

The **GSE** REPORT™

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Major Events

In House Financial Services Subcommittee hearing, Fannie declares war on OFHEO and Democratic allies come to Fannie's defense

- Embattled Fannie Mae Chairman Franklin D. Raines came out swinging in testimony before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprise, insisting that the company's accounting practices are appropriate despite OFHEO's allegations to the contrary. Raines and Fannie's CFO Timothy Howard testified under oath before the subcommittee to discuss OFHEO's recent report alleging accounting improprieties designed to boost executive bonuses and willful misapplication of accounting standards. Raines and Howard energetically denied every conclusion in OFHEO's examination report and claimed that Fannie Mae was "trying to do the right thing" in its disputed accounting practices. "These accounting standards are highly complex and require determinations over which experts often disagree," Raines said. "We believe we applied those standards in accordance with" GAAP.
- Raines also sought to distance himself from the decisions made by Howard and other accountants, which OFHEO criticized in its report. "I have made efforts to understand the facts related to the issues discussed in the OFHEO report, some of which involve highly detailed issues that I would not normally focus on in my role as CEO," Raines said. "My comments today will therefore include a combination of my own recollections and the facts about these issues that I have learned recently."
- Raines disputed OFHEO's allegation that management deferred a \$200 million expense in 1998 to meet earnings targets and claim multimillion dollar bonuses. "This is a serious allegation, and we strongly disagree with it," he said. "We looked into the facts of what happened six years ago and we found no facts that would support the allegation that's in the OFHEO report," he added. Raines also testified that Fannie's former chairman and CEO James Johnson wasn't involved in the 1998 deferral of expenses. "We have done a look at the 1998 incident that has been alleged by OFHEO, and we have found no acts that relate to Jim Johnson whatsoever," Raines told the panel. "Indeed, he was not the CEO when these decisions were made. I was. And any implication that Jim Johnson had something to do with this is just totally without factual basis. It shows what happens in these kinds of frenzies." Raines said he became CEO at the beginning of 1999 and that the accounting in question "would have happened in 1999," not in 1998 when Johnson held the reins at Fannie. "The books are closed in January," Raines said. "So I would have been CEO."
- Raines also noted, "This entire [OFHEO] examination has been unusual. It's been the most unusual regulatory endeavor I've seen in the 30 some odd years I've been in

the city. ... This has been something that's inexplicable to me as to why they would follow this path," Raines said, criticizing OFHEO for not reviewing its report with management before presenting it to the board and releasing it to the public. Instead, Raines said OFHEO forced Fannie's independent directors to enter into a supervisory agreement and then publicly released the examination report, which detailed OFHEO's allegations. Raines testified that OFHEO's move to increase Fannie's capital surplus by 30% would most likely mean a decrease in the company's market activities and with it a decrease in its ability to service lower-income homeowners. Raines also contradicted OFHEO's version of its examination events, claiming that Fannie Mae was willing to cooperate with the agency's exam before the regulator issued administrative subpoenas. "We said there is no need for this [subpoenas] because we will produce the people and we will produce the documents," said Raines.

- Raines added that, if improprieties are found, "The board and shareholders will hold me accountable, and I will hold myself accountable." In a final dramatic flourish, Raines appeared to choke up while answering a question from Representative Maxine Waters (D-CA). "When your daughter says to you, 'I support you,' and I'm supposed to be supporting her, that's hard," said Raines with tears in his eyes. Far from contrite before his interrogators, Raines mounted what an observer described as a "daring defense," in which the polished CEO "defended his honor," but vowed to take full responsibility if the SEC ultimately determines Fannie Mae has committed significant errors.
- CFO Howard testified, "At all times I believed that the accounting applications we adopted were within the boundaries defined by GAAP, as interpreted and understood by our accounting experts both inside and outside the company." Howard added, "Fannie Mae has not withdrawn those financial statements [questioned by OFHEO] and KPMG has not withdrawn its opinion that those financial statements were prepared consistent with GAAP in all material respects."
- OFHEO Director Armando Falcon told the panel that Fannie Mae deliberately flouted and "willfully misapplied" accounting rules to make its earnings growth appear steady and to boost executive compensation. Falcon said his office has documented the company's pervasive and willful misapplication of accounting principles. "Fannie Mae understood the rules and simply chose not to follow them," he said. "The stakes are too high to just forgive past sins," said Falcon. "If any company, especially a government-sponsored enterprise, is allowed to get away with this type of accounting misconduct, then no regulator can do its job and no investor is safe." Falcon acknowledged that there has been no criminal referral from OFHEO to the Justice Department. Falcon said he is "currently considering" if Fannie Mae needs changes in top management. "We're having discussions with the board about the issue of management accountability and confidence in current management," Falcon said. The subcommittee chairman, Representative Richard Baker (R-LA) said OFHEO's accusations of accounting manipulation underlined the need for changes at the top at Fannie Mae.

- Falcon told the panel that OFHEO had begun to look more closely at the role played by KPMG, Fannie Mae's outside auditors for 35 years, and that he had referred the matter to the Public Company Accounting Oversight Board, the new federal agency that oversees the accounting profession. Falcon also told the panel that OFHEO is now looking into the stock sales of individual executives at Fannie Mae, following reports by *Dow Jones Newswires* that Fannie Mae insiders have cashed in more than \$35 million in restricted stock and options. The bulk of these sales took place after OFHEO started an investigation into Fannie Mae's accounting practices. Falcon addressed allegations the company deferred expenses in 1998 in order to allow top managers to receive millions in bonuses. In response to the questions from subcommittee Chairman Congressman Richard Baker (R-LA), Falcon said his agency is now looking at other years, as well.
- Representative Artur Davis (D-AL) suggested that Falcon was putting Fannie Mae in more danger with OFHEO's public release of the examination report and unproven allegations. Falcon responded, "I understand the politics. You can question my motives. But that won't change the content of the report."
- Representative Barney Frank (D-MA) charged that OFHEO was "irresponsible" by releasing a report charging safety-and-soundness problems that the agency could not quantify. "I have seen nothing in [the OFHEO report] that is a safety and soundness issue," Rep. Frank said. "It serves us badly to raise safety and soundness issues and not have it there."
- The hearing turned sharply partisan with some Republicans on the panel making it clear that they do not have confidence in Raines' leadership at Fannie Mae. Many Democrats on the panel challenged Falcon's harsh assessment of Fannie Mae's accounting practices and criticized the agency's failure to identify weaknesses at the GSE sooner. Some Democratic lawmakers questioned how some details of the OFHEO investigation were made public before it was complete, while other Democratic lawmakers accused Republican lawmakers of rushing to judgment. The Democrats' arguments were a critical sign that Fannie Mae's political support remains as strong as ever.
- Members of the Congressional Black Caucus, who rely heavily upon Fannie Mae and its foundation for campaign contributions and donations to their nonprofit foundation, rushed to Raines defense. Several member of the Congressional Black Caucus "ramped up" their rhetoric at the hearing, questioning the motives of investigators, who they said were on a "witch hunt" or worse. Representative William Lacy Clay (D-MO) said, "This hearing is about the political lynching of Franklin Raines," in a reference to Raines' race. Representative Maxine Waters (D-CA), who left the hearing with Raines, waged an all out battle against OFEHO at the hearings. Waters accused OFEHO of inappropriately leaking confidential information to the press about its exam report and failing to follow proper procedures in conducting its exam. Waters suggested that OFHEO was fronting for FM Policy Focus, a group of Fannie Mae and Freddie Mac competitors which has been lobbying to rein in the powers of

Fannie Mae and Freddie Mac. “I feel like I’m in the middle of another battle between FM Watch and Fannie Mae and Freddie Mac,” said Waters.

- One Republican staffer said he noted “zero interest” by many panel Democrats in the possibility that Fannie had made accounting mistakes. “If allegations by OFHEO bear out, one wonders at what point Fannie Mae’s defenders in Congress will stop being so supportive,” said the GOP staffer.
- Later, Fannie’s presiding director Ann McLaughlin Korologos told the committee that she considered Raines a “first class” CEO but that she won’t prejudge the various investigations the Board has initiated. Korologos said Fannie Mae and its outside auditors “have a disagreement with OFHEO about some aspects of implementation” of FAS 91 and FAS 133. “To date, that difference has not been resolved. ... The SEC will determine what is and is not compliant with GAAP. The SEC has not prejudged these issues,” she said.
- Republicans stood behind OFHEO’s report and sought to keep pressure on Fannie Mae. “The culture of mismanagement in this report must be eliminated and assurances gained that the highest standards of conduct will be consistently practiced,” Baker told the hearing. “Never did I question whether the GSEs were professionally managed. Now I do.” Representative Michael Oxley (R-OH), chairman of the full Financial Services Committee said, “It’s unfortunate that we are here today. After earnings smoothing at Freddie Mac was discovered, the public and the markets and the members of the committee were assured that there were no similar issues at Fannie Mae. The findings in OFHEO’s report, if accurate, are disturbing.” Representative Christopher Shays (R-CT) defended Falcon and OFHEO, noting its critics are trying to “shoot the messenger” for exposing problems at Fannie Mae.
- Members on both sides of the aisle now look to the SEC for guidance on whether or not Fannie cooked their books. Both the SEC and the Justice Department have launched investigations in the wake of the OFHEO report. Baker spokesman Michael DiResto told *Market News International* that representatives from the SEC have met with panel staff and “made it clear they take these matters very seriously.”
- Given Raines’ forceful and “masterful” defense before Congress, most observers concluded that the Fannie Mae strengthened its position. Wall Street reacted positively to Raines’ testimony with Fannie Mae’s stock rising approximately 4.5% in two days following the hearing. Despite Fannie Mae’s “victory” at the House hearing, new allegations or investigative findings about Fannie Mae could change the landscape quickly. (*Market News International*, Claudia Hirsch, 10/07/04; *Reuters*, Mark Felsenthal, 10/06/04; *Associated Press*, Marcy Gordon, 10/07/04; *USA Today*, Sue Kirchhoff, 10/07/04; *Wall Street Journal*, Dawn Kopecki, 10/07/04; *NPR’s All Things Considered*, 10/06/04; *Dow Jones International*, Dawn Kopecki and Jennifer Corbett Dooren, 10/06/04; *Credit Union Journal*, Ed Roberts, 10/11/04; *Reuters*, 10/06/04; *National Mortgage News*, Brian Collins, 10/11/04; *American Banker*, Rob

Blackwell, 10/07/04; *American Banker*, Rob Blackwell, 10/08/04; *American Banker*, Rob Blackwell, 10/08/04; *Dow Jones Capital Markets*, John Connor, 10/08/04; *Reuters*, Mark Felsenthal, 10/06/04; *National Mortgage News*, Paul Muolo, 10/11/04; *New York Times*, Stephen Labaton, 10/06/04; *Dow Jones Newswires*, Dawn Kopecki and Jennifer Corbett Dooren, 10/07/04; *Knight Ridder Newspapers*, Charles Homans, 10/07/04; *Washington Post*, David S. Hilzenrath, 10/07/04)

Whistleblower Roger Barnes submits devastating testimony against Fannie:

“Although Fannie Mae is a Company that receives accolades for providing a diverse and positive work environment, it is also plagued by a corporate culture that uses threats, intimidation, and reprisal, to create an atmosphere where even those employees with great integrity, employees who rightfully feel duty-bound to report improprieties and irregularities, cannot risk doing so, fearing the retaliation that they know will follow.”

“What the [OFHEO] report does not address, however, is the punishment I and others like me have been subjected to by Fannie Mae management for calling attention to the very problems OFHEO investigated.”

“Fannie Mae espouses a policy of adherence to good corporate governance, emphasizing the importance of integrity. The company professes to maintain policies to ensure proper and fair treatment of employees. The reality, however, is far different. I am telling my story today, fearing that I will suffer further retaliation as a result, because I believe that doing so is in the best interests of the investing public and the Company’s current employees. The atmosphere and culture, particularly within the Controller’s Division, is one of intimidation, restraint of dissenting opinions, and pressure to be part of the “Team,” giving Chairman Franklin Raines and Vice Chairman Tim Howard the numbers the Office of the Chairman desired to please the markets.”

- Barnes’ testimony continues, “From 1998 to October 2003, I was employed by Fannie Mae as Manager of Financial Accounting, Deferred Assets, in the Company’s Controller Division. I was one of the few employees within the Controller’s Division who was both a certified public accountant and had an MBA...Beginning in 1999, and continuing each year thereafter, I repeatedly alerted Fannie Mae management to improper accounting practices, including the fact that the Company’s Amortization Integrated Modeling System (“AIMS”) used inaccurate methods that violated Generally Accepted Accounting Principles (“GAAP”), in particular ...FAS 91... “I also ... advised management that it appeared that AIMS had been designed and employed to manipulate the level of income reported by Fannie Mae in its earnings statement and other public filings, which would constitute fraudulent conduct that violates federal law.”

- “Fannie Mae implemented the AIMS system in 2000. Thereafter, I became increasingly concerned about serious flaws in the program, and several of the Controller’s division’s processes related to amortization. I raised these concerns with Mr. [Jeffery] Juliane [manager of AIMS] and with our joint superiors. For example, I raised questions about repeated retroactive factor changes. I also questioned why the system employed factors that resulted in negative amortization, or in amortization that exceeded 100%, and why AIMS was designed and employed to not retain as audit trails each modeling sensitivity run that was executed.”
- “On January 4, 2001, I participated in a meeting with Ms. [Mary] Lewers (Fannie Mae Director of Financial Accounting, and my direct supervisor), Richard Stawarz, Director of Financial Reporting, and Mr. Juliane, to discuss the effects of a recent cut in interest rates by the Federal Reserve. During the discussion, Mr. Juliane indicated that the rapid fall of rates had led senior management to consider adjusting the ‘on-tops’ -- a term the Controller’s division used to refer to manual journal entries that could be used to adjust arbitrarily the Company’s income as the books were closed each month. Senior management had stated that ‘on-tops’ could be used to reflect a desired amount of income for December 2000, which would maintain margin and net interest income levels.”
- “On January 10, 2001, I alerted Ms. Lewers to a problem that arose when Mr. Juliane processed a factor change in December 2000, which included several errors. Specifically, the AIMS system had applied a set of factors to the wrong inventory, thereby placing into questions the AIMS system’s reliability.”
- “On June 12, 2001, I discovered that during the closing of the Fannie Mae books for May 2001, the Company’s management had posted a \$10 million ‘on tops’ entry in order to increase Fannie Mae’s reported income.”
- “On November 6, 2001, an amortization factor change requested by management resulted in a \$100 million increase to the Company’s interest income. I recognized this increase as concrete evidence that the AIMS system, as developed and used by the Company, produced grossly inaccurate and unreliable results when calculating Fannie Mae’s income and expenses.”
- “During 2002...I became aware that Fannie Mae was routinely using negative factors for discount and premium in order to revise current period net income. This use of negative factors allowed management to incorrectly report income by incorporating it into the balance sheet through accumulated amortization, thereby removing or adding income or expenses from the Company’s income statement, even if those amounts had already been amortized.”
- “On June 13, 2002...I realized Fannie Mae’s use of negative factors had caused some of the Company’s mortgage and MBS related assets to appreciate rather than to depreciate -- a result completely inconsistent with GAAP and economic realities”

- “By September 23, 2002, it was clear to me that management in the Controller’s division had no intention of responding to my disclosures of accounting impropriety.... I [then] formally raised my concerns in an intraoffice memorandum to Franklin Raines, Fannie Mae’s Chief Executive Officer (“CEO”) and Tim Howard, the Company’s Chief Financial Officer (“CFO”)...regarding the serious financial improprieties I had repeatedly brought to the attention of my managers. Specifically, I highlighted the following:”
 - “that reconciliation differences from systems were being input as future deferrals instead of the current period’s income and expenses;”
 - “that the Controller’s division was intentionally limiting the AIMS system capabilities so that it would not provide audit trails for modeling;”
 - “that the division had a practice of using negative factors in amortization and allowed amortization to exceed 100%;”
 - “that the division routinely understated and overstated income;”
 - “that the division managed income to meet the Company’s desired objectives;”
 - “that the division used ‘On Top’ entries in order to manage income and margin calculations;”
 - “that the Company was using a miscellaneous balance sheet account in order to manage reporting of some income in periods other than when it was received;”
 - “... that there were serious problems with the amortization of purchased discount and premium, and that ‘the possible impact reaches hundreds of millions of dollars and possibly affects the integrity of the current financial statements and those we will issue after beginning compliance with SEC reporting in 2003.’ I urged Mr. Raines and Mr. Howard to investigate the issues identified.”

- “In April 2003, I again spoke with Mr. Stawarz about my concerns regarding Fannie Mae’s amortization accounting practices. I told Mr. Stawarz that I felt that it might be necessary to make the Company’s management aware that several of the amortization accounting policies and procedures were not in compliance with GAAP, and affected the accuracy of Fannie Mae’s financial reporting. Mr. Stawarz agreed that there were significant problems, but told me that in Fannie Mae’s corporate climate...I should not raise my concerns. As a result of this discussion, I decided to undertake a detailed study of Fannie Mae’s amortization accounting and other areas in which I had noticed irregularities, in order to document the seriousness and prevalence of these irregularities.”

- “In May 2003, I offered substantial assistance to members of the Internal Audit division who were conducting a routine audit. I attempted to discreetly alert the internal auditors to the serious problems I had identified to my managers and was discovering through my own research.”
- “On July 23, 2003, I completed my research regarding Fannie Mae’s unamortized balances. Over the past months I had confirmed and documented my earlier suspicions that Fannie Mae’s general ledger accounts reflected a large number of irregular unamortized balances, that there were numerous amortization factor errors produced by the modeling system, and that the amortization speeds employed by the Company frequently conflicted with GAAP and economic realities. Upon completing my research and confirming that there were significant problems with Fannie Mae’s amortization accounting, I attempted to set up a meeting with Sam Rajappa, the head of the Internal Audit division . . . [O]n July 29, 2003, I again attempted to set up a meeting with Mr. Rajappa, this time by e-mail.”
- “On August 4, 2003, I met with Mr. Rajappa and Ms. Eilers of the Internal Audit division. I gave them a memorandum titled “Unamortized Balances and Factor Analysis” that summarized the findings of my substantial research of the previous months. The memorandum raised several concerns regarding Fannie Mae’s accounting practices, including: the inadequacy of controls and review of accounting processes; the AIMS system’s failure to retain audit trails; the lack of correlation between factors and loan prepayments; the inaccuracy of Fannie Mae’s financial statements as a result of the arbitrary selection of factors; the lack of adequate checks and balances for the PDI and AIMS systems; the problem of “on top” adjustments; the problem of deferred assets being amortized in excess of 100% or in reverse; and the fact that improper amortization speeds were being used. All of the practices I highlighted were ones that caused Fannie Mae to not be in compliance with GAAP.”
- “In addition, I provided Mr. Rajappa and Ms. Eilers with approximately 60 examples of factor errors and other analyses that I had completed relevant to the issues I raised. These 60 examples were all taken from the period ending June 30, 2003. I also alerted Mr. Rajappa and Ms. Eilers to the most recent \$6.5 million factor change, which I believed was an example of intentional misstatement of income. I told Mr. Rajappa and Ms. Eilers that, based on my research, I believed that Fannie Mae’s amortization accounting was not in compliance with GAAP, and that the Company was manipulating and managing income in order to create a picture of artificially stable earnings.”
- “The response from the Audit division, as detailed by OFHEO in its September 17, 2004 “Report of Findings to Date: Special Examination of Fannie Mae” was incomplete, perfunctory, and ineffective.”
- “On August 5, 2003, I gave Ms. [Leanne] Spencer (Senior Vice President and Controller), Ms. [Janet] Pennewell (Senior Vice President for the Company’s

Controller's division), Ms. Lewers, and Messrs. Stawarz and Juliane a copy of what I had provided to the Internal Audit division, including documentation reflecting the over 60 factor errors I had discovered for the period ending June 30, 2003."

- "On August 8, 2003, Mr. Rajappa convened a meeting of the Controller's Office managers, including, among others, me, Jonathan Boyles of the Financial Standards division, Ms. Eilers, Ms. Philip, Paul Jackson, and Gunes Kulaligil of the Internal Audit division, Deborah House from the Office of Corporate Justice, and two representatives from KPMG, Fannie Mae's external auditors."
- "Mr. Juliane gave a complex explanation for the accounting issues I had raised. Although these answers did not justify Fannie Mae's non-compliance with GAAP, and were in several instances contradictory, Mr. Rajappa appeared eager to accept Mr. Juliane's explanations. Ms. Spencer and Ms. Pennewell also concurred with Mr. Juliane's explanations and the KPMG representatives stated that GAAP was being followed, although they cautioned that they had not conducted a formal audit."
- "Faced with enormous pressure from my superiors, and fully aware that no one at the meeting appeared interested in fixing the problems, I did not voice my disagreement. However, on October 2, 2003, I sent an e-mail to Mr. Jackson indicating that I did not endorse the investigation completed by the Internal Audit division."
- "OFHEO investigated and observed that Fannie Mae promoted literally every employee who was involved in or assisted the effort to suppress the truth about the accounting and financial irregularities I reported, and which OFHEO confirmed. More importantly, they also watched while I was stripped of my duties, excluded from meetings, downgraded in my performance reviews, denied appropriate promotions, had my abilities denigrated and my motives questioned, and was ultimately forced from the Company."
- "As a result of Fannie Mae's refusals to take the concerns I had raised about financial and accounting practices seriously, and the retaliation I faced for raising these concerns, I had no choice but to separate from the Company in October 2003."
(Written testimony of Roger Barnes, former manager of Financial Accounting, Deferred Assets in Fannie Mae's Controller Division submitted to the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, 10/06/04)
- "When the dust settles on this one, the big moment [in the House hearing] will have been Roger Barnes," said Mark Agah, an analyst with Portales Partners. When Barnes testified that Fannie used intimidation tactics against him when he complained internally about its accounting, a federal investigation was inevitable, said Agah , adding "He provided the roadmap for all federal and state investigators [and class action litigants]."

- Barnes' attorney, Debra Katz of Bernabei & Katz, said her client is not suing Fannie Mae. Barnes plans to meet with the SEC and the Department of Justice in the near future to answer their questions about his work in Fannie Mae's Controller Division and the company's work environment.
- In response to Barnes testimony, Janice Daue, a Fannie Mae spokeswoman, said the company had no tolerance for retaliation. "Fannie Mae has a culture that encourages employees to raise issues and the company takes these concerns seriously," she said. Daue said that three separate Fannie Mae offices and KPMG investigated Barnes's concerns. After those investigations concluded and Barnes left Fannie Mae, she said, Barnes stated both informally and in writing that his concerns had been addressed. "Nonetheless, OFHEO has suggested in its report that Mr. Barnes's claims were not adequately addressed," she said. "This is one of the issues that [Fannie Mae's] independent counsel will be looking at."
- (*Dow Jones Newswires*, Dawn Kopecki and Jennifer Corbett Dooren, 10/07/04; *New York Times*, Eric Dash, 10/07/04; *Washington Post*, Terence O'Hara, 10/07/04; *USA Today*, Edward Iwata and Jayne O'Donnell, 10/07/04; *Dow Jones Newswire*, Dawn Kopecki and Jennifer Corbett Dooren, 10/07/04; *New York Sun*, Roderick Boyd, 10/13/04)

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| Representative Baker's release of Fannie Mae compensation causes firestorm |
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- During the hearing on Fannie Mae's accounting practices, Chairman Richard H. Baker (R-LA) displayed a chart outlining the compensation of the top 22 executives at Fannie Mae showing that 20 of Fannie's top executives earned more than \$2 million and nine received more than \$3 million in 2002. At Freddie Mac, seven executives received more than \$1 million in compensation in 2002 and only two executives received more than \$1.5 million.
- Some lawmakers were outraged at Fannie's compensation levels, while others were outraged at Baker for making the information public in a confrontation with Fannie Mae Chairman and CEO Franklin Raines. Raines insisted that the compensation information not be released, stating, "It is confidential and protected by laws of the United States." He said the release of this information was an invasion of privacy and would provide a road map for recruiters interested in raiding Fannie Mae's talent. The company had fought to keep the information private, hiring Kenneth W. Starr, the former special prosecutor who investigated President Bill Clinton, to represent Fannie on this matter, and threatening to sue Baker if he released the information.
- "I released this information. I am accountable for its release and I put it into the public forum pursuant to my rights as chairman subject to a response from the regulator," said Baker. "I wanted to make sure I didn't get criticized for leaks...we had all these accusations that people got advance information inappropriately before it was released." The committee's ranking minority member, Representative Barney

Frank (D-MA), defended Baker's actions, saying Fannie and Freddie's government sponsorship makes it "entirely appropriate" to release their executive compensation data. "At the level of compensation you get, we ought to be able to count on you to do your very best without any additional incentives," Frank told CEO Raines and Chief Financial Officer Timothy Howard.

- Baker said that Fannie's compensation material was an integral part of a hearing on OFHEO's allegations that Fannie executives manipulated financial results, in part to ensure bonus packages. Baker said he would seek similar data for the past 10 years. In an interview after the hearing, Baker said he wanted to show fellow lawmakers "the scope of the benefits being paid to these executives for an entity created by the Congress which is intended to help low-income people get access to housing." He added, "There seems to be a mismatch here."
- Representative Christopher Shays (R-CT) told Raines he was surprised by Fannie's lucrative pay packages and bonus system, noting that the company's executives have received a cumulative total of \$245 million in cash bonuses over the last five years. "It's a tiny, tiny percentage of our revenues," Raines responded, noting that Fannie had after-tax income of approximately \$30 billion over that period. "It's a tiny, tiny percentage of our profit," Raines added. Shays countered, "That's a quarter of a billion dollars. That's a lot of money."
- The data Baker released offer a broader view of what is at stake for the people who run Fannie Mae. Baker's chart showed that 16 Fannie executives received bonuses in 2002 that were larger than their salaries. According to a Fannie Mae filing with the SEC, executive bonuses in 2002 were tied to an "aggressive" earnings target that Fannie exceeded. Fannie's regulator has argued that pay incentives focused primarily on short-term earnings can lead to "improper conduct," such as the earnings manipulations disclosed last year at its smaller rival, Freddie Mac.
- Under federal law, OFHEO is responsible for prohibiting "excessive compensation" of Fannie Mae and Freddie Mac executives. OFHEO has not found Fannie Mae's compensation to be excessive, said Fannie Mae spokeswoman Corinne Russell. She added, "As we review in more detail the conduct of management and as the board of directors reviews management conduct, it could be determined that it is excessive." (*Dow Jones Newswires*, Dawn Kopecki and Jennifer Corbett Dooren, 10/06/04; *Washington Post*, David S. Hilzenrath, 10/11/04; *Dow Jones Newswires*, Dawn Kopecki and Jennifer Corbett Dooren, 10/06/04; *National Mortgage News*, 10/11/04; *Wall Street Journal*, James R. Hagerty, 10/07/04)

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| "High entertainment" at the Fannie Mae hearing |
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- In an October 14th editorial, the *Wall Street Journal* captured the "spirit" of the House hearing on Fannie Mae's accounting abuses by writing, "There were many moments of high entertainment during ... [the] House hearings on Fannie Mae's

creative accounting. But our favorite was the Mister Magoo performance given by Barney Frank (D-MA) after learning that Fannie had handed out \$245 million in bonuses over five years. Mr. Frank chided Fannie CEO Frank Raines and CFO Tim Howard, saying, “At the level of compensation you get, we ought to be able to count on you to do your very best without additional incentives.” Here’s a case of misplaced moral outrage if we’ve ever seen one. Mr. Frank is mad about the salaries when he really should be mad at the rigged political game that has made them possible. Fannie’s regulator, the Office of Federal Housing Enterprise Oversight, has reported that Fannie has been cooking its books. Add that to the increasing evidence that Fannie has been ignoring its mission to provide affordable housing, and we wonder if Mr. Frank doesn’t need an eye checkup.”

- “Ditto for the good liberals in the Congressional Black Caucus. Members of this group are often the loudest defenders of Fannie and her brother, Freddie Mac. Can it be that the annual donations made by the Fannie Mae Foundation to the Caucus have blurred their vision too? [Representative] Maxine Waters (D-CA) cooed all over Mr. Raines, and [Representative] Clay Lacy (D-MI) played the race card by calling the hearings a “political lynching” of Mr. Raines, who is African-American. Are CEOs not supposed to be accountable simply because they’re persons of color? By the way, Roger Barnes, the whistle-blower who was fired by Fannie after complaining about its accounting procedures, is also black. In a more consistent world -- where political principles mean something -- these liberals would be scorching a company that used a government subsidy to enrich its own executives. Instead, they’re defending it.”
- “The default position for Fannie’s defenders is that the giant mortgage finance company provides more affordable housing. At least that’s Fannie’s declared mission and that’s why the government offers it an implicit subsidy. But as study after study has demonstrated, Fannie does not provide homeowners with significant savings... The disconnect between Fannie’s rhetoric and its self-enriching practice was clear a few months ago when the Department of Housing and Urban Development proposed a rule to require Fan and Fred to purchase more mortgages from lower-income households... It was a modest request, especially since HUD data shows that Fan and Fred have lagged behind other mortgage lenders in financing such loans. Well, you would have thought that HUD was proposing to kick poor folks out of their homes, not make it easier to buy them. Fan and Fred’s Congressional sympathizers (including some of the same Members who lavished valentines over Fan last week) sent a letter to HUD complaining against the new quotas. And you can bet the companies were egging them on behind the scenes.”
- “To be sure, Mr. Frank is right that Fannie’s executive compensation is rich by any standards. When a government-sponsored company pays its top 21 executives more than \$1 million each in 2002 (and three of them are lobbyists), that fact does bear some reflection. And, aside from the evidence that Fannie was cooking its books to trigger big bonuses, there’s also the issue of performance. Mr. Raines’s 2003 compensation was over \$20 million. That’s about \$14 million more than the median for CEOs of very large companies. What did Mr. Raines do to deserve this giant

sum? Not much. In the five years that Mr. Raines has been at the helm, Fannie's cumulative shareholder return, including reinvested dividends, has been 4% compared with the 23% achieved by the S&P financial sector. The evidence is overwhelming that Fannie only pretends to be a tribune of the poor. Not only does the company use its implicit subsidy to enrich its executives, some of that money is funneled into the Fannie Mae Foundation, which, no surprise, motors it back out to favorite charities of Fannie board members. It's an odd sort of liberal principle that endorses private profits at public risk." (*Wall Street Journal* editorial, 10/14/04)

Fannie Mae and Freddie Mac

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| GSE regulatory reform is on the agenda for 109 th Congress |
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- With Congress in recess for the November elections, GSE regulatory reform is on the back burner until the next year. According to the *Wall Street Journal*, "the smart money is now looking at a breakthrough next year on the GSE regulatory revamp front as close to a mortal lock." Retired Senator Phil Gramm (R-TX), the former chairman of the Senate Banking Committee, concurred with this view, saying he thinks there will be a new regulator for the GSEs next year no matter what. "I think Fannie has come to the realization they need one (a bill)," said Gramm. "They know they need a better regulator than OFHEO."
- Following the House hearing on Fannie Mae's accounting improprieties, many lawmakers said improvements need to be made to OFHEO and its regulatory authority, but did not indicate that they would move on legislation to more strictly regulate Fannie Mae and Freddie Mac. "It is...my hope that when we revisit this issue in the 109th Congress we will continue to remain resolute and unwavering in our bipartisan efforts to create a strong, independent and world-class regulator," said Representative Paul E. Kanjorski (D-PA) in his opening statement.
- Representative Michael G. Oxley (R-OH), Financial Services Committee chairman, echoed Kanjorski's comments, saying OFHEO's report "reinforces" arguments for the creation of a regulator for GSEs with the powers and authorities granted to other financial regulators. Oxley said he and Representative Richard Baker (R-LA), the chairman of the capital markets subcommittee with oversight of the government sponsored enterprises, were still working on a bill to revamp the regulation of Fannie and Freddie Mac. "There's a good chance in the next Congress we'll revisit that," Oxley said. "I'm working with Chairman Baker on some issues and we hope to have more to say about it later this week."

- With the 108th Congress coming to a close, Baker said he would move legislation next year. “By next February, I expect some formal action in my committee,” Baker said. Oxley has pledged to bring the legislation before the full committee, Baker said.
- In the Senate, Senator John Sununu (R-NH) said he believed “there’s an excellent chance that the [Senate] Banking [Housing and Urban Affairs] Committee takes up a bill next year. All the accounting problems at Fannie underscore the need for a stronger regulator.” Sununu noted that the Senate Banking panel passed a bill in April to put oversight under the Treasury Department, but the legislation stumbled when House Financial Services cancelled a markup. This time around Fannie Mae can’t avoid legislation, Sununu said — even though executives there voluntarily agreed to implement some safety and soundness rules, including increasing the level of capital it keeps on hand. “If it’s a cynical effort simply to head off legislation yet again, they are going to be very disappointed,” said Sununu. While the Senate Banking Committee has not scheduled a hearing on revelations in the OFHEO report, a committee spokesman said Chairman Richard C. Shelby (R-AL) intends to make the GSE regulatory reform a priority for the Committee next year. (*Dow Jones Capital Markets Report*, John Connor and Elizabeth Price, 10/04/04; *CQ Today*, Michael R. Crittenden, 10/06/04; *American Banker*, Rob Blackwell, 09/29/04; *Roll Call*, Emily Pierce and Amy Keller, 10/01/04)

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| Outcry for GSE regulatory reform intensifies in wake of Fannie Mae accounting scandal |
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- Newspaper editorial boards across the United States have called upon Congress to improve the regulation of Fannie and Freddie before it is too late. In an editorial, the *Daytona Beach News Journal* wrote, “While regulators and investigators are belatedly doing their job, Congress is still playing footsy with Freddie Mac and Fannie Mae. This despite Federal Reserve Chairman Alan Greenspan’s insistence that more regulation was necessary. Congress has been too polite with Freddie Mac and Fannie Mae, too willing to let the two companies coast behind pretenses of privacy. The two companies’ lobbyists are also among the fiercest and best-bankrolled in Washington. They are constantly reminding Congress that stricter regulations will mean more expensive mortgages, and more expensive mortgages will mean unhappy voters. So Congress has been backing off from immediate and necessary changes: ending Fannie Mae’s and Freddie Mac’s generous federal subsidies ...and developing stricter regulations for the industry. Freddie Mac’s troubles were the first warning to do something. Fannie Mae’s are the second. The third, should Congress keep dragging, may not be so charmingly manageable.” (*Daytona Beach News Journal*, 10/05/04)
- The *Los Angeles Times* writes in an editorial “[I]t seems clear that Fannie Mae, with its \$1-trillion mortgage portfolio, and younger brother Freddie Mac have outlived their purpose as federally backed entities...OFHEO’s findings, coming on the heels of Freddie Mac’s accounting problems, are an indictment of its own record as a regulator and bolster the Bush administration’s desire to have a stronger regulator for

the entities, presumably one overseen by the Treasury Department. Congress, for its part, should consider ways to make Fannie and Freddie compete in the marketplace without a taxpayer subsidy, implicit or explicit.” (*Los Angeles Times*, 10/05/04)

- In an editorial, the *Cox News Services* writes, “Lack of oversight by Congress, federal regulators and boards of directors has put at risk the financial futures of millions of Americans...The latest company accused of cooking its books to enrich top management, cover up deficiencies and manipulate earnings is [Fannie Mae]...It is Congress’ job to fund and oversee the government’s regulatory agencies to ensure they are protecting the public...Previous efforts to reform Fannie Mae and Freddie Mac with stronger regulations or reduced government backing have gotten nowhere following extensive and expensive lobbying by [Fannie Mae and Freddie Mac]. Federal Reserve Board Chairman Alan Greenspan has long called on Congress to increase oversight and regulation of Fannie Mae and Freddie Mac that together lower mortgage rates by less than a tenth of one percent...Congress, federal regulators, boards of directors and administration officials have been asleep at the wheel. A lot of work needs to be done quickly to protect the public.” (*Cox News Service*, 10/05/04)
- The *St. Louis Post-Dispatch* writes in an editorial, “It’s clear that Fannie and Freddie must be under the watch of a strong and well-funded regulator without the current agency’s tendency toward narcolepsy. The purpose of good regulation is to help keep the regulated on course and diagnose problems and solve them before they become catastrophic. Regulators must be corrective, but need not be punitive in helping Fannie and Freddie stay solvent. The Treasury Department’s regulation of national banks may serve as a model. Federal examiners troop through banks every year and insist that problems be fixed. As a result, banks rarely fail. It’s also clear that Fannie has too much clout in Congress. It has managed to fight off previous efforts to increase regulation...They shouldn’t be allowed to talk their way out of tighter federal oversight.” (*St. Louis Post-Dispatch*, 10/08/04)
- In an editorial, *The Republican* writes, “News of the SEC’s probe [of Fannie Mae] must serve as a wake-up call about the need to change government oversight of Fannie Mae and Freddie Mac. The Office of Federal Housing Enterprise Oversight was created by Congress in 1992 to keep an eye on the doings inside Freddie and Fannie. The thought at the time was that the housing market would be badly disrupted if one or both got into financial trouble. But the thinking at that time was flawed, creating an oversight body that lacked authority and leaving Freddie and Fannie playing by far looser rules than those governing banks and other financial institutions...Together, Fannie Mae and Freddie Mac provide nearly half of the nation’s mortgage money, owning or guaranteeing some \$4 trillion in mortgages. They had better be stable. When a new Congress is in place next year, it should set to work on changing the rules of governance and oversight.” (*The Republican*, 09/25/04)

- The *Washington Times* writes in an editorial, “[Fannie’s and Freddie’s] regulator should be given greater authority in setting capital requirements to ensure the companies are properly insulated from potential interest-rate risk. Also, these institutions should be regulated more like banks, and shouldn’t be given advance warning about which accounting areas they will be tested on, which has been the prevailing practice. The roles of Fannie and Freddie in helping to make housing more affordable remain important, and Congress should be even-handed in reforming their regulation. Congressional Democrats could pay a serious price if they maintained the companies’ privileges at the expense of the health of the overall economy.” (*Washington Times*, 10/04/04)
- The *Kansas City Star* writes in an editorial, “It’s time for Fannie... to face greater regulatory scrutiny...Lawmakers should subject Fannie and Freddie to a level of scrutiny commensurate with their potential liability to the taxpayer or answer the question why they shouldn’t be privatized.” (*Kansas City Star*, 10/14/04)
- In its October 18th editorial, *BusinessWeek* writes, “Should we break up mortgage giant Fannie Mae? Is it so big and out of control that it threatens the entire U.S. financial system? A lot of people in Washington think so, especially after the 211-page broadside against it by the Office of Federal Housing Enterprise Oversight (OFHEO) on Sept. 22. Unfortunately, the financial questions about Fannie Mae are entwined with ideological battles between Republicans and Democrats. The truth is hard to come by. Yet one thing is increasingly clear: At the least, Fannie Mae and its smaller sibling, Freddie Mac, need a more sophisticated and powerful regulator...It’s time for serious, sustained oversight. Our choice is the Treasury Dept., which already regulates national banks...[T]here are serious questions that must be addressed about [the GSEs’] governance, [their] benefit to society, and [their] risk to the financial system. This is not simply politics. It is an economic issue.” (*BusinessWeek*, 10/18/04)
- Robert Reich, former Secretary of Labor in the Clinton administration, writes in *Newsday*, “Washington hasn’t been nearly tough enough with Fannie Mae and Freddie Mac. It’s time for some tough regulations, before these two mortgage titans harm the safety and soundness of our entire financial system.” (*Newsday*, Robert Reich, 10/06/04)
- Steven Pearlstein writes in the *Washington Post*, “[Fannie Mae’s accounting scandal] is what happens when an enterprise chartered to provide liquidity and stability to the mortgage market turns itself into a growth stock, promising Wall Street double-digit earnings growth delivered in smooth, quarterly increments. It’s what happens when a private firm gets a government license to print money -- and uses its resources to ensure it is lightly and incompetently regulated...To me what [the OFHEO report] suggests...is the value of getting government more involved -- keeping closer watch, setting clearer rules and making sure that these enterprises strike a better balance between the sometimes conflicting goals of maximizing profits and increasing the efficiency of the mortgage market.” (*Washington Post*, Steven Pearlstein, 10/01/04)

- In a letter to Senator Richard C. Shelby (R-AL), chairman of the Senate Banking Committee, Steve Bartlett wrote on behalf of the Housing Policy Council of The Financial Services Roundtable, urging Congress to complete its action on GSE regulatory reform as soon as possible. Bartlett wrote, “This is a safety and soundness issue that requires immediate attention.” He added, “the housing GSEs should be subject to stronger supervision and regulation and that their federal regulator should operate independently.” (*Housing Policy Council of The Financial Services Roundtable*, Steve Bartlett, 10/05/04)
- The Citizens Against Government Waste (CAGW) released a statement noting, “The GSEs have operated with impunity for so long that the accounting scandal at Fannie Mae should come as no surprise. If members of Congress claim that they are shocked, shocked at what has happened at Fannie Mae, it may be an attempt to divert attention from the fact that Congress has done very little to improve GSE oversight. While it may be satisfying and appropriate to rake GSE executives over the coals at yet another hearing, Congress created the GSE business model in the first place, has spent years bowing to pressure from the GSEs themselves to maintain a hands off attitude, and aided and abetted these corporate giants in their quest for excessive profits at the expense of the nation’s homebuyers and taxpayers. The warning signs are now flashing red. Congress’s inaction in the face of sensible calls for reform has gone on for far too long. Legislators need to take action to finally protect taxpayers.” (*Citizens Against Government Waste Press Release*, 10/05/04)
- Following the hearing on OFHEO’s report on Fannie Mae’s accounting, CAGW’s Leslie Paige issued a press release saying, “The accounting scandal at Fannie Mae should lead to real changes in its financial practices. But with the exception of Chairman Richard Baker (R- LA), Christopher Shays (R-CT.), Doug Ose (R-CA.), Ed Royce (R-CA.) and a handful of other House members, Fannie Mae has been routinely shielded by Congress and has escaped any sort of sensible scrutiny. Congress owes the taxpayers much more. Let’s hope members remember who they work for and pass GSE reform legislation.” (*Citizens Against Government Waste Press Release*, Leslie Paige, 10/06/04)

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| Cato Institute joins the call for privatizing Fannie and Freddie |
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- In a policy analysis published by the Cato Institute, Professor Lawrence J. White examines the role of Fannie Mae and Freddie Mac in the U.S. economy and concludes that true privatization of the GSEs is good public policy. White writes that as the two dominant entities in the secondary residential mortgage markets of the United States, Fannie Mae and Freddie Mac are an important and prominent part of a larger mosaic of extensive efforts by governments at all levels to encourage the production and consumption of housing. Although the GSEs appear to be “normal” corporations, each with shares that trade on the NYSE, they have federal government origins and entanglements that make them quite special and unique. Their

uniqueness, however, is a double-edged sword. While the GSEs cause interest rates on many residential mortgages to be lower than would otherwise be the case, their size and mode of operation have created a significant contingent liability for the federal government and the taxpayers. The GSEs' size and prominence has recently led to concerns about the impact on the U.S. economy if Fannie or Freddie were to experience financial difficulties.

- White argues that while there is strong evidence that home ownership has positive spillover effects for society, the broad policies that encourage home ownership simply encourage the consumption of more housing—at the expense of other things—by those who would have bought anyway. As a consequence, society's resources are less efficiently allocated than would otherwise be the case.
- White concludes that the special governmental subsidies for Fannie Mae and Freddie Mac yield little that is socially beneficial, while creating significant potential social costs. From White's perspective, the best policy would be to privatize the GSEs completely by severing all governmental links and convert them to truly "normal" corporations and to pursue other measures that would better address the positive externality of home ownership and efficiently reduce the cost of housing. In the event that true privatization of the GSEs does not occur, suitable "second best" policies would include stronger statements by Treasury officials that the federal government has no intention of supporting the two companies; improved safety-and-soundness regulation of Fannie and Freddie; limits on the amounts of their debt that can be held by regulated depository institutions; and increased efforts to focus Fannie Mae and Freddie Mac on the segment of the housing market where their social benefits would be greatest, writes White. (*Cato Institute Policy Analysis No. 528*, Lawrence J. White, 10/07/04)

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| Atlanta Federal Reserve economists conclude that Fannie and Freddie need higher minimum capital requirements |
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- Economists with the Federal Reserve Bank of Atlanta (FRBA) called for higher minimum capital requirements for Fannie Mae and Freddie Mac in a recently released report, saying Fannie's reported capital holdings are unreliable in light of the accounting problems reported by OFHEO. "At this time, it's unclear that one can draw reliable conclusions about either the risk profile of Fannie Mae or its capital adequacy using its publicly reported information," said the economists. "We recommend that the minimum and critical capital requirements for housing enterprises be somewhat increased ...to account for the possibility that the estimated economic value of the portfolio may be overstated due to modeling errors." The report, written by the FRBA's research director and two staff economists, argues that OFHEO should be given authority to put Fannie and Freddie into receivership if the companies run into financial trouble.

- The analysis examines the potential impact of OFHEO’s examination findings on Fannie Mae’s capital holdings. The economists conclude that OFHEO’s capital requirements are fundamentally flawed because they largely measure book value ratios, the accounting for which can be easily manipulated, and doesn’t reflect underlying economic value. “The potentially large gaps between book and economic value suggest that if OFHEO is to continue using book value ratios, a substantial increase in the minimum and critical capital ratios is necessary” for Fannie Mae and Freddie Mac, concludes the report. The economists suggest that OFHEO replace book value capital adequacy requirements with market value requirements for both assessing the GSEs’ capital holdings and determining when OFHEO can take enforcement action against either for falling short. It makes the same suggestion for bank regulators as well.
- “Although the measurement error would be reduced by using market values, it would not be entirely eliminated,” the authors say, adding that the value of many of Fannie and Freddie’s holdings is based on internal estimates because the markets for some securities are not sufficiently liquid to yield accurate market values. Even if the capital requirements are changed to reflect economic value, the economist still recommend an increase in minimum and critical capital requirements “to account for the possibility that the estimated economic value of the portfolio may be overstated due to modeling errors.”
- The economists credit OFHEO for “doing its job” in catching problems at Fannie ahead of time while also criticizing the regulator for allowing them to persist for years and missing similar issues at Freddie Mac. “Clearly, a major reason is that the agency has been understaffed (particularly in the area of accounting expertise) and under funded. “OFHEO is currently subject to the appropriations process and as such is fair game for political shenanigans,” the report says.
- The authors also note that Standard & Poor’s credit ratings service recently reaffirmed Fannie Mae’s triple-A rated debt, suggesting that analysts still believe Congress will appropriate taxpayer money to bail out debt holders if either becomes insolvent. “The likelihood (actual and perceived) of such a bailout would go down substantially, however, if an insolvent enterprise could be resolve without congressional intervention,” they said. (*Dow Jones International News*, Dawn Kopecki, 10/04/04; *Reuters*, 10/04/04)

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| <p>HUD confirms that Fannie and Freddie met their 2003 housing goals Freddie Mac fell slightly below its 2002 goals</p> |
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- Fannie Mae and Freddie Mac met the government-set goals for making home ownership affordable in 2003, but only because three unusual multibillion-dollar deals were counted toward the targets, HUD officials said. After an extensive review of the deals, HUD officials decided to allow the year-end transactions - one by Fannie Mae and two by Freddie Mac - to be counted. The GSEs’ separate yet similar deals

with Citibank and Washington Mutual involved mortgages on multifamily buildings. The deals were designed to help Fannie Mae and Freddie Mac meet the affordable housing targets. Without these deals, Fannie Mae and Freddie Mac would have fallen short of the goals for all three performance gauges: financing mortgages for low- and moderate-income home buyers, in underserved areas and for poor families, said assistant HUD secretary John Weicher. “There has been an ongoing question” about the multifamily deals, he said. The department has concluded that “they are in fact permissible,” Weicher said. HUD is reviewing the issue of allowing such transactions to go toward the housing goals, starting with next year’s targets.

- For 2002, HUD said Freddie Mac counted some mortgages it financed toward the goals for that year even though it had put them toward the 2001 goals. Agency regulations prohibit such double-counting, and HUD said that Freddie Mac’s 2002 performance therefore had been overstated. After correcting Freddie’s 2002 results, HUD found that the company fell short in financing underserved markets by just 90 housing units, or 0.002%. Federal law and HUD regulations require the GSEs to submit housing plans when they miss their affordable housing targets. “However, because this shortfall occurred in 2002 and Freddie Mac exceeded this goal in 2003 by approximately 95,000 units, or 1.7%, the department will not require a housing plan for underserved areas goal in 2002,” HUD said.
- “The [Citibank and Washington Mutual] transactions as described raise obvious questions, and it appears that Fannie and Freddie may have been trying to game the system,” said Andrew Cuomo, the former HUD secretary in the Clinton administration.
- “While the GSEs met the affordable housing goals in 2003, they must do more to genuinely lead the mortgage finance industry as Congress intended,” said HUD Secretary Alphonso Jackson. “HUD is now finalizing new housing goals, which over the next four years, will push the GSEs to do what is expected of them—helping low- and moderate-income families at least at the same percentage levels as primary market lenders.” He said the new goals for 2005-2008 will push the companies “to do what is expected of them - helping low- and moderate-income families at least at the same percentage levels” as their bank and mortgage lender competitors. (*Associated Press*, 10/14/04; *Dow Jones International News*, 10/14/04; *Inman News*, 10/14/04; *Wall Street Journal*, John D. McKinnon and John R. Wilke, 10/15/04)

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| HUD releases OFHEO audit – but HUD’s IG refuses to release results of OFHEO investigation |
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- According to a HUD audit, OFHEO doesn’t adequately track how much time and money it spends supervising Fannie Mae and Freddie Mac. The release of the audit, requested by Senator Christopher Bond (R-MO), preceded the contentious House hearing on accounting irregularities found at Fannie Mae by OFHEO. HUD’s Office of Inspector General (IG) found that OFHEO employs similar budgeting methods as

other federal financial regulators and devotes 80% of its resources, with 80% to direct supervisory functions. However, the IG concluded that those numbers cannot be relied upon, because OFHEO doesn't "adequately support its method for allocating employee expenses, or the resulting use of funds reported in its annual reports and budget requests." The IG criticized OFHEO for not tracking with precision the amount of time employees spend on projects. Instead, OFHEO employees prepare a limited daily report of their activities without noting the exact amount of time spent or goals accomplished.

- In a letter to HUD, OFHEO Director Armando Falcon conceded that the agency doesn't have an employee time tracking system that can validate estimates given by managers. "We have concluded that such a system would be very expensive to develop and operate, and any resulting benefits would be small at best," he said, agreeing to HUD's suggestion to conduct a time usage study to validate project time estimates given by OFHEO's managers.
- Bond, a frequent OFHEO critic who chairs the Senate panel that approves the agency's annual budget, sponsored a provision in current law that requires OFHEO to devote 60% of its annual funding to direct supervisory functions. Falcon noted that some OFHEO's activities, such as working with other financial regulators on mortgage fraud and ensuring the GSEs have adequate financial disclosures, are not counted toward that goal. "Clearly these activities also have an impact on the agency's supervision and regulation of Fannie Mae and Freddie Mac," he said. (*Dow Jones International News*, Dawn Kopecki, 10/06/04)
- The HUD's IG declined to release the results of a special investigation of OFHEO requested by Senator Bond, saying that such disclosure could "interfere with enforcement proceedings." Patricia E. Sanders, who handles Freedom of Information Act requests for HUD's IG, declined to explain the nature of any enforcement proceedings that could stem from the OFHEO investigation. Sanders cited a legal provision that allows the government to withhold "records or information compiled for law enforcement purposes" to the extent that release of those records "could reasonably be expected to interfere with enforcement proceedings."
- HUD Secretary Alphonso Jackson has a copy of the IG's report, said spokesman Douglas P. Duvall. "After reviewing it, we'll decide on what if any actions need to be taken," Duvall said. "We're not reviewing this report necessarily for action," he added. "We're reviewing it because the IG gave it to us for review."
- OFHEO spokeswoman Stefanie Mullin said that as far as she knew, no one at the agency has received a copy of the IG's report and declined to comment further.
- Leanne Boyer, a spokeswoman for Bond, said she didn't know when Bond might release the report. "The senator has not had the opportunity to review it in depth, being busy with prior commitments," Boyer said.

- In April, Bond asked HUD's IG to assess whether OFHEO's public statements about an ongoing examination of Fannie Mae's accounting "reflect any inappropriate or undue political influence in the examination process." Bond criticized OFHEO for a March statement that the agency' review could lead to a restatement of Fannie Mae's past financial results, which was contained in the agency's quarterly assessment of the adequacy of Fannie Mae's capital, a financial cushion the company must maintain. The timing of OFHEO's March statement "appears to be a cynical attempt to unfairly influence the political process" as the Senate Banking Committee was preparing to draft legislation to create a more powerful regulator for Fannie Mae, Bond wrote in a letter to the IG. (*Washington Post*, David S. Hilzenrath, 10/14/04)

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| HUD to declassify some GSE data |
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- On October 4, HUD published a final rule that would reclassify early next year certain data from Fannie Mae and Freddie Mac that has been considered proprietary. The rule makes a number of changes to the "proprietary classification" of certain single-family and multifamily mortgage elements. The information HUD plans to release includes data on whether a mortgage purchased by a GSE was originated in a metropolitan or rural area, the purpose of the loan, and the borrower's race and national origin. HUD will start making the data available next year on its public database. By making more data publicly available, HUD will give researchers a better grasp on how the GSEs contribute to homeownership opportunities. (*American Banker*, 10/14/04; *National Mortgage News*, 10/11/04)

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| If we can't trust the GSE's accounting -- how can we rely on their underwriting systems? |
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- Josh Rosner, an analyst at Medley Global Advisors, points out that Fannie Mae and Freddie Mac have come to dominate all aspects of the mortgage business. The GSEs are now the primary source of software programs used by banks for underwriting mortgages, appraising properties and working out problem loans. Rosner writes, "Are the software programs too lenient?" With Fannie Mae's regulator severely questioning the accounting and risk management systems of Fannie Mae and Freddie Mac, Rosner suggests that the GSEs' other systems - like these software programs - could be designed to produce earnings growth. How can we trust these systems?
- "Investors and policymakers need to call into question all of the systems they put into place - automated underwriting and automated appraisal systems on the front end and loss mitigation systems on the back end," he said. "Were they put into place with safety and soundness as the goal, or with growth as the driver? And were they properly stress tested? And by whom?" The U.S. economy has a lot riding on these systems. Five years ago, there were more than a half-dozen automated underwriting systems that banks commonly used in originating mortgages. Today, the Fannie Mae and Freddie Mac systems dominate.

- Robert B. Reich, the former secretary of labor in the Clinton administration, has also voiced his concerns about the GSEs' mortgage underwriting systems. Reich writes, "If the mortgage giants own ways of assessing its financial risks are weak, then we better start worrying about the systems in place for gauging mortgage underwriting risks across the nation." (*New York Times*, Gretchen Morgenson, 10/03/04; *Newsday*, Robert B. Reich, 10/06/04)

Fannie Mae

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| Fannie Mae will delay its release of 3 rd quarter results |
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- Fannie Mae announced that it will delay releasing its third quarter earnings in October and will "actively seek" to meet the SEC's deadline in filing its regular quarterly statement by November 15. Fannie's delay is a departure from its usual practice of releasing earnings to investors about two weeks following the close of the quarter, which ended September 30. Previously, Fannie Mae had filed its quarter reports with the SEC on an accelerated basis, due November 10 for the third quarter. Instead, the company will file its third quarter 10Q on November 15th for "non-accelerated filers," a designation for smaller companies or new registrants with the SEC.
- Fannie Mae spokeswoman Jayne Shontell said Fannie Mae will "actively seek to file within this time frame" of November 15, apparently leaving open the possibility that the company could miss the deadline. Fannie officials would not say what prompted the delay of its earnings release. In light of OFHEO's recent allegations of accounting manipulation by the company, Fannie's move raises questions about whether the GSE is preparing to restate its earnings. Spokesmen for OFHEO and the SEC declined to comment on the matter. (*Dow Jones Newswire*, Dawn Kopecki, 10/14/04; *Washington Post*, David S. Hilzenrath and Carrie Johnson, 10/15/04)

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| SEC launches a formal investigation of Fannie Mae |
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- The SEC's inquiry into the accounting practices at Fannie Mae has "escalated" to a formal investigation after the SEC voted to provide agency staff the power to subpoena documents and testimony from witnesses, said sources briefed on the investigation. (*Washington Post*, David S. Hilzenrath and Carrie Johnson, 10/15/04)

- In its fight with OFHEO, Fannie Mae has turned to the SEC in hopes of finding a new ally in the interpretation of accounting rules FAS 91 and FAS 133, which the company's executives described in recent testimony before Congress as unwieldy in their complexity and open to wide discretion and judgment. In contrast, OFHEO director Armando Falcon told the panel, "We feel very strongly that these issues are black-and-white accounting issues. These are not issues of interpretation" The SEC will make the final determination on these accounting issues.
- Donald Nicolaisen, the agency's chief accountant, has the primary responsibility for making the SEC's decision in consultation with attorneys in the SEC's enforcement division. Nicolaisen is considered as one of the nation's foremost experts on the accounting rules for financial-services companies. Before joining the SEC last year, Nicolaisen was a partner at PricewaterhouseCoopers LLP, where he audited J.P. Morgan Chase & Co., another prolific user of derivatives. In an interview with Associated Press, SEC chairman William Donaldson affirmed the SEC's role as the final authority on accounting rules, saying questions related to Fannie Mae's accounting "will ultimately be determined by the SEC."
- According to people familiar with the SEC's inquiry into Fannie's accounting, the SEC's staff may need several months before it is ready to decide whether Fannie needs to restate. While this delay gives Fannie time to rally longtime allies in Congress, the company faces significant challenges in winning its appeal. In an editorial, the *Washington Post* wrote, "It could be a year or more before the SEC ... can pass a final judgment –plenty of time for Fannie to shape a political and legal settlement that ensures its profitable survival while avoiding disruption to housing and credit markets."
- According to *BusinessWeek*, one SEC official said the agency will give Fannie a chance to make its best case regarding the accounting allegations made by OFHEO. The SEC could differ with what may be OFHEO's most damaging charge -- that Fannie's hedge accounting is improper, said the SEC official. Fannie uses hedge accounting to keep the swings in asset value out of its earnings. But to do so, Fannie must routinely test whether the derivatives are properly matched to the assets they're hedging. OFHEO alleges that Fannie failed to do those tests. "Their approach is so complicated and so large that they lost track," says James Midanek, an investment manager at Pak Advisors in Walnut Creek, CA. OFHEO alleges that Fannie misapplied the rules since 2001 and wants the SEC to order it to stop using hedge accounting. If the SEC concurs, some \$7 billion in net losses in the derivatives portfolio must be subtracted from income which would decimate Fannie's net income of \$7.9 billion in 2003. Instead, the SEC could give Fannie a chance to adopt procedures to make sure its hedging is done properly. "We could say 'go and sin no more,'" said the SEC official.

- The second most serious charge is that Fannie delayed recognizing certain expenses -- largely prepaid interest -- if they were below a threshold, a practice which OFHEO says is inconsistent with GAAP. However, the SEC may beg to differ, since other companies often make similar judgments based on whether a dollar amount is “material.” The SEC could “wave off” the charge, unless Fannie intended to manage earnings or create a cookie jar reserve. “It gets into a whole lot of judgment between the auditor and the [company],” said one SEC official. “You wouldn’t necessarily do your accounting down to the last dollar.” Fannie’s intentions will be the focus of the SEC’s review of the \$27 million in 1998 bonuses. If OFHEO uncovers more cases where earnings management helped executives hit performance goals in order to get bonuses and stock options, the SEC may bring an enforcement case.
- *BusinessWeek* writes, “Washington is abuzz over Falcon’s chutzpah and the merits of his case. Says Stanley Sporkin, a retired federal judge and ex-SEC enforcement director now advising OFHEO: “More than any other case I’ve seen, it’s all there.” But OFHEO isn’t taking any chances. After all, it hired Sporkin for his deep connections within the SEC. And on September 29, he and Falcon met with SEC Enforcement Director Stephen M. Cutler. With the forces massing on both sides, it could be a long and bitter battle.”
- Accounting experts say the SEC could find in favor of Fannie on some issues, but not on others. OFHEO’s claim that Fannie did not account properly for its derivatives transactions is a grey area, said Itzhak Sharav, an accounting professor at Columbia Business School. “The composition of a reliable fair value measurement technique is still in the ‘work in process’ stage,” Sharav said. But the allegation that Fannie massaged its income to meet earnings goals appears to be a “clear cut” case of income manipulation, he added. “Needless to say, in this post-Enron period, such tactics should not be tolerated, and those who are found to have engaged in them should bear the consequences.”
- “The major risk facing Fannie is that by tainting a certain portion of the portfolio with redesignations and improper documentation, it may well lose hedge accounting for the whole derivatives portfolio,” said Gerald Lucas, a bond strategist at Banc of America Securities, New York. In 2003, Fannie’s amount of derivatives not designated for hedge accounting under FAS 133 was minimal. In January it began rising from \$43 million and reached \$51 billion at the end of March. This number declined to \$14 billion at the end of June, suggesting that Fannie has been terminating a lot of the swaps, traders said. “The fact that Fannie Mae has been pulling a large amount of swaps out of FAS 133 hedge accounting shows that it agrees with what OFHEO is saying, and it may have much more to do,” Lucas said. If OFHEO’s position is confirmed, JP Morgan analysts think Fannie Mae eventually may have to restate earnings to transfer large losses over the past few years out of AOCI and into income.
- Analyst Jim Vogel of FTN Capital Markets said in reviewing Fannie Mae’s alleged accounting violations that the SEC now occupies the “hot seat.” Vogel said, “If the

SEC agrees with OFHEO and brings about an earnings restatement, it will be challenging the audit conclusions of the firm that handles four of the largest financial institutions in the country. If the SEC passes on most of Fannie's accounting choices, then it would be a devastating blow to the credibility of the government regulator of two very important borrowers in the capital markets." He added that the SEC under that scenario also might have to worry about charges from congressional critics of Fannie Mae and Freddie Mac (FRE) that it "let Fannie off the hook." He concluded, "Regardless of the SEC's accounting conclusions in this matter, Fannie Mae will carry the scars of this fight for years. In essence, no one ever wins a public fight with its regulator." (*Wall Street Journal*, Jonathan Weil and John D. McKinnon, 10/12/04; *Dow Jones International News*, John Connor, 10/07/04; *Associated Press*, Marcy Gordon, 10/12/04; *Business Week*, Paula Dwyer and Amy Borrus, 10/11/04; *Financial Times*, Jenny Wiggins, 10/11/04; *Wall Street Journal*, 10/05/04; *Washington Post*, 10/03/04)

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| Will the SEC hold Fannie Mae to the same standards as National City Bank? |
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- On October 6, 2004, National City Bank released the following statement concerning the company's financial restatement: "The [Bank's] restatement is in response to comments from the staff of the SEC concerning the technical application of effectiveness tests under FAS 133 relating to hedging programs for mortgage servicing rights and loans held for sale. While not questioning the economic effectiveness of the hedging programs, the SEC staff believed that in some situations the contemporaneous testing evidence needed to be more robust than had been in place at the time in order to qualify for special hedge accounting under FAS 133. The restatement primarily changes the timing of recognition of changes in the fair value of loans held for sale and mortgage servicing rights in the financial statements, moving mortgage revenue and net income among several quarters and between years during the three-year period ended December 31, 2003. FAS 133 is a complex accounting standard subject to different interpretations relating to its application. The SEC staff had an interpretation different from that previously applied by National City. The change in application of the FAS 133 effectiveness tests had no effect on the economic results of hedging activities or cash flows for any period, and no significant impact to the balance sheet at December 31, 2003." (*National City Bank Press Release*, 10/06/04)

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| Department of Justice probe begins and Fannie Mae "lawyers up" |
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- The Department of Justice has formally notified Fannie Mae that it has begun a criminal investigation into the company's accounting practices, according to a recent 8-K filing by Fannie Mae with the SEC. Fannie Mae has been instructed not to destroy key documents "relating to matters discussed in the [OFHEO] report." Fannie Mae also acknowledged in the filing that the Attorney General of Ohio has begun an investigation on behalf of Ohio public pension funds that have investments in the

company. According to the 8-K, eight separate class-action lawsuits are also being prepared against Fannie Mae.

- Fannie has retained some of Washington's highest-priced securities and white-collar criminal attorneys to defend it against OFHEO's charges, mounting shareholder lawsuits and in related probes by the Department of Justice and the SEC. Fannie has hired at least two of Enron's top defense firms, Wilmer Cutler Pickering and Skadden, Arps, Slate, Meagher & Flom, and has several other top firms on regular retainer, which company spokespeople declined to name. Wilmer Cutler is one of the top securities litigation law firms in the country, which maintains extremely close ties to the SEC after hiring about 20 former SEC attorneys over the last decade. Partner William McLucas led the SEC as its long-time enforcement chief in numerous high-profile investigations, including its case against notorious junk bond trader Michael Milken. McLucas also represented Enron Corp.'s directors as the board's lead investigator in its internal probe of Enron's books.
- Fannie has hired white collar criminal defense attorney Robert Bennett at Skadden Arps, who led the firm's defense of Enron Corp. and HealthSouth Corp. Bennett is most famous for his work defending former President Bill Clinton against Paula Jones' sexual harassment charges.
- Fannie's board has also hired former Senator Warren B. Rudman, Republican of New Hampshire, who is now a partner in Paul, Weiss, Rifkind, Wharton & Garrison, to lead an independent investigation into OFHEO's allegations. Fannie also employs, directly or through its legal counsel, the company's long-time auditor KPMG LLP and Ernst & Young LLP to defend its accounting practices in the OFHEO investigation.
- Fannie CEO Franklin Raines has retained Robert Barnett of Williams & Connolly to represent him personally. Barnett's clients are a "Who's Who of Washington elite," including Bill and Hillary Clinton, Madeleine Albright, Queen Noor of Jordan and James Baker. Williams & Connolly also represents Freddie Mac's former CEO Leland Brendsel in a separate accounting scandal and OFHEO charges there.
- According to the *Wall Street Journal*, Fannie Mae had more than 50 people working full-time on the OFHEO investigation as of this summer, a number company officials didn't dispute. In comparison, OFHEO had a staff of less than 20 dedicated to Fannie's investigation over the last several months.
- OFHEO has hired its own team of top attorneys and accounting experts to aide in its probe at Fannie, including Stanley Sporkin, a certified public accountant and partner at Weil, Gotshal & Manges. The former U.S. judge is a legendary long-time SEC enforcement director who has mentored some of Washington's top securities litigation attorneys, including many of Fannie Mae's outside attorneys at Wilmer Cutler & Pickering.

- OFHEO’s team of outside accountants at Deloitte & Touche LLP is lead by Enron investigator Robert Maxant and Lisa Choi, a former Federal Reserve bank examiner with an expertise in derivatives and fixed-income trading. Maxant worked with Wilmer’s McLucas in 2001 after McLucas tapped Deloitte in 2001 to help in the Enron probe. Maxant was Deloitte’s lead partner in that investigation. (*Dow Jones International News*, Dawn Kopecki, 10/12/04)

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| Fannie’s hedging deals may result in criminal complaint against Fannie |
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- Peter Eavis writes on *TheStreet.com*, “The OFHEO report on Fannie makes a simple, but chilling, allegation: Fannie has claimed close hedging relationships for most of its derivatives and thus kept losses on them out of earnings, but it appears to OFHEO that most of those derivatives don’t in fact qualify for exclusion. In other words, it appears that Fannie has done what FASB always feared, which is wrongfully claiming that loss-making derivatives deserve to be kept out of earnings to make the company look stronger than it really is.”
- “What might be the reasons for Fannie choosing this possible path? The best likely explanation so far is that Fannie hated FAS 133 so much that it never seriously set out to implement it. Maybe it thought it was too big to have to use FAS 133 properly. After all, Fannie may never have set out to specifically hide losses. The OFHEO report has a memo that shows that the chief guiding principle for FAS 133 implementation was to limit volatility in earnings, i.e., to protect earnings against both gains and losses on derivatives. Most accounting-abuse cases start out at the top of a slippery slope. The first infraction might seem rather inconsequential, like ‘limiting volatility.’”
- “But this possibly deliberate misapplication of FAS 133 could have come in handy when losses, and not gains, started to pile up on Fannie’s derivatives after the Federal Reserve slashed interest rates following the September 11, 2001, attacks. Fannie, unlike GSE sibling Freddie Mac, was inadequately hedged for lower rates, and failed to get proper protection for the new low-rate environment. As a result, derivatives losses continued to balloon, and losses on FAS 133-related derivatives climbed to dangerous levels in 2002 and 2003. Did earnings get hurt in the period when the huge losses were sustained? Nope, because of the way Fannie applied FAS 133.”
- “And FAS 133 wasn’t the only area in which Fannie appears to have made grave missteps. OFHEO has shown in scrupulous detail how another rule, called FAS 91, was allegedly misapplied to smooth out earnings. An ex-Fannie employee named Roger Barnes aided that segment of the OFHEO report. And in testimony before the House committee hearing last week, Barnes described what he saw as the culture within key accounting units at Fannie. ‘The atmosphere and culture...is one of intimidation, restraint of dissenting opinions, and pressure to be part of the ‘Team,’ giving Chairman Franklin Raines and Vice Chairman Tim Howard the numbers the Office of the Chairman desired to please the markets,’ according to Barnes. If the

office of the chairman did in fact misuse FAS 91 to help earnings, there is every reason to suppose that it could have done the same with FAS 133.”

- “Fannie said ...that the Justice Department told the company “to preserve certain documents, including documents relating to the matters discussed in the OFHEO report.” No doubt the feds are heading straight for the FAS 133 file.” (*TheStreet.com*, Peter Eavis, 10/13/04)

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| Fannie Mae’s management should be removed NOW |
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- James Cramer wrote at *RealMoney.com*, “The more I think about the guts of these Fannie Mae executives, the more I am sick to my stomach about the way they are handling themselves. Their regulator finally does a first-rate job analyzing the problems Fannie has and what does Fannie do? It blasts the regulator! The gall of that is astounding. Can you imagine today if *The New York Times* issued a statement saying, ‘SEC, take your subscription inquiry and shove it!’ Can you imagine Chiron saying to the Justice Department, ‘We aren’t cooperating with your vaccine inquiry. In fact, we are ripping up the subpoena because do you know how hard we work to try to help save lives here?’ Can you imagine if Computer Associates just said, ‘The SEC has no right to look at our books because they are incompetent to analyze this stuff and we are just going to ignore them’? Chaos. We’d have utter chaos.”
- “But the Fannie Mae folks have gotten away with it so far. The press has taken their derisive comments about their regulator as if that was just par for the course, as if everyone blasted their regulators when they ask a lot of questions that are a nuisance and raise worries about capital shortages and earnings management. In fact, the conventional press’s tone to date goes something like this: ‘The inane regulators at Office of Federal Housing Enterprise Oversight have besmirched the terrific reputations of Frank Raines and Tim Howard.’ They have been almost apologetic that Raines and Howard had to be put through the embarrassment of the report when they are so busy building cheap homes for the poor.”
- “Look, Fannie Mae’s a hedge fund gone wild, it is a total run amok make-up-the-numbers company that reminds me of the portrayal of the American military in Dr. Strangelove. And I know why. The commentators and writers simply haven’t read the *%#\$^&@^(report. I don’t blame them; it took me six hours to read, six hours that I wish I had spent doing something else. I only read it because David Darst from Morgan Stanley -- my former boss -- insisted that I read it. It’s an amazing report, covering only one small part of the abuses that this company seems to have routinely committed. If you had read the report, you would know that Fannie Mae simply makes it all up as it goes along. It’s an unbelievable report. That anyone would challenge it, let alone attack the authors as Raines and Company are doing, is the height of lunacy, just preposterous. They should be thanking OFHEO, not stoning them.”

- “To me, it just proves even more so that Fannie Mae is run by a bunch of actors and politicians. And it’s so darned big and out of control that nobody even has a clue how to rein it in anymore. I hope that somewhere, someone in the government will take aside a retired derivative expert from Goldman Sachs or Morgan Stanley or Merrill Lynch or Smith Barney and read the report with them and recognize all of us who trade this stuff know: **The executives from Fannie Mae must be removed now and a new team, a team that understands that Fannie is not above the law, should be put in place in their stead. Period. End of story.**” (*RealMoney.com*, James J. Cramer, 10/13/04)
- “Investors are feeling as though Frank Raines didn’t level with them with respect to the issues that Fannie Mae had,” said Lynn Turner, a former chief accountant at the SEC. “It is very difficult for a board to support a CEO who has damaged his credibility with investors.” (*Associated Press*, 10/05/04)
- *The Wall Street Journal* writes in an October 4th editorial, “With the Justice Department already starting a criminal probe, we find it hard to comprehend that the Fannie board still believes that investors can trust its management team.” (*Wall Street Journal*, 10/04/04)
- In a editorial, *The Economist* writes, “Fannie Mae was thought to be better at this sort of stuff. For a year or more, ever since regulators started looking into the company, there have been suspicions that it is not. Now OFHEO’s report has shown that those suspicions were justified--and the only surprise is that Fannie Mae’s top executives have not yet gone the way of Freddie Mac’s.” (*The Economist*, 10/04/04)
- In a September 29th appearance on CNBC’s Kudlow & Cramer, Representative Barney Frank (D-MA) said, “My role will be, as it has been, to try and protect the housing function. Individuals (Fannie Mae management) are not the people that we’re trying to protect here.” (*Kudlow & Cramer*, Representative Barney Frank, 09/29/04)
- “Mr. Howard and Fannie Mae’s chief executive, Franklin D. Raines, have left a long trail of embittered opponents who have complained about high-handedness. “They are a study of power in Washington,” said Andrew M. Cuomo, who battled Fannie Mae on housing issues as HUD secretary for the Clinton administration. “Once the myth of invincibility is gone, the act crumbles.” (*New York Times*, 10/03/04)

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| Just how “independent” are Fannie’s outside board members? |
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- Fannie Mae’s “outside” board members have the responsibility of evaluating the company’s management team in light of serious management issues raised by the OFHEO examination report. But just how independent are Fannie Mae’s outside board members? The *Washington Post* examined closely the company’s board

members and their working relationships and ties to Fannie Mae, which raises serious questions about their independence.

- Fannie Mae chairman and chief executive Franklin D. Raines and Fannie board member Frederic V. Malek have worked on assembling a high-powered ownership group seeking to buy a major league baseball team for Washington DC. The close connections between Raines and Malek are part of a broader web of relationships that link Fannie Mae, the Fannie Mae Foundation, Raines and some outside directors.
- Ann McLaughlin Korologos, who testified as the company's lead outside director, is one of two independent directors who hold senior posts at organizations that have received hundreds of thousands of dollars from the Fannie Mae Foundation, the company's philanthropic arm which Raines also chairs. Since joining the Fannie Mae board a 10 years ago, Korologos has served as a top official of the District-based Aspen Institute. Since Korologos joined the company's board, the Fannie Mae Foundation contributed \$280,000 to the Aspen Institute, including \$135,000 in grants in 2002. Korologos is also head of a committee of outside Fannie directors overseeing an internal probe of the alleged wrongdoing. (In addition to serving on Fannie's board, Korologos serves on five other major corporate boards, chairs the California-based Rand Corp., and lives in Brussels with her husband, the Bush administration's ambassador to Belgium.)
- Fannie Mae director H. Patrick Swygert serves as president of Howard University, which has received grants of more than \$450,000 from the Fannie Mae Foundation since 1996. The Foundation also contributed several thousand dollars to pay expenses for Swygert's inauguration as Howard's president in 1996 and hired Swygert's son, who is no longer with the company, as an employee.
- Another issue complicating the independence of Fannie Mae board members is that a number of outside directors work for profit making enterprises that have had business relationships with the company. Donald B. Marron, formerly headed Paine Webber Group Inc. and was chairman of UBS Paine Webber Inc. when he joined the Fannie Mae board in 2001. Two other Fannie Mae outside directors, Joe K. Pickett and Stephen B. Ashley, come from the mortgage banking industry, which has had extensive business and political dealings with the company. Board member Kenneth M. Duberstein, has worked for Fannie Mae as a contract lobbyist since 1991, being paid \$375,000 annually in recent years. As former chief of staff to President Ronald Reagan, Duberstein is not listed as an independent director because of his direct business relationship. He has been a director since 1998.
- The remaining two non-management directors, Thomas P. Gerrity, a professor and former dean of the Wharton School, who is chairman of the audit committee, and Leslie Rahl, an expert in a type of complex financing the company uses, appear to have no financial ties to Fannie Mae, the Fannie Mae Foundation or Raines, other than the director fees they receive.

- “I don’t know how you can do a good job of evaluating the CEO and be in business with him in a side deal at the same time, particularly now when the CEO’s tenure is very much in question,” said Nell Minow, editor of the Corporate Library, which tracks corporate boards. “I think that shows poor judgment on both of their parts.” Minow added, “There is a pattern there.” By giving grants to entities headed by outside directors, the Fannie Mae Foundation “creates another layer of real and apparent conflicts and another reason to be less than independent in oversight.”
- Patrick S. McGurn, special counsel of Institutional Shareholder Services, said the links among Raines, the Fannie Mae Foundation and the company’s outside directors are “red flags” for investors.
- While board members declined to be interviewed for this story, Fannie Mae spokesman Charles Greener strongly defended the board and the company, saying Fannie Mae has received high marks from corporate governance groups reviewing its policies and practices in recent years.
- Last January, Fannie Mae adopted new standards for who would be classified as independent directors on its board. Fannie Mae directors are not considered independent if they receive any payment from Fannie Mae other than fees for board service or if the Fannie Mae Foundation contributes more than \$100,000 a year to a charity affiliated with a director.
- Fannie Mae directors are paid \$35,000 annually for serving on the board, or \$45,000 if they chair a committee. In addition, they receive thousands of dollars for attending board sessions or participating by phone in meetings. This year, according to company filings, the outside directors also received \$191,568 in restricted stock and options to buy an additional 4,000 shares. (*Washington Post*, David A. Vise and Jeffrey H. Birnbaum, 10/06/04)

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| Why is Fannie in trouble? |
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- Bill Mann writes at the *MotleyFool.com*, “Want to know why Fannie Mae is in trouble? It’s simple enough: This company, more than any other in America, is run by, in the interests of, and with the protection from politicians, not businesspeople. Yes, I know that it seems crazy, given the shambles of ethics extant in Corporate America, to crave their leadership, but there you go. There is no company that has more powerful lobbying in Washington than Fannie Mae. Really, the only thing more absurd than Corporate America wagging its finger about shareholder interests is a bunch of politicians wagging their fingers about crooked accounting. Fannie Mae’s long been a cat in desperate need of having a bell tied to it.” (*MotleyFool.com*, Bill Mann, 10/06/04)

Is the “Frankenstein-like” Fannie too powerful to be regulated?

- Does Congress have the stomach to rein in Fannie Mae by passing meaningful regulatory reform that creates a “world class regulator?” Only time will tell. With its army of high-powered, high paid lobbyists, its board and executive ranks stacked with Washington power brokers of all political stripes, a mortgage portfolio of \$1 trillion and an “apple pie core mission” of helping people afford the American dream, Fannie Mae has long been considered untouchable. Representative Richard Baker (R-LA), chairman of the House subcommittee which oversees Fannie Mae, describes the company as “...Frankenstein-like, seemingly grown so powerful that it can intimidate and arrogantly flout all accountability to the very government that created it.” In a recent appearance on *Bloomberg Television*, Representative Christopher Shays (R-CT) said “The bottom line is you have Fannie Mae, that isn’t by law under the 33 or 34 Acts, they’re not under Sarbanes-Oxley, basically, and they play by their own rule.” On CNBC’s *Kudlow & Cramer*, Shays said, “I have been trying for years just to make some sense out of why we should have both of these organizations outside basic law.”
- “The historical perspective is that Fannie and Freddie were 800-pound gorillas and nobody could take them on,” said Wright Andrews, a lobbyist who once worked for FM Policy Focus, a group of Fannie Mae competitors. “With this new issue of [OFHEO’s examination of] Fannie, people are saying, ‘Wait a minute, maybe the emperor has no clothes and we need to take a much closer look.’” Ed Rothschild, a lobbyist hired by FM Policy Focus, wrote Congressional members, “The current situation provides an opportunity for Congress to fix” regulation of Fannie Mae and Freddie Mac, and argues that the two GSEs “have been hiding behind their special privileges, such as exemption from full registration with the SEC, while simultaneously manipulating their accounting to maximize profits and reward senior executives.”
- Others in Washington note that Fannie Mae may be wounded, but its influence should not be underestimated. Fannie Mae has never been slow when it comes to protecting its domain and striking out at its enemies. “You can never lose sight that Fannie Mae and Freddie Mac have a greater incentive than any player in Washington to maintain their political influence,” said Jonathan Kopell, an assistant professor of politics at the Yale School of Management. “Everything about their business model is subject to change if Congress chooses to change it.” And, Fannie Mae is an expert at courting lawmakers. Since 1998, the company has contributed \$5.2 million to federal candidates and political parties, reports the Center for Responsive Politics.
- The company derives much of its influence by collecting an A list of Washington’s influence peddlers, including its top Congressional lobbyist Duane Duncan, former chief of staff for Representative Richard Baker (R-LA) and Michele Davis, the Fannie’s vice president for regulatory policy, worked in the Treasury Department under Paul H. O’Neill. Fannie Mae CEO Raines served as budget director under President Clinton; his predecessor, James A. Johnson, is a prominent Democrat who

was an adviser to Vice President Walter Mondale and now to the Kerry campaign. Other former and current officials with Fannie include Frederic V. Malek, who along with President Bush was part owner of the Texas Rangers baseball team; Robert B. Zoellick, currently the United States trade representative; Jamie Gorelick, a deputy attorney general in the Clinton administration and a member of the 9/11 Commission; and Lawrence M. Small, the secretary of the Smithsonian Institution. In addition to its own staff of 10 or so lobbyists, Fannie Mae spent \$1.2 million for the services of 60 Washington lobbyists at 16 different firms through July, according to Senate filings.

- Fannie Mae's political heavyweights have not made the company less agile on Capital Hill. For example, a Clinton administration official from the OMB mentioned to a senior Treasury Department official that the White House was considering removing an exemption from Fannie and Freddie and asked him not to mention that to anyone. "Within 15 minutes of the person leaving the office, the phone was ringing off the hook," with callers expressing concern, said the OMB official who spoken on condition of anonymity for fear of retaliation from Fannie Mae.
- At a 1998 Christmas party, a Fannie Mae executive heard a tip that the Clinton administration was thinking of pushing a proposal to end the GSE's longstanding exemption from paying fees to the SEC when it registers its securities. Fannie Mae mobilized its troops, recalled executives from Christmas vacations, and "galvanized" dozens of mayors, lobbyists from the housing industry and lawmakers, including members of the Congressional Black Caucus, to interrupt their holidays to call the White House and express displeasure at the proposal and its effect on low- and middle-income homeowners. In response to such pressure, the White House quietly shelved the proposal before it was made public.
- Fannie Mae has not been shy about using its deep pocketbook to undermine its competitors and critics. When Charlie Leonard was helping organize FM Policy Focus in 1999, he received a phone call from a Fannie Mae executive offering to double his compensation if he would instead come to work for Fannie Mae. "It was a very telling experience about how readily they were willing to spend money to prevent any organized opposition," said Leonard, a partner at Chlopak, Leonard Schechter, a public relations firm that does work with financial backers of FM Policy Focus. Within 48 hours of the group's interviewing two lobbying firms to do work for FM Policy Focus, Schechter said he received telephone calls informing him that Fannie Mae had hired both firms.
- Fannie Mae has also built a broad base of support in local communities and their political structure, which has been groomed through the Fannie Mae Foundation, the GSE's private nonprofit organization, and a network of satellite and 55 partnership offices. Through the Fannie Mae Foundation, the company has financially supported a wide range of charities ranging from the Alvin Ailey Dance Company and the Arena Stage in Washington to housing organizations like the Kansas City Neighborhood Alliance and the Los Angeles Housing Services. According to

Congressional staffers, Fannie's lobbyists can give just about any Congressional member of a map of their district showing how much Fannie has contributed through the company and its foundation.

- While Fannie Mae's influence may have been weakened by the recent accusations over its accounting, the GSE's opponents may not be in a position to capitalize on the company's stumble. Some Capitol Hill staff members say that Fannie's most vocal critics lack both the political organization and the coherent message to challenge the company that has always vigorously defended itself. Some of Fannie Mae's opponents had hoped that the two most influential critics of the company, Federal Reserve chairman Alan Greenspan and Treasury Secretary John W. Snow, would help lead the charge. Both men have remained largely silent, honoring Bush administration's policy of not making statements about pending enforcement actions.
- As Fannie faces its new challenges, some of the company's most stalwart allies and advocates appear to be distancing themselves from a company tarnished by investigations. The National Association of Home Builders, a \$100 million lobbying group that has often aligned its grass-roots membership of 215,000 with Fannie Mae, may be pulling back. Only time will tell.
- People who have worked with Fannie Mae believe the company will inevitably get ahead of the "pace of political change," especially if new regulation appears inevitable in the next Congressional session. "They'll embrace the process, but they'll work behind the scenes," said Michael Basham, a deputy assistant secretary of the Treasury in the first Bush administration, who oversaw the 1992 legislation that regulated Fannie Mae. "It's the classic, 'Don't pay attention to that man behind the screen.'" (*New York Times*, Jennifer Lee and Eric Dash, 10/06/04; *Wall Street Journal*, Representative Richard H. Baker (R-LA), 10/06/04; *Bloomberg News Television*, Representative Christopher Shays (R-CT), 10/06/04; *Kudlow & Cramer*, Representative Christopher Shays (R-CT), 10/06/04; *USA Today*, Pamela Fiawoo, 10/06/04)

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| Even in accounting, you get what you pay for |
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- There's a lesson that investors and corporate directors everywhere can take away from Fannie Mae's recent woes: You get what you pay for when it comes to audits. Fannie Mae's outside auditor since 1969, KPMG was paid \$1.4 million to audit Fannie's 2001 financial statements, \$2 million for its 2002 audit, and \$2.7 million for its 2003 audit.
- How can an accounting firm perform a quality audit on a highly complex financial company with \$1 trillion in assets for less than \$3 million? Some accounting specialists say that it probably can't be done. "I think it's crazy that anybody could expect Fannie to get a quality audit for that amount of money," said Randi Schultz, an accountant and analyst at proxy-advisory firm Glass Lewis & Co. in Broomfield,

CO. “I think the audit team would resort to taking a lot of shortcuts, and would probably end up making mistakes or missing important audit steps in the process.”

- Since the passage of Sarbanes-Oxley legislation in 2002, publicly held U.S. companies’ audit fees have risen sharply. While audit fees have remained surprisingly low at some companies, critics claim that auditors too often take a cost-effective streamlined approach that may not be sufficiently thorough.
- While Fannie’s audit fees have nearly doubled since 2001, the company’s fees look meager when compared to the higher audit fees paid by other large financial companies with complex financial statements. For example, Freddie Mac, paid PricewaterhouseCoopers LLP \$46.1 million for its 2003 audit, which was up from \$4.3 million the year before, when it hired PricewaterhouseCoopers to replace Arthur Andersen LLP. After changing auditors, Freddie disclosed that its new auditor had found widespread accounting manipulations, which prompted a costly restatement and a management shake-up. Freddie had \$803.4 billion of assets at December 31. With \$1.3 trillion of assets at December 31, Citigroup Inc. paid KPMG \$39.8 million for its 2003 audit. J.P. Morgan Chase & Co., with \$770.9 billion of assets at December 31, paid PricewaterhouseCoopers \$25.1 million for its 2003 audit. Fannie paid just slightly more for its 2003 audit than did Countrywide Financial Corp., even though the mortgage banker’s \$97.9 billion of assets at Dec. 31 were roughly one-tenth the size of Fannie’s.
- Daniel Goelzer, a member of the Public Company Accounting Oversight Board, has cautioned that the pressure to keep audit fees low had led major accounting firms to place more emphasis on “risk-based auditing,” which he said had “contributed to the erosion of trust in auditing.” In risk-based auditing, auditors plan their work based on judgments about which areas of a client’s financial reports are most prone to error or fraud. Perceived low-risk areas of accounting, like cash on the balance sheet, often get just a cursory review. Auditors typically rely more heavily on what management tells them and data from the client’s financial-information systems. Perceived high-risk areas receive more attention. Goelzer cautions that significant accounting problems may go unchecked if an auditor’s judgments about risk prove incorrect.
- While OFHEO’s September 22 report didn’t directly address the quality of KPMG’s audits, the exam’s findings raise questions about how KPMG could have missed basic accounting deficiencies at Fannie. (*Dow Jones International News*, Dawn Kopecki, 10/12/04; *Wall Street Journal*, Jonathan Weil, 10/06/04)

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| Fannie Mae CFO completes his last sales of Fannie stock |
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- Pursuant to a trading plan adopted on February 27th that allowed the sale of 92,800 shares of Fannie Mae stock obtained through the exercise of stock options, Fannie Mae Vice Chairman and CFO Tim Howard sold the remaining 1,800 shares of stock

under this plan for \$67.75 to \$69.00 each for options with strike prices of about \$18.63 each.

- OFHEO Director Armando Falcon testified before a House panel that his agency has been “monitoring all insider sales of the company and [we] are beginning to shift our examination of that.”
- A Fannie Mae attorney, who asked not to be identified, said Fannie decided not to restrict insider transactions when OFHEO initially notified the company of the pending probe last July because ‘at that time, [OFHEO] announced that it was a prudential matter,’ not that they thought anything was wrong. Company officials said Fannie instituted a wide-scale ‘black out’ period for most employees the on September 21, when OFHEO met with the board to review its preliminary examination report. According to the *Wall Street Journal*, “It’s unclear whether the blackout period is still in effect.” (*Dow Jones Chinese Financial Wire*, Dawn Kopecki and Jennifer Corbett Dooren, 10/06/04; *Dow Jones Corporate Filings Alert*, 10/08/04)

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| Wall Street ratings of Fannie’s stock raise questions (again) of the stock analysts’ “independence” |
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- According to *Thomson Financial*, Fannie Mae’s top five underwriters earned close to \$700 million in fees since 1999 from the company’s underwritings. That’s an important fact to keep in mind, when reading analysts’ reports on Fannie Mae’s stock. Perhaps that’s why 11 of 21 analysts who cover Fannie Mae, still recommended it as “buy” to their clients on October 6th. According to *Bloomberg News*, firms listing Fannie Mae as a “buy” or its equivalent, included Argus Research Co., A.G. Edwards, Bank of America, Bear, Stearns, Credit Suisse First Boston, Merrill Lynch, Piper Jaffray, Smith Barney, Sanford C. Bernstein, Susquehanna Financial, and UBS Securities. Follow the money...So much for the “new era of independence” for Wall Street analysts, promised by the Securities Industry Association president Marc Lackritz, who said Wall Street would ensure that “the quality and integrity of financial analysis is beyond reproach.”
- One of Fannie Mae’s biggest supporters, Sanford Bernstein’s Jonathan Gray, a member of the coveted *Institutional Investor’s* All-America Research Team since 1974, is recommending clients buy the company’s stock and has a \$98 price target. Gray dismisses OFHEO’s charges of questionable accounting at Fannie Mae as “implausible” and “unproven.” He said that OFHEO’s charge that Fannie hid billions in derivative losses in an account that would not affect earnings growth was due to the extreme complexity of the “controversial” accounting rule FASB 133, governing the proper valuation of derivatives and hedging instruments. “This rule has no objective standards for treating derivative valuations,” Gray said, which results in “a situation where almost every accounting firm is going to interpret this differently.”

Gray said a mistaken reading of the rule could force “most every major financial firm into regulatory capital problems.”

- On October 6th, Portales Partners’ Mark Agah had placed the only “sell” recommendation for Fannie stock. He initiated his sell rating in late January when the stock was at \$75 and has reiterated this recommendation every following quarter. Agah said he put the sell rating on because “it was clear from reading the filings that Fannie was playing games with their hedges.” He noted that the wide quarterly swings in the dollar value of Fannie Mae’s Other Comprehensive Income account clearly indicated, “something was wrong with their hedges,” particularly since interest rates remained in a tight range. Agah said that once he put a sell on the Fannie Mae, none of the company’s officers would return his phone calls. Agah said, “The stock will probably stick in a tight range here, but the next 10 point move will be down to \$55, not to \$75.” Agah has told clients he expects Raines and Howard will be forced to resign and that the restatement of prior earnings will force the recognition of “up to \$15 billion in losses.” At that point, “It’s just a point of how much Fannie has to reduce its portfolio by,” Agah said.
- In the *MotleyFool.com*, Bill Mann writes, “I believe that Fannie Mae is unanalyzable. Fannie Mae, like its sister company, Freddie Mac, uses extraordinarily complex financial statements, layers of derivatives, and has enjoyed years of poor regulatory oversight. Even before Fannie received a stunning and long overdue rebuke from its governmental overseers, it took a Herculean effort to be able to determine how much actual cash flow the company made in a given year. Greed and avarice in Fannie’s executive offices have brought scandal down on a setup that should have been by all rights pretty tough to screw up. What staggers me, though, is the fact that of 21 Wall Street analysts who cover Fannie Mae, 11 still recommend it as a “buy” to their clients. That’s unbelievable to me. This is a company that in the best of times has financial statements a Turing machine couldn’t decipher, is at the very beginning of uncovering a scandal that goes who knows how deep, is facing what could be a multiyear reformation, and has a management team that looks unlikely to survive the probing. It’s not so much that I think that most investors have no idea how to analyze Fannie Mae, it’s that I don’t believe that the analysts have much of a clue, either.” (*New York Sun*, Roderick Boyd, 10/06/04; *Newsweek*, Charles Gasparino, 10/18/04; *Washington Post*, Jerry Knight, 10/04/04; *MotleyFool.com*, Bill Mann, 10/06/04)

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| Is AVM technology finally being accepted by Fannie? |
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- *Mortgage Technology* writes, “True automated valuation model acceptance has been hindered due mostly to the fact that the government-sponsored enterprises will not accept AVMs in lieu of actual appraisals on purchase loans. However, all that appears to be changing as Fannie Mae has been accepting AVMs on vanilla purchase loans from both Countrywide and Bank of America for some time now, according to several mortgage technology sources. When asked to confirm this change of policy at

Fannie Mae both lenders refused comment. BofA did not return calls by press time and a spokesperson from Countrywide said, 'If anything is happening in that area with Fannie Mae it would be up to Fannie to make a statement. Countrywide won't comment.'

- Fannie Mae provided *Mortgage Technology* a “hedged” statement by saying, “We don’t comment on contracts or relationships with customers,” said a Fannie Mae spokesperson. “However, certain customers have unique processes and we try to accommodate them in some cases. So, in that respect it wouldn’t be unusual, but again we don’t comment on specific customer relationships.” *Mortgage Technology* writes, “Six executives from six different mortgage technology companies who do not want to be named confirmed that in fact Fannie has been accepted AVMs on purchase loans from Countrywide, Bank of America and other lenders as well. In fact, one of the sources went further to say that this practice has been going on for the past six months. In reference to what type of loans would qualify, one source said that Fannie was accepted AVMs on only vanilla purchase loans. Loans with relatively low risk, meaning good LTV and FICO data, are the papers impacted by this trend.” (*Mortgage Technology*, 10/01/04)

Fannie’s pursuit of the American Dream continues

- Minority home buyers are not an “emerging market,” as they are often described, Fannie Mae’s COO Dan Mudd, told 1,600 people attending the National Association of Hispanic Real Estate Professionals. “They are the future,” he said. “They are the future of the American dream.” Mudd noted that minorities are fueling the growth in the mortgage lending business, with minorities expected to account for more than 45% of all first-time home buyers by 2010. The Hispanic population will increase by 75%, the black population by 28% and the Asian population by 80% in the U.S by 2020, he said. As the nation’s largest minority group, Hispanics account for one out of every eight people in the U.S. and represent \$700 billion a year in buying power, a number expected to triple by 2010. Mudd added, 11 million Hispanic households, about 5.8 million are renters. “These are households we might want to reach out to with partnerships,” he said. Mudd announced at the convention that Fannie Mae plans to create 6 million first- time home buyers, including 1.8 million minority families, by 2014 , through its American Dream Commitment program. (*Rocky Mountain News*, John Rebchook, 10/06/04)

Presidential politics?

- A John Kerry victory in the coming presidential election would “abruptly improve the political climate” for Fannie Mae, said Jonathan Gray, an analyst with Sanford C. Bernstein. Fannie has the potential to raise per-share profit by an average of 10% to 11% a year for the next five years. Even if Bush wins the presidency and Fannie

faces regulatory or political changes, Gray is still predicting average annual profit growth of 5% to 6% for Fannie through 2008. (*The Globe and Mail*, 10/12/04)

- The Business Council said it erred when it said its member chief executives expect the economy to grow by a sluggish 2.1% next year. They actually expect growth of 4.5%. *The economist who prepared the report, David W. Berson, chief economist for Fannie Mae, blamed “a tabulating error.”* Berson said, “Today’s revision confirms that the outlook is considerably more positive than originally thought and provides better alignment between projected economic growth and the sales and profits anticipated for their own firms by the Council members in 2005.” [*More accounting troubles surface at Fannie Mae?*] (*Wall Street Journal*, 10/13/04)

Freddie Mac

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| Freddie Mac dismantles its broker dealer operation |
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- Freddie Mac’s Chairman and CEO Richard Syron’s “retrenchment” of the GSE advanced another step, as the government-sponsored enterprise said it would dismantle its Securities, Sales & Trading Group (SSTG), its broker-dealer operation, which had been a source of criticism. Critics argued that Freddie’s securities sales and trading group added to the GSE’s risk and profits without doing much to further its mission. By closing SSTG, Syron signaled that Freddie would become a less active trader of mortgage-backed securities. Syron’s move is part of a larger effort to refocus Freddie on its basic mission of supporting the mortgage market. The broker-dealer group had played a central role in Freddie’s accounting scandal.
- Over the next few months, Freddie’s SSTG will be wound down. Afterward, Freddie Mac will no longer make markets in its mortgage bonds. The Company will purchase mortgage-backed securities only to hold its retained portfolio and not for trading accounts. Freddie said its core businesses of buying, securitizing, and insuring mortgage assets would be its main tools to “support the liquidity and depth of the market” for its bonds.
- Observers said the move raised the question of whether SSTG ever played a central role in meeting Freddie’s mission, or only made the GSE more like a hedge fund. “If they were ever really questioned on it, Syron couldn’t justify it,” said Paul J. Miller with Friedman, Billings, Ramsey & Co. Inc.
- Freddie Mac spokesman Douglas Robinson would only repeat Syron’s quote from the press release that the new setup will be a more effective and efficient way of serving Freddie’s mission. Robinson would not comment on whether Freddie would lay off any of the group’s 100 staffers, but cited the transfer of some of SSTG’s functions as

a reason some employees may not be affected. In a related move, Freddie also said it would end a “money manager” program, through which investment advisers manage “a small portion of the company’s capital under prescribed investment guidelines.” On its web site, Freddie said that the investments are “primarily” in its mortgage bonds and the goal is to increase their liquidity.

- Many analysts saw Freddie Mac’s move to close SSTG as a sign that the company had decided it had pushed its luck far enough on Wall Street, since this group directly competed with the Street with trading mortgage-backed securities. The dealer has always been a thorn in the side of major bond brokers. “SSTG was set up to tap a niche market in areas where the Street was not going to focus its resources, period,” said a former SSTG executive, now a senior executive at a Wall Street firm. While SSTG covered a spectrum of institutional accounts, the group concentrated primarily on smaller mortgage investors that are traditionally less covered by Wall Street firms. When Wall Street’s bond business slowed this year, SSTG began to rankle the Street’s large firms who viewed SSTG as another competitor in a tightening market. (*American Banker*, Jody Shenn, 10/05/04; *New York Sun*, Roderick Boyd, 10/05/04; *Reuters News*, Aleksandrs Rozens)

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| Freddie Mac updates its proxy statement about a board nominee that is not yet independent |
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- Freddie Mac said one of its board nominees will not become independent of the company until the end of the year, in accordance with its corporate governance guidelines. Thomas S. Johnson, a candidate for election to Fannie’s board at the November 4 annual meeting, will be considered independent after his employment with North Fork Bancorp ends on December 31. Johnson was the former chairman and chief executive of GreenPoint Financial Corp., which was acquired by North Fork. Freddie Mac said each of the other 10 nominees for outside board positions are considered independent under its guidelines. (*Associated Press*, 10/06/04)

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| Court rules that Freddie Mac acts as lenders agent |
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- The U.S. District Court for the Eastern District of Pennsylvania has granted a Summary Judgment in to dismiss Freddie Mac in its entirety in the case of Donald Weidman v Federal Home Loan Mortgage Corporation (Civil Action No. 02-7990).
- The plaintiff, Weidman, charged Freddie Mac with violations of the Fair Credit Reporting Act (FCRA), claiming the company (1) violated FCRA requirements for assembling and evaluating consumer credit information; (2) violated the notice of adverse action requirements of FCRA; and (3) had no permissible purpose in obtaining credit information on the plaintiffs for a loan application that was denied.

- Freddie Mac licensed Loan Prospector (LP) to a mortgage lender who used LP to evaluate Weidman's loan application. As part of the licensing agreement, lenders agree to subscribe to the three major credit repositories (CRAs); to warrant that they will comply with all applicable laws; to confirm that they have a permissible purpose to access the credit reports; and to notify the applicant of any adverse action they may take. A LP report rates the application either "accept" or "caution." A "caution" rating requires that the lender manually underwrite the loan if they later wish to sell the loan to Freddie Mac.
- The Court held that Freddie Mac is not a "Credit Reporting Agency" because the Federal Trade Commission specifically held that "an agent or employee that obtains credit reports does not become a CRA by sharing such reports with its principle or employer" and that as a "joint user" of the credit reports, Freddie had no "notice of adverse action" requirement. The Court also held that only the lender, not Freddie Mac, was capable of taking "Adverse Action" against the borrower. Further, the Court held that Freddie, as agent for the lender, did have permissible purpose to obtain the credit information. (*United States District Court for the Eastern District of Pennsylvania, Memorandum and Order: Donald Weidman v. Federal Home Loan Mortgage Corporation, Civil Action No. 02-7990; September 2004*)

Federal Home Loan Banks

Finance Board is paying more attention to accounting issues in FHLBs

- Mindful of the accounting firestorms that erupted at Freddie Mac and Fannie Mae, the Federal Housing Finance Board's regulators have heightened their attention to accounting issues within the FHLB system. Carter Wood, a spokesman for Federal Housing Finance Board Chairman Alicia Castaneda, said the agency already was attentive to accounting issues involving derivatives and hedging, but that developments at the Fannie and Freddie "have heightened our attention" to the FHLB system's accounting issues. On June 30th, the FHLB-Chicago entered into an agreement with the Finance Board to adopt a revised business plan and to take other steps, such as retaining outside consultants to review and report on matters including "accounting, recordkeeping, and reporting practices and controls."
- In September, the FHLB-Seattle announced that it was discontinuing offering derivatives as a stand-alone product, saying that "declining use by our members and increasingly complex accounting requirements for derivatives have combined to offset the value of this offering to the bank and its members." (*Dow Jones International News*, John Connor, 10/13/04)

Ronald Rosenfeld nominated to Federal Housing Finance Board

- President George W. Bush has nominated Ronald Rosenfeld to be a member of the Federal Housing Finance Board. Rosenfeld, currently president of Ginnie Mae, was nominated for the remainder of the term expiring in early 2009 of John Korsmo, the former board chairman who resigned in March. Rosenfeld's nomination has been sent to the Senate for confirmation. (*Dow Jones International News*, 10/12/04)

Federal Housing Finance Board names chief information officer

- Thomas J. Leach has been named Chief Information Officer (CIO) for the Federal Housing Finance Board, said Chairman Alicia R. Castaneda. Leach comes to the agency from Advanced Technology Systems of McLean, Va., which has worked for the past 18 months as Project Manager at the Finance Board. He has been employed by Advanced Technology Systems for 14 years. As CIO, Leach will be responsible for all day-to-day Information Technology activities at the agency, including information security, application development and the planned redesign of the Finance Board's Internet site. He will also oversee the development and

implementation of IT policy. Leach joined the Finance Board on October 18.
(*Federal Housing Finance Board press release, 10/07/04*)

International GSEs

Fannie Mae and Freddie Mac are “the old fashioned approach”

- Chancellor Gordon Brown has left open the option for Britain to model its mortgage market on America, despite the accounting scandals which have engulfed Fannie Mae and Freddie Mac. Brown favors long-term, fixed-rate mortgages to shield British homeowners from fluctuating rates. He told *Financial Mail*, “We are not modeling our system on one institution and the debate on housing finance in the UK goes on. But you cannot generalize from the problems of one instance.” The European Mortgage Finance Agency, a trade body funded by banks, has been working to promote a European version of Fannie Mae. (*The Mail on Sunday, 10/03/04*)

Sallie Mae

Congress adjusts policy on student loans

- Congress has ended a promise to banks that has allowed them to reap billions of dollars in profits from a federal college aid program. Legislation halting the federal guarantee of a 9.5% rate of return to lenders of certain student loans was passed by the House and Senate and has been sent to President Bush for his signature. The bill has been endorsed by the White House.
- The 9.5% interest rate on many student loans will be replaced with an adjustable rate reflecting the market. The estimated \$285 million in savings will be diverted to forgiving up to \$17,000 in student loans for teachers who spend five years in poor schools and in the fields of math, science and special education. The change would last one year, with sponsors promising a permanent fix when Congress renews the nation’s higher education law next year.
- According to a GAO study, the bank subsidy cost taxpayers \$556 million in 2003 and \$634 million through June 2004. Without government action, the cost would quickly escalate into billions of dollars, the GAO found. Without the passage of this bill, “we would have essentially ended up with a windfall to these lenders, and these

individuals who go out and teach in these tough schools and difficult subject matters would have ended up with large student loans,” said Senator Judd Gregg (R-NH), chairman of the Health, Education and Labor Committee.

- Democrats favored a permanent fix but reluctantly backed the one-year version fixing this loophole. They complained the Republican version still leaves open a way for banks to recycle profits from current loans and then create new ones that promise the large government payments. “No one should be fooled,” said Senator Edward M. Kennedy (D-MA). “Half of the student loan loophole that this bill leaves wide open goes to for-profit corporations like Nelnet and Sallie Mae. We should be helping students who are eligible for Pell grants, instead of subsidizing big banks needlessly.” (*Associated Press*, 10/10/04)

Farm Credit System/Farmer Mac

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| Does the Farm Credit Council oppose stockholder democracy? |
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- Bert Ely writes in *Farm Credit Watch*, “With refreshing candor, Jerold Harris, speaking on behalf of the Farm Credit Council (FCC), told Congress that it should deny the owners of Farm Credit System of America (FCSA) the right to vote on whether or not FCSA should terminate its FCS status. Harris, CEO of U.S. AgBank, one of the five FCS funding banks, made this most undemocratic assertion when testifying on September 29 to the Conservation, Credit, Rural Development and Research Subcommittee of the House Agriculture Committee. FCC is the trade association for FCS associations and banks or, more accurately, the trade association for the FCS “management class,” the full-time FCS executives who do not necessarily represent their members’ interests.”
- “The hearing, chaired by Representative Frank Lucas of Oklahoma, was ostensibly held as a review of the FCS. However, its real purpose was to debate the pros and cons of FCSA’s desire to leave the FCS so that Rabobank, the large Dutch agricultural lender, can acquire FCSA’s loan portfolio... The FCS management class is scared stiff of democracy within the FCS. They understandably fear that if the owners of FCSA vote to accept the Rabobank offer, then the owners of other FCS associations will become receptive to offers to sell their associations. Those sales, of course, will upset the comfortable, well-paid, government-favored jobs that FCS CEOs and managers have long enjoyed. Their world, as they have known it, would soon end. Fearing that the FCA board will not block the deal, the FCS wants Congress to block it by immediately repealing those provisions of the Farm Credit Act that permit an association to terminate its status as an FCS association. FCS to

Congress: We can't win under the present rules, so please, pretty please, change them so we can win, and stay as we are. Harris (a 41-year FCS veteran), stated that the FCSA-Rabobank transaction, "should it be completed, would set a dangerous precedent that could harm America's farmers and ranchers." Translation: America's farmers and ranchers don't know what is best for themselves. Speaking on behalf of the FCS management class, he stated, quite authoritatively "we simply can't see how the Rabobank purchase proposal works out as a good deal for stockholders." Translation: FCSA's owner/borrowers don't know what is in their best interest."

- "CEO Harris then told Rep. Lucas "Irrespective of the numbers, Mr. Chairman, it makes no sense for a System institution to terminate its System status, or for Congress to allow it." Translation: Mr. Chairman, the owners of FCSA might actually vote for the Rabobank deal. Making his final point, Harris told the subcommittee: "What needs to change to prevent this from happening? We are asking that this Committee repeal the termination authority as soon as possible." Translation: Congress, save our bacon. We don't believe we can prove our relevance to those we supposedly serve."
- "Above all, the hearing demonstrated that the FCS management class not only fears stockholder democracy, but does not recognize that American agriculture no longer needs an FCS. Harris cited the Farm Credit Act, which stated that the FCS is to be a "permanent source of credit for all sizes and types of agricultural producers." Interestingly, the Act does not have the word "sizes" in it -- perhaps Harris was trying to slip in a justification for FCS's increasing focus on lending to America's larger, better capitalized farmers, ranchers, and agribusinesses."
- "More importantly, Harris and the management class he spoke for seem unwilling to acknowledge that nothing is permanent in this life, and certainly not the institutions Congress has created. The institutional structure of the financial services industry changes constantly, responding to new technologies and evolving markets within our dynamic society. The proposed FCSA-Rabobank deal has pulled the FCS into the growing debate over all GSEs, as it should. This deal is just one manifestation of the pressure for change. FCS managers cannot possibly believe that Congress will spin them a cocoon that will protect them forever from change, and the possibility that rural America no longer needs the FCS."
- "The challenge to the FCA board is to let democracy prevail. While the FCA is obligated to ensure that FCSA stockholders are fairly and fully informed about the Rabobank deal, ultimately, those stockholders, and not the FCA or Congress, should determine FCSA's fate. Who knows, maybe FCSA's stockholders/ members/ borrowers will reject the Rabobank offer. The FCS management class needs to place its faith in the democratic process." (*Bert Ely's Farm Credit Watch*, Bert Ely, 10/04)

“Farmers for Farm Credit” demand details on the Rabobank/FCSA merger

- Farmers for Farm Credit (FFC), a group of farmers opposing the proposed sale of Farm Credit Services of America (FCSA) to Rabobank, are asking the two agricultural lenders to release details of the proposed sale to the public. Details of the transaction have been scarce because confidential agreements between the two parties and federal regulations restrict what information is released. Representatives of FFC met with the FCSA’s board of directors and asked members to release the sale agreement. “We thought it was important that document be released so that everyone knows what’s in it,” said Myron Edelman, chairman of the group. “This whole issue has been surrounded by secrecy from the very beginning, and most of it has been self-imposed by the directors.”
- FFC wants to know whether the agreement includes provisions for financial compensation for senior managers or the directors from FCSA who would serve on a new board created by Rabobank. “Who benefits from this transaction?” Edelman asked. “It comes down to what Rabobank gets out of this and what the senior management gets out of it. That’s what we would like to ask. That’s why we want to see the agreement, and I think it should be made public.” Edelman said he also wants to know if FCSA would have to pay Rabobank if the FCS board backs away from the deal.
- Edelman claims an attorney representing FFC was told by federal regulators that the FCA would not object if the sale agreement were made public. However, a spokeswoman for the FCA said she had no knowledge of anyone at the agency making such a statement. FCA’s policy is not to comment on corporate filings, she said. Executives with Rabobank and FCSA have maintained that such information is restricted until the FCA approves what information should be presented to shareholders. FCSA was expected to file papers a month ago with federal regulators outlining the transaction but has yet to do so. (*Omaha World-Herald*, Chris Clayton, Lori Nitschke, 10/12/04)

FCSA acquisition stirs concern over potential for takeover of other FC associations

- Rabobank’s offer to buy FCSA in Omaha, NE has touched off speculation that similar cooperatives and lending institutions might become takeover targets. If units of the Farm Credit System can be taken over, some are beginning to ask if the same can be true for other government-supported credit institutions, like credit unions and home-loan banks.
- Given these concerns, some potential targets are taking protective action to ward off hostile takeovers. The board of directors for GreenStone Farm Credit System in Lansing, MI, approved a resolution in August telling big banks and other financial institutions “that we are not for sale.” Outside director Bill Oemichen, said, “There is

nothing to discuss. We had been solicited by others, but I don't think I should go any farther and say who they are.”

- At a recent meeting in St. Paul, MN, state commissioners of agriculture cited the public interest and need for the Farm Credit System. The National Association of State Departments of Agriculture, which is chaired this year by Minnesota Commissioner Gene Hugoson, adopted a resolution to opposed the FCSA sale and said it “supports the congressionally established mission of the Farm Credit System.” (*Saint Paul Pioneer Press*, Lee Egerstrom, 10/12/04)

Postal Service

Postal reform issue is not going away

- In an October 8 email to members, Direct Marketing Association president and CEO John Greco declared that postal reform this year “appears very unlikely” as the 108th Congress winds down. Of almost equal concern to mailers is the size and scope of the next postal rate increase. The USPS plans to initiate a postal rate case during the first quarter of 2004 to increase postage in all mail classes in January 2006, the first rate hike in 3.5 years.
- Greco asked mailers to urge their congressmen to address the USPS's problem pertaining to its Civil Service Retirement System (CSRS) escrow account requirement before Postal Service files for the rate increase next year. The CSRS escrow is expected to represent a \$3.5 billion liability for the USPS in 2005; if the escrow is not adjusted appropriately, the USPS would have to add an additional 5.4% increase to the rate hike it is seeking, propelling the expected increase from single- to double-digits. Correcting the CSRS problem should amount to a two-year elimination of the escrow, Greco said. Congress adjourns on October 8, but may reconvene after the November 2 election and again after Thanksgiving.
- Greco said that the legislative process for postal reform can pick up where it left off early in the 109th Congress, since both bills were passed through their respective committees. “Our industry is now closer than it has ever been to passing [postal reform] legislation,” said Greco. (*Catalog Age*, 10/08/04)

Bush Administration criticized for “inaction” on postal service reform

- Lawmakers in both parties are frustrated by the White House's inaction on legislation to reform the USPS. House Government Reform Chairman Tom Davis (R-VA) is

frustrated that the White House does not appear to recognize the urgency of reforming the Postal Service and has not lent its clout to advance the bills, said Davis' spokesman David Marin. While the Postal Accountability and Enhancement Acts, S 2468 and HR 4341, have been passed unanimously by the House Government Reform and Judiciary committees and the Senate Governmental Affairs Committee, the bills have not been scheduled for a vote in their respective chambers.

- Bush is the first president since Richard Nixon to publicly support postal reform. Following years of failed USPS reform legislation, the White House formed a commission to study the challenges facing the Postal Service and recommend changes to the agency's business operations in December 2002. The commission released a report in July 2003 and President Bush met with the commission and announced five broad principles for postal reform in December 2003. Since that meeting, the administration's only public statements on postal reform effort have been objections to provisions that would make the Treasury once again responsible for paying postal employees' military pensions and release billions of dollars scheduled to go to an escrow account beginning in 2006.
- A Democratic aide on the Hill involved with the reform effort said the White House refuses to discuss its objections to the postal reform legislation. "The White House had plenty of time to engage us on their concerns," the aide said. "They haven't contacted or met with us."
- Marin said Davis feels the administration does not understand how important the escrow and military pension issues are to postal reform. Both complications were created in 2003 when Congress corrected a potential overpayment by the Postal Service into the Civil Service Retirement System. The amount of the potential overpayments, about \$3 billion a year, will go to an escrow fund in 2006. The military pensions will cost the Postal Service about \$27 billion. (*FederalTimes.com*, Stephen Losey, 10/11/04)

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| President Bush nominates Louis Guiliano and Carolyn Gallagher to USPS Board of Governors |
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- President George W. Bush has announced the appointment of Louis J. Giuliano to the USPS Board of Governors for a term expiring December 8, 2009. Giuliano was most recently Chairman, President and CEO of ITT Industries, Inc, a \$4.4 billion Fortune 500 engineering and manufacturing company serving the global pump, defense, interconnect and specialty industrial markets. He has served on the Board of Directors of the National Defense Industrial Association, the Board of Governors of the Aerospace Industries Association and is the honorary chairman of Armed Forces Emergency Services for the American Red Cross in Westchester County, NY.
- The President has also announced the appointment of Carolyn L. Gallagher to the USPS Board of Governors for the remainder of a term expiring December 8, 2005.

Previously, Gallagher served on the President's Commission on the USPS. She is a resident of Austin, TX and currently serves as an investor and advisor to several businesses. Gallagher has 20 years of experience in acquiring and growing companies. (*Alliance for Nonprofit Mailers*, 10/12/04)

President of NALC rallies letter carriers to support postal reform

- In a NALC Bulletin, National Association of Letter Carriers President William H. Young said President George W. Bush has clearly communicated that he is against postal reform, by ordering Republican leaders in the House and Senate to stop floor action on the H.R. 4341 and S. 2468 so the bills will die when the 108th Congress adjourns for the year. In so doing, Bush virtually ensured that the Postal Service will be forced to seek a 6 cent postage increase. "Here's the reality," Young said. "We are looking at a 6 cent increase in postage if we can't get postal reform passed. That 6 cent increase in postage could signal the death of the United States Postal Service." Young said he was setting into motion the union's e-Activist network by asking NALC's 115,000 letter carriers and family members to contact their senators and representatives and President Bush, "telling him that it is wrong that he has put a stop to postal reform and we want this legislation moved." Young said, "I'm going to test this network. I hope they are flooded across the street [Capitol Hill] with e-mails, phone calls and letters – angry letter carriers – saying this is not right." (*PostalWatch.com*, 10/06/04)

USPS YTD net income is over budget and mail volume is up

- With one month left to report for the fiscal year that ended September 30, the Postal Service announced net income of \$2.8 billion, or \$656.6 million over budget, for the October 1, 2003, to August 31, 2004 period. The Postal Service's fiscal and operating statements showed that revenue totaled \$63.1 billion, 0.2% less than planned, while expenses totaled \$60.3 billion, 1.3% under the planned budget.
- Total year-to-date mail volume of 188.3 billion pieces increased 1.7% from a year ago. Standard and International mail grew 5.6% and 4.0%, respectively, while most classes experienced declines. Express Mail fell 3.2%; Periodicals, 3.1%; Priority Mail, 1.8%; First-Class, 1.4%; and Package Services, 0.8%. (*DMNews.com*, Melissa Campanelli, 10/06/04)

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