

# The **GSE** REPORT™

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## Major Events

***“Why the hell does this [restatement] take so long?”*** asks Fannie Mae’s CEO Mudd, as Fannie Mae hires 1,500 consultants and budgets \$420 million for its FY2004 restatement “which is not likely to occur prior to the second half of 2006”

- In its 12b-25 filing with the SEC, Fannie Mae acknowledged that it would not complete its financial restatement until the second half of 2006, a move that hypothetically could result in the NYSE delisting the company. [The company’s last filing of financial statements with the SEC was the second quarter of 2004.] In an investor analyst conference call, Fannie Mae’s CEO Daniel Mudd told investors that the company would restate earnings for fiscal years 2001 through 2004 “sometime during the second half of 2006,” and that earnings for 2005 “would follow that,” but offered no specific timeline. In its disclosure, Fannie Mae said that it continues to be plagued by poor internal controls given the “magnitude of material weaknesses that currently exist” and that management is “likely to conclude” that its financial reporting will be “ineffective” for fiscal year 2005. Mudd said that Fannie is “leaving no stone unturned” in the restatement process. The company will hire more than 1,500 consultants and devote six million to eight million labor hours in the restatement process at a cost of \$420 million in 2005. He said that Fannie Mae needs to record one million lines of journal entries, determine hundreds of thousands of commitment prices and securities values, and verify some 20,000 derivative prices for the restatement. Fannie also plans to invest over \$100 million in technology projects to enhance or create new systems for accounting and reporting. Mudd said, “Our overriding focus is on doing [the restatement] once, getting it right and being done with it.”
- Mudd told investors that Fannie is on schedule to reach a 30% capital surplus by September 30<sup>th</sup>, as required by OFHEO. Mudd also said that Fannie Mae has been successful in rebuilding a new management team and is “getting close” to naming a new chief financial officer and new chief risk officer. He told investors that despite the company’s accounting scandal, Fannie Mae has been “largely successful in retaining key customers.” However, the company’s market share has been significantly eroded by the increased demand for adjustable rate mortgages and other exotic mortgages, resulting in Fannie Mae’s market share falling from 45% in 2003 to 23.9% in the second quarter of 2005. During the second quarter of 2005, the company sold \$29.8 billion of “almost exclusively” its traditional 15-year and 30-year fixed rate mortgage-related securities and supplemented its portfolio with a higher proportion of adjustable-rate mortgages.
- While some analysts believe it is unlikely that the company’s stock will be delisted, such an event could force institutional investors to dump Fannie Mae’s stock, further depressing its stock price, and result in an increase in its cost of funds. Mudd said that Fannie Mae is “engaged in regular discussions with the staff of the New York

Stock Exchange regarding the status of our restatement and [its] continued listing.” The NYSE has discretion to extend Fannie’s listing. In fact, it would be unprecedented for the NYSE to delist a company with Fannie Mae’s capitalization of more than \$50 billion. Kenneth Posner, an equity analyst at Morgan Stanley & Co. Inc., said the NYSE has historically, “tended to give companies some slack” if they are large and continually making progress in their restatement. NYSE spokesman Scott Peterson said the exchange is closely monitoring Fannie’s progress and is “looking hard at the unique characteristics of Fannie Mae, including its size and importance to the U.S. economy.”

- Fannie’s update irked some investors, who were dismayed by the lengthy restatement process and frustrated that Fannie wouldn’t disclose more data regarding current operations. Aside from details on the restatement’s costs and length, analysts said little else was new in the company’s update. Mudd provided few new details about the company’s financial condition and indicated that Fannie could scale back several supplemental disclosures that it voluntarily provides investors on a regular basis. Mudd “opened up the comments that [Fannie] ought to be more shareholder centric, more transparent. It’s not the same old Fannie Mae, but only one or two stripes have changed,” said Ed Groshans, a Fox-Pitt, Kelton equity analyst. “We’re almost a year into it and we have almost another year to wait if not longer. Are we going to get [the 2005 earnings] by 2007, or another year later? How much longer will we have to wait? We get a little bit of certainty for 2004 but nothing for 2005.” Banc of America Securities (BoAS) equity analyst Robert Lacoursiere said “Today, I think, was a wake-up call for some holders of Fannie that it will take longer to get a picture of the (company’s) true financial position. The length of the delay to get back to timely disclosure directly reflects the underlying situation.” Lacoursiere repeated his sell recommendation on the stock. While it maintains an overweight rating on Fannie Mae’s common stock, JPMorgan Chase has removed Fannie Mae from its focus list, saying recent weakness in its stock has sent the issue below internal performance guidelines for maintaining the stocks on its focus list. Wachovia Capital Markets dropped its research coverage of Fannie Mae, citing concerns about the company’s future business model and saying it “simply lack(s) any meaningful financial data” needed to evaluate the GSE’s financial condition and future earnings prospects.
- Fannie Mae’s latest revelations are in stark contrast to the boastful statements made by the company’s former CEO Franklin Raines in July 2003, when Freddie Mac announced its need to restate earnings. Complaining that Freddie Mac’s accounting troubles were “unjustly” depressing the GSE’s stock price, Raines said, “I now know what the definition of collateral damage is. I think we’ve suffered unfairly. We did not do these things. There is a difference in management, management does matter. And a management that cares about internal controls does matter.” Unfortunately, Raines’ comments proved to be inoperative.
- In fact, Freddie Mac was able to complete its three-year restatement within 11 months, delaying its 2002 earnings statement by less than a year, and its 2003 earnings by just one quarter. In contrast, Fannie Mae anticipates it will take two

years for the company to complete its FY2004 restatement and is uncertain when FY2005 results will be available. Further, Freddie's cumulative accounting correction reflected an understatement of its earnings by \$5.3 billion, in contrast to Fannie's projected *overstatement* of earnings of approximately \$11 billion. BoAS analyst Lacoursiere noted, "There is a difference between the timeliness and quality of the information being disclosed between the two companies," adding that Fannie's slow restatement process, delayed financial results, lack of public disclosures and transparency, and restrictive regulatory environment make the company's stock unattractive, particularly when compared to Freddie Mac.

- In response to Fannie Mae's 12b-25 filing, the credit rating agencies re-evaluated the GSE's rating status. Moody's affirmed Fannie's senior unsecured debt, short-term debt and bank financial strength ratings but left the company's preferred stock and subordinated debt ratings remain on review for possible downgrade. Fitch also affirmed its triple-A senior debt rating for Fannie Mae and it might still cut the company's "AA-" subordinated and "A+" preferred ratings. "The ratings are based on an expectation that Fannie Mae will meet the regulatory capital requirement excess of 30 percent in a timely manner and without issuance of any new preferred or common stock," said Fitch. Despite delays in the company's financial reporting, "positively, there have been no new accounting issues surfaced today and we believe management is appropriately addressing systems and internal accounting issues," said Fitch. S&P said that its "AA-" risk to government, subordinated debt and preferred stock ratings on Fannie Mae remain on CreditWatch Negative, where they were placed on September 23, 2004. S&P analyst Michael T. DeStefano said that the delay in Fannie Mae's restatement "underscores the challenges the company faces as it seeks to restore order to its internal accounting and controls process."
- Market observers are again questioning how the credit agencies continue to issue ratings for a company like Fannie Mae, which has not issued financial statements in over 12 months and likely will not provide such information for more than two years. Writing on *HoweStreet.com*, market analyst Mike Shedlock asked, "...[H]ow can anyone possibly know what is in those books [at Fannie Mae] if it takes 1,500 consultants working a year to straighten them out? I contend that no one can possibly know what the bottom line result of that audit will be. If one does not know what is in the books, the next logical question is how can it be possible to affirm a top rating on that company's debt? ...Going one step further, does anyone even care what is in the books?"
- In an article entitled "The Potential Crisis at Fannie Mae," the Comstock Partners write, "It seems to us that anybody reading that press release [about Fannie Mae's recent 12b-25 filing] should be shocked by what appears to be the paucity of knowledge about what is going on at a company of such great size and importance to the U.S. economy. ...Now it appears that Fannie Mae's internal controls have been so weak that no one actually knows what the risks are or what the auditors will find—and we won't know for at least another year. For a company as important to the U.S.

as Fannie Mae, this is a national problem with widespread potential for developing into a dangerous financial crisis.”

- Nevertheless, Fannie Mae stock receives a consensus "buy" rating from analysts who track it, including two "strong buys," 10 "buys," six "holds," one "sell" and one "strong sell," according to Thomson Financial. Fannie Mae's earnings are expected to decline 10% in 2005, versus an 11% increase projected for the credit-services industry. Analysts forecast a decline of 1% for 2006 compared with a 9% increase expected industry wide. (*PR Newswire*, 08/09/05; *Form 12b-25, Federal National Mortgage Association*, 08/09/05; *Dow Jones Newswires*, Dawn Kopecki, 08/09/05; *Dow Jones Newswires*, John Connor, 08/10/05; *Dow Jones Newswires*, Dawn Kopecki, 08/10/05; *Dow Jones Newswires*, Dawn Kopecki, 08/11/05; *American Banker*, Jody Shenn, 08/10/05; *Market News International*, Claudia Hirsch, 08/11/05; *Financial Times*, Richard Beales, 08/10/05; *CFO.com*, Stephen Taub, 08/11/05, *Dow Jones Newswires*, 08/08/05; *American Banker*, Matthew Quinn, 08/12/05; *American Banker*, 08/15/05; *Market News International*, 08/12/05; *Reuters*, 08/11/05; *National Mortgage News*, 0/15/05; [www.HoweStreet.com](http://www.HoweStreet.com), Mike Shedlock, 08/25/05; [www.comstockfunds.com](http://www.comstockfunds.com), The Comstock Partners, Inc., 08/11/05; *Chicago Tribune*, Andrew Leckey, August 28, 2005)

SEC raises new accounting concerns with the FHLBs' SEC filings, potentially derailing all 12 banks from meeting the Finance Board's registration deadline
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- Eight of the FHLBs have announced that they will miss their August 29<sup>th</sup> deadline for registering with the SEC due issues related to accounting for derivatives under FAS 133 and accounting for convertible advances. To date, only the FHLB-Boston, FHLB-New York, FHLB-San Francisco, and FHLB-Seattle have not announced any delays with their SEC filings and appear to be on track to meet the deadline imposed by the Federal Housing Finance Board for filing under the 1934 Securities Exchange Act. Thus far, the FHLBs of Atlanta, Dallas, Des Moines, Indianapolis, Pittsburg, and Topeka have reported problems for accounting for derivatives under FAS 133, making them unable to meet their filing deadline. Most recently, last-minute questions from the SEC about the FHLBs' accounting for convertible advances have created new problems and delays with the FHLBs' registration filings. The SEC's concerns about the System's accounting for convertible advances could require other FHLBs to revise their original restatement estimates. The FHLB-Chicago, which completed a multi-year earnings restatement in March, will likely have to make further corrections to its financial statements and could be forced into a second earnings restatement, said FHLB officials.
- After denying several requests to extend its August 29th deadline, the Finance Board imposed new rules to limit the payment of dividends for FHLBs who fail to meet the filing deadline with the SEC and lack current financial statements. Late filers will need to seek regulatory approval for the payment of future dividends and “demonstrate to the satisfaction of the Finance Board” that the FHLB has enough in

retained earnings or current quarterly profits to cover the payout, said the Finance Board. “Until the [FHLB’s] registration with the SEC becomes effective, it should declare a dividend only following consultation with and approval by the Board’s Office of Supervision,” said the regulator. It is unclear whether the new requirement will significantly impact the FHLBs’ ability to continue paying generous dividends to their members. “It could be a very modest change; it could be a draconian change. We don’t know. This is how they’ll be able to keep close control of the system,” said one FHLB executive. “We don’t really know exactly what this means until the banks start making requests to pay dividends next month and the Finance Board begins to approve them.” The Finance Board’s announcement has drawn criticism from banking interests who say the agency’s last-minute actions are “arbitrary and capricious,” in light of the good-faith efforts made by the FHLBs to meet the filing deadline. Diane Case-Landry, president and CEO of America’s Community Bankers, said, “I don’t know what this action by the Finance Board gains them as a regulator. Are they trying to show the world that they can be a stickler for arbitrary deadlines?”

- The FHLBs’ Office of Finance said that it doesn’t believe that the FHLBs’ restatements will have a “material impact” on the FHLB System’s combined results. “However, the final impact will not be known until all of the restatements are completed,” said the Office of Finance. The FHLB System’s accounting problems underscores the increased interest rate risks that some of the banks took in an effort to grow and compete with Fannie Mae and Freddie Mac in the booming secondary mortgage market, according to some analysts.
- John Connor writes in the *Dow Jones Capital Markets Report*, “While things might not be going swimmingly within the [FHLB] System, at least there’s evidence that the process of the [FHLBs] registering with the SEC isn’t worthless in terms of helping to flush out accounting and perhaps other problems. This is in contrast to the case of Fannie Mae, which went through the voluntary SEC registration process a while back to the accompaniment of loud praise and hallelujahs about transparency and enhanced disclosures and enlightening investors and high confidence in its accounting and such things and then found itself embroiled in accounting scandal. In due course, everything no doubt will get worked out all across the housing GSE spectrum.”
- Observers say that it is doubtful the FHLBs’ restatements will have an immediate impact on GSE regulatory reform legislation, which would create a new regulator for Fannie Mae, Freddie Mac, and the FHLBs. To date, the FHLBs have not played a large role in the Congressional debate and the accounting problems at Fannie Mae and Freddie Mac are expected to remain dominant. (*Dow Jones Newswires*, Dawn Kopecki, 08/23/05; *PR Newswire*, 08/25/05; *Bureau of National Affairs*, Richard Cowden, 08/24/05; *Dow Jones Newswires*, Dawn Kopecki, 08/22/05; *American Banker*, Rob Blackwell and Luke Mullins, 08/23/05; *Reuters*, Richard Leong, 08/19/05; *Dow Jones Newswires*, Dawn Kopecki, 08/25/05; *American Banker*, Rob Blackwell, 08/26/05; *The Cincinnati Post*, Jon Newberry, 08/26/05; *BNA’s Daily Report for Executives*, Richard Cowden, 08/26/05)

## ***Fannie Mae and Freddie Mac***

### GSE regulatory reform alive and kicking?

- Claudia Hirsch writes in *Market News International*, “If politics is the art of the possible, then there is life left in the legislative effort to revamp the regulation of the [GSEs] according to analysts and Washington insiders.” With two substantially different GSE regulatory reform proposals emerging from the House Financial Services Committee and Senate Banking Committee, lawmakers face a challenging task in reaching an accord for this complex problem. “Outside observers have been too quick to declare this dead,” said a Republican congressional aide close to the process. “Of course the Senate and the House have differing bills, but right now we are further in the legislative process than ever before on this issue,” he added. Josh Rosner, a financial analyst at Medley Global Advisors, said the area of dispute has narrowed to two major issues – portfolio authority and affordable housing financing. But, Bert Ely, the Arlington, VA-based financial institution consultant, said these two headline issues hide an array of other “brewing” controversies, including product approval authority and [increasing] conforming loan limits in high cost markets.
- Conventional wisdom in Washington says that GSE regulatory reform legislation will pass this year only if more bad news befalls Fannie Mae -- and soon. The most likely sources are pending investigations from Fannie’s outside consultant, former Senator Warren Rudman, and a potentially larger earnings restatement than the \$11 billion estimate provided by the company. Also in the mix are the three ongoing probes of Fannie Mae by OFHEO, the SEC, and the Justice Department. It is unclear, however, if any of those shoes may drop before Congress’ scheduled September 30 adjournment. In a recent interview, Rudman said that his report probably will not be done until “late fall.” He added, “It is my fervent hope to be done by the end of the year. But this assignment has produced a lot of extra work that we have come across. I am just not going to establish any hard-and-set deadline. We are going to get it done as quickly as we can.” Some critics speculate that Rudman may be stalling because he does not want to release his report in time to add momentum to the GSE reform bill. Observers agreed that if the Rudman report contains new revelations of wrongdoing, his findings could add impetus to the Senate bill. “If that report were to come out early it could jump-start the legislation,” said Jaret Seiberg, policy analyst for Stanford Washington Research Group.
- An OFHEO spokeswoman said that the agency’s ongoing exam of Fannie Mae is a “top priority,” but declined to say when it might be completed. Most observers believe that OFHEO will probably wait until Rudman has concluded his investigation before weighing in, so it can put its own stamp on any findings. The SEC and a criminal probe by the U.S. Attorney’s Office for the District of Columbia will likely take much longer.

- Some equity analysts are worried that Fannie’s restatement estimate of \$11 billion could go up. So far, Wall Street has not punished Fannie because many investors feel the restatement does not affect the GSEs underlying economic value, said one analyst. The analysts argue that the \$11 billion estimate would be just a “loss on paper” due mostly to changes in valuations of derivatives. If the company’s restatement total starts to increase for other reasons, it could spook investors, said an analyst. “There is probably more than just an accounting loss in this mess. But you can’t quantify it,” he added. (*Market News International*, Claudia Hirsch, 08/08/05; *American Banker*, Rob Blackwell and Luke Muffins, 08/15/05)

Minority Leader Reid opposed “efforts to limit homeownership”

- Senator Harry Reid (D-NE) said, “The legislation from the Senate banking committee, passed ...on a party-line vote by the Republican majority, includes measures that could cripple the ability of Fannie Mae and Freddie Mac to carry out their mission of expanding homeownership. Ironically, rather than promote the President’s ‘ownership society’ agenda, this legislation would have the opposite effect. Strong and effective oversight by our country’s housing regulators is important to the continued vitality of the U.S. housing market and I support efforts to ensure the safety and soundness of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system. These entities have been unquestionably instrumental in bringing homeownership opportunities to a wide swath of Americans and have fueled economic growth. Our goal in Congress should be to strengthen the appropriate regulatory measures to ensure the financial health of these entities so that even more Americans can own their own home. While I favor improving oversight by our federal housing regulators to ensure safety and soundness, we cannot pass legislation that could limit Americans from owning homes and potentially harm our economy in the process.” (*U.S. Fed News*, 07/28/05)

The National Association of Homebuilders take the GSE reform fight to the Senate

- Following the Senate Banking Committee’s passage of GSE regulatory reform legislation on July 28th, the National Association of Homebuilders (NAHB) lobbyist Joe Stanton sent a strongly worded letter to every member of the Senate saying that the Senate bill “represents a missed opportunity” and “takes a potentially damaging approach” to Fannie Mae and Freddie Mac.
- NAHB’s letter raised eyebrows on K Street. Lobbyists who have worked the GSE regulatory reform issue questioned why the NAHB would choose to challenge Shelby directly rather than work quietly for compromise before the full Senate takes up his bill. “This is very, very unusual,” said one lobbyist. “There’s plenty of time before it gets to the floor, on the floor, in conference” to effect desired changes. “Usually, trade associations are a little more careful.” Another lobbyist said, “It’s not a letter I

would have wanted to send. The homebuilders have been, more or less, either picking a fight or putting a finger in the eye of the chairman.”

- NAHB’s political action committee gave \$39,500 to Banking Committee Republicans in 2004, including the maximum of \$10,000 to Shelby. So far in 2005, the only Banking Committee member to receive money from the NAHB’s PAC money is Senator Debbie Stabenow (D-MI). (*The Hill*, Elana Schor, 08/03/05)

Rumblings on GSE regulatory reform on the editorial pages
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- In an editorial titled “Leave Fannie Mae, Freddie Mac alone Congress, Keep Hands Off Housing Policy” in the July 31<sup>st</sup> edition of *Monterey County Herald*, Wayne Madsen argues that the innovations of Fannie and Freddie have kept Americans in the homeownership game “at least up to now,” but that is in jeopardy with the Senate Banking Committee’s proposal to limit the GSEs’ mortgage portfolios, as advocated by Federal Reserve Chairman Alan Greenspan. “Advocating a cap on publicly-traded corporations like Fannie and Freddie would seem to be a distinct departure from Greenspan’s longtime advocacy of allowing the free market to work,” writes Madsen. “Greenspan’s interference threatens to limit severely the amount of capital [Fannie and Freddie] need to buy up home loans from banks and sell them to third parties...” (*Monterey County Herald*, Wayne Madsen, 07/31/05)
- In a Letter to the Editor of *The Washington Times*, Ronald C. Moe, fellow of the National Academy of Public Administration, responded to an editorial written by James Miller, III (“Fannie Today, Citigroup Tomorrow?”). Moe argues that Miller, a consultant for Freddie Mac, is dead wrong in arguing that the Congressional proposal to restrict Fannie’s and Freddie’s mortgage portfolios is, in effect, transferring shareholder value from one private company to another. Miller views Fannie and Freddie as purely private corporations. Instead, Moe argues that the companies are GSEs and the U.S. taxpayers have a direct fiduciary interest in their policies and practices. Moe writes, “The GSEs were originally created to rectify market imperfections related to the absence of national liquidity in the mortgage market. This purpose was achieved long ago and GSEs are not longer necessary or desirable. If ever the conservative philosophy of free markets has been violated, it is in the instance of GSEs. Mr. Miller should be warning conservatives not to support GSEs but instead to work toward their full privatization.” (*Washington Times*, Ronald C. Moe, 08/11/05)
- Paul J. Gessing, Director of government affairs for the National Taxpayers Union, also responded to Miller’s editorial, in a July 31<sup>st</sup> Letter to the Editor in the *Washington Times*. Gessing wrote, “James C. Miller, III gets it mostly wrong in defending Fannie Mae and [Freddie Mac] against conservative criticism... Sure, forcing the two mortgage lending giants to downsize their portfolios is a less than ideal solution to the significant problems Fannie Mae and Freddie Mac create for federal taxpayers, including the possibility of a government bailout if the companies

make enough bad loans. Unfortunately, the two government-chartered enterprises have used their tremendous influence on Capitol Hill to lobby against any substantive reform - especially complete privatization.”

- “As subsidized entities, Fannie Mae and Freddie Mac harm banks that do not receive implicit government backing and do pay taxes. Even in their core mission of assisting low-income home buyers, they pass just \$1 out of every \$2 in these subsidies to homeowners. Moreover, given their market dominance, Fannie Mae and Freddie Mac pursue increasingly risky loans to maintain a portfolio that has grown at 18 percent per year over the past decade. To be sure, conservatives find the idea of setting aside 5 percent of Fannie Mae’s and Freddie Mac’s profits into an affordable-housing slush fund to be one egregious aspect of the legislation passed out of committee in the House. Perhaps more dangerous is that it increases the size of home loans that may be purchased by Fannie Mae and Freddie Mac in some areas of the country to \$540,000, thus enabling them to use their subsidized position to gain an even greater market share. Fannie Mae and Freddie Mac truly are big and successful enough to fend for themselves. It is time for Congress to cut the subsidy cord.” (*Washington Times*, Paul J. Gessing, 07/31/05)
- In an August 14th editorial in *The Philadelphia Inquirer*, former Congressman Bob Barr (R-GA) wrote, “If there was one thing I hated about serving in Congress for eight years, it was constantly being asked by major companies to tilt the economic playing field in their favor. The big problem with these requests lies in their side effects - some unpredictable, but most clearly foreseeable. In almost every case, congressional efforts to play favorites with specific sectors and companies lead to destabilization of the parts of our economic system on which folks in real America depend each day. Such is the case with an ongoing campaign by major Wall Street banks to cripple or destroy government-sponsored enterprises (GSEs) - Freddie Mac and Fannie Mae - that make the dream of homeownership possible for millions of American families. ... If major banks want to compete with Fannie and Freddie, there is no impediment to doing so (in fact, they already do). And, despite the red herring of taxpayer “subsidies” of GSEs brandished by their critics, the fact is there is no taxpayer money at stake here, because the GSEs don’t receive any. The only reason for Congress to involve itself in this debate is to shut down someone’s competition, and that path invariably leads to public-policy disasters.” (*The Philadelphia Inquirer*, Bob Barr, 08/14/05)
- In its July 15<sup>th</sup> issue, *Architecture Magazine* wrote, “With millions of Americans squeezed by the housing bubble, why are politicians mute on the subject? Happily, there’s fresh hope: Congress is quietly considering a proposal to support low-cost housing by earmarking to the cause 5 percent of profits earned by Fannie Mae and Freddie Mac, the federal mortgage goliaths whose cartoonish names belie the \$20 billion margin they’ll pocket this year. But there’s opposition, mainly on doctrinal grounds, from anti-welfare forces. Reinvesting mortgage profits in housing the less fortunate is both sensible and cosmically just, say practitioners involved in similar state programs, and it complements the limited effect of tax credits. And meanwhile,

many architects continue aiding private and nonprofit groups fighting valiantly for more affordable--and more livable--housing for all. Last year brought a record number of charitable charrettes, competitions, and homebuilding campaigns displaying far more creativity than our elected bodies have managed. (*Architecture Magazine*, 07/15/05)

Federal Reserve study finds GSEs have fueled the red-hot housing sector with policies that mainly benefit wealthier consumers

- In a study conducted the by the Federal Reserve Bank of Atlanta, the researchers conclude that Fannie Mae, Freddie Mac and the FHLBs have helped fuel the red-hot housing sector with policies that primarily benefit wealthier consumers, drive up housing prices and increase rental prices, and lead to higher loan default rates. Staff economist Karsten Jeske and German economist Dirk Krueger concluded that the federal subsidies received by the GSEs in the form of lower borrowing costs aren't distributed evenly through society. "The subsidy leads to an increase in household investment in housing assets and an increase in the construction of real estate. The rental price of housing increases," said the economists. "The results also suggest that households with low wealth prefer to live in an economy without subsidy while high wealth households benefit strongly from it, indicating adverse distributional effects of reform." On balance, the GSE subsidy passed on to consumers is disproportionately benefits high-income, high wealth households, the researchers concluded.
- In recent years, Fannie and Freddie have lowered downpayment requirements from 20% to as little as zero to help more people qualify for mortgages for borrowers with good credit. Jeske and Krueger found that lower downpayments increase the amount of leverage borrowers are willing to take on and leads to higher default rates and more home purchases. "Households use far fewer mortgages in the absence of the subsidy partially due to less housing consumption, but mainly due to lower leverage," the economists said. "As a result, the subsidy has a very strong effect on mortgage default rates, which are substantially lower without the subsidy, as most households are less leveraged. ...Removing the subsidy has even stronger effects on the decision of whether and how high a mortgage to take out," the researchers found. "Without the subsidy, not only are mortgages lower for all household types...mortgages drop even more than housing, resulting in a decline in housing leverage."
- Jay Brinkmann, Mortgage Bankers Association's vice president of research and economics, and Frank Nothaft, Freddie Mac's senior economist, were critical of the Fed study, arguing that the highly theoretical analysis relied on inaccurate assumptions about the marketplace, which skewed the study's findings. Brinkman said, "The paper is a useful intellectual exercise, but it is a theoretical construct whose results are driven by the assumptions behind it." Nothaft argued that the study ignores data showing more than half of the loans Freddie buys finance loans to lower-income borrowers and simplifies certain assumptions to make the economic model

used by the researchers work. (*Dow Jones Newswires*, Dawn Kopecki, 08/16/05; *Dow Jones Newswires*, Dawn Kopecki, 08/17/05)

California Association of Mortgage Brokers argue that every taxpayer should have equal access to Fannie Mae's and Freddie Mac's subsidies

- In a study of boosting the conforming loan limit in high cost real estate markets, the California Association of Mortgage Brokers (CAMB) found that the economic benefits of such a change could save borrowers anywhere from \$57 to \$171 a month from the 25 to 50 basis point benefit accorded such loans. "Every taxpayer should have equal access to the government subsidies through Fannie Mae and Freddie Mac," said Michael Faust, chairman of the CAMB's Government Affairs Committee. "Every dollar saved can make the difference between homeownership and a lifetime of renting." CAMB president John Marcell said, "Our association is calling for an end to what we believe is a policy that discriminates against working families based on the community they live in." By passing the H.R. 1461's provision to raise the conforming loan limit in high cost areas, the study found that nearly 43,000 more borrowers could afford a median-priced house if they qualified for conventional financing, along with 22,500 borrowers in Boston, and nearly 65,000 borrowers in California.
- Some experts disagree with making such a change to conforming loan limits. Javier Silva of Demos, a New York-based think tank, said raising the limit would extend a dangerous trend of loosening lending standards to enable consumers to buy homes they can't truly afford. "The answer is to find ways to lower home prices, not simply raise debt limits to allow inflated prices to soar even higher," Silva said.
- Dean Baker, co-director of the nonprofit Center for Economic and Policy Research in Washington, D.C., said he agreed with Federal Reserve Chairman Alan Greenspan's proposal to restrict the mortgage holdings of Fannie Mae and Freddie Mac. "I am with Greenspan on this one," Baker said, adding that lifting the conforming loan limit would be "a really bad idea right now." Anthony Downs, a senior fellow at the Brookings Institution, said raising the lending limits would "run contrary to efforts to better regulate Fannie Mae and Freddie Mac." Downs added, "I don't think there is any shortage of people trying to buy houses in high-cost communities. The American Dream, homeownership is being achieved at a record rate every place in the nation outside of California." (*Union-Tribune*, Emmet Pierce, 08/05/05; *Chicago Tribune*, Lew Sichelman, 08/14/05)

Federal Reserve Chairman Alan Greenspan warns that real estate bubble could pop, if property values are driven higher

- In his strongest warning to date, Federal Reserve Chairman Alan Greenspan warned American homebuyers that they risk a crash if they continue to drive property prices

higher. Greenspan said that the U.S. house-price spiral had become an economic imbalance, threatening stability like the country's trade gap or its budget deficit. He predicted that the housing boom would "inevitably simmer down." In his August 26<sup>th</sup> pre-retirement speech at the annual Federal Reserve Jackson Hole Symposium, Greenspan said that people were investing in houses as if they were a one-way bet, not allowing for the risk of price falls. "History had not dealt kindly" with investors who kept ignoring risks, he said. The Chairman's warning, his strongest yet, sent stock prices falling on Wall Street, at one point knocking 66 points off the Dow Jones industrial average. At the close [on July 26<sup>th</sup>], the DJIA had recovered to 10,397.30, down 53.30 points. (*Timesonline.com*, Graham Searjeant, 07/27/05; *Financial Times*, Andrew Balls, 07/26/05; *Dow Jones Newswires*, Joseph Rebello, 08/27/05)

- Worried about excesses in real estate investment, Greenspan has also privately called on other federal regulators to take a closer look at imprudent speculation, reports Robert Novak. Greenspan has told the regulators with the Comptroller of the Currency and Office of Thrift Supervision, among other agencies, that there is a limit to what the central bank's monetary policy can do in tamping down inflationary pressures, according to Fed sources. Novak also notes that high officials in the Japanese Ministry of Finance recently commented privately that the vibrant U.S. home mortgage market is supporting an otherwise shaky global economy. ([www.realclearpolitics.com](http://www.realclearpolitics.com), Robert Novak, 08/13/05)
- Noting Greenspan's pending retirement in January, *The Financial Times* wrote, "Fed policy has become personalized around the chairman, potentially leading to market trauma after a mere mortal takes the job..." The search for Greenspan's successor is being lead by Vice President Dick Cheney and National Economic Council Director Allan Hubbard. Rumored to be under consideration include former Fed governor Lawrence Lindsey; Fed governor Ben Bernanke, Glenn Hubbard, former chairman of the Council of Economic Advisors; and Martin Feldstein, the president of the National Bureau of Economic Research. (*American Banker*, Todd Davenport, Damian Laettta, and Rob Blackwell, 08/08/05)

31% of housing market "extremely overvalued"
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- In its August 2005 *Financial Market Outlook*, National City Corp. wrote, "The word "bubble" still doesn't do justice to all of the U.S. housing market, but the descriptor has become increasingly apt as time has passed. Our research of single-family housing markets indicates that when 2004 began, only 2 percent of markets were over-valued to degrees typically observed prior to past price declines. By year-end 2004, however, such frothy conditions characterized 25 percent of the market before advancing to 31 percent early this year. The cause of overvaluation is simple: Price increases have run rampant, far outstripping income gains in most markets. Of the 299 metropolitan areas included in our latest study, 85 percent experienced house price gains exceeding household income gains during the past year. At the extreme, 29 percent demonstrated price increases exceeding income gains by 10 percentage

points or more. Bakersfield, California, for instance, experienced a 33 percent gain in prices while incomes rose just 3 percent – an enormous spread of 30 percentage points!”

- “Meanwhile, signs are emerging that the five-year boom in house sales and price appreciation may be losing its heat. Mortgage applications, for example, hit consecutive records during the months of April, May and June but seem to have since hit a ceiling. While the price of existing homes sold in June was up a hearty 15 percent, inventories hit a 15-year high, suggesting that any slowdown in demand will reduce pricing power. That dynamic may already be playing out in the market for newly constructed homes, where inventories are at an all-time high and prices are unchanged from last year’s levels. If these tentative signals firm up in the months ahead, it’s likely that the housing wave has already crested. What lies ahead, of course, is uncharted terrain, but history provides some guidance. For starters, outright property depreciation is rare – almost unheard of – even in egregiously overvalued markets absent a localized, or generalized, economic decline. Specifically, falling home prices typically occur in the context of falling employment, which, to our thinking, is unlikely in the near term. Secondly, if or when such corrections occur (California and Southern Florida seem likely candidates), they should be restricted to the portion of the housing market that’s precariously overvalued. Moreover, unless such declines are broadly synchronized, the adverse consequences will be diffused. Continued property price appreciation in the majority of housing markets will also help to mitigate broader repercussions. Third, price corrections in the housing market tend to be slow, drawn-out affairs, taking an average of three years to play out. Unlike financial market corrections, the consequences should emerge gradually with ample time for policy adjustments to cushion the effects. None of this is to say that the adjustment won’t be difficult, especially for borrowers and lenders caught unaware. But the most likely scenario is that of an orderly correction, not a disruptive crash.” (*Financial Market Outlook*, National City Corp., August 2005)

<i>Radical solution for the red-hot real estate market</i>
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- Wachovia’s chief economist John Silvia raised a few eyebrows at the National Press Club’s panel on the housing bubble, when he floated a “radical solution” for dealing with the red-hot real estate market. Silvia said, “I would suggest that if you’re worrying about a housing bubble and want to correct it, shut down Fannie Mae and Freddie Mac. Don’t give mortgages to anybody who doesn’t have a 20% down payment. All right?” The *American Banker* noted that while Silvia wasn’t “seriously advocating the closure of the two [GSEs], ...he noted that their mortgage purchases make it easier for more people to buy homes -- and that higher demand equals higher prices.” (*American Banker*, Geeta Sundarmoorthy, Jim Cole, Paul Davis, Ethan Zindler, 08/12/05)

OFHEO reports strong growth in housing sector in 2004,  
but reduced growth opportunities for Fannie Mae and Freddie Mac

- Although the U.S. housing sector was strong in 2004, internal problems at Fannie Mae and Freddie Mac coupled with changes in the mortgage market reduced growth opportunities for the companies said OFHEO. While outstanding residential mortgage debt in 2004 jumped 13.4% to \$8.7 trillion, Fannie's and Freddie's purchases of single-family mortgages declined, representing 34% of originated single-family loans, compared with 53% in 2003, according to OFHEO. While housing construction and sales set records in 2004, originations of single-family mortgages dropped 26.7% to \$2.8 trillion in 2004. "Nevertheless, underlying business fundamentals of both Fannie Mae and Freddie Mac remained sound in 2004," said OFHEO.
- Fannie and Freddie's growth opportunities were hurt by growth in demand for adjustable-rate products and other exotic mortgages, OFHEO said. A strong adjustable-rate mortgage market in 2004 reduced the number of mortgages available for sale in the secondary market because originators retained these loans on their own balance sheets, said OFHEO. Moreover, private companies pooling mortgages and selling them as securities competed successfully with the GSEs as secondary market purchasers, increasing their market share by buying a high proportion of adjustable-rate and subprime loans, said the regulator. (*Reuters News*, 08/23/05)

Long-term agency debt issuance off sharply in 2005

- Long-term debt issuance by U.S. agencies totaled \$347.7 billion in the first half of 2005, down sharply from the \$589.9 billion total registered in the first half of 2004, according to Bond Market Association. "The Federal Home Loan Banks, Fannie Mae and Freddie Mac accounted for most of the decrease, as the agencies continued to adjust their portfolio strategies," said BMA, explaining the 41.1% decline. Freddie Mac's \$67.1 billion long-term debt issuance in the first half of this year was down 49.7% from the \$133.3 billion registered in the first six months of 2004, while Fannie Mae's long-term debt issuance of \$97.4 billion in the first half of 2005 was off 47% from the \$183.7 billion total in the first half of last year, according to the report. The FHLBs issued \$158.4 billion of long-term debt in the first half of 2005, down 34.7% from the \$242.5 billion total in the first half of 2004, said BMA. (*Dow Jones Newswires*, John Connor, 08/18/05)

K Street action in the GSE debate

- Freddie Mac has recently hired three new lobbying firms and "stepped up" the services of another firm. Freddie Mac paid \$150,000 to the Cypress Group for the lobbying services of J. Patrick Cave, former Treasury Department deputy assistant

secretary and former aide to Representative Richard Baker (R-LA). Freddie also hired Royer & Brooks for \$120,000 and Compass Consultants for an undisclosed fee. During the first six months of 2005, Freddie Mac also spent \$340,000 for the lobbying services of Covington & Burling.

- FM Policy Focus engaged the services of Capital Ideas LLC, a new lobbying firm run by Geog Gradler, a former Charles Schwab lobbyist and aide to House Majority Leader Tom Delay (R-TX). During the first six months of 2005, the Financial Services Roundtable “invested” \$2.7 million in lobbying, making the top ten list of PoliticalMoneyLine’s big spenders for lobbying on Capitol Hill. (*American Banker*, Michele Heller and Luke Mullins, 08/22/05)

#### President Bush nominates Emil Henry for Assistant Treasury Secretary

- President Bush plans to nominate Emil W. Henry, Jr. to be assistant secretary of the Treasury for financial institutions, said the White House. Henry, age 44, is a senior partner with Gleacher Partners, an investment banking and asset management firm, and holds a bachelor degree from Yale University and master’s degree from Harvard Business School. If confirmed, Henry will be the contact man at Treasury for all issues related to financial institutions – everything from deposit insurance reform to GSE regulatory reform—and would report to Randal Quarles, under secretary for domestic finance.
- While most policy makers don’t know Henry or his politics, associates say he earned a reputation on Wall Street as a smart and savvy business man, who should prove successful in Washington. “His intelligence, judgment and depth of his experience will make him a very effective as a policymaker,” said Sergio Galvis, partner at Sullivan & Cromwell, who knows Henry personally and professionally. “He understands how banks work and the issues -- both market and regulatory -- that they face by virtue of his experience over the last 18 years or so in the private sector working with banks on their transactions.” (*Dow Jones Newswires*, 08/01/05; *American Banker*, Michele Heller, 08/12/05)

#### New York Fed calls meeting with major participants in the credit derivative market

- The Federal Reserve Bank of New York has invited 14 of the “major participants” in the credit derivatives market to a meeting at their office on September 15th amid concern the \$8.4 trillion industry is rife with trades lacking key paperwork. According to an August 12th letter sent to bank CEOs by Timothy Geithner, the president of the New York Fed, the meeting will focus on market practices. Representatives from the SEC, the Office of the Comptroller of the Currency, the New York State Banking Department, the U.K.’s Financial Services Authority, Germany’s Federal Financial Supervisory Authority, and the Swiss Federal Banking Commission will also attend the meeting, said Fed spokesman Peter Bakstansky.

- In 2004, demand for credit derivatives more than doubled and are the fastest-growing part of the \$24 trillion derivatives market. A backlog of trades left unconfirmed may undermine investor confidence, said an industry group led by E. Gerald Corrigan, managing director at Goldman Sachs Group Inc. In a July 27<sup>th</sup> report, the Counterparty Risk Management Policy Group said that the “serious” need to tackle the accumulation of trade confirmations is “urgent.” JPMorgan Chase & Co., Deutsche Bank AG, Goldman Sachs, Morgan Stanley, and Merrill Lynch & Co. are the five most-cited trading partners in the credit derivatives market, according to Fitch Ratings. (*Bloomberg News*, 08/24/05)

First cash sale of electronic mortgage to secondary market investor is closed
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- Document Processing Systems, Inc. announced that its DPS eMortgage Studio<sup>TM</sup> online lending platform has been used by 1st Advantage Mortgage to execute the industry’s first cash sale of an electronic mortgage loan to a secondary market investor through the MERS® eRegistry. The mortgage was electronically closed, registered and immediately sold, using the eMortgage Studio as the interface between DPS partner 1st Advantage Mortgage, LLC of Chicago and the eRegistry. The transaction opens the door for lenders to transition to electronic mortgage closings by ensuring that eNotes can be easily, efficiently and securely sold in the secondary market. (*PR Newswire*, 08/23/05)

## ***Fannie Mae***

### Fannie Mae's mortgage portfolio shrank at an annualized rate of 25.5% in July

- Fannie Mae's mortgage holdings contracted by \$19.4 billion to \$788.8 billion for an annualized rate of 25.5% in July, as homeowners continued to take advantage of low interest rates to refinance for the third consecutive month. During the seven months ended July 31, the company's portfolio fell at an annualized rate of 20.9%. While Fannie Mae was expected to reduce the size of its mortgages holdings this year to meet its higher reserve requirements taking effect at the end of September, the size of the company's decline in July surprised experts, because most analysts believed that Fannie had an adequate capital cushion. Portfolio purchases of \$9.4 billion last month and sales of \$9.3 billion, combined with a \$1.1 billion increase in portfolio liquidations caused the shrinkage, said Fannie Mae. While mortgage rates actually rose in July, the prepayments Fannie experienced during the month were a delayed reaction to declines in interest rates during May and June, said Jim Vogel, executive vice president at FTN Financial Capital Market. Fannie Mae also said its duration gap, a measure of the portfolio's sensitivity to interest rates, averaged one month during July, compared with zero months in June. (*Dow Jones Newswires*, Allison Bisbey Colter, 08/26/05; *Reuters News*, Julie Haviv, 08/25/05; *Washington Post*, 08/26/05)

### Management changes continue at Fannie Mae

- Ann M. Kappler will step down as Fannie Mae's general counsel at the end of the year to join the Washington, D.C. law firm of Collier Shannon Scott. Kappler, who joined Fannie Mae in 1999, was responsible for dealing directly with the company's regulator, OFHEO. Fannie Mae will launch a search for Kappler's replacement immediately. (*AFX Asia*, 08/25/05; *Washington Post*, 08/25/05; *Dow Jones News Service*, James R. Hagerty, 08/24/05)
- Andrew McCormick, Fannie Mae's senior vice president of portfolio management, and Darren Thompson, the company's former interim head of credit finance, have left the GSE to start a real estate investment trust. McCormick ran Fannie Mae's \$808 billion mortgage portfolio under executive vice president Peter Niculescu. The executives' departures come as Fannie is embarking on a multiple-year earnings restatement to correct its accounting for derivatives. "We'll be watching to see who else might depart, and how the vacancies are filled," said Jim Vogel, executive vice president for FTN Financial Capital Markets.
- Fannie Mae spokesman Jason Lobo said Andrew Bon Salle and Ramon deCastro, two long-time veterans of the company's portfolio business, will take over McCormick's responsibilities. DeCastro has been with the company 14 years and has worked in all

three areas of the portfolio business -- treasury, strategy and assets; Bon Salle has been with the company 12 years. (*Dow Jones Newswires*, Allison Bisbey Colter, 08/18/05)

- Fannie Mae also announced the appointments of Eric Schuppenhauer as senior vice president for accounting; Sal Mirran as senior vice president for single-family-home mortgage business and strategy development; and Scott Lesmes as a senior vice president and deputy general counsel. Previously, Schuppenhauer was managing director for global accounting policy for Credit Suisse First Boston (CSR) and Mirran was a senior vice president and head of capital markets for Bank of America's consumer real estate division. Since 2000, Lesmes has served at Fannie Mae's vice president and deputy general counsel. (*The Wall Street Journal*, James H. Hagerty, 08/25/05)

Fannie Mae officials ignored accounting principles to meet earnings expectations and earn lucrative bonuses, argue company shareholders
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- In a filing opposing the dismissal of their securities fraud lawsuit against Fannie Mae, shareholders say their complaint adequately alleges that the company's management ignored accounting principles to meet Wall Street expectations and earn lucrative bonuses. The plaintiffs contend that former president Franklin D. Raines and former CFO J. Timothy Howard both knew of, or recklessly disregarded, the accounting fraud that occurred during their tenure at Fannie Mae. The company is expected to restate its 2001 through mid-2004 financial results and reduce earnings by \$12 billion, approximately half the earnings reported during that period.
- Raines and Howard allegedly inflated Fannie Mae's financial results to get bonuses and compensation tied to the company's earnings. With Fannie Mae meeting its earnings targets from 2000 to 2003, Raines and Howard earned an additional \$50 million during this four-year period, alleged the plaintiffs. Moreover, Raines and Howard also sold close to \$20 million of Fannie Mae stock while the accounting fraud was occurring. The defendants argue that the stock sales were predetermined and not based on the stock value at the time of sale. Nevertheless, the plaintiffs argue that their suit adequately alleges that Fannie Mae and its executives intended to deceive the investing public in violation of the anti-fraud provisions of federal securities laws. The accounting principles at issue were not simply differences of opinion, the plaintiffs claim, and a jury will need to determine whether the defendants' accounting decisions were made in good faith. (*Corporate Officers and Directors Liability Reporter*, 07/25/05)

### Fannie Mae's exposure to private-label securities doubled in 2004

- Moody's Investors Services reported that Fannie Mae more than doubled its exposure to securitized home equity loans and other private-label securities in 2004 in a new analysis of the company. According to Moody's, Fannie Mae's holdings of home equity loans increased from 4% at the end of 2003 to 10% at the end of 2004, while the company's holdings of other private-label securities increased from 2% to 4% over the corresponding period. In the report, Moody's analysts said that Fannie has "demonstrated discipline with these loans, imposing standard underwriting and risk-based pricing, as well as securing significant third-party credit enhancements." Moody's expects loan delinquencies at Fannie Mae and Freddie Mac will rise as the companies move even further down the credit spectrum to purchase bonds backed by Alt-A loans. Despite the riskier nature of these loans, Moody's expects Fannie and Freddie "will continue to exercise discipline through prudent underwriting, and credit losses will remain manageable throughout the credit cycle." (*Dow Jones Newswires*, Allison Bisbey Colter, 08/19/05)

### Future of Fannie Mae's subordinated debt program in doubt

- Fannie Mae is in negotiations with OFHEO about its \$12.5 billion subordinated debt program, fueling speculation that the securities will be redeemed. The company's subdebt program, launched in 2001, acts as kind of capital cushion for senior debt holders. Under pressure from Congress, Fannie Mae and Freddie Mac committed to build up and maintain an amount of equity and subordinated debt equal to 4% of their on-balance-sheet assets, net of certain adjustments. However, issuing subordinated debt is problematic and prohibitively expensive, until Fannie Mae completes its multiple-year earnings restatement, which won't be completed until 2006. .
- Fannie Mae's ability to fulfill its program commitment might come into question when the first \$1.5 billion tranche matures in May 2006. While it is unlikely that Fannie Mae's subordinated debt will fall below the 4% threshold given the company's recent reduction in its asset base, Fannie may fall short of its pledge to support the liquidity of its outstanding subordinated debt by keeping an active market presence and maintaining a weighted average maturity of at least five years. Fannie hasn't issued subordinated debt since 2003.
- An unnamed debt analyst said any reduction in the amount of subordinated debt outstanding could add two or three basis points to the risk premium on Fannie's senior debt, relative to other issuers such as Freddie and the FHLBs. "With no financials, and no information about the health of the organization, you want to leave the safety blanket in place," said the analyst. Others contend that the subordinated debt program no longer serves its original purpose. "How is the market supposed to figure out what the subordinated debt is worth without any audited financial

statements?” asked Jim Vogel, executive vice president at FTN Financial Capital Markets. (*Dow Jones Newswires*, Allison Bisbey Colter, 08/10/05)

Fannie Mae reduces the size of its three-month and six-month auctions

- On August 10<sup>th</sup>, Fannie Mae reduced the minimum weekly three-month and six-month auction amounts to \$1 billion each, while the monthly, one-year auction minimum size will remain at \$1 billion. Previously, the minimum sizes of three-month and six-month auctions were \$4 billion and \$1.5 billion, respectively. As the company has sold assets to augment its capital base, Fannie Mae’s funding needs have been dramatically cut. During the first six months of 2005, Fannie Mae has issued \$100.86 billion less of short-term debt than the amount maturing. (*Dow Jones Newswires*, Allison Bisbey Colter, 08/05/05)

Foreign appetite for GSE debt continues

- On August 17, foreign investors purchased more than 50% of Fannie Mae’s \$3 billion offering of two year notes, easing doubts that such investors would cut their purchases of GSE debt. Non-U.S. investors bought 57% of Fannie Mae’s debt offering, up from 38% of the company’s \$3 billion benchmark two-year sale in April. Asian investors bought 24% of the August issue, up from 19% of the April issue, while European purchases fell to 10% from the prior 16%. The yield on the August offering was 4.258%, with a spread of 22 basis points over Treasuries. (*Reuters*, 08/17/05)

## ***Freddie Mac***

### Freddie Mac's portfolio declines 9% on annualized basis in July

- In July, Freddie Mac's retained portfolio fell by \$5 billion to \$660.04 billion, for an annualized rate of decline of 9% following a 5.6% decline in June. During the first seven months of 2005, Freddie Mac's mortgage holdings increased at an annualized rate of 1.9%. During July, Freddie purchased \$23.23 billion of mortgage securities and sold another \$11.02 billion, while \$17.18 billion either matured or were repaid early. Freddie's holding of mortgage-backed securities not issued by housing agencies, which tend to be backed by adjustable-rate or hybrid mortgage products, rose to \$217.05 billion in July from \$213.32 billion in June, while its holdings of MBS that it issued and guaranteed itself fell to \$329.93 billion from \$335.23 billion and its holdings of MBS issued by other housing agencies fell to \$51.98 billion from \$54.46 billion. Freddie Mac's duration gap averaged zero months in July, unchanged from June. (*Dow Jones Newswires*, Allison Bisbey Colter, 08/23/05; *Reuters News*, 08/23/05)

### Freddie Mac to disclose loan level data on new bonds

- By year end, Freddie Mac expects to expand its disclosures on single-family mortgage participation certificates. At the time of issuance, the company plans to provide loan-level information on all new fixed- and adjustable-rate mortgage participation securities. This information will provide investors better information for predicting prepayment speeds than the pool-level and quartile breakdowns currently provided by Fannie and Freddie. Further, the disclosures would limit the GSEs' use of hidden data to "cherry pick" the best assets for their portfolio. The company said that the additional disclosure will increase transparency and Freddie's competitiveness. At this time, Freddie Mac does not intend to provide the new data for existing deals or on an ongoing, monthly basis, but will later consider such changes, said Mark D. Hanson, the company's vice president of mortgage funding.
- Some argue that increased disclosures for agency securities may fragment the market, drawing money away from TBA trades - forward sales that can be filled with bonds with a range of characteristics, and a backbone for the MBS market's overall liquidity. Hanson said that Freddie believes the expanded disclosures will cut down on the "uncertainty premium" built into the TBA market. Freddie is doing other things to bolster the TBA market, particularly by encouraging the larger securities, he added. (*Reuters*, 08/10/05; *American Banker*, Jody Shenn, 08/17/05)

#### Freddie Mac's Euro Notes to be ECB-eligible collateral soon

- Freddie Mac expects its euro-denominated securities will become eligible collateral at the European Central Bank “very shortly,” which is expected to increase demand for the notes and expand its investor base. “We’re currently in the process of getting our securities listed in their [ECB] database,” said Freddie’s spokesman Michael Cosgrove. “We’re working on the last details and expect that to be completed very shortly.” Freddie Mac’s euro reference note program, which was launched in 2000, has EUR29.1 billion outstanding. (*Dow Jones Capital Markets*, Adam Bradbery, 08/24/05)

#### Freddie Mac hires new executive vice president for human resources

- Freddie Mac has named Paul G. George executive vice president for human resources, responsible for recruiting, organizational development and management training, employee relations and diversity. Most recently, George was head of human resources for Wachovia Corp. (*Dow Jones News Services*, Jennifer Corbett Dooren, 08/03/05; *Freddie Mac Press Release*, 08/03/05)
- The Small Business Administration has hired Michael Hager, formerly the senior vice president of human resources at Freddie Mac, to oversee the agency’s loan and venture capital programs. (*Birmingham Business Journal*, 08/01/05)

#### Freddie Mac Foundation awards \$5.5 million in grants during the first six months of 2005

- The Freddie Mac Foundation has approved 82 grants totaling \$5.5 million during the six months ended June 30, 2005 to organizations with innovative programs to help better the lives of children and families in the Washington, DC metropolitan area. The Foundation’s largest grants were awarded to Arlington Community Temporary Shelter (\$500,000 to fund the demolition and rebuilding of a emergency shelter in Arlington, Virginia) and Bright Beginnings (\$300,000 to operate the evening care program for infants and preschoolers in Washington, DC). (*Freddie Mac Foundation Press Release*, 08/05/05)

## ***Federal Home Loan Banks***

Moody's says the FHLB System is financially "very strong"

- In its August Special Commentary, Moody's Investors Services said the FHLB System was financially "very sound," bolstered by its joint and several liability policy that lifts the ratings of the weakest of the 12 banks and tempers the ratings of the strongest. The FHLB System and each of its banks are at low risk of an extraordinary rescue by the government, scoring a bailout risk rating of two on a scale of one to six, said Moody's said. The agency's appraisal takes into consideration the FHLBs' explicit and implied government-bestowed benefits as well as those not associated the system's status as government sponsored enterprise. The FHLBs' rating denotes "high dependence, high support," said Moody's.
- According to Moody's, the FHLBs' interest rate and credit risk management capabilities are appropriate. Because of mortgage purchase programs, some banks' interest rate and operational risks are rising but still remain "relatively modest." Credit risk remains "very low," said Moody's, while the individual banks' credit profiles are "strong and improving." In aggregate, Moody's noted that the FHLBs' exposure to mortgage investments accounted for 12.9% of total system assets as of June 30, 2004, down from 13.8% on December 31, 2003. "Moody's expects [the Mortgage Purchase Program] and [Mortgage Partnership Finance Program] growth to moderate and remain in the mid-teens as a percentage of FHLB system assets," said Moody's. "A change in the political or interest rate environments would not change these expectations." According to Moody's, the FHLB System has more than adequate liquidity with liquid assets totaling 119% of short-term debt. All FHLBs maintain at least the required minimum of five days of liquidity and some voluntarily carry a minimum of 90 days' liquidity, said Moody's.
- Moody's said the GSE regulatory reform legislation under consideration in Congress would not have a significant impact of the FHLBs' creditworthiness, given that many proposed changes to the GSEs' oversight are already in practice at the Federal Housing Finance Board. With regard to corporate governance, Moody's said the FHLB System has limited central leadership, making interbank coordination more difficult and in need of improvement. Moody's said the process of registering with the SEC is strengthening the FHLBs, forcing them to re-evaluate and improve their systems, personnel and processes. "Given the SEC registration, restatements by several of the [FHLBs] and intense regulatory scrutiny, we believe all numbers will be scrubbed by year end 2005," the report said.
- All 12 FHLBs have triple-A long-term deposit and P-1 short-term deposit ratings from Moody's with stable outlooks. The senior unsecured debt issued by the FHLB System, which is the joint and several obligation of all 12 FHLBs, is rated triple-A

with a stable outlook. (*Market News International*, 08/19/05; *Dow Jones Newswires*, Allison Bisbey Colter, 08/17/05)

Standard & Poors outlook for FHLB-Dallas is “Negative”

- Standard & Poors affirmed its AAA long-term counterparty credit rating and its A-1+ short-term counterparty credit rating for the FHLB-Dallas, but changed its outlook from “stable” to “negative.” S&P took this action after the Bank announced its registration delay and earnings restatement, which it estimated would reduce its 2001-2005 earnings by \$25 million to \$30 million. The Bank attempted to cut its losses and reduce future earnings volatility by selling \$1.2 billion in securities and terminating the corresponding hedges. S&P’s credit analyst Robert B. Hoban, Jr. said, “This [reduction in earnings] is a meaningful portion of retained earnings, which were \$145 million at the last period end, March 31, 2005.” The agency affirmed that its triple-A rating on the consolidated obligations of the FHLBs is not affected by these actions. (*Market News International*, 08/22/05; *Dow Jones International News*, Dawn Kopecki, 08/22/05)

GSE regulatory reform debate has yet to address the risk of the FHLB System

- The Congressional debate on GSE regulatory reform has focused on the risks of rapid growth by Fannie Mae and Freddie Mac, but has yet to focus on the risk of the rapid growth of the FHLB System. A new study by economists at the FDIC and the Federal Reserve Banks of Richmond and St. Louis analyzes the potential dangers posed by the growing reliance of commercial banks on financing by the FHLB System. The authors conclude that the FDIC has failed to price risks from the rapid growth in FHLB advances to banks. With FHLB funding surging since the early 1990s, the study warns of both a “moral hazard” from subsidized bank risk-taking and the subordinate position the FDIC would have in sorting out a failed bank with FHLB obligations. Moral hazard occurs as the FHLB System faces no credit risk because of its privileged status as a GSE and its monopoly position, the study says. “Banks can take risks with advances, keep the upside, and shift the downside to the FDIC,” it says.
- “The evidence suggests [FHLB] advances have increased expected losses by a non-trivial magnitude,” conclude the authors. “The policy implication is that the FDIC should charge for increases in expected losses arising from advances,” the study concludes. The ideal solution would be passage of legislation creating an explicit linking of FDIC insurance premiums with FHLB funding and eliminating pre-payment penalties in failure resolutions. A more practical solution would be for bank regulators to levy capital charges for heavy use of FHLB advances, increasing the deductible for deposit insurance, said the authors. “A higher deductible would curb appetites for risk and trim resolution costs by shifting losses to bank owners,” they

conclude. (*Dow Jones Capital Markets*, Campion Walsh, 08/10/05; *Dow Jones International News*, Allison Bisbey Colter, 08/17/05)

FHLBs must adopt anti-predator policies by December 31st

- The Federal Housing Finance Board is requiring the FHLBs to adopt written anti-predatory-lending mortgage purchase and advance policies by December 31st. The Finance Board is requiring Banks' policies to address whether a loan's terms require mandatory arbitration or its rates trigger mandatory disclosures, but is leaving much to the FHLBs' discretion. The regulator recommended that the FHLBs review the lending policies of Fannie Mae and Freddie Mac and the anti-predatory-lending guidance developed by other federal and state regulators before developing their new policies. The Banks will publicly disclose their anti-predatory policies and certify to the Finance Board that their members are aware of and will comply with the new policies. (*American Banker*, 08/26/05)

## ***Ginnie Mae***

Subprime lenders take bite out of Ginnie Mae's securitizations

- It appears that 2005 could be one of Ginnie Mae's worst in five years in the agency's single family program, as it has lost business to the subprime market and to a lesser degree the IO and payment option products. During the first seven months of its fiscal year, the Ginnie Mae guaranteed \$48.4 billion in MBS backed by single-family loans. On an annualized basis, the agency could wind up securitizing only \$83 billion of single-family loans compared to \$208 billion in 2003. Based on first-quarter volumes in 2005, subprime production is accounted for 20.3% of all loans funded compared to just 3.5% for federally backed mortgages guaranteed by GNMA. In contrast, GNMA had a production market share of 11.1% compared to 5.5% for subprime ten years ago. (*Mortgage Servicing News*, Paul Muolo, August 2005)

## ***Farm Credit System / Farmer Mac***

### FCA's "Investment in Rural America" initiative

- In an August 2<sup>nd</sup> speech at the AgFirst Farm Credit Annual Meeting, FCA chairman and CEO Nancy C. Pellett said, "I want to continue to emphasize the necessity for the System to modernize and stay relevant and this applies to FCA as well. ...As you know, at FCA we have begun an initiative called "Investments in Rural America," in which we are considering, on a case-by-case basis, your requests to make mission-related investments or to conduct pilot investment programs. We have begun to use the investment authority outlined in the Farm Credit Act to approve new investments that fund the needs of agriculture or rural America."
- "You have submitted several proposals to us that we've been able to respond positively to including the first pilot program which allows AgFirst Farm Credit Bank to work with other lenders in promoting increased liquidity for affordable home financing to rural America through investments in rural housing mortgage securities guaranteed by government-sponsored agencies (RHMS). The FCA Board also unanimously approved a booklet that outlines the Farm Credit System's institutions' authorities to provide lump-sum payments to tobacco quota holders and producers under the Tobacco Reform Act. The Tobacco Buyout program has significant implications for Farm Credit System institutions in the Ag First territory that serve the financing needs of tobacco quota holders and producers. We clearly understand that the ability of FCS institutions that serve tobacco quota holders and producers to provide lump-sum payments through assignments, successor in interest contracts and lending transaction is essential so they can immediately put their payments to work and reinvest in their future."
- "...FCA Board approval of these and other projects shows that we are serious about living within the statute yet also allowing the System to participate in some new and important projects that help agriculture and rural areas throughout America." (*FCA Press Release*, Honorable Nancy C. Pellett, 08/02/05)

### FCA approves final rule on preferred stock

- The Farm Credit Administration's board of directors approved a final rule that amends the regulatory treatment of preferred stock issued by Farm Credit System (FCS) institutions. The regulation will ensure the stability and quality of capital at FCS institutions, ensure the fair and equitable treatment of all shareholders of FCS preferred stock, and minimize the potential for insider abuse. The final rule requires greater involvement in and oversight by FCS institutions' boards in the retirement of preferred stock. The rule enhances FCA's current standards of conduct regulations to specifically address insider preferred stock transactions, streamlines and clarifies the

FCA review and clearance process, and requires disclosure of senior officer and director preferred stock transactions. The final rule also requires prior approval by FCA of investments by System banks, associations, and service corporations in the preferred stock of other FCS institutions, including Farmer Mac. The regulation will become effective 30 days after publication in the Federal Register during which either or both Houses of Congress are in session. Certain sections of the rule will be delayed for six months from the effective date of the final regulation to allow System institutions with existing preferred stock programs to adopt the policies and procedures necessary to comply with the rule. FCA will publish a notice of the effective date for the delayed portion of the rule in the Federal Register. (*Farm Credit Administration Press Release*, 08/11/05)

## ***The Privatized GSE -- Sallie Mae***

Sallie Mae buys GRP Financial – a specialty mortgage finance company
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- Sallie Mae will purchase GRP Financial Services, a specialty mortgage finance company formed six years ago by investment advisor, Angelo, Gordon & Co. GRP Financial's shareholders include Greenthal Realty Partners LLC and Angelo, Gordon. Through this acquisition, Sallie Mae will enter the business of buying and servicing of distressed mortgages and sales of foreclosed properties. Sallie Mae's chief executive and vice chairman Tim Fitzpatrick said, "With the addition of GRP to our existing debt management operations, we will be able to service virtually every type of major consumer debt." Matt Snowling, an analyst with Friedman, Billings, Ramsey & Co., said that Sallie Mae's acquisition of GRP was consistent with the company's strategy of holding the assets it services and getting into business lines other than student loans. "Quietly, Sallie Mae is becoming one of the bigger debt collectors in this country," said Snowling. (*American Banker*, Matthew Quinn, 08/22/05)

## *Postal Service*

### Postal Service's enthusiasm for postal reform wanes

- On August 2, the U.S. Postal Service Board of Governors (BOG) chairman James C. Miller III warned that the path to postal reform would not be easy, and that additional postal rate hikes could be likely. The White House has made it clear that H.R. 22 will be vetoed if it's not revenue-neutral, which conflicts with both H.R. 22 and S. 662, said Miller. What's more, if such revenue-neutral legislation were enacted, it would give the BOG limited authority to run the Postal Service like a legitimate business enterprise, and make it hard for the USPS to meet consumer needs. If the President vetoes postal reform bill legislation, the public would likely face an additional postal rate increase in the mid-single digits in 2007, *on top of* the pending 5.4% increase on First Class mail still scheduled for January 2006.
- The Association for Nonprofit Mailers writes, "So, if we're reading [Miller's comments] correctly, the USPS suggests that without legislative reform we can expect the 5.4% increase in 2006 and another 4-6% increase in 2007 -- then the USPS would 'target future annual increases at CPI or below.' If reform is enacted that meets the White House revenue neutral requirements, we'd also see the 5.4% increase in 2006, another 4-6% increase in 2007 then the new CPI-based ratesetting mechanism would be triggered. However, under this scenario the USPS anticipates 'extreme difficulties' in 'meeting consumer's needs' given the Board's "very limited authority to govern the organization as an efficient business enterprise." Hmmmm. ..[W]e are reminded of what Board Chairman Jim Miller said to us at the National Postal Forum in Nashville: 'We're better off with no bill than with a bad bill.'"
- Meanwhile, another top postal official came out against the postal reform bills being debated in Congress, saying they would harm the Postal Service. "My personal opinion is that the governance structure that is oriented in the current postal reform legislation is disastrous," said Richard J. Strasser, USPS executive vice president and CFO, who addressed business and nonprofit mailers at the quarterly Mailers' Technical Advisory Committee meeting. Both bills [H.R. 22 and S. 662] contain provisions that replace the current Postal Rate Commission with a more powerful Postal Regulatory Commission, he said. "I'm sorry, but I really felt that I needed to tell the industry that passing legislation for the sake of passing legislation is not a good idea," said Strasser, who emphasized that he was only voicing his personal views and not that of the USPS. He added that it makes sense to solve the escrow situation and to return the military service responsibility to the Treasury Department, but implied that these issues should be put onto a separate bill.  
([www.postalwatch.com](http://www.postalwatch.com). 08/08/05; [www.postalwatch.com](http://www.postalwatch.com). 08/18/05; [www.nonprofitmailers.org](http://www.nonprofitmailers.org), 08/03/05)

The USPS is not the only one worried about the consequences of postal reform

- In a recent commentary, Don Soifer, Executive Director of the U.S. Consumer Postal Council said, “With a major Postal Service reform bill now having passed the House of Representatives, debate over the legislation is focused on Senate and White House approval. Lost amid the political wrangling is the fact that the new law does little to fix the most fundamental problems that affect post office consumers: Exorbitant spending on labor, flat productivity, and murky accounting practices. It’s a shame that the new bill is so ineffective on these crucial matters, especially since it caps 25 years of Congressional efforts to repair the USPS. The Senate is not likely to vote on the postal bill until lawmakers return from the summer recess, and there’s no telling when, or if, the President will endorse it.” (*Marshville News Herald*, Don Soifer, 08/15/05)
- Speaking before an assembly of the National League of Postmasters, Postal Rate Commissioner Dawn Tisdale [and former postmaster] said “If the final [postal reform] bill will have an adverse effect on the federal budget, the [President’s] advisors will recommend a veto. How do you avoid affecting the budget? No other business, government or private enterprise, could survive with that type of burden on its head. I hope the bills will be able to relieve that burden, but anything is possible.” ([www.nonprofitmailers.org](http://www.nonprofitmailers.org), 08/08/05)

“The rest of the story,” according to the USPS

- In a July 27<sup>th</sup> broadcast by Paul Harvey, the radio commentator said, “[The] United States Postal Service is dying, from rising rates and increasing competition, so Congress is voting another increase in the price of postage stamps and equivalent increases in other rates, [while] competing postal services, including the internet, [have] no subsidies...” In a letter to Harvey, USPS spokesman Azeezaly S. Jaffer said, ““Dying?” Far from it. We closed the books on fiscal year 2004 \$3.1 billion in the black and that followed a \$3.9 billion surplus in 2003. Overall mail volume grew to 206 billion pieces delivered in 2004 compared to 202 billion in 2003. Of larger significance, however, is that we haven’t increased rates in three years.” (*USPS Press Release*, 08/12/05)

The “Hallmark Hold” on S. 662

- According to the National Association of Postmasters of the U.S., “...[On] July 29, the only obstacle to Senate passage of S. 662, the Collins-Carper Postal Enhancement and Accountability Act, was a “hold” that Senator Christopher Bond (R-MO) placed on the bill, at the request of Hallmark Cards. Hallmark asked that a provision be added to the bill that would restrict USPS rate-setting flexibility. Senator Susan Collins (R-ME) did not assent to the demand, so Senator Bonds did not lift the

“Hallmark Hold.” As a result, action on S. 662 will have to wait until after Labor Day. ([www.postalwatch.com](http://www.postalwatch.com), 08/08/05)

USPS posts \$251 million loss in July, as mail volumes dip

- The Postal Service reported a net loss of \$251 million in July on total revenues of \$5.3 billion. Total revenues were down 3.1%, and total expenses increased by 1.1%, compared to the same period last year. High fuel costs and other unexpected expenses pushed the USPS results into the red, prompting the Postal Service to recalculate their year-end projections from \$1.7 billion in net income to *only* \$1.0 billion. USPS CFO Richard J. Strasser said that the escalation in fuel prices and increase in next year’s cost of living adjustments “enhance the need for a 5.4% [rate] increase in January.” In fact, Strasser said that if the USPS were to file a rate case today, that the 5.4% request would not be enough, according to the National Association of Non-Profit Mailers.
- Total mail volume for July was 227 million pieces, or 1.4% under the same period last year. First-Class volume fell 5% for the month, while Standard mail was up 2.2% and Periodicals were 1.8% higher than last year. Year-to-date, total volume is 2.6%, or 4.5 billion pieces, over last year. ([www.postalwatch.com](http://www.postalwatch.com). 08/22/05; [www.postalwatch.com](http://www.postalwatch.com). 08/18/05; [www.nonprofitmailers.org](http://www.nonprofitmailers.org), 08/18/05)

After his privatization plan for Japan Post fails,  
Prime Minister Koizumi calls for new elections

- On August 8, the Upper House of Parliament voted 125 to 108 against Prime Minister Junichiro Koizumi’s plan to privatize the \$1.3 trillion postal system, Japan Post, throwing the nation’s political outlook in turmoil and underscoring deep divisions over the direction the country’s slow-growing economy should take. In response, Koizumi dissolved the Lower House of Parliament and called for a general election on September 11, which he hopes will confirm public support for his plan to restructure the world’s second-largest economy. Analysts say that battle over Japan Post could split the ruling Liberal Democratic Party (LDP), which has ruled politics for a half-century. Koizumi’s strategy appears to be to call the bluff of rebels, who he argues are representing the special interests of postal workers and beneficiaries of Japan Post’s funds. In a public debate, Koizumi said, “Privatizing Japan Post is part of the structural reform that leads to other reforms. We will have the will and determination to pursue further reforms for Japan’s future by sacrificing some of our party’s support base.”
- Some analysts think that the Upper House’s rejection of the privatization plan could breathe new life into Japan by encouraging more open debate and more rapid change. “This could be the critical first step toward the creation of a two-party system,” said Kathy Matsui, strategist for Goldman Sachs. “This would allow [members of

Parliament] to move without as much compromise.” (*The Wall Street Journal*, Sebastian Moffett, Andrew Morse, Miho Inada, and Ian Johnson, 08/09/05; *Bloomberg News*, Eijiro Ueno, 08/21/05)

## TVA

### TVA reports \$15 million loss in third quarter

- The Tennessee Valley Authority reported a \$15 million loss in the third quarter, due to rising costs for fuel and purchased power. TVA said operating expenses totaled \$1.5 billion for the three-month period ending June 30, a 6% increase over the second quarter of 2004, while revenues totaled \$1.8 billion, up \$24 million over the same quarter a year ago. In July, the utility adopted a 7.5% percent electric rate increase - the first since 2003 - to cover the rising costs of natural gas and coal for its power plants. The rate increase, which takes effect October 1st, will add \$3.50 to \$6.50 a month to the typical residential power bill. (*Associated Press*, 08/24/05)

### TVA must operate more like a business

- Under congressional and competitive pressures 72 years after its creation, the TVA must operate more like a business, said current and former TVA officials. By December 2005, TVA will come under regulation of the SEC like publicly-owned utilities and its governing board is expected to change to resemble most other corporations. These congressionally mandated changes -- the biggest for TVA in 46 years -- are beginning to change the way agency reports financial data, accounts for its assets and deals with the public. “In many ways, TVA has become a utility business like the investor-owned corporations it competes against,” said Dr. Allan Pulsipher, a former TVA economist who is now the executive director of the Center for Energy Studies at Louisiana State University. “Most of the broader social, economic and resource development programs of TVA have pretty well gone by the wayside and their operations today are pretty much like any other private utility.” Proponents of these changes argue that TVA has become more efficient in delivering electricity to its seven-state region. Critics contend that TVA’s changes could lead to the privatization of the nation’s biggest govern-owned utility.
- Under reforms passed by Congress last fall, TVA will come under regulation of the SEC like investor-owned utilities by December, and a nine-member part-time governing board will replace the two remaining g full-time directors. The new board will hire a chief executive to run the utility. TVA will be allowed to borrow money from banks and other financial institutions, supplementing its current financing through the U.S. Treasury or by issuing bonds. And, the Federal Energy Regulatory

Commission will oversee rates TVA charges other companies to transit power across its lines. These congressionally mandated changes -- the biggest for the agency in 46 years -- already are beginning to change the way TVA reports financial data, accounts for its assets and even deals with the public.

- Senate Majority Leader Bill Frist (R-TN), who wrote the TVA reforms last year, insists the changes will strengthen TVA as a government utility, not lead to any sale or privatization of the agency. Frist said such changes “will advance TVA so it can operate like other private and quasi-public entities.” (*Chattanooga Times/Free Press*, 08/02/05)

TVA should clean up its act, clear up our skies
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- In an August 1<sup>st</sup> editorial, *The Citizens-Times* (Asheville, NC) wrote, “...N.C. Attorney General Roy Cooper plans to follow through on his promise to file suit against the ...TVA to force the federally-owned utility to clean up emissions from its coal-fired power plants. Those emissions are partly to blame for the poor air quality of Western North Carolina, harming health and obscuring views. Cooper said in 2004 that he felt TVA violated the ‘new source review’ provision of the Clean Air Act by modifying several of its plants without determining whether additional emission controls are necessary and without installing the best available technology to control dirty air. Under the 1977 act, new plants have to install the best pollution-fighting technology available. Plants built prior to 1970 were exempt unless they conduct expansions that mean more emissions. Routine maintenance was allowed. These rules were intended to phase out the older highly polluting plants while giving industry time to make the transition to compliance without costly retrofitting of nearly obsolete plants. But Cooper contends that TVA took advantage of the law to upgrade the plants and keep them in operation without installing the required pollution controls. TVA contends it is spending more than \$3 billion this decade to clean up its plants, but Cooper wants to see something in writing. ‘They won’t agree to any type of legal document that guarantees reductions,’ Cooper said. ‘It’s important for us to see the fine print. If they are willing to do these things, they should be willing to put it in writing.’” (*The Citizens-Times* (Asheville, NC), 08/01/05)

But, the judge may not agree...
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- In recent court proceedings, a federal judge in New York expressed reluctance about beginning judicial oversight of pollution issues that affect global warming. Judge Loretta Preskey heard arguments on a lawsuit brought by eight states against five power companies, including the TVA. Preskey asked why she should do something that Congress and the president have decided they don’t want to do as a matter of policy. Connecticut Attorney General Richard Blumenthal told Preskey that the states will prove that the power companies are responsible for 10% of the nation’s carbon dioxide emissions. (*Associated Press*, 08/13/05)

## Pornography bust at TVA

- The Tennessee Valley Authority has pulled the plug on sexually explicit e-mails originating from computers within the various plants, after an inspector general's sampling of electronic mail among various plants found nearly fifty employees and contract workers received and often distributed indecent pictures, videos or jokes. Auditors found extremely inappropriate e-mails containing "jokes and cartoons with inappropriate sexual material; pictures, movie clips and video clips containing inappropriate sexual material; (and) chain and other e-mails inconsistent with TVA policy," much of which amounted to pornography. Reprimands, one week suspensions and at least one firing followed the utility's probe. (*Kentucky Lake Times*, 08/25/05)

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