

The **GSE** REPORT™

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Major Events

Pandora's box is opened at Fannie Mae, as OFHEO issues interim exam report

SEC begins informal review of Fannie

Fannie Mae board responds to OFHEO report

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Department of Justice begins criminal investigation at Fannie Mae

Pandora's box is opened at Fannie Mae, as OFHEO issues interim exam report

- On September 20, OFHEO Director Armando Falcon, Jr. met with Fannie Mae's board of directors to deliver a 211 page interim report on his agency's eight-month examination of the GSE's accounting practices. Accompanying the report, Falcon wrote in a stinging transmittal letter stating that "the matters detailed in this report are serious and raise doubts concerning the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the ***overall safety and soundness of the Enterprise.***"
- "More specifically, the report documents how Fannie Mae 1) applied accounting methods and practices that do not comply with GAAP in accounting for the enterprise's derivatives transactions and hedging activities; 2) employed an improper "cookie jar" reserve in accounting for amortization of deferred price adjustments under GAAP; 3) tolerated related internal control deficiencies; 4) in at least one instance deferred expenses apparently to achieve bonus compensation targets; and 5) maintained a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures."
- Falcon continued, "These findings cannot be explained as mere differences in interpretation of accounting principles, but clear instances in which management sought to misapply and ignore accounting principles for the purposes of meeting investment analyst expectations; reducing volatility in reported earnings; and enabling fragmented processes and system, and an ineffective controls environment to exist." Falcon provided the board a regulatory agreement for their review, which outlined minimum steps that the board needed to take to address the safety and soundness issues OFHEO had identified to date and corrective actions related to Fannie's accounting policies and practices, capital adequacy, internal controls, segregation of duties, and additional reviews that need to be taken. Falcon concluded, "we must consider the accountability of management and whether we have sufficient

confidence in management to fully implement these corrective measures and bring about broad cultural and operational changes in the areas of concern. The analysis and findings of this report make it difficult to assert such confidence.”

- The OFHEO report detailed “dysfunctional and ineffective” accounting systems at Fannie Mae and a corporate culture that rewarded earnings manipulation and “tolerated weak or non-existent internal controls.” The report said, “The tenor of earnings management is deeply ingrained at Fannie Mae and has given rise to accounting policies and practices that emphasize effects on earnings volatility, rather than faithfulness to [generally accepted accounting principles].” Based upon its findings, OFHEO questions the adequacy of the Fannie Mae’s capital, the quality of its management, and its financial stability.
- OFHEO attributes heavy blame for the accounting problems on long-time CFO Timothy Howard, mentioning him by name 101 times in its report. OFHEO concludes that Howard “failed in providing adequate oversight to key control and reporting functions within the enterprise” and “developed and rewarded a staff that collectively does not possess the skills necessary to ensure that Fannie Mae has proper accounting policies, adequate resources to support proper implementation of such policies, and an effective system of internal controls.” The report said, “Fannie Mae’s dysfunctional accounting policy development, key person dependencies, and poor segregation of duties were major contributors to the accounting failures and the safety and soundness problems detailed in this report.” OFHEO also concluded that Fannie Mae failed to adequately investigate “substantive” allegations of accounting irregularities made by a former employee, Roger Barnes, who left the GSE in November and aided OFHEO in its examination.
- OFHEO’s report focused on accounting problems that may have disguised potential losses in Fannie’s derivatives portfolio and hedge relationships. The regulator said the GSE failed to account for fair value changes in certain derivatives contracts in its earnings, failed to properly document transactions and even backdated some transactions to use a more preferential accounting treatment under financial accounting standard 133, or SFAS 133. “This lack of documentation and the ability to create such documentation retroactively is not only a SFAS 133 violation, but is evidence of a poor control framework and is a significant safety and soundness violation,” OFHEO said. “The possible reclassification of [certain hedge transactions] into retained earnings could have a significant effect on Fannie Mae’s regulatory capital,” the report said. Such reclassifications could also have a significant impact on the company’s reported financial results, “both prospectively and historically,” making it “a significant safety and soundness problem.” OFHEO didn’t quantify by how much Fannie Mae may have overstated its income and it’s not clear whether Fannie will be forced to restate its earnings. While OFHEO doesn’t have the authority to require a restatement, Fannie Mae’s board of directors, its auditor or the SEC could force the GSE to restate its financial results, even if its management disagrees.

- While Fannie’s SFAS 133 mistakes would substantially impact its earnings, OFHEO said the GSE committed more serious GAAP violations in the way it estimated purchase premiums and discounts on certain securities and loans, governed by SFAS 91. OFHEO wrote, “Despite the requirement of SFAS 91 to formulate best estimates in good faith, management intentionally developed accounting policies and selected and applied accounting methods to inappropriately reduce earnings volatility and to provide themselves with inordinate flexibility in determining the amount of income and expense recognized in any accounting period. In this regard, the amortization policies that management developed and the methods they applied created a “cookie jar” reserve.” Fannie used these off-balance sheet reserves to smooth earnings for purposes of meeting the expectations of financial analysts, according to the report. OFHEO concluded that the accounting used by Fannie Mae for amortizing purchase premiums and discounts on securities and loans as well as amortizing other deferred charges is not in accordance with GAAP.
- OFHEO noted that many of Fannie’s current accounting philosophies, policies and methods stem from a sharp fall in interest rates in 1998, when the Russian currency crisis strained the global economy, which spurred a refinance boom and sped up mortgage prepayments for Fannie’s portfolio. The company’s estimated expenses ballooned to \$400 million during the third quarter of 1998, which would have reduced the GSE’s net income to \$3.11 per share, below the minimum threshold for executive bonuses. “As a result, no bonuses would have been awarded,” OFHEO said. Rather than recognizing the full expense amount that quarter, Fannie deferred about half of its estimated expense and booked \$200 million in deferred expenses as the “catch up.” While GSE’s executives told OFHEO the original loss estimate was overstated, the report said “management nevertheless developed a strategy to record planned monthly on-top adjustments to the financial statements to recognize the estimated \$200 million deferred expenses in the subsequent fiscal years 1999 and 2000.” OFHEO notes that the GSE’s external auditor, KPMG, flagged the unrecorded amount of \$200 million as an “audit difference.” By deferring the \$200 million in losses to later years, Fannie Mae was able to distribute the maximum bonus payout for executives that year. The improper expense deferral put an additional \$1.9 million, \$1.1 million, and \$494,000 into the respective pockets of then- CEO James Johnson, current CEO Franklin Raines, and CFO Howard.
- OFHEO was critical of Fannie Mae’s bonus structure for management. In 1993, Fannie decided to base 100% of its executives’ cash bonuses “exclusively on corporate performance,” setting a “range of bonus opportunity” for top managers of up to four or more times their base pay if 12-month EPS targets were hit by the end of the year. Top managers automatically receive 75% of their eligible cash bonus if the company made its annual EPS goal, while the other 25% is based on their “individual contributions” to hitting earnings targets, according to several years of proxy statements. Also of interest to OFHEO investigators are promises of double-digit earnings growth that Raines made when he became chairman and chief executive of the company in 1999, according to sources familiar with the investigations. Those goals were approved by Fannie Mae’s board in 2000 and “supported by everyone in

the company,” company spokesman Janice Daue said. Regulators have worried that such promises could tempt executives to cut corners to meet them, said the sources.

- OFHEO officials said Fannie’s accounting problems are more serious, complex and larger in scope than the problems they found after Freddie Mac’s auditor forced it to restate several years of earnings and to disclose evidence of accounting manipulation last year. An OFHEO spokesperson later disavowed this statement. Unlike the Freddie Mac investigation, Falcon addressed with Fannie Mae’s board the question of the GSE’s safety and soundness. Since questions about Fannie Mae’s accounting date back as far as 1998, the GSE faces the possibility of restating as many as seven years of financial statements.
- OFHEO conducted this examination with the help of a number of “top guns” to assist with its investigation, including Stanley Sporkin, the former U.S. judge and former celebrated SEC enforcement head, as well as a partner at Weil, Gotshal & Manges; Enron investigator Robert Maxant; and Lisa Choi, a former Federal Reserve bank examiner with an expertise in derivatives and fixed-income trading. OFHEO also retained the accounting firm, Deloitte & Touche to help conduct the examination. In this detailed probe of Fannie, OFHEO examined more than 200,000 internal documents, e-mails, and interviewed the GSE’s executives. Given OFHEO’s findings of discrepancies, “tenuous” rationalizations, unusual entries and elaborate accounting intricacies, it appears that OFHEO’s objections so far can not be disposed of quickly -- and that much, much more remains to the OFHEO probe, say sources. (*OFHEO Press Release*, Director Armando Falcon, Jr., 09/22/04; *OFHEO Report of Findings to Date Special Examination of Fannie Mae*, 09/17/04; *USA Today*, 09/23/04; *Wall Street Journal*, James R. Hagerty and John D. McKinnon, 09/21/04; *Wall Street Journal*, James R. Hagerty, John D. McKinnon, and Dawn Kopecki, 09/23/04; *Wall Street Journal*, Dawn Kopecki, 09/23/04; *Dow Jones Newswires*, Dawn Kopecki, 09/24/04; *Washington Post*, David S. Hilzenrath, Richard Drezen, 09/23/04; *Washington Post*, Kathleen Day, David Hilzenrath, and David A. Vise, 09/23/04; *Senate Republican Policy Committee Paper*, Jason M. Thomas, 09/24/04; *New York Times*, Jennifer Lee, 09/23/04; *Market News International*, Denny Gulino, 09/23/04; *Associated Press*, 09/24/04; *Barron’s* 09/27/04)

SEC begins preliminary review of Fannie

- The SEC has launched an informal inquiry into Fannie Mae’s accounting practices prompted by OFHEO’s examination findings, the company said. In fact, the SEC, which considers itself the final arbiter of publicly traded companies’ compliance with accounting rules, has been investigating Fannie informally since early this year, an SEC official told the *Washington Post*. According to sources, SEC has already, as expected, reclassified its investigation to a formal one, although a SEC spokesman refused to comment.
- How serious Fannie Mae’s problems are may not be clear until the SEC weighs in, and that could be a long while. “The SEC will play an important role here, as they will also have to conclude on what was the proper accounting,” said Lynn Turner, a

managing director of the analytical research firm Glass, Lewis & Co. and a former SEC chief accountant. Turner said that process could take three to five years to complete. According to the *New York Times*, the SEC investigation could “drag in a number of major Wall Street firms that have dealt with Fannie Mae. (*Dow Jones Newswires*, Dawn Kopecki, 09/22/04; *American Banker*, Rob Blackwell, 09/24/04; *Washington Post*, David S. Hilzenrath, Terence O’Hara, Albert Crenshaw, 09/24/04; *American Banker*, Rob Blackwell, 10/01/04, *CFO.com*, Stephen Taub, 09/29/04)

Fannie Mae board responds to OFHEO report

- In response to the OFHEO interim exam report, Fannie Mae’s board has named a special committee of three outside directors to respond to OFHEO’s allegations and the preliminary inquiry by the SEC, said Ann McLaughlin Korologos, Presiding Director of the Fannie Mae Board of Directors. Korologos stated that Fannie has retained independent counsel, former Senator Warren Rudman with Paul, Weiss, Rifkind, Wharton & Garrison LLP to assist the board this matter. Rudman’s firm will hire an independent accounting firm to provide technical assistance.
- Korologos said, “The matters detailed in this [OFHEO] report are serious and raise doubts concerning the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision and the overall safety and soundness of the enterprise,” quoting from OFHEO’s letter to the board. Korologos said the Fannie board “takes the report seriously and is working with OFHEO to resolve these matters.” She added, “Fannie Mae’s board of directors is committed to working with our regulators to resolve these matters consistent with our commitment to the highest standards of corporate governance, financial reporting and transparency to the marketplace.”
- Korologos is a 62-year old Republican, whose husband Tom was recently appointed as U.S. ambassador to Belgium. Korologos served as secretary of labor in President Reagan’s cabinet and now is a director of several other companies, including Microsoft Corp. Special committee members are Stephen B. Ashley (age 64), Chairman and CEO of Ashley Group and Donald B. Marron (age 69), Chairman, CEO and founder of Lightyear Capital. (*American Banker*, Rob Blackwell, 09/22/04, *American Banker*, Rob Blackwell, 09/24/04; *Wall Street Journal*, James R. Hagerty, 09/24/04)
- On September 19th, Fannie Mae lost one of its outside directors, Anne Mulcahy, the CEO of Xerox, who left to accept a board seat at Citicorp Inc. A Xerox spokeswoman said Mulcahy found it more convenient from her home of Stamford, CT to attend board meetings nearby at Citigroup in New York rather than at Fannie in Washington. It was a coincidence that Mulcahy’s resignation came immediately before OFHEO released its damaging report, the spokeswoman said. At Fannie, Mulcahy has served as a director since 2000, chaired the board’s compensation committee and was a member of its audit committee. OFHEO’s report is highly critical of Fannie’s bonus compensation, which ties executive compensation too

closely to meeting ambitious targets for earnings per share, according the agency. (*Wall Street Journal*, James R. Hagerty, 09/24/04)

- While Fannie Mae's chairman and chief executive, Franklin Raines, and other top managers have been effectively removed from the process, Raines issued a statement of strong support for the company's outside directors. He said, "The management team at Fannie Mae strongly supports the leadership shown by the non-management members of our Board of Directors, under the leadership of Ann Korologos the presiding director, in responding to the OFHEO report and SEC inquiry. Their efforts are in accord with the highest standards of corporate governance. We will assist them in any way we can as they carry out their duties," said Franklin D. Raines. (*Fannie Mae Press Release*, 09/22/04)
- While a senior company official said the Fannie board wants to deal decisively and swiftly with the allegations of accounting manipulations, two directors spoke publicly about the probe and defended current management. In a written statement, lead outside director Korologos said, "Frank Raines is handling this situation just as you would expect a first-class CEO to do -- with honor and absolute integrity. Frank's strong leadership and his commitment to the company's mission are appreciated by every member of the board." Director H. Patrick Swygert, president of Howard University, said Fannie's board members have not taken Raines to task on either regulation policy or the company's stock price. Swygert added, "No one should draw an implication that we are moving to a change in management." (*Washington Post*, Jeffrey H. Birnbaum and David Vise, 09/27/04)
- On September 23, Fannie Mae's board announced that it had amended the employment agreements with its top three executives, making it easier for the board to fire them and deny lucrative severance packages. Company spokeswoman Janice Daue said the contract changes are not related to "the activities that have occurred over the last week." She added, "The process had been ongoing. The employment agreements were filed in the normal course of business," with OFHEO having the final say over executive pay. "It was not related to the report that was released this week," Daue said. In May, Fannie entered into employment contracts with chairman and CEO Franklin Raines, COO Daniel Mudd and CFO Timothy Howard. OFHEO has yet to sign off on the termination provisions of these contracts, seeking tougher measures that deny lucrative severance packages if misconduct is found. If approved, the amendments will apply retroactively to July 1. The amendments to all three executives' employment pacts redefine the circumstances under which Fannie can fire them "for cause," which calls for a significantly reduced amount of salary, stock and other benefits than if the officer leaves the company on good terms. The new term "cause" constitutes being convicted of, or pleading no contest to a felony, or if the executive "materially harms" Fannie Mae through fraud, dishonesty, willful misconduct or doing their job in a grossly negligent manner. Fannie also amended Raines' contract to prohibit him from receiving a rich termination package if he decides to quit when his dual roles as chairman and chief executive are likely to be

split in 2007. (*Dow Jones Newswire*, Dawn Kopecki and David Enrich, 09/24/04; *CBSMarketwatch.com*, Rex Crum, 09/25/04)

Fannie Mae enters into regulatory agreement with OFHEO

- On Monday, September 27, Fannie Mae's board of directors entered into an agreement with OFHEO, which outlines immediate actions to be taken by Fannie to address improper accounting and inadequate controls detailed in OFHEO's special exam report. The agreement requires Fannie Mae to:
 - Implement correct accounting treatments that will bring Fannie into compliance with SFAS 91 and SFAS 133 accounting standards. [Fannie Mae also agreed to calculate the impact such changes would have on previously issued financial statements.]
 - Protect the existing capital surplus and move to a targeted capital surplus equal to 30% of their required minimum capital.
 - Undertake a top-to-bottom review of staff structure, responsibilities, independence of functions, compensation and incentives.
 - Appoint an independent chief risk officer and separate other key business functions currently performed jointly by certain individuals or departments.
 - Put in place policies to assure adherence to accounting rules and new internal controls.
- The agreement provides specific steps and timetables. Other matters, raised by OFHEO's examination, including management accountability, remain under active review.
- "The serious concerns raised in OFHEO's report require prompt action," said OFHEO Director Falcon. "This agreement is an important step toward resolving these concerns and helping to assure safe and sound operations at the Enterprise. I want to commend the Board of Fannie Mae for moving quickly to address a complex set of issues," Falcon said.
- According to a source close to negotiations between OFHEO and Fannie Mae, the company resisted some major provisions of the agreement until late in the negotiations, and agreed only after OFHEO made it clear that it would take action against Fannie Mae even if the company and the agency did not reach a mutual agreement. The *Wall Street Journal* wrote, "...Fannie Mae capitulated to its regulator and agreed to changes it has resisted for years. The moves will reduce the profitability and growth prospects of one of the nation's largest financial institutions while cushioning it against market gyrations." The agreement spares for now the jobs of CEO Franklin Raines and CFO Timothy Howard. The accord gives OFHEO veto over a wide array of the Fannie's decisions such as dividend policy and accounting

techniques, while the agency's probe continues. Through this agreement, OFHEO has placed limits on Fannie Mae's explosive growth, something long sought by the Bush administration.

- Within nine months, Fannie Mae must hold at least 30% more capital than its ordinary minimum requirement, which raises the company's minimum capital requirement by more than \$9 billion based on Fannie's latest financial results. As of August 31, Fannie said it had an 18% surplus over the minimum requirement. Based on that figure and assuming that the company's assets remain near the current level, Fannie Mae would need to increase its capital by an estimated \$4 billion to \$5 billion.
- However, Fannie's capital base may prove to be smaller than currently recorded under new accounting practices. Under the agreement, Fannie agreed to change accounting methods related to lending fees and costs and to derivatives. Adoption of those changes involving SFAS 91 and SFAS 133 could lead to a restatement of past earnings, though neither Fannie nor OFHEO offered any estimates of the size of any restatement. An OFHEO spokeswoman said the SEC would decide whether a restatement is required.
- Fannie's capital is "inflated ... due to their faulty accounting," said Tom Linsmeier, an accounting professor at Michigan State University. Under this scenario, Fannie Mae would then have to evaluate other options to raise capital. Raising capital through a stock offering would be difficult in the near term, given huge uncertainties over the effects of new accounting policies and the need to sell stock with audited financial statements. Other alternatives to raise capital for Fannie Mae include reducing or eliminating its dividend and stock buybacks, selling mortgage-backed securities from the GSE's huge portfolio, or slowing its purchases of mortgages enough so that payments received from borrowers exceed the amount spent buying new loans. Fannie Mae declined to discuss how it might reach the new capital target. According to the *Wall Street Journal*, "If Fannie's capital dwindles drastically, OFHEO could take further control of the company, possibly through its conservatorship powers, said some people close to the situation."
- To meet its capital requirement, Fannie may need to shrink its assets by as much as 10% by mid-2005 to achieve the tougher capital requirement, said Jim Vogel, a senior vice president at FTN Financial Capital Markets of Memphis, TN. As Fannie restrains or even cuts its mortgage purchases, Freddie Mac, banks and other investors will take up most of the slack, said Arthur Frank, an analyst at Nomura Securities Financial in New York. Depending on how severe Fannie's problems turn out to be, the company's retreat from the mortgage market could lead to a modest rise of 5 to 15 basis points in yields on mortgage-backed securities, which might translate into a similar rise in mortgage rates offered to consumers, Frank said. Douglas Duncan, chief economist of the Mortgage Bankers of America, believes that the effect on the housing sector should be minimal. "From our perspective, this should not disrupt the housing market, which is still strong," Duncan said.

- The agreement “doesn’t mean that the company is at all out of the woods,” said Charles M. Elson, heads of corporate governance program at the University of Delaware. “This is just really the beginning of a long inquiry into what happened,” Elson said. While Fannie’s agreement is a rare concession by a powerful and politically astute company that has long resisted regulatory and Congressional pressures to overhaul its practices and structure, analysts and others said it might be only the first of many changes at Fannie Mae.
- While Fannie Mae’s board and OFHEO have not yet resolved the GSE’s management issue, some believe that Raines days may be numbered. “Raines has lost a lot of credibility,” said Jeffrey Sonnenfeld, professor of management practices at Yale School of Management. “Raines’ powers and credibility have been reduced. He has no legitimacy with regulators anymore, let alone as a reassuring voice with investors.” (*U.S. Fed News*, 09/27/04; *Wall Street Journal*, James R. Hagerty and John D. McKinnon, 09/28/04; *Washington Post*, 09/28/04; *New York Times*, Timothy L. O’Brien, 09/28/04; *BNA Daily Report for Executives*, Richard Cowden, 09/28/04; *Reuters News*, Mark Felsenthal, 09/28/04)

OFHEO turns to Justice Department to enforce Fannie Mae’s subpoenas

- OFHEO has asked the Justice Department to help enforce some of the subpoenas issued during a special accounting exam of Fannie Mae, requiring the company to turn over documents and make employees available for testimony. In a September 9th letter responding to questions from the House Financial Services Subcommittee, Falcon told Representative Richard Baker (R-LA) that the agency has “encountered problems with compliance” in getting Fannie Mae officials to turn over requested documents and offer testimony. “Where we have not been satisfied with Fannie’s efforts to comply with the subpoenas, we have referred the matter to the Justice Department for enforcement in the courts,” Falcon told Baker, whose office released a portion of the letter. It’s unclear if Fannie Mae has turned over the documents or delivered the testimony requested by OFHEO. Officials at OFHEO and Fannie declined to comment.
- Fannie Mae’s alleged resistance to some of OFHEO’s requests for documents and interviews with employees “at the very least gives an insight into the management culture at Fannie Mae,” said Michael DiResto, a spokesman for Baker. DiResto said Fannie seemed to be “saying one thing in public while they’re doing another in private.” (*Dow Jones Newswire*, Dawn Kopecki, 09/24/04; *Washington Post*, David S. Hilzenrath, 09/25/04)

Department of Justice begins criminal investigation at Fannie Mae

- The Justice Department has opened an investigation of possible accounting fraud at Fannie Mae following the release of OFHEO’s exam report, which charged that the mortgage company may have manipulated its books to meet earnings targets. OFHEO referred its report to federal prosecutors last week, said lawyers close to the case. Justice Department officials concluded that the regulator’s disclosures

demanded an investigation, despite their concerns that a criminal inquiry could rattle the markets, said the lawyers. The inquiry is being handled by the U.S. Attorney General's office in Washington, DC. Several observers cautioned that any decision from Justice regarding criminal referrals would likely be a long way off. While scores of investigations of alleged corporate fraud have been opened in the past three years, not all of them have resulted in criminal charges. Fannie Mae spokesman Chuck Greener said the company "doesn't have any knowledge of a [Department of Justice] preliminary criminal investigation and so can't comment further."

- According to the *Wall Street Journal*, the Department of Justice's investigation of Fannie has a high bar to cross in proving accounting fraud. According to legal experts, prosecutors must show specific intent to deceive on the part of the company's management, rather than aggressive interpretations of accounting rules. Since accounting standards are often vague, prosecutors have a difficult and often impossible job of convincing a jury an intentional violation. "There are many instances when experienced accounting people would feel something crooked was going on, but if the prosecutors feel it's difficult to make it clear to the jury, they tend to hold back," said Paul Rothstein, a professor at Georgetown University Law Center. (*Wall Street Journal*, John R. Wilke, John D. McKinnon and James R. Hagerty, 09/30/04; *American Banker*, Rob Blackwell, 10/01/04; *New York Times*, Jennifer Lee, 10/01/04)

Rating firms raise the caution flags at Fannie

S & P conference call on Fannie Mae "comforts" investors

Rating firms raise the caution flags at Fannie

- Standard & Poor has put Fannie's "AA-minus" subordinated debt ratings, preferred-stock credit ratings and "risk to the government" rating on Credit Watch for a possible one-notch downgrade, pending the outcome of the investigations into the company. The "AAA" rating for Fannie's senior unsecured debt is unaffected. S&P said it was maintaining the Credit Watch action even though Fannie Mae had reached agreement with OFHOE to raise its capital reserves, among other issues. "We view the published agreement as a positive step toward the resolution of the critical findings of internal controls relating to accounting issues surrounding SFAS 91 and SFAS 133, and regulatory capital compliance matters as cited in OFHEO's 'Report of Findings to Date Special Examination of Fannie Mae,'" said Standard & Poor's credit analyst Victoria Wagner. Nevertheless, OFHEO's issues surrounding Fannie Mae's regulatory capital adequacy remain unresolved. The resolution of the CreditWatch Negative 'AA-' risk-to-the government rating will be driven by any changes to the risk profile or risk management practices at Fannie Mae that may negatively impact its underlying credit quality. Standard & Poor's focus will be on capital adequacy and the board of directors' response to the critical issues cited in OFHEO's special examination report. (*Market News International*, 09/28/04; *CBS.MarketWatch.com*, Rex Crum, 09/25/04).

- Citing uncertainty with respect to Fannie Mae's capital levels, Moody's changed its outlook on Fannie Mae's Aa2 subordinated debt and Aa3 preferred stock to negative from stable and put its A- bank financial strength rating on review for a downgrade. Moody's affirmed its Aaa rating on Fannie Mae's unsecured debt and the Prime-1 short-term debt rating with stable outlooks, citing the "strong U.S. government-implied support, important public policy mission in housing finance, tremendous franchise value, and sound interest rate and credit risk management." In a press release, Moody's stated, "The revision of the rating outlooks for the subordinated debt and preferred stock reflect uncertainty around the potential disruption in interest or dividend payments on these obligations should Fannie Mae fail to meet regulatory minimum, critical or risk-based capital standard," (*Dow Jones Capital Market Report*, Madeleine Lim, 09/28/04; *TheStreet.com*, Matthew Goldstein, 09/28/04))
- Fitch Ratings has *downgraded* Fannie Mae's subordinated debt and preferred stock ratings to 'AA-' from 'AA'. The Rating Outlook is Stable. Fitch has also affirmed Fannie Mae's 'AAA' long-term senior debt rating and 'F1+' short-term rating. Approximately \$17 billion in preferred stock and subordinated debt are affected by the rating agency's action. The rating agency's action is in response to the release of the OFHEO exam report and regulatory agreement, in which Fannie Mae agreed to raise its capital above the regulatory minimum requirements. Fitch affirmed the short and long-term ratings of senior debt. The Stable Rating Outlook includes the potential for a restatement as well as some management changes. Fitch believes Fannie Mae's ratings are supported by its GSE status and the belief that its risk management and measurement processes protect asset values and appropriately manage the duration and convexity risk in the portfolio. Fannie's management reduced the risk appetite over the last year and is well within internal guidelines. Any changes in accounting implementation are not expected to impact Fannie Mae's risk measurement nor its risk-based capital requirements. (*Business Wire* 09/29/04; *American Banker*, Jody Shenn and Rob Blackwell, 09/30/04)

S&P conference call on Fannie Mae "comforts" investors

- In a conference call with Fannie Mae investors, Standard and Poor's analysts Michael DeStefano and Victoria Wagner said that S&P "remains convinced still today as we sit here that the triple A still works" for Fannie Mae's senior debt ratings. OFHEO's interim exam report, which was highly critical of the Fannie's accounting, triggered the S&P Credit Watch warning for Fannie Mae's double-A-minus preferred stock, subordinated debt and risk-to-government ratings. S&P placed Fannie Mae's preferred stock and subordinated debt ratings under review because "both have a deferral feature based on whether Fannie Mae meets certain regulatory capital adequacy rules."
- Wagner said it was positive that OFHEO and Fannie had quickly agreed to the terms of a regulatory agreement. She said, "This agreement shows momentum. It's encouraging to see they're trying to move as quickly as possible." The S&P analysts said they believe Fannie retains enough flexibility to raise the now-necessary added capital without severe dislocations, like large asset sales. "Their overall financial

flexibility is strong,” said DeStefano. “There’s lots they can do to improve capitalization without resorting to draconian measures such as shrinking their balance sheet or issuing common equity.” He added, “We don’t think that Fannie and Freddie are going to bring down the U.S. financial system.” He continued, “My sense is that this will unwind in an orderly way. By and large, from the systemic point of view, everything seems to be under control.” (*Market News International*, Claudia Hirsch, 09/27/04; *Dow Jones Newswires*, Christine Richard, 09/27/04)

Class action lawsuits filed against Fannie
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- Fannie Mae is facing a groundswell of lawsuits from class-action specialists for billions of dollars in stock losses stemming from the company’s faulty accounting. At least five class-action suits were filed in the federal courts as of September 24, naming Fannie Mae and top executives, including chairman and CEO Franklin Raines as plaintiffs. The suits charged that Fannie Mae misrepresented its financial results by manipulating accounting so the GSE appeared as a low-risk, steadily growing company to investors. “The Company issued numerous other false and misleading statements and presented the public with materially false and misleading financial statements that created the illusion that Fannie Mae was a safe and steady earner and largely immune to interest rate fluctuations,” said the law firm Milberg Weiss Bershad & Shulman LLP, which filed its class-action suit on behalf of Fannie Mae shareholders in the U.S. District Court for the District of Columbia. Class action suits have also been filed against Fannie Mae by Schiffrin & Barroway, LLP, Lerach Coughlin Stoia Geller & Robbins, LLP, and Cohen Milstein Hausfeld & Toll PLLC, and Vianale & Vianale LLP. (*Reuters*, 09/24/04; *Schiffin & Barroway LLP Press Release*, 09/23/04; *Dow Jones News Service*, Geogrey Rogow, 09/24/04; *PR Newswire*, 09/23/04; *Marketwire*, 09/28/04)
- Ohio Attorney General Jim Petro has launched an investigation into the Fannie Mae to determine if accounting irregularities at Fannie Mae caused losses for Ohio’s public pension funds. The investigation could find information to be used in a possible lawsuit, said Kim Norris, a Petro spokeswoman. “This is generally an information-gathering kind of stage,” Norris said. Ohio’s public pension funds include the Ohio Public Employees Retirement System, State Teachers Retirement System, Ohio Police and Fire, Ohio Highway Patrol Retirement System and School Employees Retirement System. (*Columbus Business First*, 09/27/04)

Congress speaks out on OFHEO findings

Representative Baker schedules a hearing on OFHEO's report and sends letter to Fannie's board

Congress speaks out on OFHEO findings

- Reacting to OFHEO's concerns about "the quality of management supervision, and the safety and soundness of [Fannie Mae]," Chairman of the House Financial Services subcommittee Representative Richard Baker (R-LA) released the following statement:
 - "In all my years of concerns about the federal oversight of Fannie Mae, this is precisely the kind of day I always dreaded. It's a sad and disturbing day for investors, homebuyers, and taxpayers alike. The most disgusting revelation [from the OFHEO exam] is that accounting tricks were used by a government-chartered enterprise with a government-sponsored public mission and a government-bestowed massive subsidy purely for personal gain and to pad executive compensation. But the most troubling revelation is OFHEO's conclusion that Fannie Mae's actions call into serious question the overall safety and soundness of the enterprise. Investors have been fooled, homebuyers have been cheated, and taxpayers are at risk.
 - "There have been those who, following the Freddie Mac scandal, insisted that it was not a big enough deal to require legislative action to improve the oversight of these housing-finance giants. In light of today's revelations about Fannie Mae my response is: Fool us once, shame on you. Fool us twice, shame on us. Taxpayers are now totally reliant on the Congress to do its duty. We have talked about it for years, but now is the time for urgent action to establish the strongest possible regulator with all the authority and resources necessary to hold these enterprises to account. We must also get to the bottom of and sort out this inexcusable mess at Fannie Mae, in terms of what happened, how, and by whom..."
- On September 22, Representative Barney Frank (D-MA), minority leader on the House Financial Services Committee, and Representative Paul Kanjorski (D-PA) issued a letter to OFHEO Director Falcon, urging him to publicly release the OFHEO interim exam report on Fannie Mae. At that time, the agency had presented the report to the Fannie Mae board and shared its findings with Congressional leadership. Shortly after receiving the Representatives' letter, OFHEO released its report publicly on the agency's website. After reviewing OFHEO's report, Frank said he was "disturbed to read what [OFHEO] had to say" about the accounting problems. Fannie executives, he added, "get a lot of money; they don't need to be manipulating bonuses." He castigated Fannie Mae for what he called "perverse incentives" of

stock options and bonuses as a major form of compensation. “Why should Frank Raines get extra money to do what Fannie Mae is supposed to do?” Frank asked. (*Market News International*, 09/22/04; *Dow Jones International News*, John Connor, 09/22/04; *Dow Jones International News*, John Connor, 09/27/04)

- Representative Paul Kanjorski (D-PA), minority leader on the House Financial Services subcommittee charged with oversight of Fannie Mae, said “it is essential that we don’t jump to immediate conclusions” about the GSE. Kanjorski said that his initial read of the OFHEO exam report is that many people may be making too much of it. “My own impression is that perhaps more has been thought about what may be there than is,” he said. “We have to be very careful that we don’t destabilize the markets of this country and the world by letting it get hyped, and that can easily happen.” (*American Banker*, Rob Blackwell, 09/30/04; *Dow Jones International News*, Dawn Kopecki and John Connor, 09/22/04; *American Banker*, Rob Blackwell, 09/24/04; *The Wall Street Journal*, Dawn Kopecki, 09/29/04; *BNA Daily Report for Executives*, Marcia Kass, 09/30/04)
- Senator Richard Shelby (R-AL), chairman of the Senate Banking Committee, said, “The recent reports about OFHEO’s special examination uncovering accounting problems at Fannie Mae are deeply troubling.” He added he will continue pressing for legislation this year overhauling the GSE’s regulatory oversight. “I continue to believe that OFHEO has inadequate authority to regulate institutions as large and financially complex as the housing (government-sponsored enterprises). This situation reaffirms my belief.” (*Market News International*, 09/22/04)
- Senator Chuck Hagel (R-NE) said “The Office of Federal Housing Enterprise Oversight’s findings to date report on its “Special Examination of Fannie Mae” is deeply troubling. It raises serious doubts about the ability of Fannie Mae’s management to correct the safety and soundness problems at Fannie Mae. What is most troubling is that OFHEO had to use subpoenas in order to conduct its Congressionally authorized investigation of Fannie Mae. Fannie Mae’s resistance to cooperate with this investigation is unacceptable. Based on the findings in OFHEO’s report, it is clear why OFHEO’s requests were repeatedly rebuffed by a stonewall of silence and why Fannie Mae’s management insisted on keeping its financial operations in a black box. OFHEO’s report shows among other things that Fannie Mae’s top management indulged in a windfall of bonuses after it improperly manipulated the company’s annual earnings. If these actions are found to be deliberately linked, then the Board of Fannie Mae needs to take appropriate action and address the problem, just as the Board of Freddie Mac did last year.”
- Hagel continued, “The Boards of both GSEs have a fiduciary responsibility to their shareholders and the public to ensure that any improper actions by management are dealt with swiftly and accordingly. The confidence in the GSEs has a direct impact on the stability of the American economy. The American people and the markets must have confidence in the operations of the Congressionally chartered Fannie Mae and Freddie Mac.”

- “We need to build upon legislation that several of my colleagues and I introduced last year. The Senate Banking Committee passed a watered down version of our legislation, but it is clear from OFHEO’s findings that it is not adequate. To prevent these serious actions from occurring, the new GSE regulator must have at a minimum the same powers and resources as those of other financial regulators such as the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.” (*Press Release from the office of Senator Chuck Hagel, 09/28/04*)

Representative Baker schedules a hearing on OFHEO’s report and sends letter to Fannie’s board

- Representative Richard Baker (R-LA), chairman of the House Financial Service Committee’s Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, announced his panel will hold a hearing October 6 on OFHEO’s examination of Fannie Mae. Baker said, “The outrageous conduct outlined in OFHEO’s report suggests that for too long Fannie Mae has acted as if it were somehow above the law while arrogantly flouting all accountability to the Congress, and that must come to an end. We could not tolerate such behavior from Enron, but the stakes are higher and the betrayal all the more egregious when we’re talking about a company, with almost \$1 trillion in debt tied to taxpayers, that was created by and massively subsidized through Congress to serve a public mission.”
- The House Financial Services Committee voted to give the committee’s chairman, Representative Michael G. Oxley (R-OH), the power to subpoena testimony and documents from Fannie Mae. Oxley said that the vote was needed because “some of the witnesses” for the October 6 hearing investigating allegations from Fannie’s regulator that the company purposely manipulated its earnings “may not be willing to testify without a subpoena.” Oxley was backed by Representative Barney Frank (D-MA), the committee’s ranking minority leader, who said, “individuals at Fannie Mae have a responsibility to come forward.” Frank added, “My advice to those that are thinking of staying away is partly political. I cannot think of an instance in which an individual’s failure to show up was not more damaging ... than anything he said when showing up.” Frank said he welcomed the hearing. “If these allegations are proven, that there was conscious manipulation of the results, that is something that should not only be corrected, but maybe someone should be penalized for it,” said Frank.
- According Fannie Mae, both Fannie Mae chairman and CEO Franklin Raines and CFO Timothy Howard have accepted the invitation to testify before Baker’s committee on October 6. *National Mortgage News* reports that both Raines and Howard could plead the Fifth Amendment against self-incrimination depending upon the questions asked, now that the Justice Department has launched a criminal probe into accounting fraud at the company. OFHEO Director Armando Jalcon, Jr. and Fannie Mae Director Ann McLaughlin Korologos have also accepted the Committee’s invitation to testify. Roger Barnes, the former Fannie Mae employee

who gave OFHEO information about the company's alleged accounting irregularities, will not testify as planned before a committee. "The focus of the hearing has shifted in the past couple of days. We have been in communication with the Department of Justice, although I can't get into that content," said Peggy Peterson, spokeswoman for House Financial Services Committee Chairman Michael Oxley. "The focus [of the hearing] is now on the Fannie Mae executives," she said. In a letter to OFHEO Director Falcon, Baker requested "copies of all records related to the actions of Tim Howard and Roger Barnes and any other documents which relate to the key findings of the OFHEO report on Fannie Mae. Additionally, I am requesting that you provide any documents which you believe will be useful to the subcommittee as it conducts its oversight." There is some expectation that after Baker's hearing, things might quiet down for Fannie Mae for a while, at least until Election Day. [Wishful thinking?]

- On September 29, Baker sent Fannie Mae's board of directors a letter urging them to "hold to strict account all parties responsible for willful violations of" accounting rules. "Further, management failing to discover and halt the widespread and willful abuses at the Enterprise due to negligence or incompetence, must also be held responsible for their inaction," said Baker. In the letter, Baker said he was disturbed to see Fannie Mae's board appear to support company executives before they had completed a review of its management. "Rather than defending the status quo, the board of directors must take decisive action to change the enterprise's corporate culture," Baker wrote. "A simple review or reduction of Mr. Howard's responsibilities by the Board of Directors clearly falls short of the decisive action necessary to end the culture of corruption at Fannie Mae," he added. Baker's letter was in response to comments made by director Ann McLaughlin Korologos, who described CEO Franklin Raines as "a first-class CEO."
- On CNBC, Baker said "It is very clear that Mr. Howard directed ... actions which were not consistent with [generally accepted accounting principles], were not consistent with good business management principles and certainly seem to be the first on the list to be reviewed for dismissal," he said. Baker added that the penalties should be the same for any of Fannie's managers who participated in or otherwise allowed others to manipulate the company's accounting. (*American Banker*, Rob Blackwell, 09/30/04; 09/29/04; *National Mortgage News*, 10/01/04; *Dow Jones International News*, Dawn Kopecki, 09/30/04; *Financial Times*, Jenny Wiggins, 09/30/04; *Washington Post*, David S. Hilzenrath, 09/30/04; *American Banker*, Rob Blackwell, 10/01/04; *Dow Jones Capital Markets Report*, John Connor, 09/28/04; *Reuters*, Mark Felsenthal, 10/01/04; *Reuters*, 10/01/04)

Editorial pages speak out on Fannie's hands being caught in the "cookie jar"
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- The *Wall Street Journal* wrote in an editorial, "It certainly gives new meaning to getting one's hands caught in the "cookie jar." We're referring to [the] bombshell from the board of Fannie Mae that the housing-finance giant has been engaging in

some accounting funny business. ...[OFHEO] findings contradict Fannie's assurances that it can deliver non-volatile earnings, year after year, because its business isn't risky. And having first raised doubts about Fannie's derivatives hedging more than two years ago, we aren't surprised. But there's more. OFHEO found that Fannie also "tolerated" lax internal controls, deferred expenses to achieve bonus compensation targets, and "maintained a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures." Fannie has long touted the superiority of an executive compensation plan that ties most cash bonuses and other pay to meeting annual earnings-per-share targets."

- "We'll defend corporate incentives with the best of them, but not when they involve rigged earnings. Fannie is legendary for its sumptuous pay packages, and CEO Franklin Raines took home about \$12 million dollars in "performance shares" last year. We also note that Anne Mulcahy, CEO of Xerox, resigned from Fannie's board on Monday. She was head of the compensation committee."
- "This news gives new urgency to the need to reform, and ultimately to privatize, these two "government-sponsored enterprises." Although charged with a public mission to provide affordable housing, Fannie and Freddie are being run for private profit. We now know their executives have been dissembling about their earnings, and that their businesses are riskier than they admit. In order to protect taxpayers, Treasury supervision and an end to the implicit taxpayer guarantee is needed. Fannie has resisted both by attacking reformers as somehow "anti-housing." Fannie's executives will now have to explain why anyone should believe a word they say." (*Wall Street Journal*, 09/23/04)
- On September 27, the *Washington Post* wrote in an editorial "The long stalemate over the nation's two big mortgage companies may at last be breaking. For several years, critics have argued that the two companies, Fannie Mae and Freddie Mac, were not only huge but also unstable: Their approach to managing financial risk was cavalier, and if they fell apart the taxpayers would have to rescue them. The lenders replied that their financial controls were watertight, and until recently proof to the contrary was lacking. Last year, however, a report on Freddie Mac, the smaller of the two firms, said that the company was massaging its financial results. Last week a 198-page report on Fannie Mae delivered a similar verdict."
- "The new report on Fannie Mae describes a pattern of manipulation: Executives underreported earnings some years and over-reported them in others, thus smoothing the firm's apparent performance and, in the case of a particular maneuver in 1998, boosting executive bonuses. The eight-month investigation also unearthed doubts as to whether Fannie Mae kept enough capital on hand to protect itself from bankruptcy in the event of unexpected shocks, and it raised a question about 'the overall safety and soundness of the enterprise.' Fannie Mae may challenge these findings, perhaps even successfully. But the report's apparent lesson here is the same as the one taught by Enron and its successor scandals. Senior executives whose bonuses are linked to

their companies' reported earnings face powerful incentives to manipulate those earnings; restraints on such manipulation are feeble.”

- “But the report also points toward a second lesson. Fannie’s long-standing critics may be right: There is a risk that one or other of these mortgage lenders might be mismanaged into a collapse, threatening the banking system unless taxpayers rescue it. Fannie Mae is the second-biggest financial institution in the country, which means it is too big to fail; it follows that it is too big not to be regulated aggressively. The Bush administration and Federal Reserve Chairman Alan Greenspan have urged tougher regulation, but efforts have bogged down in Congress. It is time to revive them.” (*Washington Post*, 09/27/04)
- The *Chicago Tribune* wrote in a September 29th editorial, “If you haven’t heard of the Office of Federal Housing Enterprise Oversight, you’re not alone. But keep reading. It is obscure, but in the last two weeks it has shaken the ground under the nation’s mortgage lending market. The agency reported that executives at Fannie Mae ...used deceptive accounting practices to manipulate earnings and hit Wall Street financial targets. The reason for the deception was drearily familiar: The executives at Fannie Mae wanted to pump up the value of their enterprise by making its financial results appear as smooth and predictable as possible, no matter what the underlying conditions. In one instance, the regulator said, the manipulation enabled the top brass to collect performance bonuses they otherwise would have missed. Chief Financial Officer Timothy Howard gets much of the blame, but this is also a stunning rebuke to Fannie Mae’s chief executive, Franklin Raines, who is among the slickest operators in Washington. The former investment banker and Clinton administration budget chief bears responsibility for what the report describes as incompetent and deceptive financial reporting.”
- “Fannie Mae has ...critics, notably big banks that worry about competing against a government-backed institution. Until now, Raines had a trump card: Fannie Mae has helped to make mortgages cheap and widely available. But its success is based on trust. The financial markets must believe in it. That trust has now been shattered.”
- “Fannie Mae’s directors have responded by agreeing to boost reserves against risk by several billion dollars and to strengthen lax internal controls. The company may well be compelled to restate its reported earnings. Its board has disclosed that the Securities and Exchange Commission is investigating its practices. The changes are welcome, but the fact is that the top management of Fannie Mae has lost its credibility. Tellingly, Fannie Mae directors recently revised the employment contracts of Raines and other executives to eliminate giant severance payouts they would receive if they were fired. It’s pretty clear where this is leading. A business based on trust needs unsullied leadership. Raines & Co. need to go.” (*Chicago Tribune*, 09/29/04)
- The *New York Daily News* writes in an editorial, “Ever since Enron collapsed, a seemingly endless parade of America’s largest companies have been caught

manipulating their numbers, more than a few of them criminally. Revelations that were once scandalous now provoke the question, ‘So what else is new?’ Well, last week something was both new and frightening. Federal regulators uncovered accounting chicanery at a company whose financial health is critical to the health of the entire U.S. economy. If that doesn’t scare you into checking your wallet, nothing will. The company is Fannie Mae, which is probably best known from its feel-good television commercials about helping with homebuying. You’d never know it from the ads, but Fannie Mae is one of the world’s biggest financial institutions.”

- “While there’s no evidence that Fannie Mae is in financial trouble, the company and its chief executive, Franklin Raines, have broken faith with the American public. Their board must give due consideration to a management overhaul, and the government must step in. Federal Reserve Chairman Alan Greenspan has warned that Fannie Mae and Freddie Mac - which now own or guarantee half the \$7.3 trillion mortgage market - are growing too fast for the economy’s good. And the Bush administration has been pushing - against Fannie Mae’s potent congressional lobbying - to strengthen oversight. The company is now regulated by a relative pipsqueak that goes by the acronym OFHEO. That must change, and the Securities and Exchange Commission must urgently plunge into Fannie Mae’s murky finances and report back forthwith.” (*New York Daily News*, 09/27/04)
- *USA Today* wrote in a September 28th editorial, “Few people know much about mortgage giant Fannie Mae aside from its TV ads, which paint the company as the \$1 trillion version of George Bailey’s savings and loan in *It’s a Wonderful Life*. But as the nation’s largest source of funds for mortgages, Fannie Mae is a powerful force in the lives of millions of homeowners. That power has not always produced wonderful results. Last week, the federal agency that oversees the company accused it of cooking its books to meet earnings goals and ensure that executives got hefty bonuses, including \$1.1 million to then-CEO-designate Franklin Raines in 1998.”
- “While such chicanery may seem all too familiar in an era of corporate abuses, wrongdoing by Fannie Mae would represent a greater betrayal of public trust. That’s because it and its sister company, Freddie Mac, have federal charters to expand home ownership. They enjoy government-bestowed privileges that have made them behemoths with a stake in half of all home mortgages. Abuses that create financial trouble for either company — they have a combined \$1.7 trillion in debt — could hurt the economy by driving up interest rates, and force taxpayers to pay for a costly bailout.”
- “The problems at Fannie Mae, following a similar accounting scandal at Freddie Mac last year, show that Congress and federal regulators are not up to the task of policing these companies effectively. The taxpayers can be better protected by ending all federal support for Fannie and Freddie and letting them compete in the marketplace like other wholly private companies. So far, however, Congress has been cowed into inaction by Fannie’s and Freddie’s lobbying machines, which spend millions each year to protect their government perks. Those include a \$2.5 billion line of credit

each and an exemption from state and local taxes. The companies also can borrow for less because lenders assume the government will bail them out if they get in trouble. That advantage over other financial institutions is the key to their success.”

- “While Fannie Mae agreed Monday to closer scrutiny and more conservative accounting in the wake of the abuses reported by OFHEO, it and Freddie Mac have a long history of resisting tighter oversight.”
 - “Thwarting Congress. The two titans beat back legislation to create a stronger regulatory office. A Senate bill is now so weak that the Treasury Department opposes it on the grounds it would establish a feckless regulatory office.”
 - “Fighting regulators. Fannie hindered the OFHEO’s probe of its accounting by repeatedly refusing to provide information. The agency had its way only after persuading the Justice Department to turn up the heat on Fannie’s executives.”
 - “Avoiding scrutiny. Freddie Mac had concealed its accounting problems from regulators. They came to light only when the company was forced to choose a new auditor to replace Arthur Andersen, which was forced out of business by the Enron scandal.”
- “Some defenders of Fannie and Freddie say their government ties keep mortgage rates low. But a Federal Reserve Board study estimates that the two companies lower rates by less than a tenth of a percent. Fannie says it is between a quarter and a half percent. Either estimate is a small savings compared with the huge risks placed on taxpayers. If either agency gets into financial straits, donations from thankful neighbors won’t be enough to write a happy Hollywood ending.” (*USA Today*, 09/28/04)
- *New York Sun* wrote in an editorial, “With all the self-righteousness from the left that attended the fall of Enron, it sure is going to be interesting to see how the Democrats react to the accounting scandal that is unfolding at Fannie Mae. That is the mortgage finance company whose chairman and chief executive is Franklin Raines, who was the director of the White House Office of Management and Budget during the Clinton administration. Mr. Raines earned \$20 million last year, in part for achieving financial targets that were reached by improperly deferring expenses, a federal oversight probe said yesterday.
- “...Honest accounting errors are certainly possible, and what Mr. Raines or any other executive is paid is a matter that we’d ordinarily say should be left to his company’s shareholders and directors. But most financial companies are headquartered in financial capitals like New York. Fannie is based in Washington, D.C. It spent \$8.7 million on lobbying in 2003, according to a report in the *Hill* newspaper. Lately Fannie has been venturing into foreign policy, announcing a joint venture with the Egyptian government. Fannie and Freddie compete with private firms that aren’t as

closely tied to the government. It's all a reminder of the risks of the federal government getting into the real estate business." (*New York Sun*, 09/23/04)

- In a September 29th editorial, *The Baltimore Sun* wrote, "...The shattering of the [Fannie's and Freddie's] credibility since last year is the real issue here. Some, like Federal Reserve chief Alan Greenspan, have been saying that Fannie Mae and Freddie Mac should be privatized. But short of that, if they are to retain their cheap lines of credit at the federal Treasury, much firmer oversight is in order." (*The Baltimore Sun*, 09/29/04)
- In an October 1 editorial, *The Economist Global Agenda* writes, "America's legion of home-owners felt a tremor underfoot this week. It was not, fortunately, the result of an earthquake nor, for most, anything to do with the succession of hurricanes that have battered Florida's coastline lately. Rather, it stemmed from ructions at Fannie Mae, the custodian of more than \$2 trillion-worth of their mortgages."
- "On Monday September 27th, Fannie's board of directors bowed to pressure from its regulator, the pithily named Office of Federal Housing Enterprise Oversight (OFHEO), to raise by 30% the amount of capital that it holds against its debts. Fannie also agreed to bring its books more into line with generally accepted accounting practices and to appoint an independent chief risk officer to ensure that the company is not jeopardizing the assets of its shareholders and debtors. (Hitherto, this task has been spread among several people.) The company also undertook to review the roles of its senior staff, and how they are remunerated. And these were only the most pressing actions required by OFHEO's interim report, which, when it was released last week, caused Fannie's share price to wilt and its bondholders to worry. Expect further demands when OFHEO completes its investigation in the coming months, and possibly from a probe by the Department of Justice which is believed to be under way."
- "As America's biggest issuer of mortgages and securitized housing debt, Fannie is a pillar of the financial community. But many reckon that for too long it has been sailing close to the wind. In April, OFHEO gave warning that Fannie might have to restate its accounts because too many of its loans for manufactured (i.e., prefabricated) houses were in danger of not being repaid. The company promptly issued a denial, which was labeled "inaccurate and misleading" by OFHEO's director, Armando Falcon. Mr. Falcon has now gone further, saying in an open letter to Fannie's board of directors that in at least one instance the company deferred expenses, apparently to ensure that its earnings reached targets that would entitle its directors to bonuses."
- "We have been here before. Last year, Freddie Mac, Fannie's sibling, wobbled when it was revealed that it had smoothed earnings in the past and would have to delay the announcement of its results for 2003. This followed the ousting of its chief executive, Gregory Parseghian, after only six months in the job. Although it is further ahead in reforming itself, Freddie's problems are as bad, if not worse, than those of Fannie."

- “It is not just the sheer scale of Fannie’s and Freddie’s operations which worry regulators and investors alike: between them, the two institutions not only deal in each other’s debt but, as a way of hedging their liabilities, buy and sell huge quantities of Treasury bonds. It is also the fact that both institutions—which are now independent, with their own shareholders, but which began their lives as government agencies—enjoy an implicit guarantee of their debt by the federal government. In other words, there is a widely held belief among investors that if anything were to go wrong, the government would bail them out.”
- “Though only implicit, the guarantee has enabled the two companies not only to borrow more cheaply in the financial markets; it has given them an advantage over rivals and enabled them to take bigger risks and so to grow even more quickly. Indeed, as Alan Greenspan, the chairman of the Federal Reserve, observed in testimony to Congress earlier this year, the bigger Fannie and Freddie become, the greater the danger of them creating a storm in the financial markets should they fail. As a result, the government’s implicit guarantee is becoming ever more explicit.”
- “Realizing the dangers inherent in such an arrangement, Mr. Greenspan called in February for tougher regulation of both companies, similar to that faced by banks. The regulator, he said, should have a free hand to set capital standards and be able to develop a clear process, sanctioned by Congress, for placing in receivership either company (or, for that matter, any of the smaller government-sponsored enterprises also involved in housing) if they default on their obligations.”
- “That Mr. Falcon has chosen to take Fannie to task even before he has completed his investigation of the company’s accounts and governance is likely to please Mr. Greenspan. OFHEO’s action has certainly found favor with members of the House of Representatives’ Financial Services Committee. “The outrageous conduct outlined in OFHEO’s reports suggests that for too long Fannie Mae has acted as if it were above the law while arrogantly flouting all responsibility to Congress, and that must come to an end,” said Richard Baker, a Republican representative from Louisiana.”
- “Indeed, there may yet be calls for OFHEO’s powers to be beefed up or for a new regulator to be appointed. Michael Oxley, chairman of the House’s Financial Services Committee, hinted as much when he called for hearings into OFHEO’s interim findings to be held on October 6th.”
- “Meanwhile, the markets are likely to deliver their own verdict when Fannie seeks to raise extra money in order to meet OFHEO’s demand to increase its capital. Under the deal announced this week, Fannie has 270 days in which to meet the new requirements. It has 45 days to come up with a plan for raising the extra cash—a deadline that the markets will be watching with anxiety.”
- “Fannie’s options are more limited than it would like. True, it could raise its required level of capital simply by issuing fewer securitized mortgages to investors. But that

would crimp its profits and could eventually force it to cut its dividend—a prospect that might encourage some of its shareholders to sell their stock. If that were to happen on a big enough scale, and profits were to fall at the same time, Fannie could even find its creditworthiness called into question.”

- “For now, says Standard & Poor’s, a credit-rating agency, Fannie’s finances look “pretty strong”. But this assumes that neither Fannie nor its regulator do anything in the meantime to make a bad situation worse.” (*Global Economist Global Agenda*, 10/01/04)
- In an October 2 editorial, *the Economist* writes, “Fannie Mae has some difficult decisions to make. Its board, contradicting its earlier line, has acknowledged discussing an earnings restatement. Within the next nine months, the company must work out how to raise new capital. None of the standard methods looks attractive: a dividend cut will not be popular; nor, in mid-crisis, will an equity offering. Alternatively, Fannie Mae could unload assets. But selling some mortgages from its vast portfolio might disrupt the mortgage market—not to mention denting Fannie Mae’s returns. 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*, 10/02/04)

Cracks in Fannie Mae’s facade illuminated by OFHEO report

- Gretchen Morgenson wrote in the *New York Times*, “A shocking exposé hit the Street ... about one of the best-loved, all-American companies: Fannie Mae, the mortgage and financial services giant. The report, written by [OFHEO], offered a litany of accounting improprieties at the company. You might call it “In the Kitchen With Fannie: How to Cook the Books for Fun and Profit.”
- “[T]he report cuts through all the smoke and fog the company’s powerful publicity and myth machine has generated lo, these many years. Fannie Mae, the ultimate story stock, was not just a mortgage company, after all. It was the glorious institution with a mission of making the American dream of homeownership come true for millions. (Bring up the violins.) Now, however, investors know the truth about Fannie Mae: that it is just another scheming corporation run by me-first managers. And this is only an interim report, meaning that there is more to come.
- “INVESTORS ... learned from the report that when bonuses are at risk, executives will think nothing of manipulating numbers to remove the threat. In 1998, for example, Fannie Mae was facing the possibility of having to record an expense of \$400 million. Sure, the company’s earnings would have been reduced if it took the expense, but more important, its executives’ bonuses would be diminished. So, the company took only \$200 million, and put off expensing the rest. Abracadabra!

Franklin D. Raines, the company's current chief executive, and his predecessor, James Johnson, got their bonuses."

- "Then there is the revelation that companies like Fannie Mae think that following accounting rules is for girlie men. The report said that when accounting arbiters changed the rules to require Fannie Mae to mark its portfolio to market - running gains and losses through its income statement except in cases where the holdings were hedged - the company had a better idea. It used less onerous hedge accounting, shifting losses to a line on its balance sheet known as "other comprehensive income." Never mind that it could not justify the move in many cases. Its goal of smooth and steady earnings growth was achieved."
- "[A]nother revelation that Fannie Mae's fans must now face: that the company is grossly undercapitalized. Its equity capital of roughly 2 percent is much lower than the 8 percent required of "A"-rated banks, according to Sean Egan of the Egan-Jones Ratings Company. "In the past Fannie has made the argument that it was very familiar with the mortgage market and therefore needs less equity," Mr. Egan said. "Our view is the lack of diversification argues for a greater level of equity."
- "Raising capital in this environment will be difficult, to say the least. But Fannie Mae's regulator may force the issue, said Josh Rosner, a financial services analyst at Medley Global Advisors, a policy and regulatory research firm in New York. "If a company is deemed to be unsafe or unsound, the regulator may require it to hold capital in excess of statutory required capital until the problems have been addressed on a remedial basis," Mr. Rosner said. "We don't even know how much they'd have to raise, because the alleged accounting problems mean current capital may be misstated. But they will have a significant restraint on their ability to grow for some time. That is unquantifiable."
- "Also troubling is the fact that Fannie Mae's problems have implications for the entire mortgage market. One of the regulatory findings was that the company's risk controls and accounting systems were exceedingly weak and lax. Are its other systems similarly weak? That is no small question. Most of the mortgages underwritten in the nation today use automated programs designed by Fannie Mae. 'If allegations that they engineered systems for growth without regard to safety and soundness are correct, other systems, including underwriting, appraisal and loss mitigation systems should be called into question as well,' Mr. Rosner said."
- "As the report makes clear, executive bonuses and smooth earnings were viewed by Fannie Mae as far more important than accurate financial statements. The report cited an internal memo written in 1999 extolling the benefits of a brand of software Fannie Mae used when trying to assess how much income or expense should be recognized on securities and loans. The software, the memo said, allowed a user "to manipulate factors to produce an array of recognition streams," which "strengthens the earnings management that is necessary when dealing with a volatile book of business." This nugget means that Fannie Mae is probably not alone in playing fast

and loose with financial reality. That there is software out there designed to let corporate users manipulate figures to get whatever answer they desire certainly indicates that other companies want to obfuscate, too.”

- “INDEED, that is the larger and most dispiriting lesson to be gleaned from this debacle. Sure, Fannie Mae was more arrogant than most companies; it lobbied more aggressively, slapped around its regulators and threatened any politician who had the temerity to question its favored status as a government-sponsored enterprise. But the company that comes through in the regulatory report is probably not an anomaly. In other words, Fannie Mae is not the only cook in the kitchen. She has lots of company. And they’re spoiling the broth.” (*New York Times*, Gretchen Morgenson, 09/26/04)

<p>Fannie Mae enters the Enron hall of accounting infamy with an estimated shortfall in equity of as much as \$14.4 billion</p>

- Fannie Mae looks set to join Enron and WorldCom in the hall of accounting infamy, writes Peter Eavis on *TheStreet.com*. While this might seem a stretch to some, a close reading of the OFHEO report suggests that Fannie could have kept *billions* of dollars of losses out of earnings and an important capital number used by regulator to determine the company’s financial strength.
- While WorldCom hid approximately \$11 billion of expenses to boost its earnings, Fannie may have overstated its year-end capital number by more than that, by excluding as much as \$11.6 billion in pretax net losses. If Fannie failed to include those losses in earnings and capital, it would have drastic ramifications for the GSE, investors and the U.S. housing industry. Fannie may have to raise far more new capital than Wall Street currently is estimating, which will further depress its stock price. OFHEO and Fannie announced that within nine months the company must raise its capital to 30% above its required level, but the final amount may be far higher.
- The probe’s real bombshell is the assertion that Fannie incorrectly accounted for large amounts of derivatives used to hedge against adverse interest rate movements. Potentially billions of dollars of losses on these derivatives may not have been properly factored into its earnings or core capital. Given that OFHEO’s report suggests that Fannie’s derivatives accounting was endemically bad, analysts have taken the step of factoring into core capital all the derivatives losses stored up in OCI, and offsetting those with some gains that would occur if Fannie did that.
- At the end of last year, there were \$18.8 billion of pretax derivatives losses in OCI, offset by an estimated \$7.2 billion of gains, producing estimated pretax net losses of \$11.6 billion, or \$7.5 billion after tax. Given the sharp drop in interest rates in recent days, the net after-tax losses could be even higher now. When interest rates were close to current levels at the end of March, Fannie’s net losses stood at around \$10 billion after-tax, or a staggering \$15 billion pretax.

- Using these estimates, how much capital should Fannie raise? This calculation has three steps. First, subtract the \$10 billion of estimated net losses from the end-June core capital number of \$36.2 billion to get a net core capital of \$26.2 billion. Second, calculate Fannie's new minimum capital requirement with the 30% increase. On June 30, Fannie's capital was \$31.2 billion, but would be \$40.6 billion with the 30% addition. Third, subtract our net core capital number of \$26.2 billion from the \$40.6 billion to determine theoretically how much Fannie is undercapitalized and would have to raise to meet OFHEO's new minimum capital requirement. Fannie's shortfall comes to a staggering \$14.4 billion.
- With these estimates in mind, how serious is the Fannie mess? Much more serious than many on Wall Street think. There may have been times in the past three years when Fannie's core capital number, if it wrongfully excluded the OCI losses, was so far below its minimum capital requirement that Fannie probably would have been shut down by the OFHEO. During the third quarter of 2002 when plunging interest rates drove up derivatives losses, Fannie easily could have been nearly 40% undercapitalized, if it was incorrectly excluding OCI losses from core capital. Banking regulators would never allow a bank to continue normal business if it were that much undercapitalized.
- OFHEO suggests Fannie's derivatives accounting has been erroneous since it became subject to SFAS 133 in 2001. Fannie has never really hidden its dislike for SFAS 133. If it is revealed that Fannie didn't apply SFAS 133, the reason may turn out to be that management never felt they really had to, simply because Fannie was so big and exerted so much influence around Washington and Wall Street.
- OFHEO's report hints of deep arrogance within Fannie's management, suggesting the current top execs soon will be gone, possibly leaving the company effectively without direction for months.
- Josh Rosner, an analyst at Medley Global Advisors, says it'll be extremely difficult to go back and recalculate some numbers, and a true core capital number can't be quantified today. It could be several quarters before Fannie is able to file financial statements with the SEC, he adds. Raines and Howard, both of whom vigorously defended Fannie's accounting in the past, almost certainly won't want to sign off on financials that may need to be restated in the future. Thus, there could be a long delay before Fannie files SEC-registered financials again, which may severely curtail Fannie's ability to issue debt to fund its business. While Fannie isn't going to plunge into bankruptcy like Enron and WorldCom, it already has descended to their level in other ways. (*TheStreet.com*, Peter Eavis, 09/28/04)

Is Fannie Mae the Democrats' Enron?

- Terry Keenan writes in the *New York Post*, “Is the growing scandal at Fannie Mae about to become the Democrats’ Enron? That’s the hot question in Washington ... as regulators painted a scary picture of the huge home lender, detailing accounting shenanigans, including “cookie jar” reserves that smoothed out volatile results and paved the way for tens of millions of dollars in executive bonuses. For those, including Alan Greenspan, who have warned that this government-sponsored lender is a ticking time bomb, the revelations seem to indicate that Fannie’s own management believed its operations are a lot riskier than they let on.”
- “That’s just one reason this story has Washington and Wall Street buzzing. There are many others — starting with Fannie’s chairman and CEO Franklin Raines. Raines is not your average CEO, mind you. The Harvard educated exec, who pocketed \$20 million from Fannie Mae last year, is just one of a handful of Democrats who easily bridges the Washington-New York power axis. Raines was widely believed to be Senator John Kerry’s first choice for Treasury Secretary in a Kerry administration, and was even mentioned as a potential Kerry running mate. In the corporate world, Raines is a force to be reckoned with as well — heading up the Business Roundtable’s corporate governance committee. No joking.”
- “With one foot in politics and the other in business, Raines was tailor-made for Fannie, a place where job one is keeping the government off its back. That’s why Fannie and its cousin Freddie Mac boast Washington lobbying machines second to none. Time was, not long ago, when Fannie and Freddie were equal-opportunity political donors. Both companies liberally doled out money to lawmakers of both parties with little regard to party affiliation.”
- “But that equation began to change in recent years. Once untouchable, the White House and the Republican-controlled Congress began to take on Fannie and Freddie in the post-Enron era. And no surprise, execs at Fannie and Freddie began to target their donations at Democrats. Little wonder Fannie Mae repeatedly tops the list of stocks that would benefit from a Kerry victory. And until this week, the Fannie Mae strategy continued to work. Faced with proposed legislation from Republicans on the Senate banking committee that would have, among other things, removed Freddie and Fannie’s exemptions from bankruptcy, the companies fought back, and won.”
- “Remember those ads warning that any meddling in Fannie Mae’s future would mean the end of affordable housing? Eventually, the legislation was so watered down, the Republicans walked away. The next few weeks will likely tell whether the scandal at Fannie Mae will blow over, or whether it threatens to blow up into a bigger mess that could potentially leave U.S. taxpayers exposed to a mammoth bailout. It will be interesting to see if Fannie’s ties to the Democrats get as much ink as Enron’s ties to the Republicans.” (*New York Post*, Terry Keenan, 09/26/04)

Hurricane Fannie makes landfall and “unintended consequences” follow

- Ken Guenther writes in *The Guenther-gram*, “The housing GSEs have been under a political and press hurricane watch for better than a year. The fallout from OFHEO’s ...report on the accounting irregularities at housing finance giant Fannie Mae will forever change the housing shoreline. The erosion could negatively impact interest rates for future homebuyers as well as the liquidity of community banks if Fannie and Freddie buy fewer mortgages. Tim O’Brien of the *New York Times* has outlined the downside of Fannie’s agreement with OFHEO. His September 28 story states, ‘So if Fannie Mae’s activities were curtailed as a result of the current investigations, mortgage rates may rise modestly, creating a political nightmare for members of Congress who may have to face the wrath of angry homeowners. Fannie’s size, and its government backing, also allow American home buyers to enjoy mortgages with rates that are guaranteed for as much as 30 years, a financial benefit that is unavailable in most other countries....’”
- “Word on the street had OFHEO as a weak and toothless regulator, slated for legislative execution by the administration. Its place was to be taken by a new, independent world-class regulator over Fannie, Freddie and the Federal Home Loan Banks. This perception has certainly changed. The *Wall Street Journal* reports that the changes Fannie has agreed to implement ‘achieve instantly what some Bush Administration and Federal Reserve officials have long sought: limits on Fannie’s explosive growth.’”
- “In the category of beware of unintended consequences, these sea changes are going forward in a climate of rising interest rates that negatively impact the housing sector. In turn, the administration is about to propose new, increased low- and moderate-income housing goals for Fannie and Freddie that could also impact their growth. Given the importance of housing to the American economy, it is now doubly important that the administration not overreach. And looming in the background is Chairman Greenspan’s desire to see the housing GSEs privatized.” (*The Guenther-gram*, Ken Guenther, 09/28/04)

Say it isn’t so!

- The *Washington Post* writes, “A study by the former chairman of the Bush White House’s Council of Economic Advisers, R. Glenn Hubbard, ...released by Fannie Mae, concluded that the company’s ‘level of safety and soundness is comparable to or better than’ that of most large banks and that the chance the company will fail in the next year is one in 10,000. (*Washington Post*, Albert B. Crenshaw, 09/23/04)

Unresolved issues at Fannie Mae:

Will management survive or be replaced?

Will Fannie Mae restate its historical earnings?

Will insider sales of Fannie Mae stock withstand scrutiny?

Are Fannie's political allies deserting them?

Will management survive or be replaced?

- While the OFHEO exam report is explicitly critical of Fannie's subordinates, particularly CFO Howard, it is silent about the precise role played by Chairman and CEO Howard Raines and, his predecessor, former Chairman and CEO Jim Johnson in the accounting principles being criticized. Even if Raines and Johnson were not directly involved, the two must bear responsibility for any ultimate finding of systemic wrongdoing, say some experts. "I think it's very questionable that [Raines] survives this," Lynn E. Turner, a former chief accountant at the SEC during the Clinton administration. "There is enough in the report that calls into question both his abilities to manage the company and his ability to put the right people in place around him."
- James D. Cox, a securities law and accounting expert at Duke University School of Law who also owns stock in Fannie Mae, agreed. "My sense is that these were policies that were pursued systematically, and I don't think that happens without senior management being involved," said Cox. "The history of restatements at this level is that people at the most senior level don't survive." Jacob Frenkel, a former SEC enforcement lawyer and federal prosecutor said, "If you look at what major corporations are doing, where there are widespread failures relating to accounting practices, both the CEO's and CFO's heads roll."
- "I don't think Franklin Raines will survive it, and that's a shame," says Janet Tavakoli, a structured finance and derivatives consultant. "But he was on notice with what happened at Freddie, and there was burden of due diligence on Raines to put his house in order."
- In fact, Raines' own testimony before a House panel supports such arguments. In sworn testimony, Raines said, "It is wholly irresponsible and unacceptable for corporate leaders to say they did not know -- or suggest it is not their duty to know -- about the operations and activities of their company, particularly when it comes to risks that threaten the fundamental viability of their company."
- Representative Richard Baker (R-LA) said Fannie Mae should dismiss Chief Financial Officer J. Timothy Howard and hinted that the chairman and chief executive, Franklin D. Raines, probably should go, too.

- In an interview the Associated Press, HUD Secretary Alphonso Jackson said it was up to the board of Fannie Mae to decide whether to remove top managers. (Associated Press, March Gordon, 09/29/04)
- Before Fannie Mae's problems surfaced, Raines and Johnson were considered to be high on the short lists for top administration jobs in a Kerry administration, should Senator John Kerry (D-MA) win the presidency in November. Publicly, both continue to enjoy the support of Democrats. "Both Frank and Jim are pillars of the Washington community and both have impeccable reputations," said Gene Sperling, a former senior economic adviser in the Clinton administration who is now a top adviser to Kerry. "I don't see anything that would diminish their potential to contribute to a Kerry administration if either is so inclined. Both men have long public and visible records of integrity." Mary Beth Cahill, Kerry's campaign manager, said Johnson "is a highly valued and respected adviser to Senator Kerry and the campaign and we would expect his role to be the same in the future as it is today." She did not discuss Raines. Privately, Washington is awash in speculation that Fannie Mae's problems could overshadow any chance of either Raines or Johnson returning to government. (*Wall Street Journal*, John R. Wilke, John D. McKinnon and James R. Hagerty, 09/30/04; *New York Times*, Stephen Labaton, 09/29/04, *TheStreet.com*, Matthew Goldstein, 09/23/04; *Reuters*, Mark Felsenthal, 09/28/04; *Reuters News*, Mark Felsenthal, 09/26/04)

Will Fannie Mae restate its historical earnings?

- On September 30th, *The BNA's Daily Report for Executives* reported that Representative Paul Kanjorski (D-PA) called Fannie Mae's accounting problems "solvable" and "**indicated that the GSE has agreed to issue revised financial statements.**"
- There is debate among the experts over whether the SEC will require Fannie Mae to restate its earnings. During a recent investor conference call sponsored by Prudential Securities, Lynn Turner, former accounting chief at the SEC, said "I think there'll be a chance better than 50-50 it will give rise to a restatement, especially given some of the language in the agreement."
- Others argue that there is no guarantee OFHEO's criticisms of Fannie's accounting will hold up. While OFHEO has broad authority over ensuring the financial safety and soundness of the GSEs, the ultimate arbiters of the accounting rules are the SEC and the newly created Public Company Accounting Oversight Board. Lawyers familiar with these matters say the SEC likely would show deference to OFHEO in determining the rules going forward, because of the financial stakes involved with Fannie and Freddie. In determining the rules for past accounting periods and the need for the company to restate its past earnings, the SEC would have less incentive to defer to OFHEO, some lawyers say.

- In an appearance on National Public Radio, Mike McNamee, the deputy Washington bureau chief for *BusinessWeek*, said "...[W]e've been told by some SEC officials that they're rather skeptical about some of these [OFHEO] allegations and that in the end financially the mistakes or misstatements that they did on one side may balance out the ones on the other side and it will be a wash." In a September 28th article in *BusinessWeek online*, McNamee also describes Fannie Mae's regulatory agreement was a win-win outcome for the company. OFHEO emerges looking stronger, claims McNamee, and Fannie's directors "look smarter," by reassuring nervous investors and easing tensions in Washington. "...The Fannie directors' quick capitulation should take some steam out of the drive to replace OFHEO with a tougher regulator housed in Treasury." Fannie's directors knew when to "fold a losing hand" to make certain they could stay in the game, wrote McNamee
- When asked by a *Reuter's* reporter whether Fannie Mae would need to restate earnings as a result of changes demanded by OFHEO, the company's COO Daniel Mudd said, "It is not contemplated in the discussion we've had to date. As you know, there has been an informal review going on at the [SEC] and that will be a matter further down the road." However, OFHEO has told Fannie Mae's board that an earnings restatement is one of the issues it will have to consider in the process of correcting its accounting, according to *Reuters*. Fannie spokesman Chuck Greener quickly issued a correction, saying Mudd had misspoken. "The issue has come up in discussions with the board," said Greener.
- The stakes concerning the restatement also are high for Fannie Mae's executives, who are well compensated. The Sarbanes-Oxley legislation could require Fannie's executives to surrender their bonuses and other incentive-based compensation in many circumstances. For example, Fannie's Chairman and CEO Franklin D. Raines was the fifth highest paid executive in Washington, DC area in 2003, receiving a base salary of about \$1 million, and about \$15.8 million in bonus and other incentive-based compensation. Over the three years ending December 31, 2003, Raines received a total of about \$14 million in compensation and another \$25.4 in incentive-based bonuses. (*BNA's Daily Report for Executives*, Marcia Kass, 09/30/04; *Wall Street Journal*, John D. McKinnon, 10/01/04; *Washington Post*, David S. Hilzenrath, 08/16/04; *New York Times*, Stephen Labaton, 09/29/04; National Public Radio, *All Things Considered*, 09/30/04; *CFO.com*, Stephen Taub, 09/29/04; *Reuters News*, Mark Felsenthal, 09/28/04; *Dow Jones Chinese Financial Wire*, Dawn Kopecki, 09/28/04; *BusinessWeek online*, Mike McNamee, 09/28/04)

Will insider sales of Fannie Mae stock withstand scrutiny?

- According to the company's SEC filings, Fannie Mae insiders have cashed in roughly \$35 million in restricted stock and options since last spring with CFO Tim Howard reaping the biggest rewards, who has received more than \$4.5 million in proceeds from March through September. Fannie Mae officials emphasized that a bulk of his proceeds, \$7.2 million, came from automatic sales of 10-year-old options that are set to soon expire. Howard also sold off another \$1.1 million in previously restricted stock earlier this year to cover some of the taxes he owes on that compensation.

- Days before OFHEO delivered its report to Fannie Mae's board on Sept. 20, Howard locked in more than \$400,000 of his gains in automatic sales. The *Wall Street Journal* reported, "A company 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 (OFHEO) thought anything was wrong.' He said, 'Throughout the examination we've considered the issue of whether or not we needed to black out trading and have done so when we thought appropriate,' the attorney said, adding that executives are currently prohibited from trading Fannie stock. He declined to say when, or if, Fannie has halted trading as a direct result of OFHEO's investigation." According to the *Wall Street Journal*, Howard sold an *additional* 7,000 shares of Fannie Mae stock on October 1st.
- Some securities lawyers are raising questions about Howard's sale of Fannie Mae stock, while the company was under scrutiny by regulators. While Howard sold his stock under a stock-trading plan which was disclosed in February, Michael L. Zuppone, a former SEC lawyer, said the key question is whether Howard said executives can be guilty of illegal trading if they set up such plans while in possession of material inside information. Eugene Goldman, a former SEC enforcement attorney, said the key question is whether Howard had material nonpublic information when he entered into his stock-sales plan. "In other situations, the SEC has charged people with insider trading [if the insider was] disposing of company stock while aware of financial irregularities," Goldman said. "What you don't know is what he knew before he entered into the plan."
- "What is especially alarming is to have the CFO or any other officer not realize the symbolic and real consequences of unloading their own holdings amid public controversy while out of the other side of their mouth denying the problem," said Jeffrey A. Sonnenfeld, associate dean and a professor specializing in corporate governance at the Yale School of Management. "It shows a lack of faith in his own company. And it suggests that this is a bad investment because there's a bad event coming, such as a government investigation that [is] going to reveal a problem." (*Wall Street Journal*, Tony Cooke, 09/29/04; *Dow Jones International News*, Dawn Kopecki, 09/28/04; *Wall Street Journal*, Tony Cooke, 10/01/04; *Washington Post*, Kathleen Day, 09/24/04)

Are Fannie's political allies deserting them?

- Time will tell if Congressional support for Fannie Mae will wane. "Once you find serious internal control weaknesses at Fannie Mae and Freddie Mac, if that is established, then there is considerable political risk for members of Congress standing in the way of a reasonable regulatory package," said Thomas Stanton, a fellow for the study of American Government at John Hopkins University and author of a book on the potential risk the housing GSEs pose to U.S. taxpayers. "I think Fannie Mae's political clout melts away in front of members' realization that they could be held accountable." (*Washington Post*, Jeffrey H. Birnbaum and David A. Vise, 09/27/04)

- Jerry Howard, the chief executive officer of the National Association of Home Builders, said in an interview with *American Banker* that NAHB was “reevaluating” its support for Fannie. To date, the trade group has been a staunch GSE ally on Capitol Hill. Howard said he was concerned that Fannie Mae has failed to defend itself, which is “very uncharacteristic” of the GSE. OFHEO’s allegations about Fannie’s accounting problems were prompting NAHB to take another look at the situation, said Howard. “Obviously, these developments are something we find shocking and extremely disappointing, but we want to take a look at them and see what it all means before we make a decision,” he said. NAHB is forming a task force to look into the matter, said Howard. He doesn’t expect the trade group to make any policy changes until at least the first two weeks of next year. (*American Banker*, Rob Blackwell, 10/01/04)
- Alarm bells rang on Wall Street, as Fannie Mae’s shares dipped more than 15% from its closing price of \$77.21 on September 17th to the closing price of \$65.25 on October 1st. With the release of the OFHEO report, Fannie has been losing support even among investment analysts, a community that has voiced almost universal acclaim for the company for many years. Jonathan E. Gray, a Sanford C. Bernstein & Co. analyst, said that Fannie’s silence following the release of the OFHEO report has been unnerving to shareholders, particularly since the GSE has aggressively defended its actions in the past.
- “I’m shaken” by OFHEO’s findings, said Mike McMahon, an analyst at Sandler O’Neill & Partners LLP. For the first time in the eight years of following Fannie, McMahon removed his “buy” rating on the stock, reducing it to hold and saying in a report: “We think there is substantially more downside risk than upside potential in the share price.” McMahon added that “broad and significant” management changes are likely soon. Fannie may have to delay reporting third-quarter results while it untangles the accounting issues raised by OFHEO, McMahon said. “We don’t understand how management can provide the certification [of earnings] if it knows the prior-period earnings ...are incorrect,” he said. “There are still a few folks on the Street that think Fannie will get through all of this, and they may,” said McMahon. “But as news like the D.O.J. [Department of Justice investigation] comes out, reality is setting in.”
- Edwin Groshans, an analyst at Fox-Pitt, Kelton Inc., an investment-banking unit of Swiss Reinsurance Co., predicted in a newly released report that calls for the resignations of Raines and Howard “will be heeded.” He also forecast that Fannie will be fined \$250 million to \$500 million and will restate its results for the past five years.
- Now that Fannie Mae’s preferred “core earnings” (which exclude short-term volatility in the derivatives portfolio) are now being questioned by OFHEO, Wall Street is at a loss to understand exactly how volatile and risky Fannie’s business is. Tom Linsmeier, a professor at Michigan State University who specializes in derivatives

accounting, said, “The big question with Fannie Mae and Freddie Mac is, ‘what is their risk position?’ In both instances, they are trying to smooth out earnings to have their business appear less risky. Right now, we have no knowledge of their risks.”

- Nevertheless, Fannie Mae retains some support on the Street. David Hochstim, an analyst at Bear, Stearns & Co., maintained his “outperform” rating on the stock and said the recent share-price drop has “more than adequately adjusted” for the possibility of slower growth and a lower return on equity. (*Wall Street Journal*, John R. Wilke, John D. McKinnon and James R. Hagerty. 09/30/04; *New York Times*, Jennifer Lee, 10/01/04; *Financial Times*, Stephen Schurr and Jenny Wiggins, 09/29/04)
- In an article appearing at *RealMoney.com*, Jim Cramer wrote, “...For those of us who lived and breathed Enron and WorldCom, I can tell you that if this [OFHEO] report is right, Fannie Mae’s inner workings were every bit as sinister as those others’ were, and I have no reason to doubt that report. Every accounting device known to man was employed by these guys. And they repeatedly lied about it to anyone who would ask.
- “The [OFHEO] report itself is a road map for prosecutors that leads right to the very top. If you own this stock, you are not getting the full story unless you read the report. The analysts who cover the darned thing can’t be objective because if current management survives, retribution will be swift: no more underwritings. I want to continue to warn people about what happened at Fannie Mae. It is no different from any of the other scandals: Insider selling after trumped-up earnings led to inflated performance of the stock. The only difference is that taxpayers will foot this one if Fannie implodes like the others. I don’t think it will, but I also don’t want to be long any of Fannie’s securities until this mess is sorted out. And believe me, it is a mess of gigantic proportions. Heaven knows I have disagreed at times with Peter Eavis, but I have read all the reports about the report and he is the only one who has reached the difficult, hard conclusions: **Fannie’s a sham, plain and simple.** (*RealMoney.com*, James J. Cramer, 09/30/04)
- Outraged about Fannie Mae’s misdeeds, *The Motley Fool* wrote, “[I]t is unbelievable that the executive teams at Fannie and Freddie have managed to screw up what may be the sweetest deal in the history of mankind. Freddie and Fannie, as federally chartered institutions, have the implied faith and credit of the U.S. Treasury behind their debts. There is no statutory cap on their sizes, so these companies can simply take on more risk and pile on more debt with the spoils of success going to shareholders, the agony of defeat going largely to taxpayers. Should Freddie or especially Fannie collapse, the cost to the U.S. economy would be massive, so unlike companies where executive malfeasance is a risk only to the company’s stakeholders, that there is even a *question* of Fannie Mae monkeying with capital is simply beyond the pale. If this isn’t a scandal, it damn well should be. Those responsible shouldn’t be entrusted to feed their neighbors’ hamsters, much less run one of the most

important, dangerous enterprises in the world, which is precisely what Fannie Mae has become.” (*The Motley Fool*, 09/22/04)

Raines’s words come back to haunt him

- “Corporate spin can be a powerful thing. Just ask Fannie Mae’s investors,” writes Rachel Beck for *Associated Press*. Over the past year, Fannie investors have heard Fannie Mae’s chairman and CEO Franklin D. Raines continually defend the accuracy of the company’s accounting practices. OFHEO issued a new report that details how Fannie Mae was allegedly involved in a pervasive pattern of earnings manipulation, lax internal controls and a corporate culture with an intense focus on stable earnings growth. Investors are hearing two different tales and now the question is what Raines believed himself.
- In the summer of 2003, Raines began defending Fannie Mae’s bookkeeping, shortly after Freddie Mac disclosed that it had understated profits by some \$4.5 billion for 2000-2002 in an effort to smooth earnings. As Freddie’s woes put Fannie Mae’s accounting under closer scrutiny, Raines kept saying that there was nothing wrong. Over the course of the past twelve months, Raines seemed to be constantly defending Fannie’s procedures.
- At a news conference in July 2003, Raines attempted to distance his company from the Freddie Mac. At that time he said that Fannie Mae didn’t “have any of the same issues” as Freddie Mac and said that the company hadn’t “undertaken any transactions to distort our true financial condition.” When asked if Fannie Mae had used any accounting judgments that its employees or auditor considered debatable, Raines replied “The answer to that is clearly no.”
- In an interview with *National Mortgage News* last year, Raines talked about Fannie Mae having “a very careful process of approval of transactions before they can be entered into ... We spend a lot of time focusing on operations risk and internal controls.”
- Raines’ words seem to be at odds with Fannie Mae’s actual practices, at least according to the findings in the OFHEO report. With OFHEO’s findings now public, Fannie Mae’s publicity machine seems to have broken down. Once investors realized there was trouble, they bolted out of the stock. Fannie’s stock is now down about 18% since the start of last week, wiping out more than \$13 billion of its market capitalization.
- Many are wondering what Raines really knew regarding this mess. While Raines wasn’t singled out for blame in the OFHEO report, it did say that there was “culture and environment that made these problems possible.” Raines has been touting the company’s internal controls and talking about how it hadn’t circumvented accounting rules, when in reality that wasn’t the case, according to OFHEO. Perhaps Raines

really didn't know anything. Raines did certify the authenticity of Fannie Mae's financial results, so he would have been violating the law had he been aware of the accounting problems when he signed off on the company's records.

- Even if that is true, it shouldn't get Raines off the hook. Top executives have a responsibility to know what is happening in their corporate ranks and must take some responsibility when things go wrong. OFHEO has demanded "immediate action" to fix this mess, which is spurring some speculation that Raines could be out of a job. And the Justice Department has opened a criminal investigation into Fannie Mae's accounting irregularities.
- On October 6, Raines is expected to appear before a congressional panel to explain Fannie Mae's accounting troubles. This time investors [and perhaps Congress] will be more skeptical of what he has to say. (*Associated Press*, Rachel Beck, 10/01/04)

Fannie Mae and Freddie Mac

OFHEO does not receive extra funding in Congress' Continuing Resolution

- On September 30, President Bush signed H.J. Res. 107, a temporary funding of agencies at FY2004 levels in FY2005. The resolution is valid from Oct. 1 through November 20, 2004, and extends appropriations for many agencies, including OFHEO. While OFHEO and members of the House Financial Services Committee had urged the House Appropriations Committee to provide OFHEO with additional funding for its investigation, Congressional Appropriators kept funding at the current level. In a September 29th letter, the chairmen and ranking members of the House Financial Services Committee and its Capital Markets Subcommittee urged House appropriators to stick with a high level of funding for OFHEO, saying the funds are needed for ongoing examination of Fannie Mae and Freddie Mac. Committee Chairman Michael Oxley (R-OH) and ranking member Barney Frank (D-MA) asked leaders of the House Appropriations Committee to keep fiscal year 2005 funding for the Office of Federal Housing Enterprise Oversight at its originally proposed level of \$59.2 million, which comes from fees paid by the Enterprises that they regulate. Oxley and Frank said the lower funding level would "severely constrain" OFHEO's ability to continue an examination into accounting irregularities at Fannie Mae and ongoing court action involving former senior officials of Freddie Mac. "We would strongly encourage the Appropriations Committee to approve a Continuing Resolution that funds OFHEO at the FY 2005 level of \$59.2 million previously approved by your Committee," they said. The letter was also signed by Capital Markets Subcommittee Chairman Richard H. Baker (R-LA) and the panel's ranking minority member, Representative Paul E. Kanjorski (D-PA.).

- OFHEO said a delay in its funding increase would damage its recent efforts to crack down on accounting irregularities at Fannie Mae and Freddie Mac. “There is too much at stake to ignore OFHEO’s funding needs at this critical time,” said an OFHEO spokesman. “This will place a severe constraint on the agency’s ability to continue its special examination of Fannie Mae’s accounting misdeeds said the spokesman. OFHEO had requested \$59 million in funding for FY2005, an increase of \$19.5 million over FY2004. OFHEO’s funding increase would have supported the hiring of 59 additional full time employees, bringing the agency’s staffing to 237 full time employees. By comparison, Fannie Mae about 5,000 employees. OFHEO would have used \$3.3 million of its extra funding for service contracts for special examinations and \$1.4 million for analytical software to monitor interest rate risk at the GSEs. (*Dow Jones International News*, Dawn Kopecki and John Connor, 09/22/04)
- However, as noted above, the CR passed without additional funds for OFHEO. “OFHEO was treated in the CR the same as all other federal agencies. As important as the work that OFHEO has, it's not more important than the work the FBI has, and Homeland Security," said Appropriations Committee spokesman John Scofield. (*Bureau of National Affairs*, 09/30/04; Mark Felsenthal, *Reuters*, 9/29/04)
- The final CR did not include the provision that was included in the Senate Committee-passed HUD-VA Appropriations bill that would have withheld \$10 million in funding for OFHEO until a new director was appointed. (*H.J. Res. 107*)

<p>As Fannie Mae accounting scandal fills newspaper headlines across the U.S., GSE regulatory reform languishes in Congress</p>

- In the Senate, movement on GSE regulatory reform this year is unlikely, said Andrew Gray, spokesman for the Senate Banking Committee. Gray said Chairman Richard C. Shelby (R-AL) considers this issue a priority for the 109th Congress and no hearings on GSE-related matters are scheduled at this time.
- House Financial Services Chairman Michael G. Oxley (R-OH) said he doubts that Fannie’s troubles would propel legislation overhauling oversight of Fannie Mae and Freddie Mac before year-end because of Congress’ shortened calendar due to the November election. When asked by reporters if Congress could pass GSE legislation before it adjourns, Oxley said, “Are you kidding me?” Oxley said he is working with Representative Richard Baker (R-LA), who chairs the subcommittee overseeing Fannie and Freddie, on a proposal for next year. When asked by reporters.
- Senate majority leader William Frist (R-TN) said it is unlikely a GSE reform bill would come to a vote in the days remaining on the legislative calendar.

- On the floor of the Senate, Senator Chuck Hagel told his fellow Senators that the time has come to reform the regulatory oversight of Fannie Mae and other GSEs. “The American people and the markets must have confidence in the operations of the congressionally chartered Fannie Mae and Freddie Mac. We need to build upon legislation that several of my colleagues and I introduced last year. The Senate Banking Committee passed a watered down version of our legislation, but it is clear from OFHEO’s findings [on Fannie Mae] that it is not adequate. To prevent these serious actions from occurring, the new GSE regulator must have at a minimum the same powers and resources as those of other financial regulators such as the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. ... Given the frequency of the accounting problems, pattern of manipulation and questionable management actions at both Freddie Mac and Fannie Mae, Congress can no longer look the other way. (*The Main Wire*, 09/28/04)
- Representative Barney Frank (D-MA) reiterated that he supported legislation to create a stronger supervisor for GSEs, but warned against the Bush administration demands that Frank sees damaging to the housing sector. “Enhancing the ability of the regulator to catch these things is important, but going beyond that to things that would impinge on the housing function is a mistake,” said Frank. Fannie Mae and Freddie Mac “have been caught doing things they shouldn’t be doing in accounting,” but “they did not come close to endangering the stability of the entity, much less the taxpayer.” [Do we *know* that yet?]
- When asked later by a reporter if Fannie Mae’s alleged accounting improprieties might help the reform cause in Congress, Frank said that the Bush administration holds all of the cards. “It’s entirely up to the White House. They have to back off their anti-housing stance. Will we sign off? We already had. We were there and the Administration pulled the plug.” Frank also objects to the Bush administration “go[ing] overboard” on its affordable housing goals.
- In a speech before a Federal Home Loan Bank forum, Frank also called the Bush administration’s bluff by predicting that there would be a “firestorm” if the administration blocked or limited Fannie Mae and Freddie Mac from issuing debt to fund their operations and growth. “I think they would run into an absolute firestorm if they did that,” said Frank. Earlier at the forum, Treasury under secretary Brian Roseboro indicated that the department has exerted its power over GSE debt sales several times in the past, and noted, “I will not speculate on how we will or will not use that authority.” Roseboro added, “Our objective is real GSE reform that improves safety and soundness and minimizes systemic risk.”
- Representative Paul E. Kanjorski (D-PA.), minority leader on the House Financial Services Subcommittee that deals with GSEs, warned that privatizing Fannie Mae and Freddie Mac in response to recent revelations of Fannie Mae’s accounting irregularities would cause far larger problems than it would solve. The accounting flaws discovered OFHEO does not provide evidence of “systemic risks,” said

Kanjorski. If the GSEs were privatized, Kanjorski predicted that within three to five years, Fannie and Freddie would “gobble up” institutions on the scale of Citibank, for example, that are “entirely too large to fail.” He added, “If they went to a private mode, there would be no regulation, no containment.” OFHEO as “a weaker regulator will be taken care of in due course,” Kanjorski said, adding he would support only an “independent, world-class regulator with the same powers others have.”

- The *American Banker* (AB) writes that OFHEO report does little to alter the entrenched divisions between political parties and other factions on the issues surrounding regulatory reform for GSEs. AB notes, “It remains to be seen whether the initial reaction [to the OFHEO report] will spark momentum for a bill next year or whether Fannie will be able to quell concerns.” What happens next year will depend, in part, on what else happens this year. OFHEO’s special exam could turn up more trouble for Fannie Mae and momentum for regulatory reform could continue. AB writes, “Of course, the November election could change the political calculus; reform would be less likely under a Kerry administration.” (*Congressional Quarterly*, 09/28/04; *Wall Street Journal*, Dawn Kopecki, 09/29/04; *The Main Wire*, 09/28/04; *BNA’s Daily Report for Executives*, Marcia Kass, 09/29/04; *National Mortgage News*, Brian Collins, 09/20/04; *Market News International*, 10/01/04; *BNA’s Daily Report for Executives*, Marcia Kass, 09/29/04; *Bureau of National Affairs*, Marcia Kass, 09/30/04; *Bureau of National Affairs*, Richard Cowden, 09/28/04)

Bush administration repeats call for GSE regulatory reform
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- Treasury Secretary John Snow said Fannie’s accounting problems should demonstrate the importance of regulatory reform of the GSEs. “These recent developments underscore the need for Congress to act” to tighten government regulations of Fannie, Freddie Mac and the FHLBs, said Snow. The GSEs are a “very important part of the housing market, of the mortgage market and of the larger financial structure of our country,” he said. “The safety and soundness of those financial institutions is very important.” Their regulator therefore must have “appropriate powers” to do its job, including having authority over capital and new lines of business, Snow said. He wants to see regulation of the GSEs removed from politics as far as possible, including the manner in which the new regulator is funded. (*Market News International*, Claudia Hirsch, 09/24/04)
- Wayne Abernathy, the Treasury Department’s Assistant Secretary for Financial Institutions, said he hopes that Congress could act quickly before adjournment on legislation to restructure the regulatory regime for the housing GSEs. Asked what short-term measures could be taken to address concerns raised by reports of accounting irregularities at Fannie Mae and Freddie Mac, Abernathy said, “What we think is needed is the legislation that [Treasury] Secretary [John] Snow passed to Congress last year. Congress has come very close to enacting it. We think the sooner it gets enacted the better.” Abernathy added that he has seen legislation that he hopes

Congress could pass “in a matter of days when you have a consensus develop around it.” He added, “Now, do we have a consensus around this right now? Not yet, but as soon as we do, I think this will get enacted.” Asked if passage was possible in the few remaining days on the congressional calendar, Abernathy said, “I do. Like I said, I have seen legislation done very quickly. ...As of last week, there wasn’t that kind of consensus, but could one form while Congress is still in session? Sure. And we would hope that it could be done. But it’s got to be the whole package.” Asked if the Bush administration is working on achieving a consensus, Abernathy responded, “Actively today? No. We presented our proposal up there and frankly it’s a matter of Congress to work its way through.” (*BNA’s Daily Report for Executives*, Richard Cohen, 09/24/04; *Dow Jones Newswire*, Deborah Lagomarsino, 09/27/04)

Federal Reserve Governor Bies says if the GSEs want to act like a shareholder company, they should privatize and abandon their government subsidy

- If Fannie Mae and Freddie Mac want to pursue bold growth to please their shareholders, Federal Reserve Governor Susan Bies said the GSEs should cut their government ties. “What I worry about is these organizations have gotten so large and they have such aggressive growth plans that they’ve told their shareholders, that there’s not room for mistakes,” said Bies. “If there is an implicit government guarantee, and they get exempted from taxes and other benefits ...they have to have a very strong oversight because the systemic risk is so large,” she said. “If they want to act like a shareholder company, they should privatize and abandon the government [subsidy].” Bies added, “If [Fannie and Freddie] don’t do things right it’ll be like the savings and loans,” referring to the 1980s U.S. banking scandal, “and every taxpayer will have to bail them out even if it benefits [the GSE’s] shareholders.” (*Reuters News*, 09/28/04; *Dow Jones Newswires*, Dawn Kopecki, 09/29/04)

IMF warns that GSEs could “amplify” swings in interest rates

- In its semi-annual World Economic Outlook, the International Money Fund (IMF) said the “large and increasing” share of mortgage-backed securities held by the GSEs has concentrated interest rate risk, the hedging of which could “amplify” swings in U.S. interest rates as the GSEs hedge their mortgage holdings against expected rate increases. The IMF, which has supported the Bush administration’s push for legislation strengthening the GSEs’ regulatory oversight, said the increased risks the two GSEs pose to the U.S. financial system underscore “the importance of improving supervisory oversight and establishing an independent regulator.” (*Dow Jones Newswires*, Dawn Kopecki, 09/29/04)

Are Fannie Mae and Freddie Mac too big to fail?

- A policy paper from Senate Republican Policy Committee analyst Jason Thomas notes, “The recent media attention on the management and accounting scandal at Freddie Mac [and Fannie Mae] has exposed a more pressing concern: Fannie Mae and Freddie Mac have grown so large and are counterparties to so many transactions that if unforeseen interest rate volatility caused either or both companies to fail, the potential cost to U.S. taxpayers could range into the hundreds of billions of dollars.” From the taxpayers’ perspective, the basic problem at Fannie and Freddie is their aggressive investment strategy that attempts to leverage their implicit guarantee to accumulate vastly increasing amounts of mortgage investments with a huge amount of debt. As the GSEs’ investment portfolios have grown, so has the amount of interest-rate risk that they retain. The government’s implicit guarantee to the GSEs causes investors to continue to loan to Fannie and Freddie despite these risks because of the expectation that the Treasury would come to their aid in a crisis. This also encourages the GSEs’ management to take on more risk and more debt than they otherwise would. As a result, Fannie and Freddie have a combined outstanding debt equal to 39% of the total outstanding U.S. public debt, and their combined financial assets are worth 44% more than those of Citigroup, the largest bank in the U.S.
- Thomas adds, “To insure against the failure of either or both GSE, however remote it may seem, Congress should improve disclosure requirements and transparency; increase risk-based regulatory oversight; and begin to consider how to create a greater separation between the taxpayers and the business operations of these firms without causing financial dislocation or upsetting the mortgage markets.” (Jason Thomas, Republican Policy Committee, “Problems at Freddie Mac and Fannie Mae: Too big to fail?,” 09/09/04)

Time to get the government more involved in regulating the GSEs

- In the *Washington Post*, Steven Pearlstein writes, “When all the smoke has cleared, my guess is that there will be a lot less to the so-called accounting scandal at Fannie Mae than the news now suggests. That’s not to say that Fannie Mae doesn’t deserve criticism. This 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. And it’s what happens when an organization becomes so arrogant that, even in the face of a changed and hostile political environment, it fails to accept a reasonable set of new restrictions that would have been far less damaging than what is now about to befall it.”

- What these circumstances suggest to Pearlstein, “is the value of getting government more involved [in the regulation of GSEs] -- 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, 09/30/04)
- The *Atlanta Journal-Constitution* writes in an editorial, “The time has come [for Congress] to decide if companies (Fannie and Freddie) that violate public trust should continue to receive special treatment.” (*Atlanta-Journal Constitution*, 09/30/04)
- Mike House, executive director of FM Policy Watch said his group’s major concerns are not about Fannie Mae’s operations but about the system for regulating the GSEs. “The system is not set up for proper oversight [of the GSEs] and what has happened over the past couple of days shows that is still the case,” House said. “The only solution is a strong and effective regulator, with adequate authority over safety and soundness and programs.” (*BNA’s Daily Report for Executives*, Richard Cowden, 09/23/04)

A private Fannie Mae and Freddie Mac?

- When Fannie Mae was chartered in 1938, it may have made sense for the federal government in a much poorer country without a tradition of long-term mortgages to inject capital into the housing finance market. But that day is long past with the Wall Street’s invention by Salomon Brothers of the mortgage-backed security that has drawn billions of dollars into housing markets. In the private sector, Fair Isaacs Corporation came up with credit-scoring, which has allowed more precise evaluations of mortgage risk and has opened the door to the sub-prime lending, allowing homeownership to those with checkered credit histories.
- Howard Husock writes in the *Wall Street Journal*, “Were Fannie and Freddie either to be scaled back or fully privatized, there is every reason to believe that the cause of homeownership would still be well-served.” As Federal Reserve Secretary Allan Greenspan said, “our financial system would be more robust if we relied on a market-based system that spreads interest rate risks, rather than on the current system, which concentrates such risk with the GSEs.”
- The good news is that the critique of Fannie’s accounting, on the heels of a similar scandal at Freddie, may at last lead to change. Congressional calls for stronger GSE regulation, including higher capital reserve requirements meant to ward off financial failure, are likely to gain traction. Fannie and Freddie may not be able to fend off the higher affordable housing goals, which may have the unintended effect of limiting the part of the market on which Fannie and Freddie can focus. The AH goals could even motivate the GSEs to give up their special status and simply go private of their own volition, similar to Sallie Mae’s privatization efforts which began voluntarily in 1997.

- Today's housing market bears little if any resemblance to that of the Depression era, when Fannie Mae was first chartered or even in 1968, when Fannie nominally ceased to be a government agency and became shareholder-owned. The fact that Fannie Mae and Freddie Mac must apparently go to questionable lengths to manage both the public markets and politicians shows that the time for deeper change has arrived. (*Wall Street Journal*, Howard Husock, 09/27/04)
- In a *Christian Science Monitor* editorial, the paper writes, "[Fannie and Freddie] enjoy privileges for low-cost borrowing that are the envy of banks. Wall Street assumes the two quasi- governmental entities, which hold what amounts to only a symbolic line of credit at the U.S. Treasury, that Uncle Sam (read: taxpayers) would bail them out if they were ever to fail. They're also exempt from paying state and local taxes. Even Fed chair Alan Greenspan thinks they should eventually be privatized. He's right. As of now, both Fan and Fred are trying to boost their shareholders' bottom line, as well as fulfill a public mission to provide affordable housing. They need to resolve that inherent tension. If Fannie and Freddie are allowed to grow unchecked, Mr. Greenspan warns, their possible failure could threaten the U.S. financial system. With both administration and Congressional action, step by step, these lions should ultimately be tamed." (*The Christian Science Monitor*, 09/30/04)

How to privatize the GSEs

- Peter Wallison, resident fellow with the American Enterprise Institute, argues that privatization is the only solution that will eliminate risks associated with Fannie Mae and Freddie Mac. Wallison writes, "To be sure, the objections to privatization raise serious issues. Some argue that it would disrupt the residential finance market and drive up home mortgage rates. Others believe that if Fannie and Freddie were shorn of their government support they would become dominant players in the mortgage market simply because of their size -- which would also make them too big to fail."
- "These objections are overcome in two complementary plans developed for the American Enterprise Institute and outlined in its recent publication "Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How." (*American Banker*, Peter J. Wallison, 10/01/04)

GSE business model: a mix of profit-side capitalism and loss-side socialism

- Michelle Malkin writes on her Weblog, "Fred Smith, president of the Washington, D.C.-based Competitive Enterprise Institute, has noted, these financial beasts [Fannie and Freddie] are a textbook example of 'profit-side capitalism and loss-side socialism.' When things go right for Freddie Mac and Fannie Mae, they keep the profits. But when things go wrong, taxpayers -- not just private shareholders,

managers, and employees -- will be on the hook.” Malkin adds, “If Martha Stewart is the face of capitalist excess, Fannie Mae and Freddie Mac are the poster children for government-sponsored gluttony. The potential fall of Freddie Mac or Fannie Mae could rival the savings and loan collapse of the 1980s. Too bad the Martha bashers, blind to the far greater catastrophes of market socialism, won’t pay attention until it’s too late.” (www.michellemalkin.com, Michelle Malkin, 09/23/04)

HUD Secretary Jackson says GSEs should focus on AH goals

- In an interview, HUD Secretary Alphonso Jackson said there could be a silver lining in Fannie Mae’s troubles, in that the regulators could move the two GSEs to fully cooperate in meeting the goals set for them by HUD to fulfill their mandated role of making home ownership more widely available and affordable. “They have not been meeting their mission,” said Jackson. “What I hope is that Fannie and Freddie will stop fighting HUD and start meeting their housing goals.” (Associated Press, Marcy Gordon, 09/30/04)

Federal Reserve to end GSEs’ overdraft fee exemption in July 2006

- The Federal Reserve issued final revisions to its payment-systems policy for GSEs and certain international financial institutions that restrict their use of intraday credit, or “daylight overdraft,” effective July 20, 2006. The new policy, which has few changes from the Fed’s proposal in February, ends the GSEs’ exemption from the Fed’s daylight overdraft fees that they have enjoyed for the past 10 years. “The Board determined that the practice of releasing such payments before they are fully funded by the issuer is neither necessary to achieve the Federal Reserve’s statutory mission nor appropriate risk management policy for the central bank,” said the Fed.
- When the Fed’s new daylight overdraft policy goes into effect, GSEs and others will need to make sure their Fed accounts are fully funded by the time payments are due. Otherwise, the Fed could delay interest and redemption payments to bondholders, which are usually paid at 9:15 a.m. ET. The latest the Fed could receive funding for same-day payments would be 4:00 p.m. ET.
- In other changes going into effect on July 20, 2006, the Fed plans to crack down on daylight overdraft used during corporate business over the course of a day. GSEs and certain international institutions will be held to the same standards as private-sector firms that don’t have access to the Fed’s discount window. “Such treatment includes strongly discouraging daylight overdrafts and applying a penalty fee to daylight overdrafts that nonetheless result from these entities’ general corporate payment activity,” the Fed said.

- To ensure a smooth transition to the new daylight overdraft policy, the Fed will be coordinating a working group through the Federal Reserve Banks' Wholesale Product Office in New York. "Organizations that commented on the planned policy changes, members of those organizations, and fiscal principals to whom the policy applies will be invited to participate," said the Fed. (*Dow Jones Newswires*, Deborah Lagomarsino, 09/23/04)

Fannie Mae

OFHEO announces 2nd quarter capital classifications and will now publish Fannie's capital ratios on a monthly basis

- On June 30, 2004, OFHEO said Fannie Mae's minimum capital requirement was \$31.188 billion as of June 30 and the company's core capital of \$36.115 billion exceeded its minimum capital requirement by \$4.927 billion. Additionally, OFHEO reported that Fannie's risk-based capital requirement was \$24.391 billion on that date and its total capital of \$36.862 billion exceeded the risk-based requirement by \$12.471 billion. "Fannie Mae's capital classification is based on financial information and the application of accounting policies currently under review by OFHEO," the agency said, noting that, "The outcome of this review may result in a restatement of prior period results and a revision of the respective capital classifications."
- OFHEO said it will now determine and publish Fannie Mae's capital classification on a monthly basis. "This monthly determination will take effect based on their capital position as of Sept. 30, 2004, and will continue until such time as all safety and soundness concerns are fully addressed," the agency said. (*Wall Street Journal*, John Connor, 09/30/04)

Fannie Mae issues new rule concerning loans with mandatory arbitration clauses

- Following through on an earlier pledge, Fannie Mae has stopped financing subprime loans with mandatory arbitration clauses for loans originated after October 30. The GSE has exempted loans that include arbitration clauses that "immediately and automatically become null and void and cannot be reinstated" once Fannie buys or guarantees the loan. In such cases, the seller must inform the borrower within 60 days that the clause was voided. Fannie disclosed this new policy in an update to its seller/servicer guide. A company spokesman said the ban will also apply to Fannie Mae's purchases of mortgage-backed securities. In the update, Fannie said that it would not buy "high-cost home mortgage" loans from Massachusetts. Standard & Poor's said it would not allow such loans in the securitizations it rates, because it

could not quantify investors' liability under a Massachusetts state law that goes into effect in November.

- Fannie also altered its guidelines to encourage lenders to waive prepayment penalties when a borrower sells a home. In June the GSE said a lender could do so only when it delivers a loan to Fannie. Now Fannie permits lenders to waive the penalty at their discretion. (*American Banker*, Jody Shenn, 10/01/04)

Fannie training irks some critics

- *National Mortgage News* reports that Fannie Mae's training of Utah Realtors on how to advise homebuyers on getting low-cost financing from "responsible" lenders is drawing criticism from Fannie's foes at FM Policy Focus. FMPF feels the GSE is marketing its products directly to Realtors and steering business to the GSE's approved lenders. "We are not fans of this," the group's spokeswoman. "[We] don't believe Fannie should be picking winners and losers in the marketplace." (*National Mortgage News*, Jessica Forres, 09/27/04)

Fannie Mae Foundation provides financial and technological support for hurricane victims in Florida
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- The Fannie Mae Foundation announced it has given \$200,000 in funding to the Florida Community Loan Fund, Homes in Partnership, and Centro Campesino to aid in housing-specific recovery efforts for Floridians affected by the recent hurricanes. This new funding will allow these organizations to provide interim and gap funding to low-income residents awaiting public or private resources to make their homes habitable. "We are happy to provide housing-targeted funding to nonprofits that will aid low-income, hurricane-affected Florida residents who may lack the out-of-pocket funds to pay deductibles on insurance settlements to repair or rehabilitate their homes," said Stacey D. Stewart, president and CEO of the Fannie Mae Foundation. (*Fannie Mae Foundation Press Release*, 09/27/04)

Freddie Mac

Criminal charges not expected from DOJ's criminal probe of Freddie Mac

- Sources familiar with the Justice Department's criminal probe of Freddie Mac say that the investigation is winding down with no indictments expected, even though the GSE agreed to pay \$125 million as a civil penalty. (*Wall Street Journal*, John D. McKinnon, 10/01/04)

Freddie Mac reduces its FY2003 profits by \$75 million

- In its recently published annual report, Freddie Mac cut its profit for 2003 by \$75 million to include a reserve for legal costs arising from a restatement of its results last year. "We are subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement," said Freddie in its 2003 annual report. "We believe that a loss in connection with the proceedings ... is probable and currently estimate the range of minimum loss to be from \$75 million to \$100 million." The provision reduces the GSE's income from \$4.89 billion to \$4.82 billion. Freddie Mac raised its forecast of 2004 portfolio growth slightly, but warned that marking certain derivatives to market probably hurt first-half profits. In the 2003 annual report, Freddie Mac said it now expects portfolio growth in "the low to middle single digits" during 2004, which is somewhat more bullish than the "low single digits" it predicted June 30. From January through August, Freddie Mac's portfolio grew at a 3.7% annual rate to \$661 billion. Freddie said more originations of adjustable-rate mortgages contributed to its recent portfolio growth. (*American Banker*, Jody Shenn, 09/27/04; *TheStreet.com*, Matthew Goldstein, 09/24/04; *Wall Street Journal*, 09/27/04)

Freddie Mac issues proxy statement and schedules its annual meeting for November 4th

- Freddie Mac issued the company's Proxy Statement for its annual meeting to be held on November 4, 2004 and its Information Statement and Annual Report to shareholders for FY2003. The GSE also announced that its board of directors has nominated four new candidates for election as directors, which will be included in the slate of 13 directors to be elected by stockholders at the annual meeting. The board nominated Barbara T. Alexander (age 56), an independent consultant and previously a senior advisor to UBS Warburg LLC; Geoffrey T. Boisi (57), retired vice chairman and co-chief executive officer of JP Morgan Chase and Company; William M. Lewis, Jr. (48), managing director and co-chairman of investment banking at Lazard Frères & Co LLC; and Eugene M. McQuade (55), president and chief operating officer of Freddie Mac. (*PR Newswire*, 09/24/04; *Freddie Mac Press Release*, 09/20/04)

OFHEO announces Freddie Mac's capital ratios for the second quarter

- OFHEO announced that on June 30, Freddie Mac's minimum capital requirement was \$24.266 billion and that the GSE's core capital of \$32.884 billion exceeded the minimum capital requirement by \$8.619 billion. Freddie's risk-based capital requirement of \$3.858 billion on that date, said the agency. Freddie's total capital of \$33.081 billion exceeded this requirement by \$29.224 billion. OFHEO said Freddie Mac's capital classification is based on financial information and the application of accounting policies currently involved in the agency's ongoing financial review process. "The publication of Freddie Mac's financial statements for 2004 will impact both minimum capital surpluses and, to a lesser degree, risk-based surpluses as reported and relief upon by OFHEO," the agency said. "OFHEO will continue to monitor and analyze 2004 capital resubmissions once financial results for these periods are issued by Freddie Mac."
- OFHEO said, "Freddie Mac has submitted, and OFHEO has analyzed quarterly 2003 minimum capital resubmissions, including recent revisions for three quarters of 2003 due to the establishment of special reserves. OFHEO has determined Freddie Mac remained adequately capitalized during all periods in 2003. OFHEO also determined, based upon analysis of information submitted by Freddie Mac, that Freddie Mac was not required to resubmit risk-based capital for the four quarters in 2003."
- The regulator imposed a capital surcharge for Freddie Mac in January 2004 due to increased operational risk. "Freddie Mac has maintained their minimum capital surplus in excess of the surcharge during the second quarter 2004," it said. (*Wall Street Journal*, John Connor, 09/30/04)

Freddie Mac's retained portfolio growth slows in August

- Freddie Mac said its retained or investment portfolio grew at annualized rate of 9.2% in August, well below July's 20.8% increase. The GSE's duration gap exposure averaged zero month in August, unchanged from July, said Freddie Mac in its monthly volume summary.
- Freddie Mac's total mortgage portfolio grew by 5.8% in August to \$1.484 trillion. The company said its retained portfolio grew to \$661.4 billion at the end of August, the fourth straight month of growth following six months of a declines in the portfolio. (*Reuters*, 09/22/04)

Freddie Mac announces new delegated underwriting initiative for AH multi-family

- Freddie Mac announced that it is testing a new delegated underwriting and risk-sharing program for multifamily properties. The new initiative gives certain qualified correspondent lenders more flexibility when underwriting mortgages on apartments with units affordable to families with low- and very-low incomes. Through this new delegated underwriting initiative, Freddie Mac will provide faster commitments for permanent debt financing or credit enhancement for properties with tax-credit financing. GMAC Commercial Mortgage Corp, through its Affordable Housing Division, was the first Freddie Mac correspondent lender to participate in the program. Other participants in the program now include MMA Financial Services, PNC Multi-family Capital, and PW Funding Inc. Freddie Mac is working on agreements with other lenders that are interested in the risk-sharing arrangement. (*Freddie Mac Press Release, 09/27/04; American Banker, Jody Shenn, 09/28/04*)

Freddie Mac makes affordable housing available for its own employees
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- In a speech before the National Leadership Forum on Workforce Housing, Freddie Mac chairman and chief executive officer Richard F. Syron announced that his company has introduced for Freddie Mac employees a new employee home benefit program for first time homebuyers. Syron said, “we rolled out a Home Benefit Program for our employees. We designed this program for full-time employees who earn up to about the local median income [\$75,000] and what to buy their first home. For these employees, we provide a benefit of up to \$12,000 after taxes, which can be used for a down-payment or closing costs. And over time, we’ll forgive the loan.” This program is available to Freddie Mac employees who have been with the GSE for at least one year and who have attended a homeownership class sponsored by the GSE. Freddie Mac will forgive 20% of the interest free loan over a five-year period of continued service with the company. (*Freddie Mac Press Release, Richard F. Syron, 09/30/04; PR Newswire, 09/30/04*)

Federal Home Loan Banks

FHLB forum provides update on FHLB issues

- In *The Guenther-gram*, Ken Guenther writes about a recent forum sponsored by five national financial trade associations on issues facing the FHLBs. The roster of speakers included Treasury Undersecretary Brian Roseboro, FHLB Chairman Alicia Castaneda, Senate Banking Committee member John Sununu (R-NH) and the ranking minority member of the House Financial Services Committee, Barney Frank (D-MA.). The principal banking trade groups and the Federal Home Loan Bank leadership also participated on discussion panels.
- Senator Sununu made the “sign of the cross”, writes Guenther, over any GSE legislation this year and noted that such legislation will be front and center in the next Congress.
- Chairman Castaneda and Undersecretary Roseboro made a strong case for SEC registration of the FHLBs. Castaneda argued, “SEC registration will help support the reputation of the FHLBs as solid, capable, respected financial institutions.” Once registration occurs there would be no turning back, she said Guenther concludes, “It’s highly likely this is the definitive word on this controversial matter.”
- Roseboro reiterated the Bush administration’s position that existing law does not permit multi-district membership of the FHLBs. If and when the Congress considers changes in the law, it should do so “within the general context of evaluating the FHL Bank system charter,” said Roseboro. Advice like this causes people to lose sleep, writes Guenther. Since housing GSEs such as the FHLBs aren’t universally loved, political attack might be waiting around any corner--and opening charter questions can be especially risky, writes Guenther.
- Roseboro indicated that the administration welcomes the idea of greater FHLB competition with Fannie and Freddie. He then cited product conversion as an argument for putting the housing GSEs under a single regulator. “The Federal Home Loan Banks are no longer simply a wholesale financing outlet for their members, but have moved directly into the mortgage investment business, which encompasses the same type of risks as Fannie Mae and Freddie Mac face,” he said. Castaneda did not discuss this very sensitive issue. While some have questioned the single regulator concept, given the FHLB system’s unique characteristics in debt issuance, capital structure and co-operative nature, Roseboro’s answer was still a clear signal that the FHLB system, Fannie and Freddie will be regulated by one agency. Castaneda stated, “I have maintained a neutral position on this question, believing that it is a policy question best left to the Congress.” Right now the “ayes” appear to have it, given the position of the Senate Banking Committee’s bi-partisan leadership, Representative Ed

Royce (R-CA.), the FHL Bank presidents, World Savings and the trades, writes Guenther. (*The Guenther-gram*, Ken Guenther, 09/29/04; *National Mortgage News*, 09/20/04)

FHLBs are “uneasy” about the stock registration process with SEC

- With the regulators insisting that the way is clear for the FHLBs to register stock, shareholders in the FHLB system are uneasy about the way the process is being handled with the SEC and are urging the Federal Housing Finance Board to take a more active role. Members of America’s Community Bankers complain that the SEC stopped negotiating over disclosure issues after the Finance Board put out its rule, putting the FHLBs “over a barrel.” (*National Mortgage News*, 09/20/04)

FHLB-Chicago joins the Council of FHLBs

- The Board of Directors of the FHLB-Chicago has voted to join the Council of FHLBanks, the trade association of the FHLB System, bringing the Council’s membership to all twelve wholesale credit institutions. J. Mikesell Thomas, President and CEO of the FHLB-Chicago said, “The Chicago FHLB can best serve our member institutions by working collaboratively with our fellow Home Loan Banks to advance our common goals. While each FHLB may have its own view on a particular issue, we intend to work together whenever possible to achieve consensus.” (*FHLB-Chicago Press Release*, 09/22/04)

Sallie Mae

Senator Gregg and Representative Boehner propose end to student loan subsidies

- Senator Judd Gregg (R-NH) and Representative John Boehner (R-OH), chairmen of the Senate and House education committees, announced plans to introduce legislation that would eliminate excess subsidies to student loan providers. The bill would end a practice of having the government guarantee to lenders the difference between the borrower’s interest rate which currently ranges between 3% and 4% and the 9.5% minimum rate of return that Congress provided in 1980. The bill will provide for the money saved through the elimination of the subsidy would be used to expand incentives for teachers to work in high poverty public schools. The bill would triple the federal student loan forgiveness for math, science, and special education teachers who agree to teach for at least five years in high poverty schools from its current maximum amount of \$5,000 to \$17,500.

- “We are short-changing the students, and we should stop it,” Gregg said. “The government is spending millions unnecessarily because some lenders are exploiting loopholes in the federal higher education laws. ... [T]hese dollars could be put to use in programs that help students,” he added. (*Bureau of National Affairs*, 10/01/04)

Sallie Mae goes on buying spree

- Sallie Mae has bought a majority interest in Arrow Financial Services, a full-service collections company based in Niles, IL. Terms of the transaction weren’t disclosed. Sallie Mae has the option to purchase the rest of privately held Arrow over a three-year period. Arrow will retain its brand name and Jack Lavin, will continue as its president and CEO. Arrow buys and collects debt, including card receivables, provides contingency collections services and operates an outsourcing collection unit. (*CardLine*, 09/24/04)
- Sallie Mae is also buying the secondary market and related businesses of the Education Assistance Foundation, a Seattle nonprofit, and its Student Loan Finance Association. The deal includes the association’s \$1.6 billion loan portfolio and its origination business. The terms of the transaction weren’t disclosed. The proceeds from the sale will be donated to the Education Assistance Foundation, making it one of the largest philanthropies focused on higher education in the Northwest. (*American Banker*, 09/27/04)

Farm Credit System/Farmer Mac

Farm Credit System leaders ask Congress to end termination authority for Ag banks
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- Rabobank’s proposal to acquire Farm Credit Services of America (FCSA) has prompted Congress to consider the first changes to the Farm Credit Act since 1971. Saying he was fearful that a sale of the \$7.8 billion-asset FCSA to the Dutch company would leave farmers without a lender of last resort, Senator Thomas Daschle (D-S.D.) has introduced legislation that would increase the waiting time for a Farm Credit institution to get approval to merge with a private-sector company. Some lawmakers are even calling for legislation that would prohibit Farm Credit lenders from leaving the system.
- Rabobank’s offer to buy FCSA for \$600 million has created a stir in the Farm Credit system. (The Omaha lender would have to pay \$800 million to leave the System.) If the deal goes through it would be the first acquisition of a GSE by a private-sector company. Concerned about fallout from the Rabobank deal, Representative Frank Lucas (R-OK) called a hearing of a House subcommittee to discuss its potential

impact on the 88-year-old system. Representative Tim Holden (D-PA) said at the hearing that institutions should not be allowed to leave the system. “If this deal happens it will have a significant impact on farmers and the communities they serve.” Most attendees, including farmers and other Farm Credit System lenders, vehemently oppose the sale. They say it would violate the system’s mission of making credit available to all farmers.

- “Having spent a great deal of time in South Dakota over the past few months,” Sen. Daschle said, “I can say without any doubt that this proposed sale of one of our leading Farm Credit institutions to a foreign bank has created a whirlwind of confusion and uncertainty.”
- Agstar Financial Services ACA of Mankato, MN, another Farm Credit lender, has made a counteroffer of \$650 million for FCSA. While the two institutions’ boards have met, FCSA has given no official response to Agstar’s offer.
- Farm Credit Services of America has yet to file a termination application with FCA, which was to be filed in early September, according to a time line presented with the announcement of the deal. Some have speculated that the delay is caused by FCSA having second thoughts, but a spokesperson said that FCSA still plans to file the application.
- Testifying at hearing, Nancy C. Pellet, the chairwoman of the FCA, said that the agency would require that the Farm Credit System start a new lending body from scratch or that existing lenders expand into new territory to cover the space vacated by FCSA. Pellet suggested that it might be time to give Farm Credit lenders broader powers. “The last change” to the Farm Credit Act “was in 1971, and the act does not accommodate changes and market forces,” Pellet said. Bankers would object to any expansion of Farm Credit lenders’ powers.
- John V. Evans Jr., the chairman of the Independent Community Bankers of America’s Agriculture-Rural America Committee, called Farm Credit Services a “predatory GSE lender that cherry picks the best loans from community banks.” Evans said FCSA’s shareholders, not lawmakers or other Farm Credit lenders, should make the decision on whether to sell to Rabobank. While the banking trade groups favor the Rabobank deal because it would eliminate one of the nation’s largest Farm Credit lenders, individual bankers worry about suddenly having one of the world’s biggest banks in their backyard. (*American Banker*, Ben Jackson, Laura Thompson Osuri and Alan Kline, 10/01/04)

Postal Service

If postal reform bill stalls, Postmaster Potter warns
of double-digit increase in postal rates in 2009

- The Postal Service will be forced to seek a double-digit rate increase if postal reform legislation is not passed soon, said Postmaster General Jack Potter. Legislative action is the difference between a single-digit and double-digit postal rate increase, said Potter. While Potter repeated his pledge to hold rates stable until 2006, he said swift passage of the bill is critical for the agency's financial planning, since 16 months are needed for a rate increase to go into effect. At the National Postal Forum, Potter urged the mailing industry employees to "get up to Capitol Hill" and tell their representatives today "it's important to bring a close to this legislative process." While the postal reform bill has passed the House Government Reform and Judiciary committees and Senate Governmental Affairs Committee, it has not been scheduled for a floor vote in either chamber.
- "The law has to be changed," said David Fineman, chairman of the Postal Service board of governors. "The ratemaking process makes no sense, our ability to compensate our executives makes no sense." Fineman said the bill could "very well be voted on in the next few weeks." Fineman said that even if no vote is held this year, the legislation has "a very, very good chance of being passed by the middle of March" and would significantly reduce the need for a rate increase request.
- Although postal reform gained momentum earlier this year, little time remains to pass either bill since Congress plans to adjourn for elections on October 8th and reconvene in mid-November. While the bill has bipartisan support, it faces major scheduling obstacles because Congress is dealing with must-pass funding bills.
- The Postal Service is expected to file a rate case between December 2004 and February 2005. (*GoveExec.com*, 09/20/04; *DMNews.com*, Melissa Campanelli, 09/21/04)

Postal coalition urges Congress to enact postal reform before adjournment

- Postal Reform in the Public Interest, a coalition representing small-volume and First-Class mailers, is urging Congress to pass postal reform legislation before it adjourns. Otherwise, a double-digit increase in the postal rates may be the cost of Congress' inaction. (*DMNews.com*, Melissa Campanelli, 09/27/04)

Postal reform unlikely this session

- After meeting with legislators in Washington, Direct Marketing Association President-CEO John A. Greco Jr. said he doesn't expect postal reform legislation to pass this fall. "It's unlikely," he said. While neither the House nor Senate versions of the postal reform bill is perfect, Greco said it is more important at this point to pass something that will help meet all the reform objectives backed by the DMA, including controlling rate increases. "I'd rather do it right than rush something through," he said. (*Alliance Report*, Alliance of Non-profit Mailers, 09/24/04)

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