

The **GSE** REPORT™

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Major Events

Federal Reserve Chairman Alan Greenspan warns (again) that Fannie Mae and Freddie Mac threaten the derivatives market
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- At the Chicago Federal Reserve Bank's Annual Banking Conference, Federal Reserve Chairman Alan Greenspan reiterated his recommendation that Fannie Mae and Freddie Mac be forced to shrink the size of their mortgage portfolios, saying the GSEs' holdings are so large that they threaten the derivatives market. The sheer size of Fannie Mae's and Freddie Mac's portfolios makes the GSEs potentially vulnerable to "market illiquidity," he warned. "The supply of liquidity available to them in the swaps market is not unlimited." Greenspan added, "Concerns about potential disruptions to swaps-market liquidity will remain valid until the vast leveraged portfolios of mortgage assets held by Fannie and Freddie are reduced, and the associated concentrations of market risk and risk-management responsibilities are correspondingly diminished."
- During the question and answer session, Greenspan advised against Congress placing specific caps on the size of the GSEs' portfolios or debt issuance; instead, he supported a Treasury Department proposal that would limit the GSEs' portfolio holdings to the amount needed for their primary mission of providing liquidity to the market, implying a steep reduction from GSEs' current holdings of \$1.5 trillion. Greenspan said, "Specifically, the GSEs should hold only the minimum level of assets needed to accomplish their primary missions mandated by their charter. It is important to emphasize that decreasing their portfolio of mortgage backed securities does not in the first instance affect the level of home mortgage debt outstanding. Issuance of MBS grosses up mortgage assets and repayments of MBS reverse the process. A GSE that sells mortgage backed securities will redeem an equivalent amount of GSE debt." Greenspan does not anticipate any disruptive effects on the housing market or on the cost of mortgages from gradually reducing the size of the GSEs' portfolios. "Such transactions might affect the MBS-GSE spread at the margin, but we find little empirical evidence that the spread of home mortgage interest rates over comparable maturity Treasuries is affected at all," he said. "Moreover, the process of shrinking the GSEs' portfolio could be accomplished over a period of several years simply through normal repayment of mortgage backed securities and the mortgages that they hold. Even in periods of low refinancing a substantial amount of MBS is paid down each year with no disruptive effects on the market."
- In response to Greenspan's comments, a Freddie Mac spokesman said that the company's "portfolio is very conservatively managed and tightly regulated" and argued that shrinking the GSEs' portfolios would increase the concentration of mortgage holdings at a few even-bigger financial institutions, while limiting the availability of long-term fixed-rate mortgages. (*Wall Street Journal*, Greg Ip,

05/06/05; *Main Wire*, Steven K. Beckner, 05/06/05; *Reuters*, Mark Felsenthal, 05/05/05; *Bloomberg News*, Craig Torres, James Tyson, and Karen Brettell, 05/05/05)

Under regulatory pressure to adhere to its mission,
Fannie Mae shuts its international advisory business

- Citing guidance provided by HUD, Fannie Mae notified clients that it has decided to “disengage” from providing international advisory and training services, which it has provided for the past 15 years to public and private entities in more than 38 countries. In a May 2nd letter, Soula Proxenos, the managing director of Fannie Mae’s International Housing Finance Services (IHFS), referenced HUD Secretary Alphonso Jackson’s recent Senate testimony that the agency had determined that some of the company’s international activities were not consistent with its charter purposes. Proxenos said, “Based on our regulator’s guidance, Fannie Mae has decided to disengage from international advisory and training activities going forward.” However, IHFS seminars scheduled in Washington (on May 17-20), Mexico City (May 24-25) and Cape Town, South Africa (August 18-19) will “carry on as previously scheduled.” Proxenos concluded his letter by saying, “My staff and I have sincerely enjoyed working to help improve the availability of housing finance around the world.” (*Dow Jones International News*, John Connor, 05/02/05; *Reuters*, 05/03/05)

Fannie Mae and Freddie Mac

“Stars aligning” for GSE regulatory reform, as the Senate Banking Committee and House Financial Services Committee plan votes on GSE legislation

Debate over how to limit the size of GSEs’ portfolio continues

Bush Administration continues its push for GSE regulatory reform

“Stars aligning” for GSE regulatory reform, as the Senate Banking Committee and House Financial Services Committee plan votes on GSE legislation

- The Senate Banking Committee is on schedule to vote late this month or in early June on GSE regulatory reform, said Senator John Sununu (R-NH). Chairman Richard Shelby (R-AL), who plans to hold a vote in late “May or beginning of June,” has “done a great job of keeping” the committee on schedule, said Sununu. (*Bloomberg News*, James Tyson, 05/05/05)
- Representative Michael Oxley (R-OH), chairman of the House Financial Services Committee, said he expects the committee to mark up a bill on GSE regulatory reform legislation as soon as May 18 or May 25. In a speech to the Council of Federal Home Loan Banks, Oxley said that the “stars are lining up” for passage of the bills, and that lawmakers in the Senate and House, as well as the Bush administration, are in accord. “I see people across the Capital in the Senate and downtown at the White House coming together on these critical matters,” he said. Oxley said he does not expect the legislation to empower the FHLBs to securitize mortgages. “This is an issue the [Council of Federal Home Loan Banks] needs to address and arrive at a consensus position,” he said. “At this time, that issue is not settled and is not one I expect the legislation to address directly.” Representative Barney Frank (D-MA) said, “We’re close to the kind of bill we could have passed a while ago. We’re working on it.” The House Financial Services Committee doesn’t believe it is necessary to reduce the companies’ combined \$1.5 trillion mortgage portfolios, Frank said. “There is not a majority sentiment here for reducing portfolio limits for any reason other than [ensuring] ...safety and soundness.” (*American Banker*, Rob Blackwell, 05/06/05; *National Journal’s CongressDaily*, 05/04/05; *Dow Jones International*, John Connor, 05/03/05; *Bloomberg News*, 05/04/05)
- Despite some impediments to GSE regulatory reform, it appears likely that reform legislation will pass this year. “There are certainly modest differences with the Senate version [and House version of GSE regulatory reform]. But, I don’t see any deal-breakers,” said Representative Richard H. Baker (R-LA). “We are getting very close, and the differences aren’t that far apart,” said Joe Cwiklinski, a legislative assistant to Senator Chuck Hagel (R-NE) and the staff director for the Senate Banking

subcommittee on securities and investment. Several issues remain to be worked out, including what kind of power the new regulator should have over the size of the GSEs' mortgage portfolios; the regulator's power over the GSEs' new activities; and whether a bright line should be drawn between primary and secondary market activities. Cwiklinski said the Democrats and Republicans are close to achieving a consensus on regulating the size of the GSEs' portfolios by providing the new regulator flexibility in deciding whether to force the companies to reduce the size of their portfolios. Adam Healy, legislative assistant to Senator Tim Johnson (D-SD), said Democrats feel portfolio caps should be based on safety and soundness concerns and shouldn't arbitrarily limit the GSEs' growth, adding "the devil is in the details." Congressional aides acknowledged that a brewing showdown over judicial nominees in the Senate could cause the GSE legislation to stall. "[A battle over judicial nominees] will really slow down any progress on the Senate floor," said Healy. (*American Banker*, Rob Blackwell, 05/04/05; *CQ Today*, Michael R. Crittenden, 04/28/05; *Bloomberg News*, 05/02/05; *Dow Jones Newswires*, Dawn Kopecki, 05/02/05)

Debate continues over how to limit the size of GSEs' portfolio

- Senate Banking Committee chairman Richard Shelby (R-AL) said the new GSE regulator "should have the authority to address concerns with the size and content" of Fannie's and Freddie's portfolios. "Congress is not the best forum to set such standards, such decisions are best left to the discretion of the regulator to act when the risks warrant such action or the link to housing mission is unclear," Shelby said in a speech. "I will be very clear on this point: I will not support a bill that does not establish a regulatory structure with capital authority and enforcement powers that are needed to ensure the safe and sound operations of the GSEs. Nor will I move legislation that does not include strong, workable receivership language." (*Market News International*, Claudia Hirsch, 05/04/05; *Reuters News*, 05/04/05; *Bloomberg News*, 05/04/05; *Main Wire*, Claudia Hirsch, 05/04/05; *Dow Jones Newswires*, John Connor, 05/04/05)
- Greg Zerzan, acting assistant treasury secretary for financial institutions for the U.S. Treasury Department, said that "giving the new regulator the power to place limits on the size of the GSEs retained mortgage portfolios, according to strict criteria defined in law, is a critical element of reform without which no reform package would be complete." While more work remains to be done on legislation to beef up GSE regulatory reform, Zerzan said the foundation for meaningful reform exists, "provided that the key elements outlined by the administration are incorporated in any final legislative proposal." (*Dow Jones Newswires*, John Connor, 05/04/05)
- At a Mortgage Bankers Association conference in San Francisco, representatives of Fannie Mae, Freddie Mac and the FHLB-Pittsburgh argued that proposals to stiffen regulations for the GSEs could have unintended consequences and raise the cost of homeownership. Thomas A. Lund, a senior vice president at Fannie and the interim head of the company's single-family mortgage business, argued that the GSEs'

portfolio is critical to the companies' ability to ensure liquidity in the market. "Right now people are fooled to some extent, because there is such unbelievable liquidity in this market," he said. "We have seen that over and over in this industry - that will dry up. ...This is not the environment we are always in." Lund and Donald Bisenius, Freddie Mac's senior vice president for credit policy, said many of the mortgages held in their portfolios are subprime mortgages, providing a valuable funding source for that market. Bisenius also argued that capital requirements that are not tied to risk or the establishment of tough affordable-housing goals could also have damaging effects. "There is a huge potential to do bad," he said. (*American Banker*, 05/03/05; *Reuters News*, Kristin Roberts, 05/02/05)

- At an American Enterprise Institute forum on limiting the portfolios of the GSEs, Jason Thomas, an economic policy analyst for the U.S. Senate Republican Policy Committee, rebutted Fannie's and Freddie's arguments that their vast portfolio holdings shouldn't be limited because the portfolios reduce mortgage rates and provide liquidity to the financial markets in times of crisis. "There is a temptation to regard the accounting and internal control problems at the [GSEs] as a regulatory failure that could be corrected by enhanced supervision," said Thomas. "But I think this view, so prevalent on Capitol Hill, loses sight of the fact that Fannie and Freddie are instrumentalities of the federal government." Thomas said he failed to see "the wisdom" of simply enhancing the GSEs' oversight without capping their portfolio holdings, because it would send the wrong message to the markets that Congress doesn't have a problem with the GSEs' "taking unconstrained bets on the direction of interest rates." In fact, the capital markets treat Fannie and Freddie as federal agencies, Thomas noted. "My simple proposition is that it is long past time for Congress to [treat them as federal agencies] as well. Otherwise, we will be just chasing our tail: creating a new federal agency to regulate these shareholder-owned federal agencies."
- "Given the evolution of the credit markets generally, and the mortgage market in particular, it is difficult to see the rationale for the federal sponsorship of large, highly leveraged mortgage bond funds, no matter how safe and sound," said Thomas. "It is also difficult to see why we need federal agencies to stockpile mortgage bonds when investor appetite for new classes of fixed-income assets has been so robust," noting that the GSEs' combined \$1.5 trillion mortgage portfolios have grown the fastest "at just the time at which the capital markets have become most able and willing to absorb their MBS." Without portfolio limits, Thomas said the GSEs will "resume the exploitation of their agency status to displace private credit flows and assume more interest rate and prepayment risk."
- Thomas noted that Fannie and Freddie argue that their portfolios, not MBS issuance, help lower mortgage rates because many investors prefer to buy the GSEs' debt but not their MBS. Lack of demand for Fannie's MBS could be explained by the company's internal policy of "cherry picking," a practice of keeping the highest quality MBS for its own portfolio and dumping the rest on other investors, he said. Thomas also disagreed with the GSEs' arguments that they provide liquidity to the

markets during financial turmoil. “Since we’re talking about Triple-A credit instruments, this argument is predicated on the notion that other market participants be unwilling to take advantage of the buying opportunity presented by a widening of spreads,” Thomas said. “This seems far-fetched as private institutions would have precisely the same profit motive as Fannie and Freddie.”

- Setting arbitrary limits on Fannie and Freddie’s portfolios opens the door for critics to say that Congress wants to place “arbitrary limits on the American dream,” Thomas acknowledged. “But by not imposing such a cap, Congress would simply allow the GSEs to increase the value of their subsidy arbitrarily through the increased issuance of subsidized debt,” he concluded. (*Dow Jones Newswires*, Dawn Kopecki, 04/26/05; *Prepared remarks by Jason Thomas*, “Limiting the Portfolios of Housing GSEs, 04/26/05)
- At the AEI’s forum on limiting the GSEs’ portfolios, Dr. Dwight Jaffee, Professor of Finance and Real Estate at the Haas School of Business at the University of California at Berkley, presented a study evaluating policy proposals to limit the retained portfolios by Fannie and Freddie. Jaffee concluded that the GSEs’ retained portfolios are creating unacceptable risks for the U.S. Treasury, the taxpayers and the U.S. financial system. Through an orderly self-liquidation of the portfolios based upon normal mortgage payments and prepayments over “seven to ten years at most,” the GSEs’ portfolios and the risks they create can be readily eliminated, said Jaffee. He views this option as a simple solution, which solves the problem with no impact on the mortgage-backed securities market. Such an orderly liquidation benefits the both the taxpayers and the U.S. financial system. Jaffee concludes that mortgage borrowers “stay about even,” with perhaps a small rise in interest rates “at most seven to eight basis points” in the short-run, being offset by the much larger cost of a major disruption of the mortgage market that has been avoided. However, the Fannie Mae and Freddie Mac shareholders are likely to be “worse off” with restrictions on the GSEs’ portfolios which limit the companies’ profitability.
- Jaffee argues that it is preferable to transfer the risk of the GSEs’ mortgage portfolios to the capital market and depository institution investors for three reasons. First, there is a lack of diversification with Fannie Mae and Freddie Mac holding large mortgage portfolios, since these holdings are essentially 100% homogenous mortgage securities. In contrast, capital market and depository institution investors typically hold mortgage securities within diversified portfolios with a wide range of collateral assets. Further, the GSEs’ retained portfolios are concentrated in just two companies, while capital market instruments are spread across “potentially millions of investors and ...thousands of banking firms.” While the portfolios of the largest banks are “of a magnitude comparable” to Fannie Mae and Freddie Mac, the banks’ portfolios are widely diversified across different loan classes *and* the banks hold substantially more overall capital. Last, since investors believe that the GSEs will be bailed out in the event of default, the marketplace provides no market discipline for Fannie and Freddie. In contrast, Jaffee argues that depository institutions face capital market scrutiny. (*On Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie*

Mac, Dwight Jaffee, 04/26/05; Presentation at AEI Form on The Effects of Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie Mac, Dwight Jaffee, 04/26/05)

Bush Administration continues its call for GSE regulatory reform

- Rejecting claims that the Administration’s call for GSE regulatory reform will raise mortgage rates, Treasury Secretary John Snow said that tougher regulation of Fannie Mae and Freddie Mac won’t hurt their ability to finance home ownership and may improve their efficiency. Snow said, “The centerpiece of our effort is to establish a strong regulator that has the same authority as a strong banking regulator. Setting up the regulator as we have proposed will have no adverse effect on interest rates for the mortgage market, [and] will have no adverse effects on the ability of the GSEs to carry on their statutory function.” Snow added, “In fact, by limiting them to holdings that are necessary to carry on their statutory function and not more, it will focus their efforts on their statutory mission.” Snow reiterated that the Bush administration wants to impose investment portfolio limits and wants GSE regulatory reform legislation passed this year. (*Reuters News*, Glenn Somerville, 04/26/05; *Bloomberg News*, Kevin Carmichael, 04/26/05; *Dow Jones Capital Markets Report*, Elizabeth Price, 04/26/05)

GSEs hold “closed-door” meeting with House Democrats and alienate key ally
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- On the eve of the GSEs’ testimony before the Senate about GSE regulatory reform legislation, Representative Barney Frank (D-MA) summoned Fannie Mae’s and Freddie Mac’s management to a closed-door meeting. The secretive nature of the meeting provoked the ire of the National Association of Homebuilders, one of Fannie Mae and Freddie Mac’s staunchest backers in Washington. “The fact that they haven’t told us anything about it raises the hair on the back of my neck,” said NAHB CEO Jerry Howard. “I have to think that they are out there trying to cut a deal to protect their corporate interests, which may not be in the best interests of housing.” The NAHB is worried that the GSEs’ primary concerns in negotiating a deal on legislation is “the fate of (their) earnings and stock price,” he said. Fannie and Freddie have told the NAHB that “they have to look at this from the standpoint of their income statement and they’ve got to get it put behind them, otherwise their shareholders will revolt,” said Howard.
- Frank, the ranking Democrat on the House Financial Services Committee, said he and Representative Paul Kanjorski (D-PA) met with Freddie CEO Richard Syron and Fannie interim CEO Dan Mudd to discuss a Democratic proposal to bolster the companies’ financial commitment to affordable housing projects. “Fannie and Freddie have never liked the 5%” set aside for low income housing projects, said Frank. He said he wanted to ensure that the GSEs don’t lobby against the provision to weaken it and make certain that the money goes directly to housing projects instead of to the companies’ political allies.

- Freddie Mac spokeswoman Sharon McHale disputed that Syron was trying to “cut a deal” on broader GSE regulatory reform legislation. “The meeting was simply to exchange ideas on the various issues being discussed,” McHale said. “The company and Dick have said we want to participate with Congress in any way we can and that includes meetings to share our views whenever asked.” Fannie Mae spokesman Brian Faith confirmed that company executives have made several “courtesy visits” with Republicans and Democrats in Congress. “These visits have been consistent with the testimony of Dan Mudd provided last week before the Senate Banking Committee,” Faith said.
- At a recent Mortgage Bankers Association meeting, Fannie’s executive vice president of single-family mortgages Thomas Lund said “We are open to [creating a 5% set aside to expand homeownership] and are working with the Hill.” (*Dow Jones Newswires*, Dawn Kopecki, 04/28/05; *Bloomberg News*, Al Yoon, 05/02/05))

The public debates GSE regulatory reform
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- In an April 25 Letter to the Editor to the *Wall Street Journal*, Rosairo Marin, a former Treasurer of the United States, wrote, “Before Congress begins to dismantle what is inarguably the world’s model for homeownership, ...I would urge them to consider one potential victim if these types of organizations are diminished -- minorities. The ripple effects on the economy and the society of increased minority homeownership, in terms of more jobs, increased consumer spending and enhanced economic security of neighborhoods, are profound. The potential economic benefit of the president’s plan to add 5.5 million first-time minority homebuyers by 2010 is estimated at a staggering \$256 billion.
- “Since their creation, Fannie Mae and Freddie Mac have served as the linchpins in promoting a stable secondary mortgage market to ensure that banks and other lending institutions have a constant supply of money to lend homebuyers. Freddie Mac and Fannie Mae have spearheaded efforts to make homeownership more affordable for minorities. Freddie Mac, for example, has committed to purchase \$400 billion in mortgages supporting minority homeownership and has launched a program called ‘Catch the Dream,’ which is designed to help break down the barriers that impede minority families from buying homes. These barriers usually include misinformation about the home-buying process, mistrust of lenders, or fears of financial disclosure and being rejected for a loan. Congress should work to improve the ownership hopes and dreams of millions of minority families, and reforms should focus on strengthening not weakening Freddie Mac and Fannie Mae.” (*Wall Street Journal*, Rosairo Marin, 04/25/05)
- In response to Marin’s Letter in the *Wall Street Journal*, American Enterprise Institute fellow Alex J. Pollock wrote, “In an April 25 Letter to the Editor defending Fannie Mae and Freddie Mac, [former] U.S. Treasurer Rosario Marin suggests that

they represent ‘the world’s model for homeownership.’ But in the most recent international ranking I have seen, the U.S. is No. 10 among countries in the rate of homeownership -- far from the No. 1 position Americans, especially in Washington, D.C., often naively assume. The U.S. is nearly tied with the No. 9 U.K., which has a completely different housing finance system using primarily floating rate mortgages; it has no Fannie- or Freddie-like companies at all. Anyone conversant with international discussions of housing finance knows that the rest of the world does not admiringly look to Fannie and Freddie as the model. As a Danish colleague told me, ‘I see that when it comes to American housing finance, you are the socialists.’” (*Wall Street Journal*, Alex J. Pollock, 05/04/05)

- At the Berkshire Hathaway’s annual meeting for shareholders, Warren Buffett said that Fannie Mae and Freddie Mac have overstepped the bounds of their federal charter and that a reduction in their combined \$1.5 billion loan portfolios would not disrupt the financial markets. “It would not be the end of the world at all if Fannie and Freddie no longer had new portfolio purchases,” said Buffett. (*Bloomberg News*, David Plumb and Jesse Westbrook, 05/02/05)
- On *TechCentralStation.com*, James K. Glassman notes that the ownership society may be in as much trouble as Social Security, as architects in Congress attempt to rebuild America’s highly successful home-buying system by putting regulatory curbs on Fannie Mae and Freddie Mac. Glassman writes, “My own view is that, while more regulatory scrutiny of the already-chastened GSEs is probably needed, alterations that would change the system are not. Don’t toss these productive babies -- and chances for a true [ownership society] -- out with the bathwater. (www.TechCentralStation.com, James K. Glassman, 03/16/05)
- In *Business Week*, Mike McNamee questions if Fannie Mae and Freddie Mac will be forced to decide which they value more – government privileges or soaring growth. McNamee writes, “If Congress does move to put [Fannie and Freddie] under strict [portfolio] limits, would Fannie and Freddie consider giving up the government breaks that let them borrow so cheaply? Long before the accounting scandals, a former Clinton Administration official says, Fannie execs mused about dropping the charter so they could expand outside the mortgage market. Now pressure is growing. ‘If they want to avoid being shrunk, they have to think seriously about coming up with their own privatization plans,’ argues Peter J. Wallison, resident fellow at the [AEI]. Fannie and Freddie insist such talk is premature. But the fact that privatization is in the air shows just how far the mighty housing financiers have fallen.” (*Business Week*, Mike McNamee, 05/02/05)

<p><i>Blast from the past:</i> Former Freddie Mac CEO Brendsel testifies that his company doesn’t need to hold a large portfolio in order to fulfill its mission</p>
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- In testimony before the Subcommittee on Oversight of the Committee on Ways and Means on September 28, 1998, Freddie Mac CEO Leland Brendsel testified, “We

avoid interest rate risks by financing about 95 percent of all mortgages we purchase with mortgage-backed securities. These mortgages pass through principal and interest on the mortgage. When we receive them, we pass them through to the investors. As a result, we are insulated largely from the squeeze on earnings experienced by most depository institutions when interest rates rise...”

- Brendsel said, “...The mission of [Freddie Mac] is to increase the availability and affordability of mortgage money for home buyers and renters throughout this country. In order to do that, we must operate in a safe and sound manner. This corporation has elected a set of strategies that includes the elimination of interest rate risk and careful control in credit risk. It has been that ever since it started in 1970.”
- Chairman Pickle asked Brendsel, “[I]f you did start a large portfolio lending program, I would assume that that would increase [Freddie Mac’s] risk, and, I guess, that would cause an increase in capitalization of your own corporation; would it not?” Brendsel responded, “In general, that’s correct. That is, by increasing the risk such as with a large portfolio lending program that was not carefully and closely financed, it would increase the capital requirements of the corporation.” Pickle follows up, “Well, it seems to me like nothing would prevent you from doing it. ...Nothing prevents you from doing it; that’s the main thing; is that correct?” Brendsel responds, “If you are saying, is there any statutory limitation? Pickle responds, “Yes.” Brendsel said, “It is the general statutory direction as to how we are to operated to achieve our mission.” (*Hearing before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 09/28/89*)

S&P says GSEs’ ratings continue to depend on their capitalization levels
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- *National Mortgage News* reports that Standard & Poor’s is waiting to see if Fannie Mae and Freddie Mac can maintain capital levels above their minimum standards, as Fannie completes its accounting restatements and Freddie returns to its current reporting. “That is the big question. That’s a trend we will be watching closely,” said Vicki Wagner, director of financial institutions ratings at S&P. (*National Mortgage News*, Jennifer Harmon, 05/02/05)

A backdrop for GSE regulatory reform debate: The affordable housing crisis
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- In a speech before the Montgomery County Annual Affordable Housing Conference, Freddie Mac chairman and CEO Richard F. Syron shared his observations about the “affordable housing crisis.” Syron said, “No matter what is said here today, this much is certain ... home prices will continue to rise, working families will continue to be priced out of the market, and the quality of life for all of us will suffer – if we just stand still.” What’s driving this? A classic mismatch between supply and demand, Syron said, “There are simply not enough homes to comfortably house all of the people living in high growth areas like ours.” He pointed to a recent study

released by the Center for Housing Policy, which concluded that in less than six years, the number of working families in America paying more than half their income for housing has grown 76%, from 2.4 million working families in 1997 to 4.2 million in 2003. The study found that one out of every eight families has critical housing needs and immigrant families, in particular, are more likely to spend more than half their income on housing. Syron noted that minority and immigrant families have the lowest homeownership rates, roughly 25 points below whites, yet they are the driving force for household growth in our country. Freddie Mac is addressing this problem on a number of fronts in an effort to enhance loan programs to help make housing affordable and to increase the affordable housing supply. [The Center for Housing Policy is a nonprofit research affiliate of the National Housing Conference coalition; Freddie Mac paid for the CHP's report]. (*Prepared remarks by Richard F. Syron, Chairman and CEO of Freddie Mac, 05/02/05; Associated Press, Sobhan McDonough, 04/29/05*)

- According to new information released by the Census Bureau, a greater portion of minority Americans own homes now than ever before, but their ownership rate still lags behind whites. In the first quarter of 2005, 51.6% of minority households owned their own homes, up from 50.8% in the first quarter of 2004. Most of the recent increase in ownership occurred among Hispanics, with 49.7% of Hispanics owning homes in the first quarter, up from 47.3% a year ago. (*CBS MarketWatch, Andrea Coombes, 04/26/05*)

Bush Administration announces Treasury Department nominations

- President Bush intends to nominate Robert Kimmitt to be deputy Treasury secretary, the department's number two position, filling a vacancy left by Samuel W. Bodmann, who became Energy Department Secretary in January. Kimmitt is a senior international counsel in the defense, national security, and government contracts department at Wilmer Culter Pickering Hale & Dorr LLP. Previously, he served as executive vice president for global public policy at Time Warner, Inc. (*American Banker, Damian Paletta, 05/04/05*)
- Randal Quarles has been nominated to serve as the Treasury Undersecretary for Domestic Finance, replacing Brian Roseboro who left in December. Quarles, 47, has been at the Treasury since 2002 and became acting undersecretary for international affairs after John Taylor's recent departure. As the domestic finance chief, Quarles would serve as a liaison to bond markets, would be responsible for funding federal budget deficits, and would oversee policy for Fannie Mae, Freddie Mac and corporate pensions. "[Quarles has] been around Treasury for a long time," said Stephen Stanley, chief economist at RBS Greenwich Capital. "He's certainly a seasoned veteran of many of the issues that he will be stepping into." (*Bloomberg News, 04/26/05*)

Will GSEs curtail their investment in tax-exempt bonds as
a result of GSE regulatory reform?

- Participants in the municipal-bond market are concerned that Congressional plans to pass GSE regulatory reform may result in a sharp curtailment in the GSEs' investment in tax-exempt mortgage revenue bonds. In 2004, Fannie Mae and Freddie Mac bought an estimated \$6 billion out of the \$22 billion of these bonds sold by state and local housing-finance agencies (HFAs), providing capital to support single-family and multifamily housing. With Congress weighing plans to give a new regulator the power to limit the size of the GSEs' mortgage portfolios as well as adjust their capital requirements, Fannie and Freddie's role in the market could decline sharply or even disappear. "There'd certainly be less competition [for the bonds], so borrowing costs would increase, and they could get to the point where people would stop issuing," said John C. Murphy, executive director of the National Association of Local Housing Finance Agencies. "Then you've got the ultimate impact on the first-time homebuyer or the low-income renter."
- Fannie already has pulling back from the market, as prepayments in a low-interest-rate environment shrink its taxable mortgage portfolio, said Christopher Moriarty, an analyst in the public-finance housing group at Standard & Poor's. Under federal tax rules, the GSEs can't hold more than 2% of their total assets in tax-exempt mortgage revenue bonds. As prepayments shrink their portfolios, the 2% limit squeezes the amount of tax-exempts the GSEs can hold. "That is definitely going to be an issue for them," said Moriarty. Fannie Mae "already is starting to curtail its purchases for the near future for that reason alone," he added. Any pullback likely would be felt most in the long-term sector for bonds maturing in 20 or 30 years, where the bulk of the agency purchases are concentrated. (*Dow Jones Newswires*, Stan Rosenberg, 04/27/05)

Implementation of Basel II put on hold after impact study of Basel II finds "material
reductions" in capital requirements for banks

- A federal interagency study of the impact of Basel II concludes that the new rule could drive down regulatory capital requirements at more than half of the 30 largest U.S. banks by at least 20%, while declines at several banks would be nearly 40%, according to several sources familiar with the report. The findings, which have not been released publicly, are expected to delay the implementation of Basel II in the U.S. Only nine of the ten largest internationally active banking companies in the U.S. will have to use the new Basel II standards, but any bank can voluntarily use the rules if regulators approve their risk management ratios. Observers expect another ten banks are expected to opt in to Basel II, because of high compliance costs. Despite the delay, regulators say that Basel II will be implemented, although the timing is unknown. A recent Federal Reserve study concluded that the implementation of Basel II may result in a drop in revenue at Fannie Mae and Freddie Mac, as the large

banks invest more heavily in mortgage loans, which will require lower capital under the new rule. (*American Banker*, Damian Paletta, 05/06/05)

FDIC concludes that housing boom grew in 2004, along with growing risk of a “bust”

- According to a new FDIC study, the number of local real estate “boom” markets across the U.S. grew nearly two-thirds last year to 55 markets, whose home price appreciated 30% or more. FDIC economists Cynthia Angell and Norman Williams repeated their view that credit market conditions may make current housing market booms different than past ones, which tended to taper off rather leading to busts. “To the extent that credit conditions are driving home price trends, the implication would be that a reversal in mortgage market conditions - where interest rates rise and lenders tighten their standards - could contribute to the end of the housing boom,” said Angell and Williams. Given the leveraged conditions in today’s market, “there is risk that the percentage [of busts] could be higher in the future.” Housing prices increased 11% on average, the greatest rise since 1979, said the FDIC. The hottest markets in 2004 included “familiar” zip codes in California, Florida, New York, Los Vegas, Boston and Washington DC, while 18 markets boomed for the first time in their history, including Winchester, VA, Baltimore, MD, and Virginia Beach, VA. According to the study, subprime mortgages surged by 20% in 2004. While rates on 30-year mortgages remained under 6%, almost half of all home buyers resorted to lower-rate adjustable rate mortgages to pay for “increasing unaffordable homes,” the FDIC found. “These trends suggest that highly leveraged borrowers are increasingly taking on interest-rate risk as they stretch to afford high-cost housing,” said Angell and Williams. The authors said interest-only loans and option ARMS “increase leverage and expose owners to large jumps in monthly interest payments as interest rates rise” and have not been tested in a housing market downturn. Nationwide, investors accounted for 9% of mortgage originations, up from 6% in 2000. In Washington and other booming markets, investor loans accounted for up to 19% originations. The authors concluded that the heightened investor activity signals a “speculative” presence in the housing market that increases the risk of a downturn. “Investors are less loss-averse than owner-occupants, and thus more likely to sell precipitously in a declining market, thereby aggravating any existing downtrend in home prices. (*Wall Street Journal*, Mark Gongloff, 05/04/05; *The Washington Times*, Patrice Hill, 05/04/05)

“Worrisome trends” in real estate markets may portend surprises down the road

- While there may be no nationwide housing bubble, there are worrisome trends in some portions of the real estate market that could spell surprises later on, said industry leaders speaking at the Mortgage Bankers Association conference. “Do we see a housing bubble that’s going to burst? No,” said Thomas Lund, senior vice president at Fannie Mae. “[But] we don’t believe the home prices we’ve seen, in terms of growth, are sustainable,” Lund said, predicting that home sales will drop

perhaps as much as 7%, which would still represent a strong market. Don Bisenius, senior vice president of credit policy and portfolio management at Freddie Mac, concurred, adding current levels “of house price appreciation are not sustainable.” He said, “In coming months there will be some slow down [in the rise of home values]. Not a burst of the bubble but a slow down.”

- As the mortgage executives “celebrated” the industry’s use of innovative products developed to get more people into homes, they expressed concern that some customers are using adjustable-rate mortgages, interest-only loans and other products without fully understanding the inherent risks. “One of the things we don’t feel good about right now as we look into this marketplace is [that] more home buyers [are] being put into programs that have more risk,” Lund said. He pointed to some short-term hybrid ARMs come with prepayment penalties that stay in effect longer than the fixed-rate portion of the loan, which “are products for more sophisticated borrowers.” “[For less sophisticated home buyers,] does it make sense for borrowers to take on risk they may not be aware of? Are we setting them up for failure?” Lund asked.
- Homeowners aren’t the only ones who might be in for a surprise. “Three years ago, interest-only mortgages comprised about 2% of the market, today it’s up to 15%,” said William Batz, executive vice president of FHLB-Pittsburgh. “Three to five years down the road, when the principal payments kick in, and keeping in mind that now you’re looking at amortizing the principal over 25 years rather than 30 years, you get a real bang at that point,” he said. Companies holding those securitized loans “are going to perhaps have a surprise as well.”
- Still, Michael Frenz, an executive vice president at Ginnie Mae, was “loathe to decry innovation in the mortgage market.” “If the right homeowners are getting [access to these products], it’s a good thing. The most worrisome trend is the percentage of homes bought for investment.” Lund agreed, adding that in some markets 15% to 20% of the home purchases are made by investors.
- Another area of concern is the growth in interest-only (IO) loans for commercial real estate over the past three years, perhaps signaling a loosening of underwriting standards in a speculation-driven market. According to a Moody’s Investor Services analysis, 55.8% of all fixed-rate conduit loans featured IO periods on January 1st—up from 5.9% at the beginning of 2002—and 35.6% of these loans are IO for the full term. According to *National Real Estate Investor*, “[F]rothy loan underwriting [for IO loans] has swelled the total dollar volume to \$800 billion of the total \$1.7 trillion in commercial mortgage debt at year-end 2004.” Today, the aggregate commercial debt of \$1.7 trillion represents a “staggering” 14.4% of GDP, well above the historical average of 11.2% since 1970. The last time commercial mortgages accounted for more than 14% of the economy was during the late 1980s. (*CBS Marketwatch*, Andrea Coombes, 05/02/05; *Dow Jones Newswire*, Dawn Kopecki, 05/02/05; *National Real Estate Investor*, Parke Chapman, 05/04/05)

FBI concludes mortgage fraud is “pervasive and growing”

- In a May 4th report, the FBI concluded that mortgage fraud “is pervasive and growing,” prompting the agency to expand Suspicious Activity Report (SAR) requirements for mortgage lenders and to encourage SAR filing by mortgage brokers. Assistant director of the FBI’s Criminal Investigative Division Chris Swecker said “We’re trying to shore up the reporting aspect so we hear about these mortgage frauds early. Some of the industries that fly below the Bank Secrecy Act the radar screen, such as mortgage brokers ... We’re trying to push some regulations that would require some [SAR] reporting by them when they see suspicious transactions.” Cases of mortgage fraud are “definitely on the rise, probably because of the high volume, low interest rates, and the start-up of a lot of sort of fly-by-night mortgage brokers out there who take advantage of a whole host of inside folks who are complicit in mortgage fraud schemes,” said Swecker, adding that insiders include appraisers, brokers, title insurance companies, and closing attorneys. To address the problem, the FBI is employing undercover operations in their 56 field offices, which all have mortgage fraud cases in progress, he said.
- According to the FBI report, there was a dramatic increasing in the banks’ SARs related to mortgage fraud, which increased from 6,936 in 2003 to 17,127 in 2004. The spike in the SAR filings was due in part to an increase in filings related to high levels of refinancings in 2004. FBI section chief Brian Lampkin said lenders found false statements made by borrowers in applying for a loan refinance, and filed SARs in response. Swecker added, “The industry has sort of awakened to this and I think it may be a reflection of increased awareness of mortgage fraud and classifying it as a separate scheme, rather than lumping it in with a lot of other categories.”
- Lampkin said his office has been working with the Treasury Department’s Financial Crimes Enforcement Network (FinCEN) to encourage mortgage brokers, who are not required under the BSA to file SARs, to report suspicious activity that may indicate mortgage fraud by providing them protection under “safe harbor” provisions of the BSA from legal action by their customers. “FinCEN, I know, is taking a very strong position to help facilitate this whole reporting mechanism for non-financial institutions, such as mortgage brokers and such,” said Lampkin. The FBI report said the agency is working “to establish broader SAR reporting requirements for mortgage lenders who do have adequate protection under the current safe harbor provisions.” (*Bureau of National Affairs*, Richard Cowden, 05/05/05)

Mortgage loan applications can be made by phone 24/7, using voice recognition software

- Voice2Form, LLC., which uses a patented voice recognition system to help people fill out a variety of forms for commercial and governmental agencies, announced it has signed a license agreement with Mid-Atlantic Financial Services, Inc., to integrate Voice2Form’s technology with Mid-Atlantic’s existing telephony and back-end

database systems. Voice2Form's mortgage application system collects applicants' voice entries, converts the answers to text and enters the information into any Fannie Mae compliant loan origination software systems to create a 1003 form for exporting into DU, LP and other underwriting formats. Mid-Atlantic's president said, "By providing a solution that enables our customers to voice in their [mortgage] application 24 hours a day, convert their voice information to text and capture that into our database and our printed 1003 forms, allows us to process their loans quickly, more efficiently, and maintain the standards of excellence our customers deserve." (*BusinessWire*, 05/02/05)

Fannie Mae

More trouble ahead at Fannie Mae?

- In an interview with *Associated Press*, OFHEO Director Armando Falcon, Jr. suggested that the accounting problems that have rocked Fannie Mae may run even deeper. Asked if further discoveries could emerge from OFHEO's investigation, Falcon replied, "I can't say that we're at the end of it, and I can't also say that we will or we won't have more information about additional conduct or improper accounting that we might find. We very well might find more problems as we continue to review the company's accounting." He also noted that if his agency hadn't stepped in to identify and correct problems at Fannie Mae, "I think they would have eventually manifested themselves in the form of some larger problem that might have created some kind of systemic disruptions" in the housing market. (*Associated Press*, Marcy Gordon, 04/26/05; *Wall Street Journal*, 04/27/05)

Fannie Mae bars its employees from buying and selling its stock

- On April 29, Fannie Mae barred its 5,000 employees from buying or selling company stock for the foreseeable future, as the GSE proceeds with a multibillion-dollar restatement and deals with federal investigations into its accounting practices. In an email, Fannie Mae told its employees that the move is designed to protect them from inadvertently violating securities laws triggered when insiders trade while they are aware of material information that is not widely available in the market. Fannie Mae cited its "inability to make public filings with the [SEC], the increasing number of employees supporting our restatement effort, and the continuing progress of internal and external reviews and investigations" as the reason for the ban to employees at all levels of the company, according to the e-mail. The company may grant temporary waivers of this restriction after consulting with outside lawyers, but only for

“specified, demonstrated needs.” Since September 2004, a small group of Fannie Mae executives with access to “sensitive” financial information has been subject to a trading blackout. Company spokesman Charles V. Greener confirmed the blackout and said Fannie took the step because it “felt it was the prudent course of action.” Several employees have contacted management with hardship requests, said Greener, adding that more such requests are expected to come.

- Georgetown University law professor Donald C. Langevoort said restrictions on trading stock are not unusual, particularly when sensitive information begins to spread throughout a company, making it possible for employees will gain access to data “that has to do with the substance of the restatement ...such as how good or bad it is going to be, things employees can pick up by what’s going on in the halls.” He added, “That’s what they’re trying to control.” (*Washington Post*, Carrie Johnson, Terence O’Hara, Annys Shin, 05/05/05)

<p>The fallout from Fannie’s accounting problems continues: Fannie Mae Foundation cuts budget 22%, closes two offices and lays off 12 employees</p>

- The Fannie Mae Foundation is cutting its budget by 22% from \$92 million to \$72 million, closing its Atlanta and Chicago offices, and laying off 12 employees. The Foundation said it is not reducing its philanthropy in the Washington area, which provided \$24.1 million in funding in 2004, and will honor all past commitments, including multiyear grants. “[Fannie Mae is] having to cut costs, and so we have to cut costs,” said Foundation spokeswoman Beverly Barnes. While details on the spending cuts will be determined later this year, Barnes indicated that some cuts will involve an advertising campaign that was scheduled to end this year. Staffing will be reduced to from 87 employees to 75, with all but one of the layoffs occurring in Washington, D.C., she said. While none of the Foundation’s senior managers are losing their jobs, an independent consultant will review compensation levels for top executives based on its reduced operations, which could result in cuts of up to 20% in compensation and benefits for senior management, said Barnes. [In 2003, the Foundation’s CEO Stacey D. Stewart earned \$514,633, plus \$68,686 in benefits and deferred compensation, the most recent year for which data is available]
- The Foundation’s Community and Neighborhood Development loan fund for nonprofits will not issue any new loans, but instead will focus instead on its existing borrowers. Management anticipates that the Foundation will begin accepting new grant applications once “a process is developed that incorporates the revised budget.” (*Washington Post*, David S. Hilzenrath, 05/05/05; *Fannie Mae Foundation Press Release*, 05/04/05; *Dow Jones Newswires*, Dawn Kopecki, 05/04/05)

<p>Fannie Mae’s mortgage portfolio shrinks for fifth month</p>
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- Fannie Mae said its mortgage portfolio shrank at an annualized rate of 13.6% in March, after falling 19.1% in February, to the lowest level since July 2003. The

company's investments, which account for more than two-thirds of its profit, contracted by \$10.6 billion to \$864.6 billion. Portfolio liquidations rose to \$17.0 billion in March from \$15.55 billion in February, while purchases rose to \$11.21 billion in March from \$9.45 billion in February. Sales of mortgage bonds fell to \$4.81 billion in March from \$9.54 billion in February, bringing total sales for the year to \$20.7 billion. Fannie Mae's sales during the first quarter of 2005 already exceed its sales for the entire year of 2004 totaling \$16.45 billion. Fannie Mae's commitments to purchase mortgage-related securities rose to \$10.59 billion in March from \$3.1 billion in February. The duration gap on Fannie's mortgage portfolio was one month in March, compared with zero months in February.

- “Overall, they had some pretty nice portfolio activity,” said Jim Vogel, a senior vice president at FTN Financial Capital Markets, who noted that Fannie Mae's retained commitments were “up substantially for the first time in four months,” though overall the portfolio still shrank at a healthy clip. While the portfolio declined overall, it appears that the portfolio reduction is being handled in an orderly manner, which is likely to be taken as a positive sign by mortgage bond investors, said Vogel. Fannie Mae is “certainly not back to business as usual” said Walter Schmidt, head of mortgage research at FTN Financial in Chicago. Purchases are “very much behind portfolio sales so far in 2005, and that could weigh on the market,” he added. Fannie Mae's portfolio will probably decline by another \$55 billion by September 30 to meet OFHEO's deadline for building the 30% capital surplus, said Moshe Orenbuch, an analyst in New York at Credit Suisse First Boston. Noting other encouraging signs, Michael McMahon, an analyst at Sandler O'Neill & Partners LP, said “OFHEO apparently believes that they'll make it,” pointing to the agency's recent approval of Fannie's second-quarter dividend plan. (*Bloomberg News*, Al Yoon, 04/28/05; *Dow Jones Newswire*, Danielle Reed, 04/28/05; *Reuters News*, 04/28/05; *American Banker*, Matthew Quinn, 04/29/05)

Fannie Mae ranks #4 in contributions to leadership PACs in first quarter of 2005

- According to PoliticalMoneyLine, Fannie Mae contributed \$63,000 to leadership PACs during the first quarter of 2005, ranking fourth in such contributions behind FedEx Corp. (\$74,500), SBC Communications (\$72,500), Burlington Northern Santa Fe Corp (\$67,000), and UPS (\$63,500). During the first quarter, Fannie Mae gave \$54,500 to Republican leadership PACs and \$8,500 to Democratic leadership PACs. (*Bloomberg News*, Michael Forsythe, 05/01/05)

Ex-Fannie Mae chairman Jim Johnson “forgets” his service with the company?

- *National Mortgage News* asks, “Is ex-Fannie Mae chairman James A. Johnson ashamed to be associated with his former company?” Apparently so, *NMN* concludes, “Judging from the Target Corp.'s annual proxy statement and annual meeting notice, one might suspect that Mr. Johnson is trying to distance himself from the troubled

GSE. The Target proxy omits Mr. Johnson's tenure as chairman and CEO of the GSE -- a time when Fannie was both well respected and highly profitable." (*National Mortgage News*, 04/29/05)

Fannie Mae keeps its options open for 30-year bonds

- As it has in the past, Fannie Mae said it will "keep the window open" on 30-year bond issuance, given a possible move by the U.S. Treasury to revive its long bond. "Fannie Mae never formally shut down or discontinued the 30-year and we would consider doing one if it was consistent with our funding needs," said company spokeswoman Janis Smith. "We have done 30-years and it continues to be an option," she said. In November 2000, Fannie Mae last issued a benchmark 30-year bond, which was later reopened in October 2002. However, it is unlikely that Fannie Mae will issue 30-year bonds as the company continues to shrink its investment portfolio. (*Reuters*, 05/04/05)

Fannie Mae announces it will purchase 40-year mortgages

- At the Mortgage Bankers Association Conference, Fannie Mae announced that it will begin purchasing 40-year fixed-rate loans from lenders to help borrowers in areas where home prices are high. Such loans reduce monthly payments and make it easier for borrowers to get approved, said the company. As Fannie made this announcement, conference attendees debated the unbridled growth of interest-only mortgages, 40-year loans, and other products designed to capitalize on the rapid rise in housing prices. William Batz, executive vice president of the FHLB-Pittsburgh, said making interest-only and 40-year loans to some people could smack of predatory lending, adding "IOs may be suitable for the right market, but they could be characterized as predatory for the wrong borrower." (*American Banker*, Rob Blackwell, 05/04/05; *National Mortgage News*, 05/03/05)

Fannie Mae introduces DUS program allowing mezzanine financing

- Fannie Mae has introduced a new delegated underwriting and servicing plus program that allows the use of mezzanine financing in conjunction with its regular DUS program. Under the program, the company's DUS lenders will have the ability to offer additional mezzanine financing for Fannie Mae fixed-rate DUS loans in the \$3 million to \$25 million range for the acquisition or refinancing of multifamily properties with combined loan-to-value ratios of up to 85% and a minimum debt service coverage ratio of 1.1 times. (*National Mortgage News*, 05/02/05)

Neighborhood Reinvestment Corp. develops AU for second mortgages

- The Neighborhood Reinvestment Corp. (NRC) has developed an automated underwriting system for community-based NeighborWorks organizations to use in originating second mortgages, used to cover down payment and closing costs for low-income homebuyers that qualify for a first mortgage loan from private lenders. NRC and Neighborhood Housing Services of America hope that the AU system along with Fannie's commitment will lead to the development of a real secondary market for second liens. [Exactly *what* commitment has Fannie Mae made?] Over the past two years, the NeighborWorks revolving loan fund financed \$61.4 million in second mortgages, with an average loan size of \$14,550, and secured funding from other sources to finance another \$143.4 million in second mortgages. (*Origination News*, 05/05)

Fannie Mae ranks #4 as best place to work in *Essence Magazine's* survey

- Fannie Mae was rated the fourth best place to work by *Essence*, "the preeminent lifestyle magazine for today's African-American woman," according to the magazine's website. The ranking was determined by readers, who rated companies based upon factors such as "life balance, career advancement, diversity, workforce representation and community involvement." The survey ranked Allstate Insurance the best place to work, followed by Verizon, AFLAC and Fannie. (*Essence*, May 2005)

Freddie Mac

Freddie Mac's loan portfolio grows for second month

- In March, Freddie Mac increased its mortgage portfolio by \$2.5 billion to \$656.7 billion, its highest level in three months. While this marks the company's second month of portfolio growth, Freddie Mac's growth in March is well below its growth of 13.5% in February, tempering its annualized growth rate in 2005 to 2.3%. Freddie Mac also contracted to buy \$32 billion in mortgages and mortgage securities in March, the largest monthly purchase commitments since July 2003. The company sold \$4.1 billion in investment securities in March, up from \$2.7 billion during the prior month. In the company's monthly volume summary for March, Freddie disclosed for the first time a break-out of agency and non-agency securities holdings. The report reflected the company's shift to non-agency holdings, which have grown 7.4% over the past three months to \$188.2 billion, while mortgage-related agency securities not guaranteed by Freddie Mac fell nearly 5.6% during this period. Company spokesman Michael Cosgrove said Freddie Mac's purchased of mortgage securities "remain concentrated in non-agency floating-rate securities and I think that's very reflective of what's going on in the market." Arthur Frank, director of mortgage-backed securities at Nomura Securities International, said he believes the increase in Freddie Mac's non-agency holdings was "tactical, not strategic, since the GSE has been buying classes of securities "created for them," backed by collateral that conforms to its requirements from private label securitizations of hybrid ARMs. Freddie Mac's duration gap was zero months in March, unchanged from February.
- "Freddie Mac has raised its dividend, has two months of good portfolio growth and is showing decent purchases -- all these things put together show they are comfortable with their capital [position]," giving them an advantage over Fannie Mae, said Edwin Groshans, a Fox-Pitt, Kelton equity analyst, who rates the company "outperform." Groshans noted that Freddie's \$32 billion in mortgage purchase commitments in March is mostly floating-rate, AAA rated portions of sub-prime mortgage pools. "While Freddie has shown a penchant over the past few months for increasing their retained portfolio via the non-agency market in the face of tight MBS to agency spreads, this large increase in the commitments for the retained portfolio is still likely positive for MBS," wrote a Merrill Lynch analyst, adding that MBS has been widening versus agencies since mid-to-late February, a factor that could probably account for the rise in commitments. (*Bloomberg News*, Al Yoon, 04/25/05; *Reuters*, 04/25/05; *Asset Securitization Report*, Karen Sibayan, 05/02/05; *American Banker*, Matthew Quinn, 04/26/05)

Freddie Mac courting Asian investors to build deeper, broader MBS market

- Seeking foreign investment in its mortgage securities, Freddie Mac is making a concerted effort to appeal to investors in Asia, said Mark Hanson, Freddie Mac vice president of mortgage funding. “The Asian bid is where everyone is spending their time,” said Hanson. “From our standpoint and mission, our job is to go out and find more buyers for our securities. It’s a wealth of opportunity right now [in Asia].” Over the past six months, Freddie Mac officials have made three visits to investors in Asia as part of the company’s first outreach specifically aimed at attracting the region’s investors to its mortgage securities, he said. “It’s universal. Whether it’s domestic or not, or by investor type, that liquidity is a valued commodity,” Hanson said. “It’s almost our mission, I think, to pursue deeper and broader markets because my understanding is that liquidity is not just about the amount of product you bring but the breadth of investors,” he added.
- Some analysts believe Asian investors have stepped up MBS purchases, as Fannie Mae and Freddie Mac have reduced their issuance of agency securities as the GSEs’ mortgage investment portfolios have shrunk. Demand for liquidity will drive an increasingly heavy flow of overseas money into top quality U.S. debt like mortgage-backed securities, said Jon Voigtman, managing director of HSBC Securities USA. “There’s a lot of capital over there. I think a lot of people have laid great groundwork in terms of making sure that people understand mortgages there and because of that groundwork a lot of overseas investors are then willing to begin investing (in other securities) ...a sort of chain reaction.” (*Reuters*, Lynn Adler, 05/03/05)

Freddie Mac announces E-Note acceptance plan

- In an interview with *Origination News*, Ed Albrigo, vice president of change management at Freddie Mac, said that his company has consolidated its technology divisions, putting e-mortgage specs on the fast track. “Everyone has been asking us what it will take for us, from a process standpoint, to accept e-mortgages,” said Albrigo. “We will have our detailed e-mortgage specifications published by the end of this year so vendors can start building interfaces to us.” Emphasizing that Freddie would not create proprietary technology for e-mortgages, he said, “We don’t want to be in the technology space. The lender needs to go out and find what works for them and use it accordingly. Everyone has been doing a lot of talking about e-mortgages. We at Freddie Mac want to be in a mode where we say to the lenders, ‘Here’s what it takes to sell e-mortgages to us.’ As a side note, lenders appreciate this stance and have thanked us for staying out of the proprietary space.”
- Will Freddie reward lenders to use e-mortgage once the specifications are published? “Right now we don’t know what incentives we’ll offer to get lenders to deal with us in this fashion,” said Albrigo. “However, we do want to accelerate the process toward e-mortgage acceptance because both us and the lender will realize a

significant financial gain, which will allow us to better achieve our charter.”
(*Origination News*, Anthony Garritano, 05/05)

Federal Home Loan Banks

FHLB-Seattle considers ousting two directors accused of trading on insider information

- The *National Mortgage News* reports that the FHLB-Seattle is weighing whether it should ask two of its member directors to resign, as it investigates allegations of board members selling FHLB stock based upon “insider information,” according to industry officials. A source close to the matter said that the Bank’s independent review committee, consisting of five nonmember directors, is looking at all of its options but “has yet to make a determination.” *NMN* also reports that the FHLB-Seattle has hired Black Rock Financial to assist the Bank in the preparation of its three year business plan and capital management plan. The FHLB-Seattle has also hired Promontory Financial Group, headed by former Comptroller of the Currency Eugene Ludwig, to review of the Bank’s management. (*National Mortgage News*, Paul Muolo, 04/25/05; *National Mortgage News*, 04/29/05)

Mortgage Partnership Finance Program “here for the long term”

- The Mortgage Partnership Finance program offered by a number of FHLBs is a long-term proposition and the “political scrutiny” surrounding Fannie Mae and Freddie Mac hasn’t changed that, said Renee Pfender, vice president for the FHLB-Pittsburgh, “The MPF program has always intended to be here [in the long run],” she told attendees of the Mortgage Bankers Association’s National Secondary Market Conference. (*National Mortgage News*, 05/03/05)

Thomas Goldstein appointed to FHLB-Chicago’s board

- The FHLB-Chicago announced that Thomas Goldstein, Chairman and CEO of ABN AMRO Mortgage Group, Inc. and Senior Executive Vice President of LaSalle Bank Corporation, its parent company, has been appointed to the Bank’s board of directors. Goldstein assumes the term that expires at the end of 2005 of Scott Heitmann, who retired earlier this month from the board and from his position as Vice Chairman of LaSalle Bank Corporation, Chicago, Ill. (*FHLB-Chicago Press Release*, 04/27/05)

FHLB-New York raises its stock dividend

- The FHLB-New York will pay \$42.6 million of dividends for the first quarter for an annual rate of 4.7%, well above the Bank's fourth quarter dividend rate of 3.05%. In a letter to members, the Bank's president Alfred DelliBovi said the increase was caused largely by the Bank reaching its target level of retained earnings, which it has been rebuilding following significant loss on manufactured housing loans in 2003. With \$207 million of retained earnings, the Bank now exceeds its target by \$35 million, said DelliBovi, allowing the Bank to pay out 80% of its earnings through dividends. He anticipates that the FHLB-New York's dividend rate to be at least 4% for the remainder of the year. (*American Banker*, Rob Blackwell, 04/25/05)

FHLB-Des Moines commissions study of the future prosperity of rural America

- Rural America needs to rediscover its economic value and use it to build a new economy, according to a study conducted by the SRI International's Center for Science, Technology, and Economic Development for the FHLB-Des Moines here today. The wide ranging study revealed that the rural economy has become much more diverse than agriculture, while policy and funding have not kept pace. In the study, SRI reviewed thousands of pages of existing studies, reports, and papers on rural America; studied an array of federal programs and policies; and organized the information into a forward-looking report for the advancement of rural America.
- "It is time for a fresh start in formulating strategies to strengthen rural America," said Pat Conway, president of the FHLB-Des Moines. "As the Home Loan Bank that serves hundreds of Main Street banks in small towns, it is important that we support and stimulate economic growth in rural America. The study can serve as a framework to develop new strategies."
- The study's authors suggest there must be a shift in focus to assets and opportunities for rural America to reclaim its prosperity. The study also identifies policy and program steps that can be taken to enable economic growth in rural areas of the nation, including a consolidation of programs to make them easier to find and use; greater flexibility in terms of assistance and timeframes; and co-investment by rural communities, businesses, and institutions. To identify strengths to build on in rural America, SRI developed a Competitiveness Web Model that evaluates overall economic competitiveness in the Bank's five state region of Iowa, Minnesota, Missouri, North Dakota, and South Dakota. The study found that rural America's strengths include steadily improving education achievement, low cost of doing business, high quality of life, and increasingly high levels of entrepreneurship and small business development. Rural America's liabilities include declining population, difficulty retaining educated residents, and lack of employment opportunities, particularly in growing economic sectors. SRI's model found Minnesota to be a highly competitive state with its strengths in quality of life and

innovation, ranking fourth in the nation in competitiveness and highest among the states in the Bank's region. SRI ranked Missouri and Iowa in the middle of all states for competitiveness – based upon their strengths in quality of life and people resources, while North Dakota and South Dakota fall just below average in competitiveness among the states with quality of life and low business costs in their favor.

- While rural America is moving toward a more diverse economy and agriculture's market share is declining, the SRI study finds that the bulk of federal support remains primarily in direct subsidies to agriculture with 30% of the Department of Agriculture's 2003 budget allocated to agricultural subsidies and rural development accounted for only 3.5% of the budget. The study illustrates a need to review federal programs for rural America, which consist of 337 "key" federal programs and a total of 1,399 programs in 20 federal agencies targeted to rural America. The authors conclude that these programs are fragmented among many departments and agencies and offer little flexibility to accommodate different circumstances among communities, making accessing resources difficult. (*FHLB-Des Moines Press Release, 04/27/05*)

Farm Credit System / Farmer Mac

Farm Credit System reports net income of \$498 million for first quarter
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- The Farm Credit System reported combined net income of \$498 million for the quarter ended March 31, 2005, compared with combined net income of \$450 million for the same period last year. "In the current favorable U.S. agricultural economy, the credit quality of the System's loan portfolio remained at healthy levels," said Jamie B. Stewart, Jr., President and CEO of the Federal Farm Credit Banks Funding Corporation. "Surplus grew \$365 million during the first quarter to \$17.460 billion at March 31, 2005 and represented 18% of total System loans, further strengthening the System's capital position." Net interest income increased \$46 million to \$775 million for the quarter ended March 31, 2005, as compared to the first quarter of 2004, due to income from an increase of \$4.3 billion in average earning assets to \$120.4 billion and an increase in the System's net interest margin of six basis points to 2.57%. The provision for loan losses was \$3 million for the first quarter of 2005, as compared with \$17 million for the first quarter of 2004. The first quarter of 2005 provision for loan losses included loan loss reversals of \$11 million, reflecting continued improvement in overall credit quality at certain System institutions. (*Business Wire, 05/02/05*)

Is there a growing chasm between FCS members and FCS's management?

- Bert Ely writes in *Farm Credit Watch* that Rabobank's proposed acquisition of FCS of America (FCSA) highlighted a growing chasm between FCS members and the FCS's managerial class. Ely writes, "Working with implicit support of the FCA, FCS executives blocked FCSA members from voting on the Rabobank deal. The FCC is now seeking to amend the Farm Credit Act to bar an FCS association from leaving the System even if its members want to leave. Last September, Jerold Harris, president of an FCS bank, testified to the House Agriculture Committee that 'it makes no sense for a System institution to terminate its System status, or for Congress to allow it.' Still stunned by Harris's assertion, I viewed with great interest a PowerPoint presentation FCA staff presented to the FCA board on April 14, titled 'Core Cooperative Principles.' Here are some choice points:"
 - "User-Control: Those who control the cooperative are those who use it."
 - "Borrowers own and control the FCS."
 - "Congressional Policy: FCS should remain farmer-owned and farmer controlled."
 - "The best of all: 'User-Control: Voting on major business restructuring decisions and capitalization bylaws.' [emphasis supplied]"
- "Rabobank proposed a restructuring, yet FCSA members, who 'own and control' FCSA were blocked, through the efforts of FCS executives, from voting on Rabobank's proposal. Should Congress revisit the Farm Credit Act, it must act only to strengthen member control of the FCS, not weaken it further by barring association members from making restructuring decisions." (*Farm Credit Watch*, Bert Ely, April 2005)

Good work if you can find it

- Former FCSA president Jack Webster, who "resigned" after FCSA/Rabobank merger failed, received \$1.38 million in severance pay. Webster received this severance pay on top of \$542,500 in salary and bonuses he received for his ten months of service as the cooperative's CEO in 2004. According to the *Omaha World-Herald*, the other terms of Webster's severance agreement are confidential. (*Farm Credit Watch*, Bert Ely, April 2005)

International GSEs

EU to propose a limited plan for mortgage market
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- More than five years after vowing to create a single European mortgage market, the European Commission released a series of updated proposals aimed at opening the European Union's market in retail financial services, allowing everything from savings to insurance products to be offered across all EU nations--but not mortgages. Forging a single mortgage market in 25 countries is far from simple and laws can't just paint over Europe's language and legal barriers, particularly in a period of slow economic growth with many countries worried about "rampant" competition undermining social protection. As a result, European leaders are backing off of a set of proposals to open other service markets because of criticism that West European workers aren't protected from their less-expensive East European brethren.
- "We would like to allow an apartment buyer in Brussels to shop for the best loan deal in England, Austria or Ireland with the click of a switch," said Charlie McCreevy, EU's commissioner for internal markets. "But there are a lot of obstacles in the way." McCreevy's mortgage-market measures, which will be proposed in more detail this summer, look less ambitious than originally planned. The EU planned to create a common European mortgage market to increase the choice for consumers, force lenders to compete, and put downward pressure on interest rates. Instead, EU officials are focusing the creation of a more efficient secondary mortgage market. Cross-border mortgage market looks likely to stay limited to border regions and summer homes, while the EU studies whether consumers or lenders could benefit from a common mortgage market. A recent EU-sponsored poll showed that only 1% of home buyers were interested in getting a mortgage from another country. "Consumers are intimidated by mortgages because they're so complex," says Laurence Baxter, senior policy adviser for the consumer watchdog, Which? "We're not so sure that a lot of choice will make prices come down."
- Instead of promoting foreign mortgages, European consumer groups want an EU legislation which ensures that lenders spell out in plain English the clauses and risks in their mortgages. Today, such information is given by lenders on a voluntary basis with typical disclosures concerning the cost of buying a house, conditions of mortgage repayments, and penalties to be paid if the loan is paid off early. Moreover, national laws providing differing levels of consumer protection make it difficult for lenders to operate in multiple countries.
- The development of a sophisticated market for securities trading in Europe is more popular among consumer and lenders. In Europe, mortgage loans have traditionally been funded by retail deposits, which are an expensive way of collecting money and is becoming less and less viable. "Consumers don't put money into savings accounts much anymore because they're better informed and want a good return on their

savings. That means that lenders don't have savings to tap," says Annik Lambert, deputy secretary-general of the European Mortgage Federation. Increasingly, mortgage lenders are going to the capital markets to sell their loans as capital bonds. Europe has made headway in the development of its bond market for mortgage lenders with 20 of EU's 25 member states issuing mortgage bonds, compared with only a handful of countries a few years ago. However, the European banking and lending market is so fragmented with Germany alone has about 2,500 banks, making it hard for any one lender to accumulate a big number of loans to clinch a bond deal.

- To address this problem, the EU could establish a set of rules, making it easier for lenders to sell loans to each other. The U.S. has long had an efficient transferable securities market, used extensively by Fannie Mae and Freddie Mac. However, the U.S. enterprises are hard to duplicate in Europe, because they have the advantage of one set of legal standards and government subsidies.
- Increasing liquidity in the wholesale mortgage market could give banks the incentive to standardize their mortgages. "If you streamline the bond market, then maybe you'll make it less costly for lenders when mortgages are paid off early," says Baxter. "It's a roundabout way to go about it, but it could end up being good for consumers." (*Dow Jones Newswires*, Juliane Von Reppert-Bismarck, 05/04/05)

Postal Service

CBO slashes the cost of postal reform by \$4.5 billion

- According to the National Association of Postmasters of the U.S., "[T]he Congressional Budget Office released its estimate that enactment of the Postal Enhancement and Accountability Act (H.R. 22) would have a 10-year cost of \$4.5 billion less than last year's legislation. (A similar reduction is expected for S. 662) Nonetheless, CBO projected that H.R. 22 would still reduce federal revenue by \$5.9 billion. The cost is attributable to eliminating the CSRS escrow account." (*E-NAPUS Legislative Newsletter*, 04/29/05)

Hypocrisy is in the eye of the beholder

- Cary H. Baer, past chairman of the Association for Postal Commerce, stated in a recent commentary, "[American Postal Workers Union president William Burrus, in a communication to his membership in mid-March, wrote,] 'I am often amazed at the hypocrisy found in political debate when large sums of money are at stake. And, in the debate over postal reform legislation, some major mailers have taken hypocrisy to new heights.' The gist of his communication involved the long history of the APWU's opposition to postal work-sharing discounts. The USPS and Postal Rate

Commission have studied the issue and concluded that these discounts have saved billions of dollars. Left unsaid by the union is that eliminating these discounts undoubtedly would lead to hiring more postal workers, most of whom would become APWU members. The greatest effect of automation and work sharing on the APWU has been to reduce its membership. Some might say it's just a tad hypocritical for Burrus to have left out this little fact." (*DMNews.com*, Cary H. Baer, 04/28/05)

Postal reform impasse: Funding of military pensions

- Lawmakers and administration officials, who enacted a quick-fix bill putting the Postal Service on stronger financial footing two years ago, now disagree on how that law intended to finance pensions. Treasury officials contend that the law required the Postal Service to pay for military pensions for retired military workers. The law's congressional sponsors, House Government Reform Chairman Tom Davis (R-VA), Representative John McHugh (R-NY), and Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins (R-ME), said additional studies mandated by the law have proven that military pensions should be shifted back to the Treasury Department, which covered the pension cost before the legislation passed. The dispute is now a primary sticking point in negotiations over pending postal reform legislation. (*CongressDaily*, Alyson Klein, 04/25/05)

Mailing groups begin to broaden their lobbying efforts for postal reform

- Following the passage of the postal reform legislation by the House Government Reform Committee, interest groups supporting the bill are broadening their lobbying efforts to the White House, congressional leaders and House conservatives. Ben Cooper, who represents the Printing Industries of America, said he and others are continuing to communicate with President Bush's domestic policy advisers on the bill. Labor groups are using their membership to show support for the bill. George Gould, political director for NALC, said their efforts are focused on a provision that would shift payment of some of the Postal Service's military pensions to the Treasury Department. In the Senate, the Homeland Security and Governmental Affairs Committee is debating whether to allow the Postal Service, rather than the Transportation Department, to negotiate with foreign airlines to carry mail, an issue that proved to be a sticking point in the House markup. (*CongressDaily*, Alyson Klein, 05/02/05)

USPS executives' moving expenses questioned

- The USPS gives its executives \$10,000 to \$25,000 in moving expenses, without requiring receipts or reimbursement of any leftover money. The Postal Service said it uses the payments to ease their executives' transitions to new, sometimes more

expensive cities and ensuring that executives won't be lured away by competitors. The agency defends the practice, by saying Congress wanted it to operate like private business where salaries may be higher. Senate Finance Committee investigators discovered one senior vice president, who received \$75,000 for three moves from June 1998 to February 2001. The USPS gave 265 executives \$10,000 each and 10 others \$25,000 each in the past two years. Whether a postal executive actually gets to pocket moving expenses depends on the locations involved and the size of his or her living quarters, said the Postal Service. (*Associated Press*, 05/04/05)

Japan's Prime Minister Koizumi continues push to privatize the country's post office

- The *Nihon Keizai* [newspaper] reports that the Cabinet of Prime Minister Junichiro Koizumi has submitted the government's postal reform plan to parliament, which will debate the bill in May after the Japanese holidays known as Golden Week. The government and the ruling Liberal Democratic Party have settled differences on the legislation, said the *Nihon Keizai*. According to sources, the latest plan would keep Japan Post intact and retain state-control, hindering the government's goal of transferring some postal assets to private insurers and banks, including Mizuho Financial Group. "There has been a significant retreat from the idea of a full sell off," said Kenji Yumoto, chief senior economist at Japan Research Institute Ltd., a think tank affiliated with Sumitomo Mitsui Financial Group Inc. "It may be outlined as privatization, but the contents suggest otherwise."
- To end a standoff that would have delayed privatization efforts, Koizumi has agreed that Japan Post won't be penalized should it fail to fully sell its savings and insurance units by 2017. Koizumi also has agreed to unlimited cross-shareholdings between separate postal units after 2017 and to the government providing as much as 2 trillion yen to underwrite savings and insurance services, double the size of a fund proposed on April 4. "It's important to remember what a massive undertaking this is and how deep the vested interests are," James Barber, a Barclays Capital political analyst. Setting the wheels in motion for privatization -- even through a watered down bill -- "will still be a significant achievement for Koizumi," said Barber.
- After the sale is complete, the government will hold a one-third stake in a holding company charged with overseeing units in charge of mail delivery and the management of 24,700 post offices, roughly double the combined networks of the nation's banks. The latest plan means the government may also retain control over postal savings and insurance businesses. (*Bloomberg News*, Tak Kumakura, 04/27/05; *Bloomberg News*, 04/27/05)

TVA

Senators Shelby and Sessions provide Bush administration suggestions for TVA board

- Senators Richard Shelby (R-AL) and Jeff Sessions (R-AL) have sent President Bush the names of five possible nominees to serve as a member on the Tennessee Valley Authority's board. In a letter to President Bush, the Senators wrote, "The Tennessee Valley Authority serves over 1.5 million people in Alabama, producing nearly \$1 billion in revenue. Despite Alabama's impact on TVA and TVA's reach within the state, a citizen of Alabama has never served as a member of the TVA board." With the agency's board expanding from three full-time members to nine part-timers, Shelby and Sessions are asking that at least two Alabama names be among them. The senators have recommended that President consider appointing Ronnie Boles, general manager for Huntsville Utilities; Ronnie Flippo, a former congressman from Florence; state Representative Lynn Greer, a former Alabama Public Service commissioner; Harvey Robbins, president of Robbins Property Development in Tuscumbia; and Howard Thrailkill, president of ADTRAN in Huntsville. (*Associated Press*, Jeffrey McMurray, 05/02/05)
- In early May, hundreds of friends and families were on hand to celebrate the service of Glenn McCullough Jr.'s chairmanship on the TVA board of directors. The former Tupelo, MS mayor is completing his term on the board, which expires May 18. Legislation passed by Congress in December calls for a new nine-member, part-time corporate board to assume governance of TVA. (*Associated Press*, 05/05/05)

TVA considers using unfinished nuclear site for plant

- The TVA and the U.S. Department of Energy are preparing a feasibility study to determine if the Bellefonte Nuclear Plant site near Hollywood, AL might be suitable for use as a plant using new technology and design. While the unfinished Bellefonte plant will not be completed by TVA, the site might be used, said TVA spokesman John Moulton. He indicated the feasibility study is expected to be completed by the end of the summer. Senator Jeff Sessions (R-Al) said a decision to use the Bellefonte site would have a positive economic impact on Jackson County and surrounding areas, by creating up to 1,000 jobs during the construction phase. (*Associated Press*, 05/05/05)

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