 billion worth, by some analysts’ estimates—losses that, had they been revealed at the time, would have shown that Fannie’s earnings resembled something from Coney Island, not Vail. Last month, Fannie’s regulator, an obscure agency called the Office of Federal Housing Enterprise Oversight, issued a 211-page report alleging that Fannie Mae hid the volatility—and losses—to smooth out earnings. It appears that Fannie, far from being a prosperous enterprise that consistently delivers profits, is actually technically insolvent, and in need of billions of dollars in fresh capital to support the massive edifice of derivatives it has put on its books, in part to obscure how bad things really are.”
- “Fannie executives have reacted with the same classic denial and indignation that we saw when the Enron and WorldCom scams broke. Every time anyone questions Fannie’s ethics, Fannie produces its top brass and congressmen (typically Democrats, but often Republicans) to praise the company and to warn us not to touch it, lest the housing market get hurt and people lose their ability to buy homes. But a rare combination of a booming housing market, low interest rates, and a president who is

no friend of Fannie Mae's have made those defenses seem fanciful. Even Barney Frank, a staunch Democratic defender of Fannie, told me recently that he's interested only in protecting the company, not current management, now that the rickety mechanics of the ski lift have been exposed."

- "How bad will the fallout be? Freddie Mac, the sister company of Fannie Mae, fired its top executives last year when it was revealed that they hid billions in gains to be applied at a later date to obscure losses and keep earnings consistent. It's difficult to imagine how executives at a company that may have hid billions in losses will suffer a different fate. In fact, criminal indictments could be coming if Raines and Howard don't step down. Before the passage of the Sarbanes-Oxley reforms, prosecutors felt they needed to catch executives looting the company red-handed to bring criminal charges. Now, though, the simple act of managing earnings to produce smoothness when there is none has been criminalized. Of course, Fannie Mae the stock, unlike WorldCom and Enron, hasn't gone to zero (investors seem to believe that Fannie's supporters will eventually bail it out, and Raines's sales job has, at least to an extent, been working). But there's nothing in Sarb-Ox that says a stock has to become worthless before prosecutors can get involved. And because it appears Fannie lied for so long about its books, layering on a new derivative every time it looked like another one was about to go bad, it now must raise billions in fresh capital in order not to violate federal capital requirements. It's difficult to imagine how the Justice Department would let the same executives who may have caused the capital shortage now raise the funds needed for compliance."
- "All executives want their companies to be growth companies—even when the companies have no real growth. That way mutual funds will bid up their companies' share prices, and the insiders can cash out their stock and options for fat gains. It's just sad that after Enron and WorldCom showed just how disastrous that strategy can be, the one major company still playing by the old bogus rules, apparently, is the one that was meant to make housing affordable for all. For the good of the company, the current team would be wise to step down now and avoid the tarnish of criminal indictments. Otherwise it will only get uglier, if not fatal, for the executives—and the enterprise itself." (*New York Magazine*, James J. Cramer, 10/18/04)

NAHB still reviewing their GSE policy

- National Association of Home Builders executive director Jerry Howard told *National Mortgage News* that he was "shocked and appalled" when he first saw the OFHEO report on Fannie Mae's accounting practices. Even after Fannie chairman and chief executive Franklin Raines testified before a congressional panel on October 6 and denied anything is wrong at the company, the NAHB isn't ready to go back in the GSEs' corner. The group has formed a five-member task force to review its legislative strategy, which it expects to finalize in early December. Howard stressed that while the NAHB wants to continue to have a good working relationship with

Fannie and Freddie, the review by the task force “will undoubtedly shape our legislative strategy.” (*National Mortgage News*, Brian Collins, 10/25/04)

National Mortgage News: “Not again”

- In an October 18th editorial, *National Mortgage News* writes, “A feeling of deja vu all over again accompanies the latest round of charges of secondary mortgage agency accounting misdeeds. The charges against Fannie Mae are serious, though, and if proven they rate the same punishment Freddie Mac received in similar circumstances: a multihundred-million-dollar fine from the Securities and Exchange Commission and the firings of top-level executives responsible by the agency’s board. Especially serious are the charges that top officials at Fannie Mae manipulated earnings to ensure that they and others qualified for bonuses.”
- “While the accounting issues raised are complex, they boil down to manipulating earnings, a serious charge whether done allegedly to meet earnings goals or to smooth earnings to conform to Wall Street expectations. We would expect accounting shenanigans like those alleged here to come from desperate firms seeking to gain more time to save themselves from failing. But in the case of Freddie and Fannie, these are two hugely profitable firms, no matter how you count their money.”
- “What is going on here? We believe that a profound disconnect is gathering steam between top executives and their customers, and in its place is a misguided cabal of management and directors. Directors ask top managers to supply them with splendid profits, and the managers are rewarded with splendid salaries, bonuses and other compensation. The end results of this lunacy (not confined to mortgage agencies by any means) are such pretzel logic we have seen as banking profits to make less-successful future quarters look rosier.”
- “We believe top mortgage executives should be more concerned with giving their customers top value, and empowering their mid- and lower-level workers, who are the day-to-day keys to that operation. This is the correct way to conduct a business. If it means top executives getting paid \$10 million a year instead of \$20 million, most people would enjoy having such a dilemma.”
- “There are significant differences between the two GSEs’ accounting woes, of course. Most obvious is that Freddie CEO Leland Brendsel quickly found out he was retiring sooner than he planned, and the firings of other top Freddie officials. But Fannie’s management has signed a supervisory agreement with the Office of Federal Housing Enterprise Oversight, which may save some top-level jobs.”
- “We disagree with those who are calling for privatization of Fannie and Freddie because of these crises. Their ties to the government, which benefit both homebuyers and their own stockholders, are not the problem here. The problem that needs fixing,

and which will be fixed, is how they account for revenue and profits” (*National Mortgage News*, 10/18/04)

What if Fannie Mae was a federally-chartered bank?

- In an interview on CNBC’s *Kudlow & Cramer*, show host Jim Cramer asked *TheStreet.com* columnist Peter Eavis what would happen if Fannie Mae were a federally chartered bank. Eavis responded, “Oh, [Fannie Mae is] massively undercapitalized, and it would also be taken over by now. ...It would be [in default]-I mean, the regulators would have moved in there straight away, and they would have shoved out management. And they would have--I mean, looking at just the basic allegations made by OFHEO, if those were made against Citigroup or JP Morgan, the managements of those banks would be out; the regulators would be there running the show. And I expect that to happen at Fannie Mae, of course, maybe not quite as quickly as it would as a private bank.”
- Eavis added, “[T]o your previous question about why [GSE and Treasury] debt spreads haven’t widened out, you’ve got to remember that Wall Street’s manning an incredible defense of Fannie Mae. They’re trying to stop anybody thinking this is serious. The reason for that: Wall Street makes hundreds of millions of dollars in fees out of Fannie Mae.”
- Cramer follows up, saying, “Peter, we’ve all been around, so we know that when a company says, ‘We’re fully cooperating with the authorities,’ that means that you open the kimono; here’s the books. ...But we also know that when the SEC asks for a formal investigation, that’s because someone’s not cooperating and not handing over the books. ...Isn’t that what’s the case here, where the SEC is basically saying to Frank Raines and Tim Howard, ‘Let us take a look’? And even though they claim they’re cooperating with the press, they need subpoenas to give them the books.”
- Eavis responds, “Well, absolutely. And if you read the OFHEO report, ...you’ll see that they resisted cooperation quite a lot. And I would assume that they also are probably trying to do some of the same tricks with the SEC. I--they can’t hold out for much longer because you’ve got to also remember that the Justice Department is in there, too. And you just don’t mess with those guys. So it won’t be long before somebody starts to sing. I would imagine that it would be Jonathan Boyles, the guy who was in charge of their accounting department. Once they get him on their side. ... He’s ...one below the CFO. I think that, yeah, once they get him to sing, ‘cause he’s got no interest in pleading for Fannie at this point, then they’ll be home.”
- In closing, Cramer said, “Thank you for not being on the take to Fannie, like everybody else I talked to. It’s really a pleasure. It’s kind of an odd thing. I hope you guys have insurance or something... because everybody else I know is so owned by Fannie, it’s scary.” (*CNBC’s Kudlow & Cramer*, 10/20/04)

S&P's flagship corporate score for Fannie: "strong 9 out of 10"

- Two years after launching its flagship corporate service in the post-Enron and WorldCom era, few companies have enlisted S&P for its interactive, top-to-bottom corporate governance evaluation. Of the few that have, only embattled Fannie Mae's chairman Franklin Raines has made a point of publicizing S&P's "strong" 9 out of 10 score for the GSE.
- Following the release of OHFEO's special examination suggesting accounting irregularities at Fannie Mae, S&P has been put in an awkward position. "Nice call on Fannie Mae," joked Lowell Miller, president and chief investment officer at Miller/Howard Investments, Woodstock, NY. As a "socially responsible investment fund," his firm has been examining governance issues for many years on its own and isn't interested in S&P's governance scores, he said.
- "I don't want to say they are conflicted," said Michael McCauley, director of investment services and communications at the Florida state board of administration, about S&P. However, S&P's score is "not as independent or transparent a rating as you could get from other sources," he said.
- S&P representatives strenuously defend the firm's ability to systematically assess corporate governance without outside influence, noting that many of the practices and policies cited in the reports can be objectively measured and that a committee of analysts makes final decisions. While S&P refuses to discuss the cost of its governance evaluation services, at the time of the its product launch fees ranged from \$20,000 to \$100,000, depending upon the scope of the engagement. [Can a rating service which provides ancillary consulting-type services remain independent?] (Dow Jones Newswires, Phyllis Plitch, 10/26/04)
- "...[Fannie Mae CFO] Tim Howard a year ago was put on the [company's] board, which is, quite frankly, somewhat unusual because only 4% of the corporate boards in America have their CFO on the board. It's not considered the best practice and, quite frankly, it's viewed as a no-no," said Lynn Turner, former chief accountant for the SEC. [Did S&P question Howard's place on the board in evaluating Fannie Mae's corporate governance? And did S&P also look closely at the "independence" of the GSE's board members?] (*Prudential Equity Group, LLC Research, Recent Events Surrounding FNM and OFHEO*, 10/13/04)

Fannie's CEO Raines may be "highly quotable"-- but his ideas are *highly* questionable

- In a July 30th teleconference, Fannie Mae chairman and CEO Franklin Raines said, "I have seen a number of these sort of scandal fests before, where the issues become of vital importance that were not of any importance previously. Some people seem to be of the belief that if you manage your company with an eye to the accounting results,

that that is somehow a suspicious activity. I don't know of any company that is not managed with an eye to what the accounting is going to say at the end of the period. So let's be very clear -- every company undertakes business decisions with a view to, is this going to be recorded as a profit or a loss? That is a normal part of business. I hope we don't get to the position where someone says, have you ever thought about two alternatives, one of which would have a more favorable impact on you and the other would have a less favorable; that somehow that is suspicious. It is not suspicious. It is the normal course of conducting a business, any business, not just a business like Fannie Mae." (*American Banker*, 10/15/04)

- In a Letter to the Editor to the *American Banker*, retired banking lawyer Edward L. Levine of Princeton, NJ responded, "The quotation from Fannie Mae president and chief executive Franklin Raines in your October 15 issue "Quotable: Plain Talk from Raines," ...is one of the most appalling statements ever made by the head of a public company. What Mr. Raines should be concerned about is whether a certain action will lead to a profit or a loss. The accounting treatment can only affect the profitability of the company for a short period of time. Over the longer term, the company will either have more or less assets, and more or less net worth as a result of its business decisions. If a company takes action which will result in a decrease of its assets and net worth, or which will simply disguise its reported earnings for one period or another, that cannot be correct, no matter what the accounting treatment. When Mr. Raines speaks of choosing an alternative that has "a more favorable impact on you," we must ask who he means by "you." Is it the corporation and its shareholders, or is it the officers of the company? One of the accusations against Fannie Mae is that it made questionable accounting decisions that would result in larger bonuses to its officers. If that is true, who is the "you" that Mr. Raines says should be considered when corporate decisions are made?" (*American Banker*, Edward L. Levine, 10/22/04)
- In a Letter to the Editor at the *Wall Street Journal*, Gregg Beaty wrote, "Wow! Fannie CEO Frank Raines's 2003 compensation was \$20 million. The CBO calculates that 60% of Fannie's government subsidy goes to mortgage buyers and not to help increase the supply of affordable housing. Add to that the allegations that Fannie has been cooking its books and providing slush funds to friendly politicians at the public's expense and you have quite a brew of deceit and deception. Where is the indefatigable Eliot Spitzer when you need him?" (*Wall Street Journal*, Gregg Beaty, 10/26/04)

Fannie Mae's potent political machine: "pervasive and deft"

- Fannie Mae Chairman and CEO Franklin D. Raines has built one of the most potent political machines in Washington, says Representative James Leach (R-IA). "They are pervasive and deft," said Leach. Under Raines's leadership, Fannie Mae has increased its annual spending on political lobbying by 24%, according to *PoliticalMoneyLine.com*. In 2003, Fannie Mae paid a total of \$8.7 million to 23

lobbying firms; during the first six months of 2004, Fannie Mae paid 19 lobbying firms a total of \$4.99 million, up 31% from the first half of 2003.

- Fannie Mae has hired a number of its in-house lobbyists away from the very people seeking to regulate the company, including its chief lobbyist, Duane Duncan, 42, from the office of Representative Richard Baker (R-LA), one of the GSE's biggest critics in Congress. Duncan leads a roster of former government officials, such as outside lobbyists Terry Haines, former staff director for Baker's House committee, and Tony Rudy, former chief of staff of House Majority Leader Tom DeLay (R-TX).
- Duncan also rallies lobbyists from 17 trade groups and nonprofit organizations under an umbrella group called Homeownership Alliance (HA), formed by Fannie and Freddie in 2000. Members of HA include the National Association of Realtors, the National Association of Home Builders and the National Urban League. Fannie Mae also employs a network of 55 branch offices nationwide to mobilize legislators' constituents in its favor.
- On February 25, 2004, Raines testified before the Senate Banking Committee, "Fannie Mae supports a strong, credible safety and soundness regulator." Unfortunately, what Raines says hasn't always squared with what those Fannie Mae's actions. After he endorsed closer regulation in September 2003, Fannie Mae's Chicago office began the GSE's opposition campaign to GSE regulatory reform. In an October 6th e-mail obtained by *Bloomberg News*, Fannie Chicago office said Treasury Secretary Snow's proposal for GSE regulatory reform would hurt homebuyers in general and "underserved populations" in particular – "code" for minorities and the poor. Attached to the email was a two-page list of "talking points," which outlined Fannie Mae's objections. "Lawmakers get the message from constituents back home as opposed to lobbyists," says Representative Baker, whose office supplied a copy of the e-mail to *Bloomberg News*. "That's how they've always won."
- Fannie Mae also "woos" members of Congress by holding events in lawmakers' districts to "celebrate," according to Fannie Mae news releases, the benefits of low-income housing, minority homeownership -- and Fannie Mae financing. For example on September 27, as the firestorm was erupting around Fannie Mae and its accounting practices, Representative William Lacy Clay (D-MO) was in St. Louis trumpeting Fannie Mae's plan to invest more than \$50 million in local housing. Clay dismisses the idea that such events sway lawmakers. During the October 6th hearing on OFHEO's report on Fannie Mae's accounting practices, Clay declared, "This hearing is about the political lynching of [Fannie Mae CEO] Franklin Raines." (*Bloomberg Markets Magazine*, James L. Tyson, 10/26/04)

Fannie Mae's largess also benefits Howard University

- In a speech before the Economic Club of Washington, DC, Fannie Mae Chairman and CEO Franklin Raines described the “crown jewel” of Fannie Mae’s “House Washington” strategy was its partnership with Howard University at LeDroit Park, which included the conversion of more than 40 previously unoccupied Howard University-owned properties and vacant lots into new homeownership opportunities, with plans to rehabilitate an additional 130 vacant properties. Fannie Mae teamed up with Howard University, local lenders, developers, District government, and civic associations to rebuild this “blighted neighborhood.” Fannie Mae also helped the university develop an employer-assisted housing program for faculty members and staff via the Fannie Mae ACF, which will be deployed to advance the funds for down payment assistance offered under the Howard University’s EAHP.
- Raines said, “We have contributed \$23 million in investment capital and our partners put up another \$47 million. Together we’ve restored over 275 units of affordable housing.” He added, “When the first homes ... were completed five years ago, they were worth \$89,000 on average. Recently, one of them sold for \$210,000.” [Howard University president H. Patrick Swygert serves as an “independent” Fannie Mae board member, who will be responsible for evaluating the company’s management team in light of serious management issues raised by OFHEO’s examination report.] (*Fannie Mae Press Release, 10/19/04; Fannie Mae Website, Fannie Mae’s America’s Living Communities Plan: Fannie Mae Highlights; Fannie Mae Website, Fannie Mae’s America’s Living Communities Plan: Partner Highlights*)

Fannie Mae turmoil unlikely to affect multifamily financing

- Recent regulatory developments at Fannie Mae are unlikely to have significant effects on multifamily financing in the near-term, say industry experts. “From our perspective, there won’t be immediate impact on the functioning of the [multifamily finance] market,” said Doug Duncan, senior vice president and chief economist at the Mortgage Bankers Association (MBA). Duncan acknowledged that Fannie Mae’s higher capital requirements can potentially lower the company’s appetite for purchasing whole loans or commercial mortgage backed securities (CMBS). He argued that there are a series of other ways--such as lowering its dividends--that Fannie Mae could go about increasing its capital reserves without having to cut back significantly on its loan purchases. “Bottom line is, any [effects] would be negligible,” he said.
- John Levy, principal at John B. Levy & Co. Inc., a New York real estate investment and banking firm, said so far the impact of the OFHEO report on the multifamily financing market has been “almost non-existent.” He said Fannie Mae is not a large buyer of CMBS, while it has been as competitive as ever in purchasing whole loan

mortgages. Levy said that borrowing costs could increase as an eventual effect of higher capital reserve requirements for Fannie Mae, but he believes “the chances of that happening is a long shot.” Fannie Mae has a big commitment to affordable housing, and apartments are a large component of affordable housing, said Levy, adding, “We’re not seeing them cutting back.” So far, Levy said he has seen “no impact at all on multifamily loan pricing.” The financial market is “watching the developments carefully, said Levy. “We really cannot tell they are worried.” (*Multi-housingnews.com*, Keat Foong, 10/21/04)

Housing markets may soften says Fannie CEO Raines

- While the U.S. housing sector will remain strong, Fannie Mae chairman and CEO Franklin D. Raines told the American Bankers Association convention that housing prices may be rising too fast in some markets, causing them to “soften” as demand wanes. He noted, “The house price index was up over 9% in the second quarter the year before – the fastest four-quarter increase since 1979. The difference is that back then inflation was 11%; today it’s only 2.4%.” Raines added, “The data indicate that this price increase is fueled in part by a big increase in investor demand over the past three quarters. Investors now account for over 9% of all U.S. [mortgage] purchase originations, up from 5.75% in the middle of 2003.”
- Raines acknowledged that the atypical borrower of today will be the typical borrow of tomorrow, since over the next decade minorities will represent 80% of the population growth and account for 46% of future first time home buyers. “We know that we need to provide lenders with the products, processes and prices that enable them to say ‘Yes’ more often to nontraditional borrowers, people with slightly blemished credit or no credit at all,” said Raines. (*Fannie Mae Press Release*, 10/25/04; *Bloomberg News*, Al Yoon, 10/25/04)

Raines “talks the talk” on the subprime market – but will he walk the walk?

- In a speech before the American Community Bankers’ (ACB) annual convention, Fannie Mae chairman and CEO Franklin D. Raines said the company is “moving ahead with a concerted effort to serve the sub-prime market.” Over the past ten years, the market share of subprime lending has almost doubled and nearly \$323 billion in subprime home loans were originated last year. In this year’s slower mortgage market, subprime is growing its market share. Raines said, “We estimate that about half of subprime borrowers have only slightly blemished credit and are just a notch away from qualifying for Fannie Mae’s prime conventional financing. Raines said Fannie Mae wants to work with ACB through its Affinity Program to compete and succeed in the subprime market. (*Fannie Mae Press Release*, 10/18/04; *Reuters*, 10/18/04)

Fannie Mae announces its fourth quarter dividend for common and preferred stock

- On October 19, Fannie Mae's board of directors approved dividends on the company's common and preferred stock, unchanged from its third quarter dividend. The fourth quarter dividend payment will be made to registered holders of common stock as of October 31, 2004, to be payable on November 25, 2004. Preferred stock dividends were declared in accordance with their respective Certificate of Designation Terms. The dividend declaration complies with Fannie Mae's regulatory agreement with OFHEO dated September 27, 2004, which requires the regulator's pre-approval for "the payment of preferred stock dividends above stated contractual rates; ...or, payment of common stock dividends in excess of the prior quarter's dividend." (*Fannie Mae Press Release, 10/19/04; Office of Federal Housing Enterprise Oversight and Federal National Mortgage Association Agreement, 09/27/04*)

Fannie Mae's mortgage portfolio rises for fourth month

- Fannie Mae said the size of its mortgage portfolio increased for a fourth month in September, increasing by \$9.3 billion to \$904.8 billion for a 13.3% growth on an annualized basis. For the year, the company's portfolio has grown 0.9% on an annualized basis, well below the 13% percent increase in 2003. Fannie Mae purchased fewer mortgages over the past year because of "spirited competition" for the assets among a "variety" of investors, said CFO J. Timothy Howard. Fannie Mae said it expects the portfolio will grow because refinancing of mortgages is down from a record pace last year, rather than an increase in mortgage purchases.
- Fannie Mae may slow its growth as it builds a 30% capital surplus required by OFHEO, said Robert Napoli, an analyst at Piper Jaffray & Co. in Chicago. Fannie Mae's board of directors and OFEHO agreed to the surplus on September 27 in a regulatory agreement. "The company at the margin has become a little more conservative on purchases," Napoli said. Fannie's executives are likely focused on "building capital faster so they are in a position to buy" later, he added. To boost capital, Fannie Mae will likely rein in purchases of mortgage assets by \$100 billion over 12 months, said Jonathan Gray Sanford C. Bernstein & Co. analyst.
- The net yield on September purchases was 3.6%, down 53 basis points from August, largely because of increased purchases of adjustable rate debt, said Fannie Mae. In September, the company's duration gap on its mortgage portfolio averaged a negative two months for the second consecutive month. The conventional single-family delinquency rate rose one basis point to 0.58% in August, while the multi-family delinquency rate remained stable at 0.13%. (*Bloomberg News, Al Yoon, 10/20/04; The Main Wire, 10/20/04; American Banker, Erick Bergquist, Jody Shenn, and Rob Blackwell, 10/21/04*)

Four more years?

- “I personally think that a second Bush term might be like a root canal for Fannie Mae and Freddie Mac...” said Chuck Gabriel, Washington, DC partner with Prudential Equity Group, LLC. (*Prudential Equity Group, LLC Research, Recent Events Surrounding FNM and OFHEO, 10/13/04*)

Fannie Mae adds new statistic disclosures for REMICs

- Fannie Mae will be adding new statistics to the whole loan REMIC securities reported on its PoolTalk information service. In November, the company will let investors access statistics on whole loan REMIC Security Collateral Subgroups, such as weighted-average coupon and weighted-average maturity quartiles. Investors will also be able to access distributions on loan age, loan size, geographic location, origination year, amortization terms, amortization type, property type, occupancy and loan purpose, said Fannie Mae. (*Dow Jones Newswires, Jerry Abej, 10/27/04*)

Freddie Mac

OFHEO shifts its tactics on Freddie’s executive pay

- OFHEO is shifting tactics in a lawsuit challenging its authority to freeze executive pay, following a U.S. court ruling that the agency’s attempt to withhold compensation owed to former Freddie Chief Executive Leland Brendsel was illegal. The regulator withdrew its June 2003 “informal” guidance directing Freddie to withhold compensation currently valued at about \$1.2 million from ousted Chief Financial Officer Vaughn Clarke. Simultaneously, OFHEO issued new orders prohibiting Freddie from releasing the money. According to a mortgage industry attorney, this technical change improves OFHEO’s legal standing in holding up Clarke’s pay.
- In a related case, U.S. Judge Richard Leon recently ruled that OFHEO’s attempt to withhold roughly \$56 million in pay and benefits owed to former Freddie CEO Brendsel was illegal, in part, because OFHEO tried to freeze his assets outside of the formal regulatory process. Leon ruled that OFHEO was “simply overreaching” in trying to temporarily freeze Brendsel’s assets while awaiting a formal trial, and concluded that Congress never gave the regulator those powers. He added that OFHEO’s authority over Brendsel’s pay was even more limited because his employment agreement with Freddie predates OFHEO’s creation. The judge noted in 1992 Congress gave OFHEO the authority to review and approve Fannie and Freddie’s executive pay packages beforehand to ensure they are comparable with industry standards. This provision seemingly gives OFHEO more power to limit

Clarke's pay since his employment agreement was updated in late 2000 when he was promoted to CFO. Since OFHEO approved Clarke's pay package, Leon said OFHEO's authority to recover money after it has been awarded is unclear at best. "The fact that the plain language of the statute does not expressly authorize the (OFHEO) director to take such actions to recover past payments later determined to be excessive, also puts into question the basis of the director's power here to recoup compensation that might later be found unreasonable during an administrative proceeding," Leon said, regarding the Brendsel case. OFHEO is relying on that legal standing in issuing new orders against Freddie, prohibiting the company from releasing Clarke's money.

- One white collar criminal defense attorney said he believes the court will still side with Clarke on constitutional grounds. Leon criticized OFHEO for holding up Brendsel's compensation without a timely trial. The company has already released much of the former CEO's pay while OFHEO appeals Leon's decision. OFHEO's broader safety and soundness charges against Brendsel are not expected to go to trial until late 2005 at the earliest. The Brendsel and Clark cases are the first legal challenges to OFHEO's enforcement power and could have far-reaching implications for OFHEO in its separate investigation of Fannie Mae.
- Relative to other financial regulators, OFHEO has a higher threshold to meet if it wants to take quick action against the GSEs and/or their executives with a temporary cease-and-desist order. Leon said OFHEO has to prove that the conduct or violation is "likely to" cause insolvency, deplete core capital or cause some other irreparable harm to the company. Congress gave OFHEO the authority to issue temporary cease-and-desist orders "only under certain narrow circumstances, none of which are present in (the Brendsel) case," Leon said.
- OFHEO has taken preemptive steps to ensure it can more easily recover ill-gotten gains from executives at Fannie Mae. At the regulator's request, the company recently amended the employment agreements with its top three executives, making it easier for the board to fire senior management and provide modest lucrative severance packages. Under Fannie's new employment agreements, executives fired "for cause" would be entitled only to base salary or benefits already earned or vested at the date of dismissal. The amended agreements also broaden the terms under which an executive could be fired for cause, for example, if he or she "materially harmed Fannie Mae by...engaging in dishonest or fraudulent actions or willful misconduct." (*Dow Jones Capital Markets Report*, Dawn Kopecki, 10/19/04)

Freddie Mac's chairman Syron says GSEs' critics overstate risks and understate benefits
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- In a speech before the Mortgage Bankers' Association convention, Freddie Mac chairman and CEO Richard F. Syron outlined two "facts" about the GSE regulatory reform debate. Syron said, "Fact #1 is that the critics overstate our risks and

understate our benefits. Fact #2 ...is that in the language of economics, the GSE debate is “misspecified.” Which means that for the most part, we’re arguing about the wrong things.” He said that Freddie Mac does not oppose regulatory reform – in fact, the GSE embraces sound reform. “We look forward to working with the Legislative and Executive Branches to put to rest any doubts that our regulator has all that it needs and all that it takes to do the job right,” said Syron. GSE regulatory reform “is likely to happen next year in Congress,” he added.

- Syron also renewed Freddie Mac’s commitment to service the needs of minorities and immigrants – the “surging market” of the coming decade. He said Freddie Mac has launched Project Greenlight to generate more loans for this sector. As a part of this initiative, Freddie Mac is creating new mortgage products that allow for low downpayments and low –but still acceptable—credit scores. The GSE is redesigning “A-minus” mortgages to help lift more borrowers out of the sub-prime market. Freddie Mac is also building a range of outreach tools that will expand the pool of potential borrowers over time and is including affordable loan products in the company’s automated underwriting service. Syron said, “We’re going to work hard to manage credit risk, not simply avoid it.”
- To meet HUD’s new low-income housing goals, Syron said “We really have some learning to do about our credit culture.” He added, “In the HUD goals, there’s a thin line between being aggressive and being credit-worthy” and that hasn’t been identified yet. “We want to be more aggressive, and we will be,” said Syron, although he is “concerned” that the higher goals, created at a time when interest rates hit record lows, could encourage lending to consumers who won’t be able to afford the payments in the future. The result is a “big balancing act that has to be worked out,” Syron added. (*Freddie Mac Press Release*, 10/25/04; *Bloomberg News*, Al Yoon, 10/25/04)

Bloomberg News asks Syron: “Can you reassure America that Freddie Mac is whole and sound and that there are no problems in terms of your portfolio?”

- Freddie Mac chairman and CEO Rickard Syron responded, “I think yes. I mean we’re a big, complicated institution. We have very, very sophisticated approaches to managing interest rate risks. After all, the reason we were set up to do this was so that individual households wouldn’t have interest rate risk and the United States is the only country in the world, in which households are protected the way they are from interest rate risk because of the presence of the GSEs but I think that we’re in a strong position, very strong in a capital situation and we’re getting our past accounting problems behind us.” (*Bloomberg News*, Mike McKee, 10/18/04)

Freddie Mac's President & COO McQuade says GSEs are essential for U.S. home financing system

- Freddie Mac's new president and chief operating officer, Eugene McQuade, told the America's Community Bankers convention that the GSE is essential to the U.S. housing finance system... "Without Freddie and Fannie, thousands of community banks would find it more difficult and expensive to access the capital markets," McQuade said. "And something even worse would happen. Millions of families would lose their ability to take out a long-term, fixed-rate, prepayable mortgage." McQuade said Fannie Mae and Freddie Mac are sound and valuable entities which transfer mortgage rate risk away from consumers and to the capital markets. He added that the companies' benefits are "fundamental to our banking system, our housing system, our economy and the nation." McQuade said Freddie is not rejecting changes to its oversight and instead embraces "sensible reform." The company is beginning to emerge from its accounting troubles of last year, he said. "This has been a long, dark and expensive tunnel but we can see the light up ahead." (*Dow Jones International News*, Dawn Kopecki, 10/19/04)

Freddie Mac's mortgage portfolio shrank in September

- Freddie Mac said its loan portfolio shrank in September by \$645 million to \$660.7 billion, representing a 1.2% annualized contraction in the month. The portfolio increased at a 3.1% rate this year. Freddie Mac has slowed its growth this year from 13.8% in 2003, as competition for mortgages and mortgage securities by banks made the assets too expensive. The company said it expects the portfolio growth rate to be in the "low- to middle-single digits" for the year.
- Freddie Mac said it contracted to buy \$12.5 billion of mortgage loans and securities in September, up from \$9.6 billion in August. Average monthly purchase agreements this year are \$16.5 billion. The balance of mortgage bonds with a Freddie Mac guarantee grew \$1.9 billion to \$1.202 trillion in September.
- Freddie Mac also said its so-called duration gap, a measure of interest-rate risk, was unchanged at zero months in September. The company aims to keep its duration gap at zero. (*Bloomberg News*, Al Yoon, 10/22/04)

Freddie Mac expects lower multifamily loan production in 2004

- While Freddie Mac does not expect to beat last year's multifamily production, the company has increased its flow business this year where it purchases mortgages one at a time from lenders. "I don't know if we will beat last year's production, but we are very pleased with volumes so far. The pipeline is in pretty good shape," said Freddie Mac vice president Mitchell Kiffe. Freddie Mac expects to purchase \$8.5

billion to \$9 billion in multifamily loans this year on a flow basis, compared to \$6.9 billion in 2003. For the first eight months of this year, Freddie has purchased \$5.5 billion in MF loans on a flow basis and \$4 billion on a pool basis. (*National Mortgage News*, 10/25/04)

Freddie Mac announces enhancements to Loan Prospector®
and addition of guarantor executions to its web-based selling system

- Freddie Mac announced upgrades to its Loan Prospector® automated underwriting service (AUS) designed to expand affordable homeownership opportunities, help lenders better spot and avoid funding potentially fraudulent loans and ensure greater data integrity. “The Loan Prospector enhancements we are announcing today bring a new level of technological efficiency to two critical Freddie Mac goals – expanding affordable homeownership opportunities and ensuring greater data integrity,” said Marcia Davies, vice president of product marketing and communication at Freddie Mac. “These improvements also point the way toward Freddie Mac’s expanded use of automated underwriting to advance homeownership opportunities for more borrowers.”
- Specifically, the Loan Prospector system enhancements will automatically identify borrowers who meet the median income and property location requirements for Freddie Mac’s credit-flexible, low-downpayment Affordable Gold® and Affordable Gold 5 mortgage products. These two popular mortgage products are designed to enable more families with limited income, downpayment savings or credit histories to qualify for lower cost conforming conventional mortgages.
- Another LP upgrade will help originators spot mortgage applications for purchases or refinances with potentially high subject property values; excessively high values are a common indicator of a fraud-in-progress during the pre-funding stage of the mortgage process. Freddie Mac’s automated valuation model Home Value Explorer® will quickly estimate the subject property value submitted through LP Classic or LoanProspector and compare it to the stated value. If the stated value appears excessive compared to the local marketplace Loan Prospector will return an excessive value feedback message to the underwriter. (*Freddie Mac Press Release*, 10/25/04)
- Freddie Mac also announced that Guarantor executions for 15-, 20-, and 30-year mortgages are now available to all Sellers through its web based selling system, a move that lenders who participated in the summer-time pilot say could help lenders boost staff productivity and reduce the cost of completing secondary market executions by 20 percent or more. The company also said a Guarantor ARM and Multilender execution will be added to its web-based system and available beginning November 22. Adding Guarantor and Multilender executions to the web-based system, which sellers had been using for cash executions since 2003, will provide sellers with a full suite of secondary market functions and securities executions on an intuitive, user-friendly web-based design. The fully deployed selling system replaces

the company's older legacy systems, including MIDANET and Gold Cash Xtra.
(*Freddie Mac Press Release*, 10/25/04)

Federal Home Loan Banks

Finance Board Chair Castaneda says, "There's no turning back on SEC registration"

- The FHLBs won't win any more delays in registering with the SEC and there's no turning back, said Federal Housing Finance Board chair Alicia Castaneda in a speech before the America's Community Bankers (ACB) convention. "We gave [the FHLBs] plenty of time; a year is more than enough," said Castaneda.
- The ACB, American Bankers Association, Financial Services Roundtable, and Independent Community Bankers of Association wrote Castaneda to urge the Finance Board to delay the registration requirements for the FHLBs, if necessary, because of a number of unresolved issues which could create unintended problems for the FHLB system. The groups cautioned Castaneda from allowing the SEC to make final judgments on complicated accounting issues specific to the FHLB system. They asked the Finance Board to "remain fully involved in the process of resolving the outstanding issues with the SEC staff, and, if necessary, defer the date by which each of the FHLBs is required to file a registration with the SEC." One of the issues raised by the groups revolves around the "shortcut" accounting method used by the FHLBs to calculate the value of selected hedges, a issue being debated in Fannie Mae's accounting practices.
- Castaneda said the Finance Board resolved most of the major issues in SEC registration, before adopting its final rule that was more than a year in the making. The Finance Board will soon issue additional guidance to the FHLBs to address some of the concerns, she added. "In my visits to Capitol Hill, response to our registration rule has been uniformly positive. I simply do not believe there is any alternative to SEC registration."
- "The time for purely hypothetical questions is past," Castaneda said. "It is time to actually submit draft forms. If there are any remaining system wide problems out there that need to be resolved prior to registration, they will only come to light if the banks submit draft forms, with real numbers, to the SEC soon as part of the pre-filing, back-and-forth review process." (*Dow Jones Newswires*, Dawn Kopecki, 10/19/04; *American Banker*, Damian Paletta, 10/20/04)

FHLB System is big – and getting bigger

- In her speech at the ACB convention, Castaneda described the dramatic growth of the FHLB System. “As of June 30 of this year, total assets of the 12 Federal Home Loan Banks were \$902 billion,” she said “That represents an increase of 9% during the first half of 2004. By comparison, at the end of 2000, total assets were about \$675 billion. And, going back further, to 1990, assets were about \$175 billion. So, taken in their entirety, the Banks have grown...and grown dramatically.”
- “San Francisco, the largest Bank, has some \$160 billion in assets, while even the smallest tops \$40 billion,” said Castaneda. “To put things in perspective, both the Dallas and Topeka Banks are the largest financial institutions by assets in their regions,” she said. “Seven of the Banks are the second largest institutions (in their regions), and none of the Home Loan Banks ranks lower than fifth by assets, in their respective districts. “So,” she added, “we are dealing with large financial institutions. And, although the Federal Home Loan Banks do not draw much public attention, they are critical institutions in our nation’s system of housing finance.” The FHLB system had 8,083 financial institution members as of June 30, compared with 7,777 members on December 31, 2000, she said.
- Castaneda also said the growth FHLBs’ relatively new mortgage acquisition programs have “certainly changed the risk profile, to varying degrees, at each of the Federal Home Loan Banks,” and that a continuing challenge for the FHLBs is to properly measure and manage the interest rate risk exposure on their mortgage portfolios. As of June 30, the FHLBs’ total mortgage holdings were \$115.6 billion, or 12.8% of the System’s assets. Given conditions in the mortgage market this year, Castaneda believes that “significant near-term growth in these [loan] portfolios among the Federal Home Loan Banks seems unlikely.” (*Dow Jones Capital Markets Report*, John Connor, 10/20/04; *Federal Home Finance Board Press Release*, 10/19/04)

Finance Board names FICO directors

- The Federal Housing Finance Board has appointed two presidents of FHLBs to serve as directors of the Financing Corporation (FICO). The Finance Board named James D. “Jay” Roy, president of the FHLB-Pittsburgh, and Dean Schultz, president of the FHLB-San Francisco, to one-year terms on the FICO board, effective November 10, 2004. Roy and Schultz will serve on the three-member directorate with the managing director of the Office of Finance, John K. Darr. FICO is a mixed ownership, tax-exempt government corporation in charge of servicing debt on bonds that were issued as a result of the savings and loan bailout. The annual interest payment on the bonds is approximately \$793 million. No additional bonds have been issued since 1989. Appointments to the FICO board rotate annually among the presidents of the 12

FHLBs. Chairman Alicia R. Castaneda said she intends to designate Schultz as chairman. (*Federal Housing Finance Board Press Release*, 10/29/04)

Sallie Mae

Sallie Mae answers questions from California AG

- Sallie Mae said it is answering questions raised by the California attorney general, but is not the subject of a probe by the AG. The company said it has been responding to questions and information requests from the attorney general's office concerning career training schools that it does business with in California. The AG's questions relate to company policies on school closures and loan disbursements, said Sallie Mae.
- A Sallie Mae spokesman said the company has been given no indication of any formal investigation by the California attorney general's office and said the company will continue to work with officials to answer any questions. The company's national career training school business is very small and represents only about 1% of Sallie Mae's portfolio and the California career training schools would be even less than that figure, added the spokesman.
- Earlier *The Financial Times* reported that the California attorney general's office had launched an investigation into SLM focusing on its private loans to students at for-profit career-training schools. *Financial Times* was informed by individuals close to the inquiry that the AG was examining Sallie Mae's private loans to schools that don't have accreditation; the lender's relationships with schools; and whether students are misled about the difference between Sallie Mae's federal loan services and its private loans. (*Dow Jones Newswires*, Karen M. Lee, 10/27/04)

Sallie Mae's third quarter profit drops 26%

- Sallie Mae announced its third-quarter net income dropped 26 percent from a year ago. The company reported net income of \$357 million for the quarter, or \$.80 per share, down from \$480 million, or \$1.04 per share, a year ago. Excluding the cumulative effect of an accounting change, Sallie Mae's earnings of \$.80 per share were up 5.3% from \$.76 seen a year earlier. The company reported third-quarter core cash net income of \$219 million, or \$.49 per share, down 4% from year-ago levels of \$228 million or \$.49 per share.
- Three one-time expenses contributed to a charge of \$68 million against core cash earnings, Sallie Mae said, cause by the company's repurchased \$103 million of debt;

a \$27 million impairment charge on its portfolio of aircraft leases; and a \$62 million reversal on its risk-sharing reserve. The company said its total managed loan portfolio was \$98.3 billion as of September 30, up 15% from the same date last year, while loan originations increased 17% in the third quarter. (*CBSMarketWatch.com*, Robert Schroeder, 10/21/04)

Sallie Mae a presidential bell weather stock?

- *Business Week* writes, “It’s no secret which way investors in student loan titan Sallie Mae want the election to go. The company’s stock often slips when Senator John F. Kerry, who pledges to overhaul student loan financing, gains momentum. It usually climbs as George W. Bush’s star rises. So far this year, Sallie’s price has edged up about \$7, to \$45, after doubling in Bush’s first three years in office. ‘People are treating this as a political stock,’ says Friedman, Billings, Ramsey & Co. analyst Matthew J. Snowling. ‘It’s a proxy for the election.’”
- “Sallie Mae might face a tougher climate if John Kerry is elected. A Kerry White House could favor direct government student loans instead of those issued by Sallie Mae; curb what Kerry calls the industry’s “excess profits;” and boost the numbers of outright grants to students A second Bush administration could let the government’s direct-loan program wither; stick to a “hands-off” policy that allows Sallie to build its loan business as much as the market allows; and lift the cap on how much a student can borrow with a government guarantee.” (*Business Week*, Joseph Weber, 10/25/04)

Farm Credit System / Farmer Mac

FCA reopens the comment period on plan to expand credit to farmers

- The Farm Credit Administration has reopened the public comment period on a plan to expand the flow of credit to U.S. farms, ranches and fishing companies. The FCA board voted to reopen for an additional 30 days the comment period in response to a public request for additional time. The proposal, first formally proposed in August 2003, promotes greater cooperation between lenders in the FCS and those outside it by removing what the administration says are unnecessary regulatory restrictions. The proposed rule affects the Farmers’ Notes program, which currently allows some FCS associations to invest in notes, contracts and other obligations that farmers and ranchers exchange with lenders. The proposal would (1) let all FCS associations invest in Farmers’ Notes sold by non-FCS financial institutions and other agricultural lenders; (2) make fishing and fishery companies, harvesters and farm-related service providers eligible investments for FCS associations; and (3) extend the Farmers’

Notes program to include long-term mortgages. The proposed rule would also differentiate capital risk weighting of FCS institutions' investments in Farmers' Notes, depending on the structure and risk-mitigating factors of the lenders who sell those notes. The 30-day comment period will begin with the FCA's publication of notice in the Federal Register. (*Dow Jones Newswires*, Campion Walsh, 10/21/04)

FCS Funding Corp. should *not* promote a trade association

- Bert Ely writes in the *Farm Credit Watch*, "The incestuous relationship between the quasi-governmental FCS and the Farm Credit Council is quite evident in the annual and quarterly reports of the Federal Farm Credit Banks Funding Corporation (FC), the FCS entity through which the FCS taps the capital markets for its funding. Not only does the FC plug the FCC into the FCS organization chart (page 5 of the FC's 2003 Annual Information Statement), on a par with the FCA and the FCS Insurance Corporation ("Regulation/Supervision/Other"), but it provides FCC contact information (page S-23) and a link from its website (www.farmcredit-ffcb.com) to the FCC website. The FC website informs readers that the FCC is a 'full-service, federated trade association [which] provides the mechanism for 'grassroots' involvement in the development of [FCS] positions and policies with respect to Federal legislation and governmental actions that impact the [FCS].' The taxpayer-subsidized FC should immediately cease its highly inappropriate promotion of the FCC." (*Farm Credit Watch*, Bert Ely, October 2004)

FC Bank directors are big FCS borrowers

- Legally, the FCS can loan without limit to agricultural producers and has set a lending limit of \$500 million to any one borrower, an amount far exceeding the typical farmer's credit needs. On December 31, 2003, individual loans to farmers and ranchers exceeding \$1 million totaled about \$20 billion and loans to the ten largest borrowers totaled \$1.9 billion. Bert Ely writes in *Farm Credit Watch*, "...[T]he 86 directors of the five Farm Credit Banks, and organizations they are associated with, had borrowed \$1.273 billion, for an average loan balance of \$14.8 million." (*Farm Credit Watch*, Bert Ely, October 2004)

Postal Service

Postal Reform “water torture”

- Gen Del Polito writes, “Being a participant in this past year’s postal reform efforts has been akin to being on the receiving end of a Chinese water torture. The slow drip, drip, drip of missteps, empty promises, barely warmed left-over proposals, and an the lack of interest of those who should have been fully engaged has been a real trip. For instance, let’s take the case of the Postal Service.”
- “Talking about the “need” for postal legislative reform is nothing new. In fact, we’ve been talking about it ever since the late Postmaster General Marvin Runyon’s National Press Club speech back in January 1994. Marvin thought there was a real need to change some of the paradigms that have long been a part of the American postal system, and said so. Unfortunately, the PMG’s leading role in any subsequent postal reform debate was shunted aside by the “advice” he reportedly had been given by the then Speaker of the House, Newt Gingrich. Ostensibly, the Speaker recommended that the Postal Service not be the visible advocate for reform, but to let the Postal Service’s customers and employees take on that role.”
- “For a guy, like Gingrich, who was a former college professor of U.S. history, that had to be the worst advice anyone could give. History, after all, is replete with examples of calls for reform that were initiated by the agencies in question that have succeeded, and littered with examples in which the calls for reform have failed when they came from someone other than the leader of the affected agency. Ostensibly, Congress delegates administrative responsibility to various heads of agencies to benefit from the experience they gain as agency heads.”
- “When the IRS wanted reform, the head of the agency called for it and was engaged throughout the enter process of discussion and debate. He didn’t get the reform he sought by demurring to his ‘customers.’”
- “Throughout the past ten years of the current incarnation of a postal reform debate, the Postal Service has taken a pass instead of a leadership role. And when the agency itself fails to articulate definitively and unambiguously what it wants and doesn’t want from the legislative process, real reform just isn’t going to occur. Even worse, when the agency head signals that what you want to serve up is not a dish to his liking, why would you expect him to remain as a guest at your table? With this story, there’s more...much more. But we’ll leave that for an article of another day.”
(*Association for Postal Commerce*, Gene Del Polito, 10/18/04)
- *Catalog Age* notes, “The good news in the fight for postal reform is that there has been more legislative progress during the current session of Congress than there has been since John McHugh started the crusade in 1995. This important achievement is

the result of a great deal of effort by many individuals and organizations. Now for the bad news: It is clear that passage of any bill by this Congress, much less a bill good for the mailing community, is by no means a sure thing. Congress does not move quickly until there is a clear and present crisis.” (*Catalog Age*, John Van Horn, 11/01/04)

USPS union views Gallagher’s appointment to Board of Governors “bad news”

- American Postal Workers Union president William Burrus said Carolyn L. Gallagher’s appointment to the Board of Governors was “bad news” for postal workers. “If postal reform is considered by Congress again in 2005 as we expect, Ms. Gallagher’s presence on the Board could be an important factor when new legislation is drafted,” he said. (*APWU News Bulletin*, 10/15/04)

Postal unions address budget cutbacks

- Budget cutbacks are making the mail late and a mailbox harder to find, according to officials with three unions who claim that Postal Service cutbacks have led to slower deliveries and fewer collection boxes on Manhattan sidewalks. Letters dumped in Manhattan boxes after 1 p.m. aren’t picked up or processed until the next day, eliminating two later-day pickups. A Postal Service spokeswoman confirmed the USPS has made adjustments because of a sharp decline in first-class mail since 1997. Customers can still bring letters to post offices as late as 5 p.m. for delivery the next day, she said. (*New York Daily News*, Ulysses de la Torre and Owen Moritz, 10/26/04)

USPS work force: 688,660

- The USPS has reported to the Postal Commission that its current workforce consists of 688,660, including 607,688 full time employees, 6,868 part-time, and 74,110 part-time flexis. (*Association for Postal Commerce*, 10/30/04)

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