

The GSE REPORT™

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Major Events

OFHEO Director Falcon to step down when his term expires October 5th,
but will stay on until his replacement is confirmed

- Armando Falcon, Jr., the director of OFHEO, won't seek a second term when his five-year tenure expires October 5, the agency said. Falcon will stay on after his term lapses until his successor is confirmed, his office said. "The director's plans are to stay on through the transition to help ensure a smooth transition," said OFHEO spokeswoman Corinne Russell. Falcon is expected to stay on to see through much of OFHEO's accounting investigation at Fannie Mae. The White House has not named a nominee to succeed Falcon, a former Democratic legal counsel to the House of Representatives banking panel, who was appointed by former President Bill Clinton.
- It's unclear whether Steve Blumenthal, Falcon's second in command at OFHEO and a Republican, is being considered for the top job or whether Blumenthal will serve as interim director while the White House finds a permanent replacement. Blumenthal joined OFHEO in May 2002 as Falcon's top legal advisor and led OFHEO's investigation at Freddie Mac, which resulted in a substantial fine and extensive enforcement actions. White House spokeswoman Erin Healy said "we wouldn't speculate on a personnel announcement before we make them. The current chairman [Falcon] continues in that position."
- Falcon will leave OFHEO with nearly triple the number of employees and quadruple the budget it had when he took its helm in 1999. He struggled throughout his term to win financial backing and independence for OFHEO, an issue that drew scant attention in Congress until the Freddie accounting scandal surfaced. Critics accused OFHEO of incompetence when the company's auditor, not its regulator, forced Freddie Mac to restate several years of earnings and to disclose massive errors and evidence of accounting manipulation in the summer of 2003. Popular opinion may be shifting, as more fingers point at Congress for failing to give OFHEO the regulatory and financial tools it needed to do its job when the agency was created in 1992. That fact has been illustrated by the District Court's recent decision reversing OFHEO's attempt to freeze some \$60 million in compensation owed to former Freddie CEO Leland Brendsel. The court's ruling said Congress never gave OFHEO the authority to freeze Brendsel's compensation.
- Under fire for his supervision of Fannie Mae and Freddie Mac from critics who thought he should be tougher on the GSEs, Falcon offered to resign in February 2003, when the White House named banker Mark Brickell to head OFHEO. Falcon offered at the time to stay in office until his successor was confirmed. Brickell, who faced sharp questioning from Senate Democrats over his advocacy of deregulation of financial derivatives, withdrew his nomination in January 2004.

- Subsequently, Falcon levied quick and harsh penalties against Freddie Mac and three former executives, including an unprecedented \$125 million fine the GSE agreed to pay in December. He also began a comprehensive review of Fannie Mae's accounting practices and forced the GSE to recalculate losses on about \$8 billion of securities backed by manufactured-housing loans and aircraft leases in May.
- The Bush administration is in no hurry to see Falcon leave OFHEO. It is pushing legislation designed to rein in Fannie, Freddie and the FHLBs by combining OFHEO with the FHLBs' regulator and giving the new regulator greater financial flexibility and broader enforcement powers. The long-stalled bill is seen as a real possibility if President Bush wins re-election this fall. The Bush administration has substantially increased OFHEO's budget and authorized extra money to hire outside accounting expertise for the exams at Fannie and Freddie, requesting \$59.2 million for fiscal year 2005 compared to \$16 million when Falcon started in 1999.
- OFHEO is expected soon to release its next installment of findings in its investigation at Fannie. OFHEO recently finished new corporate governance regulations for Fannie and Freddie, a project lead by Falcon that would require GSE executives to disgorge excessive profits if misconduct is found. The rules, which were recently sent to the White House for review, would also require Fannie Mae to change auditors and to split Franklin Raines' dual roles as chairman and CEO, among other things. (*Washington Post*, 09/11/04; *Dow Jones International News*, Dawn Kopecki, 09/13/04; *Reuters*, 09/11/04)

<p>Freddie Mac begins paying former CEO Brendsel</p>
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- On September 17, 2004, Freddie Mac announced that it has begun the process of unfreezing compensation and paying amounts due to the company's former Chairman and CEO, Leland C. Brendsel as a result of a recent court ruling. Since June 2003, Freddie Mac has complied with letters issued by OFHEO, directing Freddie Mac to freeze the payment of compensation to Brendsel arising from his prior employment with the company.
- The District Court of the District of Columbia recently issued an order that preliminarily enjoins OFHEO's freeze directive with respect to Mr. Brendsel's compensation. While the Justice Department has appealed this ruling to the Court of Appeals, it has not obtained a stay of that order pending a resolution of the appeal. The District Court's order remains in effect, and Freddie Mac can no longer treat OFHEO's June 2003 letters as a valid and effective freeze directive with respect to Brendsel's compensation. Freddie Mac has advised OFHEO, that it has begun the process of unfreezing Brendsel's compensation and paying amounts due to him under Freddie Mac's contractual obligations to Brendsel. Freddie Mac had accrued these amounts due to Brendsel, and their payment does not affect the GSE's reported financial results. Administrative proceedings regarding OFHEO's demand to change

Brendsel's termination status, its request for reimbursement of past bonuses from Brendsel, and its request for penalties against him are still pending. (*Freddie Mac Press Release*, 09/17/04)

Assistant Housing Secretary Weicher says AH goals to take effect January 1st

- At a September 13 policy forum sponsored by American Enterprise Institute, Assistant Housing Secretary John C. Weicher said the Bush administration's new low-income financing targets for Fannie Mae and Freddie Mac are set to be finalized by November and become effective January 1. Weicher noted that HUD made recommended statutory changes in the GSEs' affordable housing (AH) requirements when Congress worked on legislation earlier this year to restructure the GSEs' supervisory regime. When lawmakers failed to enact the proposed reforms, Weicher said, the agency's alternative was to enhance regulations designed to promote affordable housing goals. "Our job here is to establish a rule within the context of the law that we have..." Weicher said. With regard to the disparity between CRA and GSE income-level definitions, he said, "We deal with what we have, I'm afraid." Weicher also noted that HUD is not legally permitted to establish subgoals that go beyond the standards set for the primary affordable housing goals.
- Anne Canfield, executive director of the Consumer Mortgage Coalition (CMC) and a panelist at the AEI-sponsored forum, said Fannie Mae's and Freddie Mac's AH goals should mirror standards set for private housing lenders, subject to the Community Reinvestment Act (CRA). Canfield said when CMC developed a comment letter on the AH goals proposal, its legal team determined that HUD *does* have the authority to set subgoals, "and [HUD] could set those subgoals ... to match the CRA requirements." In fact, Section 1335 of the 1992 Act requires the GSEs to fund CRA loans, but HUD has never used Section 1335 to insure that the GSEs actually created a liquid secondary market for CRA loans. The 1992 Act stated further that the GSEs should not expect to earn market rates-of-return on these [CRA] activities.
- CMC's executive director, Anne Canfield, stated that Fannie Mae and Freddie Mac have two main functions: provide liquidity to the mortgage market and to provide assistance to low- and moderate-income housing. The GSEs' value is providing liquidity to the mortgage market, whereas the GSEs' value to an individual consumer in an individual loan transaction is of deminimus benefit to individual borrowers:
 - median mortgage borrower -- 73 cents a day/\$268 per year
 - very low-income family -- 41 cents a day/\$160 per year
- Canfield stated that the CMC supports HUD's broader policy goal to improve the GSEs' affordable housing performance, but the proposed rule will still place the GSEs behind the market in key respects and will create distortions in the existing housing market. The reason is the GSEs' affordable housing goals do not match up with the CRA definitions; the rule is overly focused on a market segment that does

not need help. The difference between the GSEs' affordable housing requirements and those required of Fannie and Freddie are seen below:

LOW INCOME		
	GSE Definition	80% or below of AMI
	CRA Definition	50% or below of AMI
MODERATE - INCOME	GSE Definition	100% or below of AMI
	CRA Definition	80% or below of AMI

(AMI = area median income)

- The CMC recommended that the final rule be replaced; HUD should set either a new goal for funding CRA-eligible home-purchase loans, with low- and moderate-income (LMI) subgoals, or subgoals within the current goals for purchases of CRA-eligible or LMI home-purchase loans. Under either the separate CRA goal or through CRA subgoals, CMC recommended three CRA subgoals:
 - Affordable Housing Goal: Borrowers below 80% of AMI
 - Special Affordable Housing Goal: Borrowers below 50% of AMI
 - Underserved Areas Goal: Communities below 80% of metro or non-metro AMI

- The CMC also recommended that --
 - the goals and subgoals should be discrete for the single-family and multi-family sectors;
 - the GSEs should not count mortgages for AH goals without borrower income information, which is consistent with HMDA and CRA;
 - HUD should use its general regulatory authority to require the GSEs to develop appropriate standards to ensure that the benefits of GSE status flow through to LMI borrowers and LMI areas –
 - Underwriting standards
 - Business practices
 - Repurchase requirements
 - Pricing
 - Fees
 - HUD should also use its general regulatory authority to prevent onerous business practices (e.g, unreasonable recourse requirements)
 - No affordable housing credit should be given for loans the GSEs require lenders to repurchase unless fraud or serious misconduct is involved
 - HUD should institute a series of additional reforms and reporting requirements to assist in the enforcement of the affordable housing goals; and

- HUD should also revise its regulations regarding new programs to define “new program” more broadly and condition approval of new programs based on the GSEs compliance with their affordable housing goals.
- Jay Brinkman, vice president of research and economics at the Mortgage Bankers Association (MBA), said one of the problems with HUD’s proposed AH goal changes is that the rule seeks to accomplish “multiple objectives, multiple outcomes, essentially with a single tool.” Brinkman said MBA has concerns about the procedures HUD used in developing its proposal to project the future housing market itself. “We believe that to the extent the goals are set too high ... you end up creating operational problems for the mortgage industry,” Brinkman said. The AH proposal could create new distortions in the market for multifamily rental housing, which is currently reporting near-record vacancy rates, Brinkman said. Brinkman said. “We also believe that some of the risk-shifting that takes place will exacerbate the pattern of shifting some of the risk of the supply of affordable lending to the originators.” The proposed changes could encourage the GSEs to purchase more loans that otherwise would be suitable for FHA coverage, thereby undermining the overall federal mortgage insurance program, said Brinkman.
- In reply to Brinkman’s concern about unintended consequences in the market, Weicher said that when he first took a position at HUD in 1973, the FHA program was considered to be in danger of collapse. “That was 31 years and 23 million FHA single-family mortgages ago and since then our market share has been a pretty stable 10 to 15 percent of the market,” Weicher said.
- AEI fellow Peter Wallison said the shareholder-owned GSEs are conflicted in meeting their public missions to boost affordable housing. Wallison said both companies declined invitations to speak on the panel. “In a very real sense they are serving two masters,” Wallison said. “The way that Fannie and Freddie treat their affordable housing obligations is a case study of this phenomenon.” Wallison cited a letter sent by Fannie Mae director Ann Korologos to OFHEO in June, concerning a regulation setting new corporate governance standards for both GSEs. “We are concerned that the proposal’s focus on the federal charter and ‘public mission’ of the enterprises may detract from our role as representatives of Fannie Mae’s shareholders,” Korologos wrote. “As directors, our duty is to act in the best interest of the shareholders. While we obviously recognize, oversee and support Fannie Mae’s important public mission and the significance of Fannie Mae’s operations in the capital markets, we must be accountable to Fannie Mae shareholders,” she wrote. (*BNA Daily Report for Executives*, Richard Cowden, 09/14/04; *Dow Jones International News*, Dawn Kopecki, 09/14/04; *Reuters*, 09/13/04; slide presentations made by Anne Canfield and Jay Brinkman, 9/13/04)

FASB decides to clarify rule requiring write-down of debt securities

- The Financial Accounting Standards Board (FASB) suspended part of controversial guidance involving marking down the value of bond holdings due to interest rate rises. FASB said it would delay portions of guidance EITF03-1 relating to debt securities and the methods of booking value, which involves the procedures for accounting for the value of bonds held when prices have fallen below the price paid and included potentially writing down value when prices had fallen due to rising rates. FASB has agreed to delay the effective date of this requirement from the current quarter until the proposal gets finalized, which is expected in the fourth quarter of 2004.
- Freddie Mac and other financial institutions had called on FASB to reconsider the changes because of fears that accountants' strict interpretation of the guidance could have led some institutions significantly to write down the value of some of the billions worth of bonds they hold. "There is a hole you could drive a truck through in terms of interpretations," said Paul Escobar, senior vice-president for insurance client strategies at Standish Mellon. He said the accounting rules were originally designed to avoid income fluctuations owing to market movements. "People have trillions of dollars in bonds and this rule misses the point that asset price changes aren't meant to go through income statements."
- "The furor was caused by a restrictive and overly narrow interpretation (of the requirement) by one or more of the accounting firms," said Robert Willens, a tax and accounting expert at Lehman Brothers. "Given what's happened to the profession over the last few years," he said, "it is perhaps understandable that they appear to be adopting an overly conservative stance. But they need to strike a proper balance." (*Financial Times*, Jennifer Hughes, 09/09/04; *Dow Jones Newswires*, Lingling Wei and David Feldheim, 09/08/04)

Fannie Mae and Freddie Mac

Oxley says GSE regulatory reform “is not going to go away”

- House Financial Services Chairman Michael Oxley (R-OH) said that legislation overhauling Fannie Mae and Freddie Mac’s federal regulator is “not going to go away” any time soon. Oxley said he plans to continue working with Representative Richard Baker (R-LA) on a bill strengthening OFHEO’s regulatory powers. “I haven’t given up on the proposal of creating a world-class regulator. That would be the center piece of what we want to do,” he said. Oxley downplayed comments by Federal Reserve Chairman Alan Greenspan that said the GSEs posed a systemic risk to the health of the U.S. financial system. “Greenspan conveyed a pretty grim scenario if something happened” to Fannie Mae or Freddie Mac, Oxley said. “I’m not necessarily as pessimistic as the chairman, but I think we have to realize that some changes need to be made.”
- Oxley said he does not support requiring the GSEs to have separate chairmen and chief executives. He was also “noncommittal” about supporting the HUD’s plan to raise affordable-housing goals for Fannie and Freddie, saying he would support the goals “if they’re workable, but I’m just not totally sure.” Oxley didn’t offer any new details about his committee’s investigation into questionable transactions executed by the GSEs last year to improve their performance in financing mortgages to low- and moderate-income borrowers. Both Fannie and Freddie reportedly paid lucrative premiums on a couple deals with Washington Mutual and Citibank, and possibly other banks, that served little economic purpose other than helping them to meet their annual affordable housing goals set by HUD. Oxley, who asked the GSEs in April for documents related to those transactions, now seems somewhat sympathetic to Fannie and Freddie. “That’s part of the problem when you set unrealistic housing goals and they’re inflexible, I think it invites that kind of thing,” Oxley said. “That’s one thing I’m really concerned about.”
- Oxley’s seemingly close ties to and generous backing from the industries his committee oversees is increasingly becoming a focus in his re-election bid this November. Oxley’s Democratic challenger, Ben Konop, has accused the representative of looking out for corporate interests at the expense of his constituents. “Our concern is this pattern of really questionable behavior in terms of the money [Oxley] gets from all these financial service groups and the legislation that he attempts to block,” said Konop campaign manager Brent Smyth. “He’s really ignoring the interests of consumers in general and instead looking out for the companies...that line his campaign coffers.” Oxley has accused Konop, a former corporate attorney, of running a “smear campaign.” Oxley has raised \$1.4 million for his re-election campaign and approximately \$1 million for his PAC during this election cycle. According to the Center for Responsive Politics (CRP), corporations account for nearly all of Oxley’s PAC and campaign funds, about 99%, with roughly 60% of those contributions coming from the insurance, banking, real estate and high-

finance industries he oversees. Konop has raised just under \$100,000 so far with much of his funding coming from labor groups, according to the CRP. (*Dow Jones Newswires*, Dawn Kopecki, 09/09/04; *American Banker*, Michele Heller, 09/09/04)

Treasury Assistant Secretary Abernathy says no room for compromise
on GSE regulatory reform effort

- Treasury Assistant Secretary for Financial Institutions Wayne Abernathy reiterated the Bush administration's position that there is no room for compromise on the department's preferred principles for regulatory reform of Fannie Mae and Freddie Mac. "We're not deviating from them," Abernathy said. The administration's principles include "the need to have effective receivership language" in any reform bill, granting the regulator the power to appoint a receiver should a GSE face financial ruin. "That was a deficiency in that bill," Abernathy said of compromise language in a bill narrowly passed out of the Senate Banking Committee last spring. The amended Committee-passed bill would have given Congress veto power over the regulators' decision to appoint a receiver, which the White House criticized as weakening the regulator's power.
- Abernathy said Treasury has made progress in trying to convince lawmakers to back Treasury's GSE reform principles. He also said it's not impossible that Congress could take up GSE reform again this fall, despite the election-shortened schedule. "We're still hopeful that we can get something done this fall," Abernathy said. He added that he "presumed" Congress would keep GSE reform on the agenda next year if it was not wrapped up this year. Abernathy said there's been no negotiation between Treasury and Fannie and Freddie in recent months nor any meetings with key lawmakers recently. (*Market News International*, Claudia Hirsch, 09/16/04;)

Treasury representatives reiterate call for single GSE regulator

- Treasury Deputy Assistant Secretary Greg Zerzan told the FHLBank of Seattle that the Bush administration still wants legislation that combines the oversight of housing GSEs to a single regulator, who has the power to set capital levels, approve new activities, and to "conduct an orderly wind-down of a GSE in the unlikely event one should fail." Zerzan said, "As the activities of the housing GSEs converge, so too arises a symmetry in the risk profiles of the entities. Having a single regulator should create the institutional expertise necessary to monitor and evaluate those risks both with regard to the enterprises individually, as well as with an eye towards the health of the housing finance system as a whole." Treasury's insistence that the GSE regulatory reform legislation allows for an "orderly wind-down" of the GSEs is significant, since debt-ratings analysts have said the adoption of such a bill would prompt them to rethink Fannie and Freddie's Triple-A credit ratings.

- Undersecretary of the Treasury for Domestic Finance Brian Roseboro said some have questioned whether the “world-class regulator” proposed by the Bush administration should oversee the FHLB system, given the system’s unique characteristics in debt issuance, capital structures and cooperative ownership. “While some of these issues may need to be addressed specifically with legislation, another useful way to account for the unique characteristics of housing GSEs is to create two divisions within the new regulatory agency - one division specializing in Fannie Mae and Freddie Mac and one in the Federal Home Loan Banks,” he said. (*Dow Jones Capital Markets Report*, Campion Walsh and Deborah Lagomarsino, 09/14/04; *Dow Jones Newswire*, Dawn Kopecki, 09/17/04)

Atlanta Fed study concludes GSEs will take more risks as they face stiffer competition
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- Fannie Mae and Freddie Mac are likely to take greater risks as they face stiffer competition from banks and FHLBs, a study by an Atlanta Federal Reserve Bank concludes. “Expanded competition will likely mean narrower profit margins and reduced franchise values for Fannie Mae and Freddie Mac,” said Atlanta Fed economist Scott Frame and New York University economics professor Lawrence White in a study to be published in its forthcoming issue of the Cato Institute’s *Regulation* magazine.
- The study noted that the new Basel II international bank regulations due to go into effect at the end of 2007 will lower capital requirements for residential mortgages for banks to between 1% and 2% from the current 4%. The lower capital requirements will likely create incentives for banks to retain mortgages rather than sell them to Fannie Mae and Freddie Mac. “Because the large banks already account for a sizable fraction of residential mortgage activity, the expansion of competition from those banks could well be substantial,” Frame and White say.
- Fannie Mae and Freddie Mac are also likely to feel competitive pressure from mortgage purchases by the FHLBs, the study said. The Home Loan Banks could also eventually vie with Fannie Mae and Freddie Mac in packaging home loans into mortgage-backed securities or in issuing credit guarantees on mortgage pools, the authors said. “This heightened competition could create incentives for Fannie Mae and Freddie Mac to take greater risks, with potentially unfavorable consequences for U.S. taxpayers,” the authors said. The study concludes that regulators should increase their oversight of Fannie Mae and Freddie Mac. (*Reuters News*, Mark Felsenthal, 09/15/04; *American Banker*, Rob Blackwell, 09/16/04)

Freddie Mac CEO Syron “optimistic” that GSE regulatory reform will pass next year

- In a speech at the Lehman Brothers Financial Services Conference, Freddie Mac chairman and CEO Richard Syron said he remains hopeful that Congress, the White House and the GSEs can reach an agreement to overhaul how the Fannie and Freddie

are regulated. “I am still optimistic that we can get an agreement by both parties on legislation,” said Syron. “I think we were extremely close on the Shelby bill. That would have been acceptable to us. My hope is that when this does come up again, we’ll be able to deal with this in the same way.” Syron described the Shelby bill as a “reasonable compromise.” He said Freddie Mac wants to get lingering regulatory questions and headline risk “off the table.”

- Syron said he does not expect a debt ratings downgrade if receivership language is eventually adopted in the GSE regulatory reform legislation. He did say that a change in the GSE’s rating from a triple-A to a double-A-plus rating, for example, would affect Freddie Mac’s business. Syron added that he couldn’t predict if a Republican or Democratic White House next year would be “better” for GSE shareholders, noting that former Treasury Secretary Larry Summers, a Democrat, was as “hawkish” on GSEs as many Republican lawmakers. More important than the question of who is president, Syron said, is whom the president would appoint to key GSE-relevant positions. (*Market News International*, Claudia Hirsch, 09/15/04)

Fannie Mae’s commissioned report by economist Hubbard concludes “the GSEs are not very risky”
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- In a 33-page study commissioned by Fannie Mae and made available to *BusinessWeek* before publication, economist R. Glenn Hubbard argues that Fannie is no riskier than the 10 largest commercial banks or their holding companies and that Fannie’s capital reserve is adequate.
- Fannie Chairman and CEO Franklin D. Raines will use this study to rebut critics who charge that Fannie’s low borrowing costs represent an implicit federal subsidy created by debtholders’ confidence that the government will rescue the GSE in the event of a financial crisis. Hubbard’s study will bolster Raines’ argument that Fannie has a cost advantage because it’s low-risk. In the study’s foreword, Raines writes that Hubbard “confirms the low-risk nature of Fannie Mae’s business but also...indicates a fundamental flaw in studies that purport to quantify an ‘implicit subsidy’ to the company.” Hubbard says, “That’s Frank Raines’s view.”
- Regardless of the spin, Hubbard’s study is the first real measure of Fannie’s risk to its bondholders and the government. While Treasury and Fed spokesmen refused to comment on the paper, other experts say Hubbard’s quantitative approach fails to consider the “everyday stresses and strains Fannie faces.” Managing director for financial institutions at Standard & Poor’s Michael T. DeStefano said, “This is a theoretical, academic exercise that doesn’t capture Fannie’s real-world risks.”
- In some ways, Hubbard’s approach is similar to the mathematical arguments used by Long Term Capital Management (LTCM) to claim that the hedge fund’s risks were properly hedged, right up to its 1998 collapse. Hubbard concedes that his analysis is strictly quantitative in which his model considers “perfect storm scenarios,” such as a

one-year jump in rates to 11%, a 5% drop in home prices nationwide, and up to a 25% fall in regional housing. Unlike LTCM's illiquid assets, Hubbard argues, Fannie holds easily saleable home mortgages.

- Hubbard's study does not consider other scenarios that can't be quantified, because they have never happened. For example, it's impossible to quantify systemic risk of a rapid interest-rate increase that causes housing prices to decline, touching off a series of financial-institution failures. Hubbard argues that risk studies aren't usually based on cataclysms for which a bank would have to hold infinite amounts of capital. "You're not typically looking for events that aren't in the record," he says.
- Hubbard's analysis rests on econometric models incorporating factors such as the quality of Fannie's assets; its exposure to sudden changes in interest rates; the volatility of its earnings; and the probability of default. He concludes that if Fannie Mae failed, the government and bondholders could expect to lose \$90 billion, representing just 8.9% of Fannie's \$1 trillion in assets. Hubbard argues that Fannie's cost of failure compares favorably with the average commercial bank failure cost of 22.3% of assets. Neither Hubbard, who also writes a column for *Business Week*, nor Fannie would reveal how much he was paid for the analysis.
- It is unlikely that Hubbard's study will silence Fannie's critics. In the study, Hubbard views Fannie's high level of concentration -- 90% of its balance sheet is mortgage-based -- as a strength, since losses on mortgages have been historically low. However, S&P's DeStefano worries about the lack of diversification. DeStefano, one of few experts who has read the study, also argues that the bond market accepts a lower yield from Fannie because "everybody looks at Fannie as though it's part of the government." No study can erase that perceived link. If Fannie were to lose its implied government backing, the GSE's borrowing costs would probably go up -- if only because S&P would reconsider its triple A credit rating, he says. S&P, like *BusinessWeek*, is a unit of The McGraw-Hill Companies.
- Another economist who reviewed the study and is familiar with Fannie disagrees with Raines's conclusion that Fannie's lower borrowing costs are due to its low-risk profile. Fannie's big advantage, he says, is its ability to act like a mini-Treasury: Unlike commercial rivals, it can issue debt securities quickly and at will, without having to register the debt with the SEC. Investors accept a lower rate on Fannie's debt because they know they'll always find a buyer. Fannie owes that liquidity to its quasi-governmental status, not to lower default risk, says this economist, who asked not to be identified.
- Hubbard doesn't mention the legal limbo Fannie's debtholders would be in if Fannie were to fail. Fannie's regulator, OFHEO, has no authority to act as a receiver and determine the order in which claimants would be paid. With no receiver, Fannie's debtholders might trigger panic selling.

- Federal Reserve Chairman Allen Greenspan and Treasury Secretary John W. Snow are concerned about the risk of financial contagion based on unforeseeable events and are also alarmed by the GSEs' high debt. They and other critics aren't likely to be swayed when Raines asserts that Fannie's capital reserves are adequate. While Hubbard may add a scholarly layer to the discussion, he probably won't change many minds. (*BusinessWeek Online*, Paula Dwyer, 09/16/04)

Drip, drip, drip... is reality closing in on Fannie and Freddie?
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- Peter J. Wallison, resident fellow at AEI, writes in *The International Economy*, “After years of success in terrifying the political world and seducing the financial community, the GSEs—and particularly Fannie Mae—are now threatened with real change. The precipitating cause is a tough and determined stand by the Bush Administration for stronger regulation. This has inspired the GSEs’ previously torpid regulator—the gracefully named Office of Federal Housing Enterprises Oversight—to fight for its life with aggressive regulation, and apparently persuaded at least one rating agency that it may actually be sensible to take no for an answer. In this two-front war, Fannie is in an unaccustomed position—it is no longer in full control of the outcome. As a result, it has been required to call its usual allies into the open for whatever support they can provide.”
- “For almost the last full year, Fannie and Freddie have been buffeted with actions and statements by the Administration and others—including OFHEO—that call into question whether the two powerful GSEs still have control of their political risk.”
 - “The Treasury Department, insisting on tough minimum requirements for new regulatory legislation for the GSEs, showed its determination by opposing and ultimately dismembering a House Banking Committee bill that the Treasury considered too weak. This was the first sign that Fannie and Freddie, despite their massive network of lobbyists, would not have their usual way with the legislative process.”
 - “The Office of Management and Budget, in an analysis that accompanied the President’s 2005 budget, declared that Fannie and Freddie were undercapitalized, in need of serious new regulation, and failing to perform an important part of their mission: providing affordable housing, especially for the minority community.”
 - “At the request of OFHEO, the GSEs’ regulator, Congress voted \$7.5 million to do a forensic audit of Fannie’s accounting.”
 - “With that audit underway, OFHEO suggested that it had already turned up accounting problems, \$119 billion and \$164 billion, far higher than earlier estimates by the Congressional Budget Office (CBO); that between 42 percent and 81 percent of the companies’ market value is attributable to their

government subsidy; and that the benefit homebuyers derived from this subsidy was only seven basis points—less than a third of previous estimates.”

- “Greg Mankiw, Chairman of the President’s Council of Economic Advisers, declared in a speech that Fannie and Freddie posed risks to the economy and needed to be reined in by stronger capital regulation and other restrictions. Speeches and testimony by Treasury officials also emphasized these concerns, and a Treasury official declared that if Congress wanted to eliminate the GSEs’ \$2.25 billion “line of credit” at the Treasury—another of the links that confer GSE status—that is something that Treasury would be willing to discuss.”
- “The Organization for Economic Cooperation and Development (OECD), in a report on the U.S. economy, recommended that limits be placed on the growth of Fannie and Freddie.”
- “The Senate Banking Committee, in an action openly and strongly opposed by Fannie and Freddie, adopted a bill that provided a strong new regulatory structure for Fannie and Freddie. The bill gave a new regulator control over the GSEs’ capital and mission, and authorized the regulator to exercise receivership powers (subject to action by Congress within forty-five days). All the Democrats on the committee voted against the bill, virtually assuring that it would not come to a vote in the full Senate this year, but to get this Democratic support, Fannie and Freddie had to agree to much stronger rules on affordable housing, and to a 5 percent pre-tax charge to earnings for an affordable housing fund.”
- “OFHEO proposed new corporate governance regulations that, among other things, would require Fannie and Freddie to split the offices of chairman and CEO, and limit the terms of their directors. OFHEO also announced that it was considering whether it had the power to institute a receivership for either of the GSEs, even without specific legislation.”
- “The White House let it be known that the President would no longer appoint the five directors of Fannie and Freddie that he is authorized to appoint, a clear effort to eliminate one of the links to the government that underpin Fannie and Freddie’s privileged GSE status.”
- “The Department of Housing and Urban Development (HUD), the GSEs’ mission regulator, requested authority to levy \$6.5 million in fees on the GSEs so it could better enforce its affordable and low-income housing regulations.”
- “HUD proposed significantly tougher affordable and low-income housing regulations, which if ultimately adopted will force Fannie and Freddie to devote more resources to the less profitable and riskier underserved market.

An OMB spokesman said that the OMB toughened the requirements after HUD submitted the regulations for review.”

- “The Federal Reserve Board announced that it would no longer permit Fannie and Freddie to incur daylight overdrafts in the course of making payments on their securities, a benefit some calculated at about \$10 million per year.”
- “A Fed economic study concluded that the value of Fannie and Freddie’s government subsidy was between \$119 billion and \$164 billion, far higher than earlier estimates by the Congressional Budget Office (CBO); that between 42 percent and 81 percent of the companies’ market value is attributable to their government subsidy; and that the benefit homebuyers derived from this subsidy was only seven basis points—less than a third of previous estimates.”
- “CBO announced that it had updated its 2001 study of Fannie and Freddie’s subsidy and, using the same methodology, concluded that the subsidy had grown from \$11 billion in 2000 to almost \$20 billion in 2003. Of this amount, Fannie and Freddie retained about one third and passed the balance through to homebuyers. CBO also noted that its conclusions, although using a different methodology, were consistent with the Fed study.”
- “The Department of Justice concluded that the Treasury Department had authority under Fannie and Freddie’s charters to limit their issuances of debt. This is highly significant, since it provides Treasury with authority to slow or halt the growth of Fannie and Freddie if all other means fail.”
- “Last, but far from least, in testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan declared Fannie and Freddie a systemic danger to the economy and called for their privatization.”
- “Perhaps the most ominous signs of long-term trouble for Fannie and Freddie were not government actions at all, but changes in the way they are viewed by the private sector. Several examples suggest that their control over events was beginning to weaken. Wells Fargo, one of the nation’s largest banks and a major player in the mortgage market, publicly challenged Fannie and Freddie’s commitment to affordable and low-income housing. Only a few years ago, a public complaint about the GSEs by a participant in the housing markets would have been unthinkable.”
- “Major media outlets began to assign reporters to the Fannie and Freddie “beat.” *The Wall Street Journal*, *Washington Post*, *Financial Times*, Dow Jones Newswire, and Bloomberg News all designated specific reporters to follow events at or involving Fannie and Freddie. To call this a death watch would be an exaggeration, but it indicated that Fannie and Freddie had been recognized as a potential source of important developments in the future, virtually guaranteeing a flow of unfavorable

publicity for two companies that had successfully flown under the media radar for many years.”

- “Finally, and perhaps most importantly, investors and analysts began to draw attention to the severe decline in the price/earnings ratios of the two companies. Listed on the New York Stock Exchange, Fannie and Freddie have been consistently among the most profitable public companies in the United States. Fannie boasts that it is only one of four or five companies in the S&P 500 (one of these is Freddie) that have had double-digit increases in profitability for fifteen straight years. Indeed, the company’s profit has been doubling every five years since the beginning of the 1990s, and its return on equity has been consistently in the range of 23–26 percent. Freddie’s results have been much the same.”
- “With a success record like this, both companies should have price/earnings ratios well up into the 20s, but by early July 2004 Fannie’s P/E was about 9.1 and Freddie’s about 9.2. For comparison, the composite price/earnings ratio of the S&P 500 financials was close to 20. What this has meant for Fannie’s shareholders is that the price of the stock has not participated at all in the recovery of the securities market since 2001. Indeed, an investor who bought the stock in 1999 paid \$77 per share; in July 2004, the same shares were selling for about \$70 each. Although the Dow Jones Industrial Average has climbed almost 2,000 points since September 2002, Fannie’s stock price is today almost exactly where it was when the market began its upward move, and is lower than it was on January 4, 1999, the day that Franklin Raines became chairman and CEO.”
- “The significance of this fact should not be underestimated. What it means is that investors have built into Fannie’s stock price an enormous risk premium, perhaps anticipating that there will be some event—probably government action—that will seriously diminish the company’s value. From the perspective of investors, the many events listed above constitute what analysts call “headline risk”—the downward pressure on a stock price that follows upon the disclosure of bad news.”
- “OFHEO’s ongoing forensic investigation of Fannie’s accounting promises to be a source of more headline risk during the balance of 2004. OFHEO has already demanded that Fannie restate a portion of its financial statements that deal with impaired loans for manufactured housing, arguing that Fannie did not write off a sufficient amount of the value of these assets. After trying and failing to get the SEC’s support for its accounting treatment, Fannie agreed to change its method of accounting for impaired assets in future years.”
- “Under pressure from the Administration and OFHEO, Fannie was compelled to call upon one of its congressional supporters, Democrat Barney Frank (MA), the ranking member of the House Financial Services Committee, to complain that OFHEO was being too tough. The sight of a liberal Democrat complaining about excessive regulation is unusual enough, but it follows the virtually unanimous Democratic

opposition to a tough GSE regulatory bill that was adopted by the Senate Banking Committee.”

- “Indeed, the spectacle of members of Congress complaining about excessive regulation of the two GSEs is exactly why many commentators are skeptical that Fannie and Freddie—with their extraordinary political power—can ever be effectively regulated.”
- “But questions about Fannie’s financial condition and the quality of its accounting assumed greater importance than ever in May, when Standard & Poor’s announced that henceforth it would condition Fannie and Freddie’s ratings on their financial condition—not their governmental support. “Historically...” the agency said in its statement, “a strong governmental consensus of support for the senior unsecured debt holders of GSEs had led to the highest degree of confidence that the government would ensure full and timely payment on these securities, even if the entities themselves got into financial difficulties. We no longer have the same degree of confidence that the Government would ensure full and timely payment on the senior unsecured debt of these GSEs.”
- For several months, Treasury officials have been insisting that the government will not support Fannie or Freddie in the event that either of them has financial difficulties, and it appears that this message has finally gotten through. Standard & Poor’s no longer believes it is prudent to treat as government-backed a security that the government itself was insisting it would not back.”
- “This brings the question back to the quality of Fannie and Freddie’s financial statements. No matter how they are viewed, they do not inspire confidence. Whether or not OFHEO requires Fannie or Freddie to restate financial results for any past year, neither company’s capital position is what one would expect of a triple-A rated financial institution. Fannie’s capital position, in addition, is considerably weaker than Freddie’s. By statute, Fannie and Freddie are required to hold only 2.5 percent capital against losses on balance sheet assets, but earlier this year the Office of Management and Budget calculated Fannie’s equity— as distinct from its required capital—at 1.8 percent (the corresponding number for Freddie was 4.2 percent). Although Fannie and Freddie are hugely profitable, that profit comes from the enormous leverage they are able to obtain because of their perceived government backing. If Standard & Poor’s no longer accepts the reality of this backing, both their profits and their triple-A ratings will be in jeopardy.”
- “After many successful years of avoiding serious scrutiny, reality seems now to be finally closing in on Fannie and Freddie.” (*International Economy*, Peter J. Wallison, Summer 2004)

AEI Press publishes a “how to” book on privatizing the GSEs

- Under the The AEI Press imprint, Peter J. Wallison, Thomas Stanton and Bert Ely have published a monograph titled *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*. In this publication, Wallison, Stanton and Ely propose a comprehensive privatization program for housing GSEs, including a privatization plan that will eliminate the housing GSEs as government wards without disrupting the residential mortgage market, and a complementary plan for the U.S. housing finance system that will deliver benefits to homeowners that are at least equivalent to the benefits delivered by the housing GSEs, without the necessity for government backing. The authors also provide draft legislation to implement this privatization program. This publication may be ordered from AEI Press or downloaded in PDF format from AEI’s website. (www.aei.org, 09/13/04)

Fannie Mae’s former board member and Freddie Mac’s lobbyist play active roles in Kerry’s presidential campaign

- John R. Sasso, appointed by President Clinton to serve on the Fannie Mae board from 1993 to 1997, began serving as presidential candidate John Kerry’s liaison to the Democratic National Committee on April 2. Recently Sasso was reassigned to travel with Kerry and to help shape the campaign’s daily message. Sasso knows how Kerry thinks and will serve as a kind of gatekeeper for all the strategy advice Kerry is getting from fellow Democrats, said an unnamed senior Kerry aide. (*Bloomberg News*, Brian K. Sullivan, 09/09/04)
- Billed as the “51st Democratic senator” by Majority Leader Tom Daschle (D-SD) in 2001, Ben Barnes and his associates have earned more than \$1.1 million in lobbying fees during 2004 from seven clients, including Freddie Mac. Barnes, the former Texas lieutenant governor and speaker of the Texas state house in the 1960’s, recently appeared on *60 Minutes II* to tell Dan Rather that he helped George Bush avoid military service in Vietnam and get a place in the National Guard. John Fund writes in the *New York Sun*, “But Mr. Barnes is clearly unreliable. The *New York Times* reported last February that an unnamed former Texas official - later revealed to be Mr. Barnes - was telling reporters he had interceded on behalf of Mr. Bush but that his story ‘was subject to change, and there were no documents to support his claims.’” Fund continues, “Indeed, Mr. Barnes’s own daughter says her father’s story can’t be trusted.” (*Dallas Morning News*, Robert T. Garrett, 09/10/04; *New York Sun*, John Fund, 09/14/04)

Fannie and Freddie elect to live within the “spirit of the campaign finance law”

- Once considered among the “titans of political largess,” Fannie Mae and Freddie Mac have elected to focus on PAC donations rather than giving money to 527 groups this

election cycle. During the 2002 election cycle, Fannie Mae gave more than \$1.8 million in unregulated donations. Once the campaign-finance law passed, Fannie Mae decided to focus on its PAC for political donations, but quickly discovered that its PAC accounts were empty since employees hadn't been asked to donate for more than a decade. Fannie Mae's management sent out a call for contributions in January, which has resulted in 600 employees contributing nearly \$600,000 to date. Rather than mailing off a few big checks to party committees, Fannie Mae made 40 contributions totaling \$67,000 into the campaign coffers of every Democratic and Republican member of the House Financial Services Committee. According to the Center for Responsive Politics, individual Fannie Mae employees have contributed \$294,915 and the Fannie Mae PAC has contributed \$185,500 for the 2003-2004 election cycle through August 2, 2004. Approximately 61% of Fannie Mae's aggregate campaign donations were given to Democratic candidates and 39% were given to Republican candidates. (*Leader*, Jeanne Cummings, 09/03/04; www.opensecrets.com, 09/16/04)

- According to the Center for Responsive Politics, Freddie Mac heads the list of corporate interests that were big soft-money players and have pulled back. Looking at soft-money giving from the first part of the 2002 election cycle versus 527 donations at the start of the current cycle, the center found that Freddie Mac's contributions have declined by \$ 2.7 million. Freddie Mac spokeswoman Shawn Flaherty says it's a matter of prudence. "There's too much ambiguity for us," she says. "We want to be cautious until there's more clarity [with the campaign finance laws]." According to the Center for Responsive Politics' records, individual Freddie Mac employees have contributed \$83,061 for the 2003-2004 election cycle through August 2, 2004. Approximately 70% of Freddie Mac's employees' donations were given to Democratic candidates and 30% were given to Republican candidates. (*Washington Post*, Annus Shin, 09/13/04; *U.S. News & World Report*, Christopher H. Schmitt, 09/20/04; www.opensecrets.com, 09/16/04)

GSEs caught in the middle on mandatory arbitration in subprime mortgage lending

- Fannie Mae and Freddie Mac find themselves caught in the middle of the debate over mandatory arbitration clauses in subprime mortgage lending. Under pressure from consumer activists, the GSEs are self-imposing bans on financing loans with these clauses. Industry representatives, who claim lenders didn't have a chance to discuss the matter with Fannie and Freddie, quietly petitioned the GSEs to reconsider to no avail. Freddie Mac's ban on loans with mandatory arbitration clauses went into effect in August. While Fannie has not announced a timeline for its ban, its spokeswoman said that the GSE would offer details "soon."
- In letters dated July 30 to the GSEs' chief executives, six trade groups expressed their "deep concerns" about the potential effects of this ban and their frustration over the "lack of a complete discussion" on the issue. Most consumer advocates describe the arbitration clauses as a trap to force mistreated borrowers into a forum stacked against them. Many lenders say that the clauses serve both the borrower and lender.

Arbitration, the lenders say, is a simpler, cheaper, and quicker method for resolving legitimate disputes, which shields against frivolous lawsuits, especially class actions. Their letter cautioned the GSEs that their choices “will likely have far-reaching effects on the legitimate use of arbitration in other consumer industries as well.”

- For the “politically wounded GSEs,” Fannie and Freddie’s stance against the clauses has provided some much-needed favorable publicity. Freddie spokesman Douglas Robinson said it views arbitration as “one effective resolution tool” but sees no place for requiring it on subprime loans. “We think choice is a good thing for consumers.” Observers say that once Freddie announced its plan, Fannie had little choice but to follow suit, which it did in February. Fannie’s delay in releasing a final timeline has sparked some doubts about the GSE’s resolve to do so. Fannie Mae spokeswoman Janice Daue said the GSE would announce its guidelines sometime in the next few months. “We are committed to the announcement that we made in February,” Daue said.
- Mitchell Feinstein, chairman of the National Home Equity Mortgage Association, said that mandatory arbitration is fair for consumers. Without the clauses, “class action attacks ... that more often favor the lawyers than they do consumers” can be used as leverage to push for inappropriate settlements, said Feinstein. Added legal expenses will make subprime loans more expensive for consumers. Feinstein said that before Freddie’s announcement in December that it planned to disavow mandatory arbitration, “we had no input and no indication it was ... under discussion.”
- Previously, the GSEs had prohibited arbitration clauses in their traditional prime business, but waived the prohibition for subprime purchases. While the GSEs’ charter restrictions on buying uninsured loans with down payments of less than 20% have limited the GSEs’ appetites for subprime loans, observers say Fannie and Freddie have played a significant role in the subprime market by buying the highest-grade tranches of securitizations. The GSEs will likely increase their direct purchases in coming years because of demographic trends and regulatory pressure, say observers.
- One idea that lenders would like to discuss with the GSEs is allowing for mandatory arbitration without the results being consumers’ final avenue of redress if they lose. “We would certainly like to consider it,” Feinstein said. Fannie, which has only said it would ban “binding” arbitration, uses such an approach in employment contracts, he said. Another type of clause found on some loans says the borrower waives the right to a jury trial, but not the right to sue.
- John Taylor, the president of the National Community Reinvestment Coalition, said mandatory arbitration poses a serious problem only because of other, more inherently troubling, aspects of subprime lending. He said, “In an atmosphere where so many people have been preyed upon ... it would be illogical for consumers to give up the

right to sue,” he said. “You deal with the practices and problems, and it lessens the import of mandatory arbitration.”

- Ron Swafford, the chief counsel for DocuTech Corp., predicted that “binding arbitration will be permitted” in national legislation if it is ever passed, “but there will be guidelines, procedures, and processes adopted to ensure fairness.” Countrywide Financial’s chief legal officer Sandor E. Samuels agreed that standards are necessary. Arbitration should be held in the area where the borrower lives, and there should not be a statute of limitations, nor restrictions on punitive damages or causes of action, Samuels said. (*American Banker*, Jody Shenn, 09/07/04)

Fannie and Freddie announce mortgage relief for hurricane victims

- Fannie Mae has disaster relief provisions in place, giving lenders the discretion to help borrowers in several ways, including suspending mortgage payments for up to three months, reducing the payments for up to 18 months, or in more special cases, creating longer loan payback plans. All changes will be made on a case-by-case basis. (*PR Newswire*, 09/07/04)
- Similarly, Freddie Mac is encouraging its servicers to provide borrowers with relief through its disaster relief guidelines, which give them the discretion to reduce or suspend mortgage payments for up to 12 months for borrowers whose mortgages are owned by Freddie Mac. Each case will be individually assessed to determine which alternative will best fit the homeowner’s circumstances. Freddie Mac is also strongly encouraging mortgage servicers to provide the additional following relief to borrowers with Freddie Mac-owned loans by waiving the assessment of penalties or late fees against borrowers with disaster-damaged homes; not reporting forbearance or delinquencies caused by the disaster to the nation’s credit bureaus; and expediting the release of insurance proceeds. Freddie Mac has also authorized loan servicers to expedite the release of insurance funds to borrowers for properties in locations declared a Major Disaster Area as a result of hurricanes Charley or Francis or Tropical Storm Bonnie. (*Freddie Mac Press Release*, 09/07/04; *PR Newswire*, 09/14/04)

Mortgage fraud epidemic

- *CQ Today* Quote of the Day for September 17, 2004: “It has the potential to be an epidemic.” – Chris Swecker, FBI assistant director for criminal investigations, referring to surging cases of mortgage fraud. (*CQToday*, 09/17/04)

Fannie Mae

OFHEO's probe of Fannie Mae turns to derivatives

- In *RealMoney*, Peter Eavis asks, “Did mortgage giant Fannie Mae cook its books in order to exclude large derivatives losses from its income statement?” Finding an answer to that question, Eavis writes, is one of the main aims of OFHEO’s probe of Fannie Mae. And according to a person familiar with the investigation, one of the reasons that OFHEO sent subpoenas to Fannie Mae is to obtain information that would help it decide whether the GSE misapplied GAAP rules to keep losses on derivatives out of earnings.
- Under CEO Franklin Raines, Fannie Mae has suffered gargantuan losses on derivatives, which ballooned to nearly \$17 billion in 2003. These losses, which appear to be the result of a risky interest rate hedging strategy that backfired badly, are amortized into earnings over time. OFHEO’s investigation will determine whether Fannie was amortizing too few losses into its income statement and thus artificially boosting earnings, according to the person familiar with the probe. The probe, which began in February, is expected to end by the end of this month.
- Fannie has strived hard to give Wall Street earnings that grow at a strong and steady rate. If it was able to do that only because it was abusing its accounts to keep derivatives losses out of earnings, Fannie’s reputation would be hurt badly and CEO Raines would come under fire.
- Having seen some of the “tricks” Freddie played, OFHEO said from the start that its probe of Fannie would look at how earnings were calculated. In December, OFHEO said that it would “focus on transactions that significantly accelerate or defer the pattern of income recognition.” With that being one of its main aims, Eavis wrote, OFHEO would look closely at how Fannie’s billions of dollars of derivatives losses were treated. In theory, FAS 133, the accounting rule that covers derivatives, could be abused to keep a portion of derivatives losses out of earnings. In a November 2003 letter from OFHEO director Armando Falcon to Raines, OFHEO asked for documents pertaining to a range of subjects, but specifically requested documents “related to FAS 133.”
- Fannie may be doing all it can to avoid scrutiny of its derivatives accounting. At a July congressional hearing, OFHEO director Armando Falcon said that Fannie’s cooperation with the probe has been “spotty.” According to an *Associated Press* report, Falcon also said, “We’ve had some instances where deadlines have been missed without explanation, submissions in response to requests for information that weren’t complete -- even though there were assertions that they were complete.” The lack of cooperation may have been the reason for the issuance of subpoenas on August 20. According to the person familiar with the investigation, OFHEO’s

subpoenas are aimed at getting documents that would show whether certain accounting treatments were implemented as part of willful attempts to artificially smooth earnings, writes Eavis.

- While the derivatives losses don't all go into earnings when they occur, they have all been reflected in the balance sheet -- in the equity number. To the bemusement of many investors, Fannie has asked investors to look at equity numbers that leave out the FAS 133-related derivatives losses when assessing the strength of the company's capital. On June 30, Fannie Mac had \$8.5 billion of unrecoverable derivatives losses in its equity that had yet to be amortized into earnings. If, as makes sense, that sum were subtracted from the capital numbers Fannie asks investors to concentrate on, the company would look weakly capitalized. Since Fannie was betting on a drop in bond prices at the end of the second quarter, the recent rally in bonds may have created more derivatives losses, and the company's true capital base may be even weaker than it was at the end of the second quarter.
- To date, OFHEO's probe has scored a several successes. As a result of the probe, Fannie changed its accounting for some impaired mobile home bonds and booked heavier losses on these bonds. As a result OFHEO's pressure on the GSE to make some changes in its corporate structure to improve risk management, Fannie recently said it was going to "move transactional risk management responsibilities to its business units while strengthening the integration of its financial risk assessment capabilities at the corporate level." Fannie CFO Timothy Howard said that "because OFHEO's proposed corporate governance rule addresses issues related to the organization of risk management activities, the company anticipates making further changes to its risk-management structure once the final rule is in place."
- Eavis writes that a Bush victory in November would be a disaster for Fannie, which has resisted regulatory reforms for the GSEs proposed by the Bush administration. Fannie and Freddie have been told by the White House that a second Bush administration's stance would be tougher, according to a person familiar with relations between the administration and the GSEs. Under a Kerry presidency, Fannie management could find it hard to resist reform calls if OFHEO finds the GSE kept derivatives losses out of earnings. One of the corporate tricks of the 1990's was to find ways to manipulate accounting to defer or bury losses. Eavis concludes that there will be few supporters left in Congress if Fannie were discovered to have had engaged in "Enronesque practices and ethics." (*RealMoney*, Peter Eavis, 09/02/04)

Fannie Mae provides credit enhancement of NYC Development Corporation's \$110 million multifamily revenue bond

- The Bank of New York has been appointed auction agent and trustee by the New York City Housing Development Corporation (HDC) for its \$110,000,000 Multifamily Housing Revenue Bonds (Westport) Series. The bonds provide permanent financing for The Westport, a 371-unit development in New York City.

As part of the transaction, HDC sold \$124 million in 30-year, multifamily housing revenue bonds of which \$110 million are tax-exempt, auction-rate securities that carry long-term, triple-A credit enhancement provided by Fannie Mae. This transaction is a significant milestone in debt financing since it is the first time Fannie Mae has provided credit enhancements of auction rate bonds. Prior to this issuance, housing sector credit enhancers have not backed auction-rate securities, leaving these transactions to come to market without enhancement or bond insurance. Emily A. Youssef, president of HDC, said, "Given our long-standing relationship with The Bank of New York, we are confident that they will be able to fulfill the multiple roles of auction agent and trustee on Fannie Mae's inaugural auction-rate transaction." (*BusinessWire*, 09/09/04)

Fannie Mae backs new downpayment assistance pilot program

- U.S. housing groups have joined Fannie Mae to launch a pilot program aimed at helping low-income homebuyers raise down payments, said Edward Gramlich, chairman of the Neighborhood Reinvestment Corp and Federal Reserve governor. Gramlich said under the program Fannie Mae will buy, for its own portfolio, loans made to help low-income borrowers overcome the hurdle of raising money to make down payments to buy homes. "While homeownership rates are at a record high, many individuals and families are still left out," Gramlich said. "We believe that an open-ended source of funds for down-payment assistance loans will energize local organizations to promote home ownership in ways they otherwise would not." In the past, he said housing groups have tried to help low-income buyers with down payments, but have found little help from capital markets.
- Stand-alone mortgage-backed securities may eventually be developed, "making such loans effectively financed by capital markets at large," Gramlich said. "I see this project as just the beginning of a larger design, one that reflects the ever-growing and ever-changing nature of housing financial markets," he added. "In a collaborative effort involving public and private institutions, many of us in this room are crafting a different, but we hope, an extremely effective way for low-income people to participate in homeownership." If loans to low-income borrowers could be provided through capital markets "we could solidify the gains we have been making in homeownership financing over the last 30 years," Gramlich said. (*Reuters*, 09/10/04; *Dow Jones Newswires*, Deborah Lagomarsino, 09/10/04)

Group of credit unions participate in Fannie Mae test pilot of the 40 year mortgage

- About a dozen credit unions across the U.S. have begun offering 40-year fixed-rate mortgages as part of a pilot program through Fannie Mae. The GSE began the pilot earlier this year to gauge how popular a 40 year loan would be. The concept has been slow to catch on, Fannie Mae spokeswoman Sandy Cutts said, because interest rates

are still so low. “It’s not quite the right time, ideal time, for it yet,” Cutts said. “It’s still building some momentum.” By the end of the year, Fannie Mae hopes to gauge the popularity of the 40-year mortgage, Cutts said. There is no timeline yet on whether Fannie will expand the pilot program to other lenders or make it a permanent offering. Doug Duncan, chief economist for the Mortgage Bankers Association, said he expects the 40-year fixed-rate mortgages will become a niche product, which may help the first-time homebuyers get into a home. (*Inman News*, Samantha Peterson, 08/30/04)

Freddie Mac

OFHEO appeals court decision to release Brendsel’s compensation

- OFHEO appealed a recent U.S. court decision releasing some \$60 million in withheld compensation to Freddie Mac’s former chief executive, Leland Brendsel. U.S. Judge Richard Leon had ruled that OFHEO was “simply overreaching” when it directed Freddie Mac to freeze Brendsel’s assets after widespread accounting misdeeds came to light about 15 months ago. The U.S. District Court in Washington granted Brendsel’s request for a preliminary injunction releasing his severance pay, stock, stock options and other benefits valued at approximately \$60 million. While Leon twice rejected OFHEO’s pleas against the preliminary injunction, he still has to rule on Brendsel’s request to permanently enjoin, or stop, OFHEO from taking his money. OFHEO asked the court last week to extend to October 15 the deadline Monday for its response on the permanent injunction. The ruling, if it sticks, is also favorable for Freddie’s former Chief Financial Officer Vaughn Clarke, who has a similar case pending before Leon.
- DOJ attorneys argued on OFHEO’s behalf in court filings that it would have little chance of winning the case on appeal if Brendsel’s pay is released beforehand. They also argue that Leon’s decision could hamper OFHEO’s ability to collect damages in separate enforcement actions against Brendsel and Clarke, who were ousted last year.
- OFHEO notified the District Court that it is appealing the case to the U.S. Court of Appeals for the District of Columbia, but hasn’t yet filed its appeal. “We remain in discussions with the Justice Department at this time,” said OFHEO spokeswoman Corinne Russell. The case - the first challenging OFHEO’s enforcement power - is a stark example of agency’s limited statutory authority compared with other financial regulators.
- House Financial Services Committee Chairman Michael Oxley (R-OH) told reporters that he wasn’t surprised by the court decision against OFHEO. “I think legally [the court is] correct,” Oxley said. When asked whether the case offered evidence that OFHEO was a weak regulator, Oxley replied, “that was a given.”

- The ruling is the first challenging OFHEO’s enforcement power and could have far-reaching implications for the regulator, which also oversees Fannie Mae. OFHEO is pursuing separate civil charges against Freddie Mac, Brendsel and Clarke and conducting an investigation of Fannie Mae’s accounting practices. OFHEO director Armando Falcon has said that Fannie’s compliance with information requests in the examination has been “spotty.” Fannie also initially resisted OFHEO’s demands to recalculate losses for certain assets. Some attorneys in Washington say Brendsel’s court decision could embolden Fannie Mae officials to resist further changes. (*Dow Jones Newswire*, Dawn Kopecki, 09/13/04)

Freddie Mac integrates compliance functions into its operations

- In October, Freddie Mac hired Jerry Weiss, as the newly-created position of chief compliance officer. “We had historically asked a variety of people in control functions and business functions to assume compliance-related responsibilities, and it seemed appropriate to bring all that together,” says Weiss, who spent 10 years at Merrill Lynch’s fund management division and later served as the group’s global head of compliance. Weiss’ first priority was to review Freddie Mac’s compliance culture and to conduct a legal and regulatory gap analysis. While his most direct day-to-day work is performed with the front-line managers of Freddie Mac’s various businesses, his office coordinates with several other departments, including legal, finance, operational risk management, and information systems and services. Weiss collaborates with Freddie Mac’s Information Systems (IS) group to develop Web-based training on compliance and business ethics for the GSE’s managers. He also has partnered with Freddie Mac’s IS team to create monitoring and surveillance tools to ensure the company’s investment securities are traded in a manner consistent with regulatory guidelines. “We view IS as a key partner in allowing us to first develop a vision for our compliance program, and ultimately implement and execute it,” Weiss says. (*Network World*, Stacey Cowley, 09/06/04)

Freddie Mac declares quarterly dividend

- Freddie Mac’s board of directors announced a dividend of \$0.30 per share on the GSE’s voting common stock for the third quarter, unchanged from that of the second quarter. Dividends will be payable on September 30 to stockholders of record as of September 20. (*Freddie Mac Press Release*, 09/10/04)

Freddie Mac is 🎵 Homeward Bound 🎵

- While Freddie Mac says it has not started an ad blitz touting the benefits of homeownership, it sure feels that way to Washington, DC residents. A bevy of ads with the tagline, “Freddie: We Make Home Possible” have appeared in print, on the

radio, and on television recently. A GSE spokeswoman said it is not advertising more than normal. Instead, Freddie Mac has merely returned to advertising after a hiatus of more than six months. She added that the GSE's ad budget has been the same for the past five years.

- In July, Freddie Mac placed the new ads which immediately attracted attention because the GSE licensed Simon and Garfunkel's song "Homeward Bound" to use in them. Although Freddie's spokeswoman would not say how much the ads cost or disclose the price tag for licensing the popular tune, you can bet it cost a pretty penny. Even though these ads do not include Paul Simon and Art Garfunkel singing their hit song, just a "cover version" likely cost the GSE tens of thousands of dollars. According to www.Howstuffworks.com, a well-known song played in a national commercial for one year costs between \$75,000 and \$200,000, depending upon where and how often the ad is played and how long the song is licensed. Sony Music Licensing, which licenses the Simon and Garfunkel tunes, did not respond to the *American Banker's* calls, requesting the cost of the use of the song.
- The GSE's spokeswoman said Freddie's TV and radio ads are playing mostly in Washington, targeting shows with audiences having "policy influence." The ads are currently being run on radio programs on National Public Radio, and talk shows hosted by Rush Limbaugh and Don Imus, and evening and Sunday morning TV news programs. Freddie Mac's print ads have appeared on web sites of *The Wall Street Journal* and *The Washington Post*, as well as in the Capitol Hill publications *National Journal*, *National Review*, and *Roll Call*. (*American Banker*, Rob Blackwell, Barbara A. Rehm, Hannah Bergman, Damian Paletta, and Todd Davenport, 09/13/04)

Freddie Mac's treasurer bolts for GMAC
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- On September 15, Freddie Mac's Treasurer Louise Herrle joined General Motors Acceptance Corp., the financing unit of General Motors Corp, as the corporate finance group head and treasurer of a newly formed holding company for GMAC's residential mortgage subsidiaries. GM has aggressively pursued mortgage as well as auto finance business in recent years. Herrle took up her post at Freddie Mac in November of 2000, and was responsible for the company's debt execution in the domestic and global markets, according to Freddie Mac's Web site. Freddie Mac has yet to announce a replacement.
- Herrle traveled to New York with Jerome T. Lienhard, Freddie's senior vice president of debt and equity financing, to reassure bond dealers about her decision to take a job with GMAC. As the executive in charge of the GSE's debt funding programs, Herrle was its public face on Wall Street. Given the turmoil at Freddie in the past year, she said, "there were some questions as to why I was leaving." But she said that her resignation, which Lienhard disclosed in a September 1 letter to underwriters, had "nothing to do with the situation at Freddie." She added, "I don't think I would have considered anything last year," but now is a good time to make a move, because

Freddie is “out of crisis mode.” (*Dow Jones Newswire*, Christine Richard, 09/07/04; *American Banker*, Jody Shenn, March Hochstein, David Boraks, 09/10/04; *National Mortgage News*, 09/09/04)

At Freddie Mac, the doctor is in

- Freddie Mac is adding an on-site health center at its office campus in McLean to provide medical services to all of the GSE’s 3,200 employees. During business hours, Freddie Mac’s health center will be open with a registered nurse on duty five days a week, a physician on-site two days a week, and a dietitian available. The GSE’s health center is in addition to a fitness center and an on-site mental health counseling center that Freddie Mac already offers its employees. While Freddie Mac did not disclose how much its contract with Whole Health Management was costing the GSE, spokesperson Shawn Flaherty says the investment is expected to pay for itself. “It will save us money within 18 months to two years, as we begin to see significant savings based on a decrease in sick days and an increase in productivity,” she says. Freddie Mac pays between 85% and 100% of its employees’ health care costs. Services at the on-site center are free and available to employees, but not family members. In addition to keeping Freddie Mac’s current work forces healthy, its on-site health center is also seen as a strong tool for recruiting and retaining employees. (*Washington Business Journal*, Jeff Clabaugh, 09/17/04)

“Get on the bus with us!” say Freddie Mac and U.S. Bank

- On September 7th, a “one-of-a-kind phenomenon” rolled into the Twin Cities, “bringing homeownership opportunities and financial services to residents in a way that no other bank has approached the metropolitan area.” The Five Star Service Express, sponsored by U.S. Bank Home Mortgage, Freddie Mac and the Community College Foundation, launched its bus tour with a celebration on Peavey Plaza in downtown Minneapolis. The Five Star Service Express is an Internet-ready, financial service center that will travel to Minneapolis and St. Paul neighborhoods for approximately five to six weeks in September and October. (*BusinessWire*, 09/07/04)

Bilingual military personnel recruited to expand Latino homeownership

- A new effort to expand Latino homeownership opportunities by helping America’s bi-lingual military service members enter the mortgage finance industry was announced today by the United States Department of Defense Reserve Forces Policy Board, the Mortgage Bankers Association, National Association of Hispanic Real Estate Professionals, National Puerto Rican Coalition, Univision, and Freddie Mac. Also participating in this new initiative are Branch Banking & Trust, CitiMortgage, GMAC Mortgage, and U.S. Bank Home Mortgage. WELCOME HOME provides a

tuition free Internet based training program designed by the Mortgage Bankers Association to prepare past and present Spanish-speaking members of the armed forces for post-service careers in all phases of the residential and commercial lending industry. The effort seeks to provide an estimated 1,000 new graduates a year for potential careers in mortgage sales, origination, underwriting, servicing, collections, and commercial and multifamily lending. (*Freddie Mac Press Release, 09/15/04*)

Federal Home Loan Banks

Reaction mixed on FHLB-Seattle's plans to buy and sell MBS

- Reaction is mixed in the FHLB System to the FHLB-Seattle's plans to buy and sell mortgage-backed securities, subject to regulatory approval. The President of the FHLB-Atlanta, Raymond Christman stated that the FHLBs must continue to innovative, even when political heat on Fannie Mae and Freddie Mac makes it a difficult time to emulate the GSEs. "I've been involved with the Home Loan Bank System for almost 12 years," said Christman. "I never, during that entire period, ever remember a time when an issue comes up where there isn't somebody in the system who is cautioning this is a dangerous time to talk about something. I don't know when a good time is." He added, "Shared funding and MortgageChoice are further examples of innovative entrepreneurial behavior that I think is a good thing we would like to see occur. These things have to be tested in the marketplace and also measured against risk mitigation and safety-and-soundness concerns. ... Bring them out, and let's see them reviewed and analyzed. The good ideas will rise to the top, and others won't." Christman is an unlikely supporter of the FHLB-Seattle's plan, given the FHLB-Atlanta's emphasis on FHLB-Advances and small investment of 1.6% of its assets in mortgages
- In contrast, FHLB-New York president Alfred DelliBovi said his board has decided to move the Bank's business back to basics and take fewer risks and accept smaller returns. DelliBovi said, "We're an advance bank." In today's political environment, DelliBovi said he believes that the FHLB-Seattle's move is unwise.
- The FHLB-Chicago, the creator of the Mortgage Partnership Finance (MPF) program, is expected to continue its emphasis on the mortgage side of its business, which now comprised more than 51% of its assets, while advances accounted for 30.4% of its assets as of June 30.
- The FHLB-Dallas has 74% of its assets in advances and 1.3% in mortgage loans. A FHLB-Dallas spokesman said that while the Bank would continue to offer the MPF program to members, it is "not a big driving force in our district." A spokeswoman for the FHLB-Topeka said mortgage loans are unlikely ever to account for more than

15% of its assets. While the FHLB-Topeka was committed to its mortgage program, the spokeswoman said “we don’t look at it as a dominant portion” of the balance sheet. At June 30, the FHLB-Topeka had approximately 4.7% of its assets in mortgages and 63% assets in advances.

- Many of the other FHLBs are watching the FHLB-Chicago and FHLB-Seattle closely, hoping that they will be will able to expand their mortgage lending programs, while continuing to focus on their advances business. Spokespersons for the FHLB-Pittsburg and FHLB-Des Moines said that they had participated in the shared funding program at the FHLB-Chicago and are interested in exploring the Seattle Bank’s plan.
- The different attitudes toward the mortgage purchasing business can largely be attributed to the banks’ membership. The FHLB-Seattle’s four largest members, Bank of America Corp., Washington Mutual Inc., Wells Fargo & Co., and Cendant Corp, are among the top mortgage originators in the country. In contrast, the FHLB-New York has relatively few large mortgage originators.
- The FHLB-Seattle’s MortgageChoice program must still be approved by the Federal Housing Finance Board. According to the *American Banker*, a knowledgeable source said that the Bush administration has concerns with the MortgageChoice plan, and that its approval exceeds the bank’s authority.
- Some outside observers say the Chicago and Seattle mortgage programs are needed to help reduce the FHLB System’s risk by getting mortgage assets off the Banks’ balance sheet. “From a public policy standpoint, you want a situation where the Home Loan banks can be more of a conduit than a holder,” said Bruce Morrison, a former Finance Board chairman and chairman of the Morrison Public Affairs Group. “This moves the assets into the marketplace. I would say this is not just a natural step -- it’s a very positive step in the alternative mortgage market.”
- Others agreed with DelliBovi’s argument that now is the wrong time for the FHLBs to look more like Fannie and Freddie. “The political timing is poor, because it is just going to raise concerns anew that banks within the system are taking risks they are not chartered to undertake and are not equipped to manage,” said Sheila Bair, a former Treasury assistant secretary for financial institutions and a professor at the University of Massachusetts, Amherst. “It diverts them from their traditional mission which is supposed to be providing advances,” she said. “I agree with the New York bank on that point -- they should stick to their knitting.” (*American Banker*, Rob Blackwell, 09/08/04)

FHLB-Seattle calls for creation of AH goals for FHLB System

- As part of its application for MortgageChoice program, the FHLB-Seattle is urging the Federal Housing Finance Board to initiate a rulemaking process that would establish affordable housing (AH) goals for the FHLBs, similar to the AH goals

Fannie Mae and Freddie Mac must meet. While the FHLBs don't have AH volume goals, they contribute 10% of their earnings to finance AH projects. "To the extent we give cash, [Fannie and Freddie] should. To the extent they have to hit some volume goals, we should also have volume goals," said FHLB-Seattle executive vice president David Bley. "I think that is part of the obligation of being a government-sponsored enterprise." (*National Mortgage News*, 09/13/04)

Finance Board Chairwoman Castaneda defends requirement SEC registration

- Federal Housing Finance Board Chairwoman Alicia Castaneda strongly defended the Board's decision to require the FHLBs to register with the SEC, arguing that the legal, accounting, and policy questions concerning this issue have been addressed. Responding to the industry trade groups that have continued to challenge the Board's June 23 decision, Castaneda said that the time has come to move forward. "There is no turning back," she said at a conference on the FHLBs. "SEC registration will help support the reputations of the Federal Home Loan banks as solid, capable, respected financial institutions." Castaneda said her agency's examiners, accountants, and lawyers are working with the SEC and the FHLBs to resolve any remaining concerns. "I and my colleagues believe those necessary accommodations have, in the case of the Finance Board, already been made, and, in the case of the SEC, the intention to make them has been clearly and publicly stated," she said. Castaneda warned against claiming to support enhanced disclosure while trying to qualify it, saying "There is a clear reputation risk in being perceived as saying, as some may characterize it, 'We are for enhanced disclosures ...but only sometimes ...and only on our own terms.'" Castaneda added, "I do not believe it is in the interest of the Federal Home Loan Bank System to court that risk."
- Speaking later at the FHLB Forum, Treasury Undersecretary for Domestic Finance Brian Roseboro also supported SEC registration for the FHLBs. "I am confident that these issues can be worked out with the SEC, and the Federal Home Loan banks will be given the opportunity to explain the unique aspects of their business to capital market participants," Roseboro said. He also addressed the issue of whether a financial institution may belong to more than one FHLB, noting that the Treasury has argued for several years that the Finance Board does not have the authority to allow multidistrict membership. While acknowledging that proponents see it as a "natural progression" for the FHLB system, Roseboro said Congress should determine if such a move would be prudent.
- Roseboro would not comment specifically on a proposal by the FHLB-Seattle to purchase and sell MBS assets. Roseboro said it is up to the Finance Board to approve or reject the plan, but added, "As a general principle, we believe increased competition is good. That increases the breadth and depth of the secondary market." Castaneda also did not comment on the FHLB-Seattle plan, except to say that was still under review. (*American Banker*, Rob Blackwell, 09/15/04; *Federal Housing Finance Board Press Release*, Chairman Alicia R. Castaneda, 09/14/04)

Representative Frank says FHLB membership should be Congress' call

- Representative Barney Frank (D-MA), the ranking minority member on the House Financial Services Committee, said Congress should resolve whether commercial banks and thrifts may belong to more than one FHLB to minimize damage to their affordable-housing programs by industry consolidation. He has complained that consolidation in the industry has hurt the FHLBs' affordable-housing programs, since financial institutions cannot belong to more than one FHLB without a separate charter. Frank said that issue has to be addressed in any GSE bill. "We have to find a more equitable way... money earned by the bank in a particular area, there has to be a way to return it to that area," Frank told the forum. Speaking with reporters later, Frank said originally the FHLB members were all local and this was not a large issue. "Now with these cross-district mergers, you have lost that," he said. "That is what we want to get back to."
- Frank also suggested that Fannie Mae and Freddie Mac should devote some portion of their earnings to an affordable-housing program as well. "If there is a [GSE regulatory reform] bill, we will have a program for them modeled after the affordable-housing program that will take a percentage of their profits," Frank said. Both issues should be resolved as part of a bill to reform the regulation of the government-sponsored enterprises.
- Currently, the FHLBs are required to set aside 10% of their earnings into an affordable-housing program, which is awarded to member institutions for grants to fund various projects in their area. Frank said that the 10% figure was "not appropriate" for Fannie and Freddie and later suggested to reporters a contribution of 4% or 5% of the GSEs' earnings. On April 1, the Senate Banking Committee passed a GSE regulatory reform bill that would have required Fannie and Freddie to set aside 5% of their income for affordable housing. Frank said that provision was a good starting point.
- Frank's words stuck a chord among some participants at the FHLB Forum who spoke at a closed-door panel later in the day about the multidistrict issue, while other FHLB presidents did not agree. Andrew Jetter, president of the FHLB-Topeka, said if there are problems with the how mergers affect the affordable-housing program that should be addressed separately. He said his bank did not favor allowing multi-district membership. "We need to think about what is the driver for multidistrict, and say, 'Is multidistrict the proper way to address those issues?' Or are there other ways to address those issues?" Jetter said. Raymond Christman, another panelist and president of the FHLB-Atlanta, said the FHLBs are facing too many other concerns -- including registration with the Securities and Exchange Commission -- to consider opening up the multidistrict issue at the moment.
- Frank said that he thought the House Financial Services Committee would return to the GSE bill next year, but warned that unless there is a new administration or the

current administration changed some of its demands, final legislation could not pass. "You could not get a bill the Bush administration wants through the House Financial Services Committee," Frank said. (*American Banker*, Rob Blackwell, 09/16/04)

Housing Finance Board unanimously approves 17% increase in 2005 budget

- The Federal Housing Finance Board adopted its FY2005 budget that will significantly strengthen its oversight of the FHLBs for safety and soundness and their housing-finance mission, Chairman Alicia R. Castaneda said. "The Finance Board is showing once again its commitment to being a strong and effective financial regulatory agency, complete with the tools it needs to supervise and regulate the Federal Home Loan Banks." The Finance Board unanimously adopted a FY2005 budget of \$36.4 million, a 17% increase over its current budget of \$31.1 million. The budget includes a 27% increase in funding for the Office of Supervision (OTS), going from \$12.4 million to \$15.7 million. Total staffing in the OTS will rise from a budgeted 80 in the current fiscal year to 96 in FY2005, including the hiring of seven additional examiners and four bank examination specialists. For the entire agency, budgeted staffing will increase from 130 to 147.
- "This budget concentrates on the additional staff, infrastructure and other resources needed to ensure the safety and soundness of the Federal Home Loan Banks," Castaneda said. "I believe in a course of constant improvement for the Federal Housing Finance Board, and this budget reflects exactly such a course of action." The FY05 budget also anticipates a relocation of the agency from its current offices at 1777 F Street, NW to space at 1625 I St., NW. (*FHFB Press Release*, 09/15/04)

Sallie Mae

Selling out higher education?

- The *Washington Post* writes in a September 10th editorial, "There are bureaucratic errors, there is congressional negligence -- and then there are bureaucratic errors and congressional negligence on a scale so vast that it is hard to believe they can be accidental. The hundreds of millions of dollars in unnecessary government payments to the student loan industry in the past 18 months amount to such a scandal. The loans in question, established in 1980, are guaranteed by the government at 9.5 percent. Yet most students are paying interest rates of 3.5 percent or less. The difference -- all taxpayers' money -- is pure profit for the companies that have taken advantage of a loophole in the law."

- “According to a recent report by the Institute for College Access and Success, a nonprofit education think tank, Congress had actually intended to end in 1993 the 9.5 percent loan guarantee, one of many programs that provide incentives for institutions to lend to students. In May 2003, one company, Nelnet Inc., wrote to the Education Department to confirm its intention to expand its holdings of old loans with the 9.5 percent interest rate. Nelnet received no answer from the department for a year, during which time the department continued paying the company. In June of this year, the department replied inconclusively -- at which point the company’s stock price climbed 20 percent. Although Nelnet is the largest holder of loans guaranteed at 9.5 percent -- and its holdings of such loans have increased by 818 percent since January 2003 -- it is only one of many such lenders. According to a preliminary Government Accountability Office report, commissioned by Representatives Chris Van Hollen (D-MD) and Dale E. Kildee (D-MI), 37 lenders receive payments for loans with guaranteed interest rates of 9.5 percent, at a government cost of \$1 billion annually, and the volume of such loans is rising.”
- “Why wasn’t the loophole shut long ago? Education Department officials argue strenuously that only a two-year regulatory process could have done so, and they didn’t initiate one, they say, because they thought Congress would deal with it. Congressional Republicans say they expected to deal with the problem in a comprehensive higher education bill, but that has failed to pass (and in any case the proposed language would not have ended all the payments). Yet, other solutions could have been found: In the wake of revelations about the scale of the payments, the House yesterday passed an amendment to an appropriations bill, offered by Mr. Van Hollen and Mr. Kildee, that would close the loophole completely, albeit temporarily. (Of course, there is no guarantee it will become law.) And one former Education Department general counsel has written to the secretary of education, Roderick R. Paige, arguing that the loophole could have been closed immediately if officials had wished to do so.”
- “There could be other explanations for their reluctance. One is that the president of Nelnet, Don R. Bouc -- who has called for the loophole to be shut and the money to be better used -- is well-connected enough to have been appointed to Mr. Paige’s advisory committee on student financial assistance. Here is another: According to a report in the Chronicle of Higher Education, Nelnet is the second-largest contributor to congressional campaigns in the student loan industry, beaten only by industry giant Sallie Mae. Over the past 18 months, the student loan industry has contributed about \$750,000 to the 49 members of the House Committee on Education and the Workforce, of which \$136,000 has gone to the committee chairman, Representative John A. Boehner (R-OH), and \$175,000 to Representative Howard P. “Buck” McKeon (R-CA), chairman of the subcommittee on higher education. Mr. Boehner’s spokesman vehemently denies any connection between the contributions and the issue and maintains that the committee’s bill would have fixed the problem, which was mentioned in the president’s latest budget. Still, it is difficult to understand, given the sums involved, why neither Mr. Paige nor Congress made this a higher priority.”

- “For nearly a decade we have argued that Congress should reduce subsidies for banks that lend to students, and instead expand the direct-loan program, which provides about a quarter of student aid -- or else reform the system to make it harder to manipulate. This scandal provides an excellent reason to look again at these questions.” (*Washington Post*, 09/10/04)

Concern at Sallie Mae

- Sallie Mae’s private lending business has experienced a sharp rise in the percentage of loans where students have difficulty making payments, raising concerns about the credit quality of some of the GSE’s highly rated debt. Not only are these “loans in forbearance” rising, Sallie’s regulatory filings also understate the level of these delinquencies since some of these loans are securitized in the GSE’s off-balance sheet trusts, which use different accounting methods from the company’s filings with the SEC. Acknowledging the accounting discrepancy, Sallie Mae said it was changing how it accounts for the loans, which would bring the percentage of loans in forbearance in the trusts in line with the figures in its annual SEC filings. “We were overstating the risk, if you will, in the securitization filings,” said Tom Joyce, a Sallie Mae spokesman.
- In its annual SEC filing, Sallie reported that \$580 million of private credit loans were in forbearance on a “managed” basis, which included off-balance sheet and on-balance sheet figures. When the forbearance loans reported in the off-balance sheet trusts are added to the forbearance loans reported on the balance sheet, the sum is 29% higher --\$750 million. The gap in reporting has consistently widened each quarter.
- Sallie Mae’s executive vice-president of finance Jack Remondi said the rising level of loans in forbearance was “typical of the trajectory” of these loans early in their lifetime and that the delinquency levels eventually come down. Private student loans classified as “in forbearance” in Sallie’s 2002 trust have climbed to 17.4% at the end of May, up from 2.8% in August 2002, according to a trust servicing report. Meanwhile, other private student loan providers have experienced a decline in forbearance levels. For example, KeyCorp’s securitized private loan trust reports since 2001 exhibited a sharp decline in forbearance levels. KeyCorp insures its loans with a bond insurer, protecting its investors in the event loans default. Sallie Mae does not insure any of its private loans. The GSE’s loans, which do not have government backing, pay Sallie roughly 7% in interest, compared with less than 4% for the federal loans it services. Sallie’s private-credit business increased 40% last year to more than \$10 billion. (*Financial Times*, Stephen Schurr and Jenny Wiggins, 09/13/04)

Farm Credit System/Farmer Mac

More rumbling about the Rabobank acquisition of FCSA
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- A group of Farm Credit Services of America (FCSA) shareholders is trying to block FCSA's sale to Rabobank Group of the Netherlands and keep control of it in the hands of local farmers. About 50 shareholders (out of FCSA's 57,000 shareholders) have organized a coalition called "Farmers for Farm Credit" (FFC) and sent a letter to FCSA's chairman Paul Folkerts. The August 30th letter requests a meeting with the board of directors and complains about the "proposed sale of our lender to a foreign entity, plans to relinquish farmer control and abandon the mission of serving farmers as part of the Farm Credit System, and the loss of over \$1 billion of farmer capital" in FCSA.
- Merlyn Groot, a Manson, Iowa farmer who serves as one of the co-chairs of FFC, said the group formed after shareholders began comparing notes. The farmers found that the directors of FCSA would not talk to shareholders, and management was not forthcoming with information. "The only response we get from the directors is they are under a gag order and can't discuss it while the management is going around telling their side of the story," Groot said. "It seems like the discussion should be open as a cooperative and include the members." Kelly Ford, a spokeswoman for FCSA, said that the board had received the letter and planned to evaluate it. A Rabobank spokeswoman said the company had not received the letter and could not comment on it.
- Farm Credit System regulations put restrictions on what FCSA can say to shareholders and when. Further, FCSA cannot tell shareholders any information that would go out in the information packet before the regulator has approved the deal. Once shareholders get their information, they will have 30 days to review it before a vote. Groot says that may not be enough time to give the deal full consideration. "I think this whole idea needs to see the light of day and stand on its merits," he said. "Just to delay and delay and delay until it's too late to get the information out to understand it is not the way to do this."
- On July 30, the \$500 billion-asset Rabobank announced that it had agreed to buy FCSA for \$600 million. If FCA approves the deal, FCSA will have to pay an \$800 million exit fee to the Farm Credit System. On August 18th, AgStar Financial Services ACA of Mankato, MN made a counteroffer of \$650 million in hopes of keeping the FCSA's assets in the government-sponsored Farm Credit System.
- Farm Credit Services of America will submit its application for approval of the deal sometime this month, and the FCA will have 60 days to review it. But shareholders

say that before it files an application, they deserve an explanation of why the lender agreed to the deal with Rabobank. (*American Banker*, Ben Jackson, 09/03/04)

Report favors merger of FCSA with AgStar
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- FCSA should merge with AgStar, another member of the Farm Credit System, instead of being acquired by the Dutch cooperative Rabobank, according to a report prepared by Professor Peter J. Barry, of the University of Illinois . An AgStar/FCSA merger would result in “more effective deployment of the association’s relatively strong, unallocated capital position,” said Barry. AgStar’s proposal to pay \$650 million as a cash distribution to FCSA shareholders makes more sense than a \$600 million purchase by Rabobank, he said. Barry added that a sale of FCSA to Rabobank would be the first acquisition of a GSE by a private corporation in the history of the Farm Credit System. If FCSA exits the System, it will have to pay an estimated \$800 million exit fee, Barry added. Barry writes, “AgStar’s merger proposal would combine the two neighboring associations, diversify the types of loans and farming regions, increase operating efficiencies and size economies, distribute \$650 million to FCS of America’s stockholders, and provide access to an on-going capital and patronage allocation program to stockholders. The merger would also continue the consolidation trends among the Farm Credit System institutions.” As long as FCSA plans to remain in the agriculture business, a merger with AgStar is preferable to purchase by the Dutch conglomerate, he concluded.
- Barry’s report proposes a solution that is like “buying a house by selling a wall,” said Lynne Burns, a public relations spokeswoman for Rabobank said. Burns explained that Barry’s alternative of FCSA selling \$1.5 billion in loans to shareholders already in the system would make the agricultural association less stable than it is at present. By merging with AgStar, FCSA would go from about 17% in retained earnings to about 10%, less than it had originally. (*Bureau of National Affairs*, Marcia Kass, 09/07/04)

Postal Service

Postal reform?

- *Congressional Quarterly* reports, “The House Judiciary Committee today [September 15th] became the second committee to approve a major overhaul of the Postal Service, the first in 34 years. By voice vote, the panel joined the Government Reform Committee in approving the measure (HR 4341), whose future in the waning weeks of this session remains uncertain. Proponents of an overhaul want to make the Postal Service operate more like a business in an effort to address a debt situation that led a presidential commission to conclude last year that the Postal Service is on the brink of crisis. The measure, which has the support of most of the major stakeholders, would give postal officials the flexibility to adjust rates on products that compete with FedEx and UPS and encourage them to enter into “work sharing” agreements with large customers. The bill would set up a Postal Regulatory Commission and limit rate changes on postage for letters, periodicals and advertising mail to changes in the consumer price index.” (*Congressional Quarterly*, 09/15/04)
- In the September 13th issue of *Business Mailers Review*, Kate Muth writes: “What, no session on legislative reform issues at the National Postal Forum?! This is the befuddled reaction from some mailers after reviewing the forum’s ‘at a glance’ agenda. A few voiced frustration that there appears to be no session focusing on postal legislation, while bills remain pending in these final days of the 108th Congress. ‘You have thousands of our customers in Washington who could march up to Capitol Hill and complain about this coming ‘stamp tax’ in the next rate case,’ said one critic, who was referring to the escrow account and the military pension costs that will have to be built into the next rate case without legislative action. This is another squandered opportunity, said more than one industry leader. You have the people who actually pay the rates coming to town just as Congress heads into the homestretch.” (*Alliance for Non-Profit Mailers*, 09/10/04)
- *DMNews.com* reports that most mailing industry insiders say there is little time to pass either postal reform bill, especially as neither has been scheduled for debate on the House or Senate floors. Jerry Cerasale, senior vice president of government affairs at the Direct Marketing Association, has not given up. “We are still working hard to push postal reform through Congress and on the president’s desk before November,” he said. Cerasale is optimistic because the Senate and House committees that oversee the USPS -- led by Senator Susan Collins (R-ME) and Representative Tom Davis, (R-VA) -- are determined to pass reform. If reform isn’t passed this year, both bills likely will be reintroduced and passed early next year, said Cerasale. “The momentum we’ve built this year has been very important,” he said. (*DMNews.com*, Melissa Campanelli, 09/07/04)

Bust the Antitrusters – including the USPS

- *National Review Online* writes, “Now is the time for the Bush administration to lighten the enforcement burden of antitrust law and for Congress to do what it should have done long ago: repeal the Sherman antitrust laws. These laws were meant to protect consumers from higher prices paid as a kind of ransom to monopolies that gain enormous market share. There are few if any such industries where this concern still exists. There are no longer discreet geographical or product markets. One technology competes with scores of others for consumer and business dollars. For example, satellite dishes keep cable TV prices in check even when the cable market is technically a monopoly. These competitive forces explain why prices are stable or falling in virtually every industry except where the government has created its own legal monopoly. **The U.S. Postal Service and public education are examples of this.**” (*National Review Online*, Stephen Moore, 09/15/04)

Potter says USPS shortchanged by \$800 million in appropriations

- Congress is shortchanging the Postal Service under planned fiscal 2005 appropriations and should restore more than \$800 million in funding, said Postmaster General John Potter in an August 31st letter to Representative Ernest Istook (R-OK), chairman of the House Appropriations Subcommittee on Transportation, Treasury and Independent Agencies. The Postal Service wants nearly \$76 million to subsidize free mail services for the blind and overseas voters, while the House spending bill would provide almost \$62 million. Potter said that Congress’ refusal to provide \$779 million to pay for machines to detect biological weapons sent through the mail and filter biohazards from the air at postal facilities makes the Postal Service “very concerned that payment for the equipment to [make mail safer is] not considered a priority.” Congress also has not budgeted for a \$29 million debt repayment, which would be the 12th of 42 payments on a more than \$1.2 billion dollar debt owed to the Postal Service. Nearly \$900 million remains, and the Postal Service could be forced to write the whole debt off if Congress reneges on this payment. (*FederalTimes.com*, 09/06/04)

Potter reaffirms pledge to hold postal rates steady until 2006

- Aggressive cost cutting produced \$8.3 billion in savings during the past three years, said postmaster general John E. Potter, letting him reiterate his commitment to maintain current postage rates until 2006. “The postal service will continue to focus on the strategies identified in our Transformation Plan, and we will continue to deliver the plan’s commitments ahead of schedule,” Potter said.

- *Alliance for Non-profit Mailers* wrote, "...USPS CFO Richard Strasser reminded the Members of the Board of Governors that much of the success in this past year was due to the savings generated by the 2003 CSRS relief legislation. 'However,' Strasser said, 'with FY 2005, those "savings" have been completely consumed in absorbing cost inflation.' Without financial reform of the USPS by Capitol Hill -- the USPS will be obliged to increase rates dramatically." (*DMNews.com*, 09/15/04; *Alliance for Nonprofit Mailers*, 09/15/04)

APWU wins again

- *PostalWatch.com* writes, "In a Sept. 10, 2004 letter, the USPS Vice President for Labor Relations formally notified the APWU that it would end the pilot and would not proceed with the Hallmark Gold Crown initiative at this time. This is a significant accomplishment for the APWU. Hallmark and the USPS had announced an arrangement under which 972 Hallmark Gold Crown Stores would sell stamps and accept mail. The Hallmark program would have expanded private postal services to a new level." (*PostalWatch.com*, 09/14/04)

Reality programming?

- According to *PR Newswire*, "The Postal Service is taking on a new look. Its own Letter Carriers are the stars of this fall's new advertising campaign. It all begins ... with a series of television and print advertising and in-store promotions. Capitalizing on the popularity of reality television, the new campaign focuses on actual postal employees who will explain the many ways customers can access postal services without having to visit a Post Office or stand in a line." As the USPS introduces this national ad campaign, the Alliance for Non-Profit Mailers writes, "we learn ... that the USPS spent more than \$40 million on ads in 2003 and \$5 million through May 2004." (*Alliance for Non-Profit Mailers*, 09/08/04)

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