

# The GSE REPORT™

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## **Major Events**

### **Wheels of justice flatten Fannie:**

SEC rules that Fannie's accounting does not comply with GAAP and directs the company to restate its earnings for FY2001-FY2004

Fannie Mae announces "material" restatement for "many" periods

OFHEO works with Fannie to minimize "fallout" from its earnings restatement

Congressional leaders respond to Fannie's restatement

### SEC rules that Fannie's accounting does not comply with GAAP and directs the company to restate its earnings for FY2001-FY2004

- In its review of Fannie Mae's accounting, SEC Chief Accountant Donald Nicolaisen agreed with OFHEO that the GSE had violated accounting rules and said that the company should restate its earnings through 2004 to correct the problems with two accounting standards. "Our review indicates that during the period under our review, from 2001 to mid-2004, Fannie Mae's accounting practices did not comply in material respects with the accounting requirements," said Nicolaisen in a statement. Specifically, Nicolaisen said that Fannie was not entitled to hedge accounting treatment for its derivatives under Financial Accounting Standard 133. Agreeing with OFHEO's earlier findings on this issue, Nicolaisen concluded that Fannie did not have the appropriate procedures and documentation in place to justify taking hedge accounting treatment for its derivatives. "Fannie Mae's methodology of assessing, measuring, and documenting hedge ineffectiveness was inadequate and was not supported by" FAS 133, said Nicolaisen. In a November filing with the SEC, Fannie said that if it was not allowed to take hedge accounting treatment for its derivatives, the company could be forced to recognize an after-tax cumulative loss of \$9 billion, erasing approximately 38% of the GSE's earnings since the beginning of 2001.
- Nicolaisen also concluded that Fannie Mae had failed to follow proper accounting procedures under FAS 91, governing fees associated with loan origination and purchasing. He said that Fannie appeared to recognize adjustments to the carrying amount of its loans only if it exceeded "a self-defined materiality limit," something that is contrary to the accounting standard. Fannie Mae should restate its financials under FAS 91 if it determines the correction is "material," said Nicolaisen. In a November filing with the SEC, Fannie suggested the adjustment for FAS 91 would

not be material, saying it calculated only an after-tax cumulative loss of \$26 million if it was forced to change its accounting under that standard.

- To be consistent with Statement Nos. 91 and 133 and to provide investors with appropriate information, Nicolaisen advised Fannie Mae to (i) restate its financial statements filed with the Commission to eliminate the use of hedge accounting; (ii) evaluate the accounting under Statement No. 91 and restate its financial statements filed with the Commission if the amounts required for correction are material; and (iii) re-evaluate the information prepared under generally accepted accounting principles (GAAP) and non-GAAP information that Fannie Mae previously provided to investors, particularly in view of the decision that hedge accounting is not appropriate.
- Nicolaisen's statement was a powerful rebuke for Fannie Mae, which appealed to the SEC after OFHEO accused the company of manipulating accounting estimates to achieve desired financial results and deliberately violating other accounting rules to "smooth" earnings. In a December 15<sup>th</sup> meeting, the SEC delivered its findings to Fannie Mae chairman and CEO Franklin Raines, company outside directors Stephen B. Ashley, Joe K. Pickett, and Thomas P. Gerrity, OFHEO Director Armando Falcon, Jr., KPMG auditors, and criminal prosecutors from the Justice Department at the commission's headquarters. According to participants when Raines took issue with the accounting rules for FAS 133, Nicolaisen shot back, "Many companies can and do comply with the rules. Sir, hedge accounting is a privilege, not a right. [It] is applied only under strict circumstances, and you did not comply." Raines seemed shocked, participants said, and asked how "far off" Fannie's books had been in relation to FAS 133. In response, Nicolaisen held up a sheet of paper and told Raines that if it represented the four corners of the rule, and said "you were not even on the page," according to participants.
- The SEC released its findings in a press release that evening during Fannie Mae's Christmas party. Nicolaisen said, "Although it is unusual for the accounting staff to provide such guidance while there are pending investigations by the Commission and other agencies, Fannie Mae requested our guidance because, in its view, these accounting issues have received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty." While largely backing OFHEO's findings in its September report on Fannie Mae's accounting practices, the SEC did not weigh in on whether Fannie Mae willfully violated the accounting rules. Nicolaisen said that Fannie had not asked the accounting staff "to express any views on factual matters or matters that require factual development and, in providing the requested guidance, we are not expressing any such views." (*SEC Press Release*, 12/15/04; *American Banker*, Rob Blackwell, 12/16/04; *Washington Post*, David S. Hilzenrath and Carrie Johnson, 12/16/04; *Dow Jones Capital Markets Report*, Dawn Kopecki, 12/16/04; *USA Today*, Greg Farrell, 12/17/04; *Wall Street Journal*, James R. Hagerty, John R. Wilke, John D. McKinnon, and Joann S. Lublin, 12/23/04)

### Fannie Mae announces “material” restatements for “many” periods

- Spokesman Charles V. Greener said that Fannie Mae “will take the steps necessary to comply fully with the SEC’s determination,” which will leave Fannie Mae with less capital than it is required to hold in reserve against a financial downturn. “The determination made by the SEC will have a negative impact on our minimum capital position, and we are committed to taking the steps necessary to comply with our minimum capital requirement.” Fannie Mae said it “expects that the impact [of the restatement] will be material to Fannie Mae’s reported GAAP and core business results for many, if not all, periods and will vary substantially from period to period based on the amount and types of derivatives held and fluctuations in interest rates and volatility.” According to its filing with the SEC, Fannie is also restating its financials to “reflect corrections as a result of its misapplication of FAS 91 for each prior reporting period.” (*Reuters*, 12/15/04; *Dow Jones Corporate Filings Alert*, David Enrich, 12/23/04)

### OFHEO works with Fannie to minimize the “fallout” from the its earnings restatement

- “OFHEO is working with Fannie Mae to address the impact [the SEC’s] decision will have on the company’s capital position and on other areas within our responsibility as safety and soundness regulator,” said an OFHEO spokeswoman. “We appreciate that the SEC has moved expeditiously in rendering an opinion on OFHEO’s findings to date of the special examination of Fannie Mae.” (*Dow Jones Capital Markets*, Dawn Kopecki, 12/16/04)

### Congressional leaders respond to Fannie’s restatement

- Two powerful Congressional committee chairmen called for sweeping regulatory reform for Fannie Mae and Freddie Mac, following the SEC’s announcement that Fannie Mae had violated accounting rules. Senate Banking Committee Chairman Richard Shelby (R-AL) said, “I am deeply disturbed but not entirely surprised by the [SEC’s] conclusion that Fannie Mae violated accounting rules and will have to restate earnings in what may exceed \$9 billion. ...[T]he SEC’s findings demonstrates the inherent tension that exists between trying to meet earnings expectations and attempting to fulfill a public mission. Fannie Mae has been trying to serve two masters in a weak regulatory environment, and it appears that sound business management has taken a back seat. This is especially troubling when considering that executive compensation has been tied to hitting earnings targets. The seriousness of the SEC’s determinations cannot be understated. ...Now more than ever, it is time to create a regulator with sufficient and flexible authority to take the necessary action to ensure the safe and sound operation and management of these important housing enterprises. It will be the top priority for the Senate Banking Committee to pass a strong bill in the 109th Congress.” (*Press Release from the office of Senator Richard Shelby*, 12/16/04)

- House Financial Services Committee Chairman Michael G. Oxley (R-OH) said, “I am deeply disturbed that investors, the markets, and Congress were misled by deceptive practices at Fannie Mae. We intend to hold hearings early next year in Chairman Richard Baker’s Subcommittee and will continue to work toward sweeping legislative reform.” (*Press Release from the office of Representative Michael G. Oxley, 12/15/04*)
- House Financial Services Committee Ranking Democrat Barney Frank (D-MA) said, “The SEC’s finding that Fannie Mae used incorrect accounting is serious and disturbing. While these improper decisions by Fannie Mae do not threaten the financial soundness of the corporation, and should not be used by anyone in an effort to cut back on Fannie Mae’s housing efforts, they do reveal troubling deficiencies in its corporate governance. Given the role that public policy plays in Fannie’s Mae operation, it is essential not only that Fannie Mae immediately come into full compliance with accounting rules, but that the decision-making processes that led to these errors be thoroughly aired and corrected. Finally, to the extent that any executive compensation was enhanced as a result of inaccurate accounting, which led to the achievement of particular earnings targets, it must be repaid to the corporation.” (*Press Release from the office of Representative Barney Frank, 12/16/04*)
- In a December 16<sup>th</sup> letter, Representative Richard H. Baker asked the SEC’s chief accountant to broaden his review of Fannie Mae’s accounting practices to include years 1998-1999. Specifically, Baker asked the SEC to review Fannie Mae’s application of FAS 91 and the company’s decision to defer \$200 million in expenses from 1998 to 1999. Baker, who chairs the House subcommittee that oversees Fannie and other GSEs, said he wanted the SEC to review the 1998 transaction because the deferral of those expenses “allowed company executives to receive maximum bonuses under the enterprise’s employee incentive program. To date, neither OFHEO nor the Congress has received an adequate explanation for the deferral from company officials.” (*Dow Jones International News, Dawn Kopecki, 12/16/04; Letter from Representative Richard H. Baker to The Honorable William H. Donaldson, Chairman of the SEC, 12/16/04*)
- In his December 16<sup>th</sup> letter, Representative Baker requested that OFHEO Director Armando Falcon, Jr. provide an immediate determination of Fannie Mae’s capital adequacy. Baker also requested that OFHEO provide a report on Fannie Mae’s progress in fulfilling the agency’s prior order to increase its capital holdings by no less than 30%. Since Fannie Mae’s restatement will invalidate the earnings upon which millions of dollars of bonus payments to the company’s executives were predicated, Baker asked OFHEO to take action “to recapture all bonus payments from executives that were based upon faulty and deeply flawed earnings statements of the enterprise.” Baker concluded by commending OFHEO and its staff for its strong commitment to excellence and strong supervision for the housing GSEs. “But for the determined and professional work of OFHEO, investors, the markets and Congress would not have knowledge of the serious problems at Fannie Mae, which jeopardize

the national housing finance system,” said Baker. (*Letter from Representative Richard H. Baker to The Honorable Armando Falcon, Jr., Director of OFHEO, 12/16/04*)

OFHEO classifies Fannie as “significantly undercapitalized” for third quarter 2004

Fannie’s board acquiesces to OFHEO’s pressure to “ax” management, selects interim management and fires KPMG, its independent auditor

Public Company Accounting Oversight Board begins investigation of KPMG

Standard & Poor’s, Fitch and Moody’s reassess Fannie’s ratings

OFHEO classifies Fannie as “significantly undercapitalized” for third quarter 2004

- OFHEO Director Armando Falcon, Jr. classified Fannie Mae as “significantly undercapitalized” under the agency’s capital standards as of September 30, 2004 and directed the company to provide the agency a capital restoration plan to bring core capital into compliance with the minimum capital requirement plus a targeted surplus of 30% over the requirement level, as set forth under OFHEO’s regulatory agreement with the Board of September 27, 2004. OFHEO has the legal authority to take further actions against Fannie Mae if it appears unwilling or unable to correct itself, including the ability to restrict the GSE’s growth and activities and appoint a conservator, if necessary. (*OFHEO Press Release, 12/21/04; American Banker, Rob Blackwell, 12/22/04*)
  
- With Fannie Mae falling short of its minimum capital requirement by approximately \$3 billion, Wall Street analysts immediately became concerned that the company would suspend its dividend payments, at least temporarily, to shore up its capital. With OFHEO’s classifying Fannie as “significantly undercapitalized,” Fannie Mae must obtain approval from OFHEO to pay dividends, under provisions set forth in the GSE’s charter. On December 22, 2004, Fannie Mae received a letter from OFHEO which approved Fannie Mae’s payment of dividends on all series of Fannie Mae preferred stock due to be paid on December 31, 2004. In reaching its decision, OFHEO said that the December 31 dividend payment would enhance Fannie Mae’s ability to restore capital to minimum required levels, enhance the long-term safety and soundness of Fannie Mae, and was in the public interest. OFHEO said it is not prepared to issue an approval for subsequent periods and will continue to review dividend payment requests for each quarter based upon the facts and conditions existing at the time. In each case, OFHEO will assess the impact of Fannie’s dividend payments on the GSE’s safety and soundness, the impact on achievement and maintenance of appropriate capital levels, and the public interest. (*Market News International, 12/23/04; Dow Jones Capital Markets Report, Christine Richard and Allison Bisbey Colter, 12/22/04*)

Fannie's board acquiesces to OFHEO's pressure to "ax" management, hires interim management and fires KPMG, its external auditor

- A week after SEC's announcement that Fannie Mae's accounting did not comply with GAAP, Fannie Mae's board of directors finally acquiesced to pressure from OFHEO to force out its chairman and CEO Franklin Raines and CFO J. Timothy Howard. Raines fought hard to stay, pleading his case to board members that the company's auditor, KPMG, had approved the company's interpretation of the accounting rules and that the SEC had not found that senior management did anything improper. In what was described as a sometimes painful debate, Raines argued passionately that he had done nothing wrong, said sources. The board's delay in ousting Raines had some observers questioning whose interests the board had been favoring. "It's very difficult for the board to throw him out," said one lobbyist who has worked closely with the GSEs. "They've been struggling with not wanting to jettison one of their own." In the past, observers have questioned the "independence" of several of Fannie's non-management board members, who have close personal and professional ties to Raines that aren't fully disclosed in the company's securities filings. For example, Raines is an investor with director Fred Malek in the District of Columbia's bid to buy a professional baseball team and Fannie Mae is a generous contributor to the Aspen Institute, which director Ann Korologos used to run.
- After seeing media reports that members of the Fannie Mae board were continuing to support Raines, OFHEO decided to use its most powerful regulatory weapon –the declaration that Fannie Mae was "significantly undercapitalized" –to force significant changes in the enterprise's management and operations. Sources said that Falcon demanded management changes, holding Raines responsible for Fannie Mae's corporate culture that emphasized stable earnings at the expense of accurate financial disclosures. The regulator was determined to initiate a public proceeding to remove Raines if the board did not act, said sources. The board concluded that the cost of an all-out fight with OFHEO was too great, so Raines was told he would have to go. When the board shifted course and abandoned Raines, OFHEO Director Armando Falcon, Jr. issued a statement saying, "We are encouraged. The board's announcement signals a new culture and new direction for Fannie Mae."
- According to Fannie Mae's public statement, Raines has accepted early retirement and Howard has resigned from the company. The board has formally split the chairman and CEO positions by naming Stephen B. Ashley as its non-executive chairman, and Vice Chairman and Chief Operating Officer Daniel H. Mudd as interim chief executive. The board also named Executive Vice President Robert Levin as interim finance chief. Fannie Mae has hired executive search firm Spencer Stuart to assist the board in finding new management for the company and has dismissed auditor KPMG, which signed off on the GSE's questionable numbers. "Fannie Mae is a great company deeply committed to its mission of expanding the dream of homeownership to all Americans and serving the nation's housing needs," said Ann Korologos, the presiding director of the non-management members of the board. "We appreciate the many contributions of Frank Raines and Tim Howard,

their devotion to Fannie Mae and their commitment to its mission. Fannie Mae's Board of Directors takes these steps today to move the company forward to serve its critical mission in a safe and sound manner." Raines said in a statement, "I previously stated that I would hold myself accountable if the SEC determined that significant mistakes were made in the company's accounting. Although, to my knowledge, the company has always made good faith efforts to get its accounting right, the SEC has determined that mistakes were made. By my early retirement, I have held myself accountable."

- For Raines, early retirement at age 55 is "an inglorious end to a charmed career." One of seven children of a Seattle city worker and a Boeing mechanic, Raines earned degrees from Harvard College and its Law School, a Rhodes scholarship, and enjoyed a successful a career with investment banker Lazard Freres, until he became Fannie's vice-chairman in 1991. He served as President Clinton's head of OMB for two years and later returned to Fannie in 1998, where he became the first African-American CEO of a Fortune 500 company in 1999. His compensation in 2004, including \$3 million in stock options, totaled \$20 million. Despite his political acumen and the lobbying clout he built at Fannie, Raines severely misjudged and mishandled the current financial crisis. When sibling Freddie Mac revealed problems with its books in June, 2003, Raines insisted that Fannie was above reproach. His high-handed attitude and arrogance spurred OFHEO into conducting a "white-glove examination," wrote Mick McNamee in *BusinssWeek Online*.
- Arne Christenson, a former Fannie Mae executive and former top aide to then-Speaker of the House Newt Gingrich, said Raines will be difficult to replace. "The thing about Frank is, he had a blend of business acumen and political savvy that was uniquely helpful to Fannie Mae," said Christensen. "I'm sure he [Raines] would have preferred to have stayed, but things are the way they are," said R. Timothy Columbus, an attorney and friend of Raines. "He did what he had to do."
- In a written statement, Representative Eddie Bernice Johnson (D-TX) said, "Mr. Raines must be commended for the outstanding job he has done in leading Fannie Mae. He has helped Fannie Mae excel as a financial institution and has been a leader in pursuing goals set forth by Congress. It is with great pleasure that I acknowledge Franklin Raines achievements and express my great respect and appreciation for all you've accomplished in your long and outstanding career. ...I consider Frank Raines a close friend. I thank him for being a strong ally of the Congressional Black Caucus. I recognize him for his many years of service to this Nation. I wish him health, happiness and personal fulfillment in his future endeavors."
- Sarah Teslik, former head of the Council of Institutional Investors views Fannie Mae's circumstances differently, saying Raines and Fannie Mae "have been so arrogant, not just to shareholders but so arrogant in Washington, that it's kind of a well-deserved comeuppance."

- “Nobody takes pleasure in the misfortune of others, but we can be grateful that none of the terrible activities disclosed to date has had any negative consequences on the taxpayers or the housing market,” said Representative Richard Baker (R-LA). “Given the unbelievable statements Fannie executives made at our last hearing, this action was entirely necessary.” Baker said the board now needs to move quickly to reform Fannie Mae, which too often has relied on powerful lobbyists to keep regulators from real oversight. “Moving forward, I hope Fannie’s board will take a long, hard look at changing the corporate culture to one that makes a greater effort at managing financial risk than it does at fighting political risk,” said Baker.
- Peter Flaherty, president of the National Legal and Policy Center (NLPC), applauded the “retirement” of Fannie Mae Chairman and CEO Franklin D. Raines. Flaherty said, “Raines’ departure is overdue. Accounting tricks are not substitutes for sound management. Fannie Mae needs someone at the helm who, first and foremost, can restore the credibility of the company.” Flaherty also announced that NLPC will file a shareholder proposal to end Fannie Mae’s support of Jesse Jackson through the Fannie Mae Foundation. Flaherty said, “Raines made the mistake of politicizing Fannie Mae. Bankrolling Jesse Jackson does little to advance Fannie Mae’s fortunes on Capitol Hill or with the public. Ending Fannie Mae’s support of Jesse Jackson is an important step in sweeping away Raines’ failed legacy.” (*International Herald Tribune*, Stephen Labaton, 12/23/04; *Financial Times*, Jenny Wiggins, 12/22/04; *Washington Post*, David S. Hilzenrath, 12/22/04; *USA Today*, Greg Farrell, 12/22/04; *TheStreet.com*, TSC Staff, 12/22/04, *BusinessWeek Online*, Mike McNamee, 12/22/04; *Market News International*, Claudia Hirsch, 12/22/04; *Times Picayune*, Bruce Alpert and Bill Walsh, 12/26/04; *Press Release from the office of Representative Eddie Bernice*, 12/22/04; *U.S. Newswire*, 12/22/04; *Dow Jones International News*, Dawn Kopecki, 12/17/04)

#### Public Company Accounting Oversight Board begins investigation of KPMG

- The Public Company Accounting Oversight Board (PCAOB), which regulates auditors of listed companies, has authorized its staff to scrutinize KPMG’s auditing work at Fannie Mae to determine if the firm breached auditing rules. KPMG, which became Fannie’s auditor in 1969, signed off on the company’s financial statements over the fiscal years 2001-2003 and first and second quarter 10Qs for 2004. KPMG said that it accepted the SEC’s findings on FAS 133 and Fannie Mae’s decision to follow the SEC’s directions with respect to prior financial reports. “It should have a jarring effect on KPMG, but the quiet undertone shared by all of the Big Four accounting firms is, ‘this too shall pass,’” said Allan D. Koltin, president of PDI Global Inc., a Chicago-based consulting firm that works with large accounting firms. (*Financial Times*, Andrew Parker and Jenny Wiggins, 12/17/04; *New York Times*, Eric Dash, 12/17/04)

## Standard & Poor's, Fitch and Moody's reassess Fannie's ratings

- On December 23, Standard & Poor's Governance Services said that its corporate governance score of CGS-9 on Fannie Mae remains on GovernanceWatch with negative implications, pending discussions with the company and receipt of more information about recent events. These events include the SEC's determination last week that Fannie Mae did not comply with accounting rules and must restate four years of financial results; the departures of CEO Franklin Raines and CFO Tim Howard; and the dismissal of KPMG as Fannie Mae's auditor. S&P expects the GovernanceWatch to be resolved as additional information becomes available. The rating agency will seek information about the board's recent deliberations; its search for a new auditor and for new management; and about severance arrangements for departing executives. The SEC, Department of Justice, and internal board investigations continue, and the GovernanceWatch will reflect the progress of these investigations as well.
- On December 16, S&P said it may still cut the subordinated debt ratings for Fannie Mae unless it rebuilds regulatory capital, overhauls internal management controls, and shows evidence of continuing to comply with its agreements with OFHEO. S&P, which cut Fannie Mae's subordinated debt and preferred stock ratings by one notch in September, said it will take up to three months to determine whether to cut the ratings. (*The Main Wire*, 12/23/04; *Reuters*, 12/16/04)
- On December 23, Fitch Ratings lowered its credit ratings on Fannie Mae's preferred stock, amid concern that the company might be unable to pay dividends next year because of its pending financial restatement. The downgrade affects approximately \$4 billion of preferred stock. Fitch also dropped Fannie's preferred stock ratings one notch to A+, and said they could be downgraded "materially" if OFHEO forces the company to stop paying dividends. The ratings agency said it believed ongoing investigations into Fannie may uncover "additional accounting deficiencies." Fannie's AAA senior unsecured debt rating was unaffected by Fitch's actions on December 23. (*Financial Times*, Jenny Wiggins, 12/24/04)
- On December 23, Moody's Investors Service affirmed Fannie Mae's Aaa senior unsecured debt rating and its Prime-1 rating for short-term debt, but said it could cut some of the company's other ratings. The A-Bank Financial Strength Rating remains under review for possible downgrade and the subordinated debt and preferred stock ratings of Aa2 and Aa3, respectively, have been placed on review for possible downgrade, said Moody's. The downgrade review reflects OFHEO's determination that Fannie Mae is significantly undercapitalized, as well as uncertainty regarding internal control and governance-related matters, said Moody's. "With this finding, Fannie Mae's ability to pay dividends on its preferred stock will be subject to prior approval by OFHEO," the agency said. While Moody's expects that OFHEO will approve dividend payment and these non-cumulative dividends will not be interrupted, Fannie Mae's exposure to this risk is suggestive of financial flexibility

inconsistent with the Aa rating category for junior securities and the A-bank financial strength rating, the agency said.

- Fannie Mae appointment of John K. Wulff to fill the unexpired term of Anne Mulcahy has prompted some questions about conflicts of interest, since Wulff sits on the board of Moody's Corp. A Moody's spokeswoman said "Our board of directors is not involved in our professional ratings practice in any way, shape or form. Board members learn what the ratings are at exactly the same time of that the public does." (*Reuters News*, 12/23/04; *American Banker*, Rob Blackwell, Damian Paletta, and Hannah Bergman, 12/13/04)

<p>As initial step in its capital restoration plan, Fannie sells \$5 billion of preferred stock in a private placement</p>
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- On December 29, Fannie Mae sold \$5 billion of preferred stock through a private placement to 50 qualified institutional investors. Fannie's 144a offering consisted of two types of preferred stock—a \$2.5 billion issue with a coupon of 5.375%, which is convertible into common stock at a price of \$94.31 and a \$2.5 billion issue with an initial coupon of 7% that resets quarterly at the higher of 7% or 237.5 basis points over the 10-year Treasury. The company's preferred stock sale was a key component of Fannie's plan to shore up its capital position in the wake of OFHEO's declaration that the enterprise was "significantly undercapitalized" at September 30, 2004. OFHEO is working closely with Fannie director Donald B. Marron, a former investment banking executive who is overseeing the company's capital raising efforts. "This placement of preferred stock is a key component of Fannie Mae's capital restoration plan," said Marron. "Working with our safety and soundness regulator OFHEO, we will be finalizing the details of the capital plan shortly."
- While the preferred stock proceeds will more than cover Fannie's capital shortfall, OFHEO has imposed a 30% increase in Fannie's capital requirements on June 30, 2005, which will require the GSE to raise at least another \$7 billion over the next six months to meet the higher minimum, based upon its September levels. It is unknown where Fannie Mae will raise capital by cutting or suspending dividend payments to cover its capital shortfall or by selling loans in its portfolio in an effort to lower its minimum capital requirement. Some analyst doubt whether Fannie Mae realistically can raise enough capital to meet the new minimum requirement in the time allowed. Other market analysts say Fannie Mae may resolve its capital shortfall through the liquidation of a portion its mortgage portfolio, sales of additional preferred stock, issuance of subordinated debt, limiting the growth of the portfolio and not re-investing mortgage runoffs.
- It is also unclear whether Fannie's preferred stock sale will improve the outlook for the company's credit ratings so long as its dividend payments remain in doubt. The ratings agencies are expected to weigh in on the preferred stock sale the first week of January.

- Fannie Mae’s common shareholders are footing “most of the bill” for the company’s efforts to raise capital. Equity analysts have been adjusting their earnings forecasts for Fannie to reflect the cost of the preferred dividends and the possible dilutive impact of the convertible tranche. Smith Barney has cut its forecast for Fannie Mae’s 2005 earnings to \$6.83 a share from \$7.15 a share and its forecast for the company’s 2006 earnings to \$7.48 a share from \$7.80 a share. In a research note, Smith Barney’s analysts said they expect Fannie will also have to sell approximately \$47 billion of assets, which are not reflected in their earnings estimates. Friedman Billings analysts said they expect dividend payments on Fannie’s preferred shares will dilute the earnings of the common stock by 23 cents per share; they declined to adjust their earnings estimates until they get further guidance from Fannie. Merrill Lynch lowered its estimate for Fannie’s 2005 earnings to \$6.87 a share, based upon the assumption that the company raises \$2.8 billion of capital through the suspension of dividend payments for the first half of 2005 and \$3 billion through the issuance of common shares. “Equity holders, in my view, are dead in the water. There’s no growth coming in 2005. All of 2005 is going to be devoted to building their capital,” said Edwin Groshans, vice president and senior mortgage finance analyst at Fox-Pitt Kelton.
- Sharp gains during the first day of trading of Fannie’s new preferred shares raised questions on Wall Street whether the company had managed the deal as efficiently as it could have. Problems with the offering were likely exacerbated by the fact that Fannie used just one manager, Lehman Brothers Holdings Inc., for the huge issue, some competitors griped. “I know it’s a panic-button fire sale,” said one market participant, but the price Fannie paid “seems exorbitant.” As a GSE, “they’ve got an obligation to shareholders and the public to do something correct[ly],” he added. (*Dow Jones Newswire*, Allison Bisbey Colter, 12/30/04; *Washington Post*, Terence O’Hara, 12/30/04; *Wall Street Journal*, John D. McKinnon and Jonathan Weil, 12/30/04; *Wall Street Journal*, John D. McKinnon and Gregory Zuckerman, 12/31/04; *Fannie Mae Press Release*, 12/29/04; *Market News International*, Isobel Kennedy, 12/22/04; Reuters News, Mark Felsenthal, 12/16/04)

SEC begins probe of violations of Sarbanes Oxley by Fannie’s former management

OFHEO begins investigation of bonuses and severance pay to Raines and Howard

Raines leaves Fannie Mae with a *minimum* \$24.2 million severance package

*LA Times* decries the “outrageous fortunes” of Franklin Raines

“Book ‘em, Danno”

### SEC begins probe of violations of Sarbanes Oxley by Fannie's former management

- Now that the SEC's chief accountant has ruled on Fannie Mae's accounting practices, the SEC will focus more sharply on the reasons for the violations and the conduct of the company's top executives, said lawyers involved in the GSE's investigation. The SEC will investigate possible violations of the Sarbanes-Oxley Act of 2002 by Fannie Mae's former senior management and will determine whether Franklin Raines, former chief executive, and Timothy Howard, former chief financial officer, infringed the legislation's requirements to certify the accuracy of its accounts for fiscal years 2002 and 2003. Infringements of the certification requirements in Sarbanes-Oxley can lead to criminal as well as civil penalties. Executives who willfully sign off on faulty financial reports knowing that they are incorrect could be sentenced to up to 20 years in prison and fined up to \$5 million. Another provision of the law allows corporate boards of directors to seize the bonuses and stock profits of CEOs and CFOs whose companies restate financial results because of "misconduct." If the Department of Justice or the SEC investigations turn up evidence against Raines or Howard, they could be subject to both measures, said legal experts. During FY2003, Raines received a \$4.2 million bonus and stock options valued at \$3 million, while Howard received a \$1.2 million bonus and options worth \$2.35 million. Democratic and Republican lawmakers have demanded that Fannie Mae's former executives return the millions of dollars in bonuses and other compensation that they earned on inaccurate financial statements issued over the FY2001-FY2003 period.
- A federal judge in Birmingham, AL recently upheld the constitutionality of executive certifications under Sarbanes Oxley, rejecting an argument by HealthSouth founder Richard M. Scrushy that the law was so vaguely worded that it failed to put defendants on notice about how they might break the law. Legal experts argue that the bonus forfeiture language in Sarbanes Oxley raises questions about the definition of "misconduct" and whether it would make top executives responsible for the actions of subordinates. The provision appears to apply to Fannie Mae starting in 2003, when the company first filed stock registration documents with the SEC. (*Financial Times*, Andrew Parker and Jenny Wiggins, 12/23/04; *Washington Post*, Carrie Johnson, 12/20/04; *New York Times*, Stephen Labaton, 12/17/04)

### OFHEO begins investigation of bonuses and severance pay to Raines and Howard

- OFHEO is reviewing the lucrative severance packages approved by Fannie Mae's board for ousted CEO Franklin Raines and CFO Timothy Howard and will seek recovery if it determines that the two executives were "unjustly enriched." OFHEO spokeswoman Stefanie Mullin said, "The terms are under review." At the behest of OFEHO, Fannie Mae's board dismissed Raines and Howard after the SEC ruled that the company violated accounting rules and should restate its earnings through 2001. The board announced that it allowed Raines to retire and Howard to resign with generous severance packages. By failing to terminate Raines and Howard outright,

Fannie's board is allowing the executives to presumably walk away with millions in salary, bonuses, stock options, restricted stock and other compensation. OFHEO, which urged the board to fire both men outright and deny lucrative payouts, is expected to pursue formal action against Fannie and its ousted executives to have them terminated, said people familiar with the situation.

- However, OFHEO does not have the same authority as other financial regulators to remove executives from companies if misconduct is found. To strengthen its hand, OFHEO forced the board in recent months to amend the employment agreements of Raines, Howard and COO (and now interim CEO) Daniel Mudd to make it easier for the board to fire them. Without the board's cooperation, the matter now falls to OFHEO. In late August, a federal judge ruled that Congress gave OFHEO limited authority to suspend employees or freeze executive pay through temporary cease-and-desist orders "only under certain narrow circumstances." Former Freddie Mac CEO Leland Brendsel prevailed in his lawsuit against OFHEO for the agency's withholding of nearly \$60 million in his compensation when Freddie forced him to retire in June 2003 amid the company's accounting scandal. In Brendsel's case, Judge Richard Leon ruled that OFHEO can only issue temporary cease-and-desist orders if it can prove the executive's conduct or violation is "likely to" cause insolvency, deplete core capital or cause some other irreparable harm to the company. In contrast, other bank regulators generally have to prove only that the institution or employee violated a law or regulation. OFHEO might have a firm legal argument to change the termination provisions for Raines and Howard based on the agency's recent classifying Fannie Mae "significantly undercapitalized" for the third quarter of 2004. (*Dow Jones International News*, Dawn Kopecki, 12/22/04)

#### Raines leaves Fannie Mae with a *minimum* \$24.2 million severance package

- Fannie Mae disclosed that former chairman and CEO Franklin Raines is leaving the company with a severance package valued at approximately \$24.2 million, which *excludes* Raines' \$1.4 million annual salary for life; another \$21 million in accelerated stock; potential future stock payouts valued at up to \$34.6 million; and an undisclosed amount of 401(k) benefits. Raines, who contends that his effective retirement date is June 2005, will collect an additional \$600,000 in salary, receive a boost in his pension payment, and benefit from further vesting of stock options, if he prevails in arbitration with the company on this claim. Fannie Mae says that its board waived Raines' contractual requirement that he give six months notice before retiring. His attorney Robert B. Barnett, a partner at Williams & Connolly LLP, said "Mr. Raines believes that he and the company should follow the exact terms of the contract as written and as specifically approved by OFHEO." Fannie Mae has agreed to maintain a \$5 million life insurance policy for Raines, who turns 56 in January, through age 60, and \$2.5 million of insurance coverage thereafter. The company will also provide Raines, his wife, and dependent children full medical and dental benefits for life.

- CFO Timothy Howard, who resigned effective January 31, will receive a minimum severance package valued at approximately \$12 million. Fannie Mae did not include in its severance valuation Howard's \$433,000 annual salary; another \$15.3 million in an accelerated stock payout that he has already earned; potential stock payouts valued at up to \$6.4 million; and an undisclosed amount of 401(k) benefits. Howard will receive \$84,000 in salary through January. Fannie Mae has also agreed to maintain a \$2 million life insurance policy for Howard until January 2009 and \$1 million coverage thereafter. The company will also provide him and his spouse full medical and dental benefits for the rest of their lives.
- In an SEC filing which disclosed the former executives severance packages, Fannie Mae said that Raines and Howard believe they are entitled to the full termination benefits and that any disputes regarding these benefits would be settled through arbitration. OFHEO has yet to approve the termination agreements. Since the regulatory agency has limited statutory authority in disputes over executive pay, OFHEO will only be able to take legal action against Fannie Mae or its executives, if the Justice Department decides to press the case. (*Washington Post*, Terence O'Hara, 12/28/04; *Reuters*, 12/27/04; *Dow Jones Business News*, Dawn Kopecki, 12/27/04)
- Representative Richard Baker (R-LA), chairman of a House Financial Services subcommittee, said that more than \$200 million of bonuses doled out to top Fannie Mae executives could be subject to disgorgement if an SEC probe finds that they were wrongly granted. "Were misrepresentations of financial statements utilized to earn these bonuses?" Baker asked in an interview. "If there's a finding of fault [with Raines' and Howard's actions], their compensation benefits would be minimized or eliminated." Baker said he plans to introduce legislation next year to create a strong new regulator of GSEs. One problem with the current regulatory structure, he said, is that OFHEO doesn't have full authority to rescind severance packages. After an accounting scandal led to management departures at Freddie Mac last year, OFHEO tried to clip the lucrative payouts awarded to those executives, but so far has failed in its attempts. OFHEO "does not have clear [legal] authority over this," said Baker. (*USA Today*, Greg Ferrell, 12/23/04)
- Representative Barney Frank (D-MA.), Ranking Democrat of the House Financial Services Committee, said "To the extent that any executive compensation was enhanced as a result of inaccurate accounting ... it must be repaid to the corporation." Frank also added, Raines' severance "is excessive and really extremely inappropriate, given the circumstances of his leaving, so I would call on Fannie Mae and Raines both to renegotiate that. If Frank Raines takes all that, he's wrong. That kind of mistake and the problems that they've been through should not be so generously rewarded." (*Washington Post*, David S. Hilzenrath, 12/23/04; *Reuters*, News, Mark Felsenthal, 12/16/04)
- Corporate governance experts also criticized Fannie's directors. "I'm disappointed that the board permitted him to take an early retirement," said Nell Minow, editor of The Corporate Library, a watchdog group. "Instead of focusing on making him give

money back, they instead seemed to focus on giving him more money.” Minow noted that Fannie’s board revamped Raines’ employment contract several times in recent months, as if preparing for his imminent departure. “The severance payments are just outrageous,” said Elliot Schwartz, director of research at the Council of Institutional Investors, a corporate governance group comprised of pension funds. “Once the guy is leaving, you don’t need to give them incentives any more.” (*USA Today*, Greg Ferrell, 12/23/04; *Knight Ridder/Tribune Business News*, 12/29/04)

- James B. Stewart writes in the *Wall Street Journal*, “After pledging before Congress to hold himself personally accountable for any accounting errors, news reports suggest [that Franklin Raines] embarked on a strenuous campaign to save his own job, huge salary and perks. Even after the [SEC] faulted the accounting and said Fannie Mae had misstated \$9 billion in profits, Mr. Raines was maneuvering with Fannie’s board to delay his departure in order to maximize his benefits, which include an astonishing \$1.4 million-a-year pension for life, not to mention a multimillion-dollar array of other goodies. Mr. Raines already is immensely wealthy; he earned more than \$17 million from Fannie Mae in 2002 alone. I’m sorry, but harvesting a massive payoff for \$9 billion in accounting irregularities doesn’t constitute accepting responsibility for the errors. This is all beginning to smell like the Richard Grasso pay and severance scandal at the New York Stock Exchange, with the massive payouts and cozy relationships between management and directors. There, too, a quasipublic institution lavished unseemly benefits on its top officer and is still embroiled in litigation and reform efforts meant to regain public trust.” (*Wall Street Journal*, James B. Stewart, 12/29/04)
- On *Slate.com*, Mikey Kaus writes that Franklin Raines, the “Rhodes scholar, Harvard Law, Lazard Freres, potential future Treasury secretary, etc.--has blotted his copybook at Fannie Mae. ...But unlike other semi-disgraced executives, Raines has a chance to redeem himself. How? By giving back the absurdly plush retirement package (\$1.4 million a year plus stock options worth an estimated \$16 million or so, according to *WaPo*) he’ll get for leading his taxpayer-aided company to a possible \$9 billion accounting loss. I think that if Raines gave it back--gave it all back--it would be such a dramatic, atypical gesture he might become something of a folk hero, turning a defeat into a PR victory. It’s not as if Raines and his family would starve if he gave up the millions--he’d still have the absurdly plush pay packages he received in prior years (e.g. \$10.9 million in 2001). But he’d salvage his political future, which you have to believe is important to him (no matter what his buddies say)... Which will it be: his money or his career? ... He’s thinking! (*Slate.com*, Mickey Kaus, 12/25/04)

#### LA Times decries the “outrageous fortunes” of Franklin Raines

- In its December 29 editorial, *The Los Angeles Times* wrote, “Two top executives at Fannie Mae deserved to be shown the door, but Fannie Mae’s directors shouldn’t have held it open while the pair made their escape pushing wheelbarrows loaded with severance pay and stock options. ...Fortunately, Fannie Mae’s no-longer-toothless

regulator, [OFHEO], has ordered that the checks not be cut until a comprehensive review is completed.”

- “Even in this post-Enron era of supposed corporate accountability, the impunity of the imperial executive lives on. Raines should have been dismissed, and the company’s board should be finding ways to make him give back some of his past pay, rather than treating him as if he were retiring in good stead. Some good will come from the growing political firestorm sparked by Fannie Mae’s accounting scandal, namely a push to subject Fannie Mae and sibling Freddie Mac to the same level of rigorous regulatory control as their truly private competitors in the home mortgage industry.”
- “Coming on the heels of the Sarbanes-Oxley law, which is supposed to hold corporate chieftains accountable, the decision by Fannie Mae’s board to allow Raines to retire would be shocking at any publicly traded company. For it to happen at a company that has profited so mightily over the years from its taxpayer backing only heightens our outrage. Shareholders and taxpayers alike must now ask whether the board has met its fiduciary duties. It is allowing Raines to claim \$8.7 million in deferred compensation, along with potentially lucrative stock options and a \$1.4-million-a-year pension. Howard could cash in stock options now valued at \$4.4 million and collect a \$432,000 yearly pension. That’s on top of salary and incentives that Fannie Mae paid them between 2001 and 2003.”
- “Raines’ last bit of creative accounting came on December 21, when he resigned with the acknowledgment that he was to be held responsible for ‘mistakes’ in Fannie Mae’s accounting. Then, with a straight face, he delivered the punch line: ‘By my early retirement, I have held myself accountable.’” (*Los Angeles Times*, 12/29/04)

#### “Book ‘em, Danno”

- In a January 2, editorial, the *New York Post* writes, “This sounds like nice work, if you can get it. Help lose nearly \$9 billion. Get ‘fired.’ Walk away with a golden-parachute package of \$26 million plus a monthly pension of \$116,300. And fully paid health and dental insurance — for life.”
- “As papers filed with the [SEC] last week show, the man in question with the sweetheart deal is Franklin Raines — now-departed CEO of Fannie Mae, the public-private non-banking entity that is America’s primary mortgage lender. Once upon a time a fully federal agency, it enjoys a special status in the lending community because of a unique line of credit at the Treasury Department. However, the company’s primary regulator, [OFHEO], recently found accounting irregularities that would wipe out the company’s \$9 billion profit reported since 2001. Despite this record, last year alone Raines pocketed \$20 million in salary, bonuses and stock. To keep the regulators at bay, Raines and his chief financial officer, Timothy Howard, were permitted to “retire.” Howard walks away with a relatively modest \$13.1 million compensation package. Given Raines’ political pedigree — he was the head

of Bill Clinton's Office of Management and Budget — perhaps neither the fiscal shenanigans nor the retirement deal should surprise.”

- “Fannie Mae’s board approved this outrageous package with various deferred compensation and stock options — even as SEC regulators warned that the top executives shouldn’t receive any bonuses. Recall former NYSE head honcho Richard Grasso’s controversial \$200 million bailout deal: The attempt to scuttle that deal is still a matter of litigation that involves Grasso’s successor, the SEC, state Attorney General Eliot Spitzer and goodness knows how many lawyers. The common-sense judgment was that the compensation was excessive. But there was never a question raised about Grasso’s integrity or competence. Indeed, under his stewardship, the NYSE thrived. Raines fails that test on both counts.”
- “While the inquiry into the financial hijinks continues — Congress and the Justice Department are also investigating — further payments to Raines and Howard must be blocked. For that matter, given behavior that most charitably can be described as incompetent, the real question is whether Raines or Howard are due any compensation at all. Or whether they belong behind bars.” (*New York Post*, 01/02/05)

Just the tip of the iceberg at Fannie Mae
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- In the short term, Fannie Mae faces numerous challenges that could damage its earnings: an expensive and time-consuming financial restatement for FY2001 through FY2004, which it has estimated could lower its earnings by some \$9 billion; the replacement of its management team; the hiring of a new accountant to replace its long-time auditor, KPMG, which will scrub the company’s books when it re-audits prior periods; and the reconstruction of its accounting systems and internal financial controls. The company also remains subject to an investigation by the SEC’s enforcement division; a criminal investigation by the Department of Justice; an ongoing special examination by OFHEO; an internal investigation of the company’s accounting, board oversight and management responsibilities, and executive compensation led by Senator Warren Rudman; and class action lawsuits from shareholders. Josh Rosner, an analyst with Medley Advisors, said, “It is important to consider that there is not likely to be a ‘global settlement’ of Fannie’s outstanding problems. It will likely be years before the company has current financial statements.”
- Investors fear that the accounting problems identified by OFHEO may be the tip of the iceberg, and that management may not have grasped the risks inherent in Fannie’s enormous mortgage and derivatives portfolios. “Once they push the key people aside, I do believe there’s going to be more irregularity that’s going to surface,” says Lance Pan, director of credit research at Capital Advisors Group. “Given the ongoing political scrutiny of the GSEs, the stakes are incredibly high for the auditors,” wrote Morgan Stanley analyst Kenneth Posner. “They can’t afford to make mistakes.” Auditing specialists say Fannie Mae’s new auditors could take as long as two years to

complete their audits, given the complexity and size of the company's financial reports.

- Perhaps a portent of things to come, Fannie Mae disclosed in an SEC filing on December 28 that KPMG found problems in the way Fannie Mae was compiling its financial results as recently as the quarter ended September 30. KPMG “observed deficiencies” in the way that Fannie Mae closed its accounting records for the third quarter, which resulted in the company making “post-closing entries” to address the auditor’s concerns. The accounting firm also cited “strong indicators of material weaknesses” in Fannie Mae’s internal controls. Subsequently, the company’s board has fired KPMG and has begun a search for a new auditor. (*Financial Times*, Andrew Parker and Jenny Wiggins, 12/23/04; *American Banker*, Jody Shenn, 12/23/04; *Wall Street Journal*, James R. Hagerty, John R. Wilke and Jonathan Weil, 12/22/04; *New York Times*, Timothy L. O’Brien, 12/23/04; *Washington Post*, David S. Hilzenrath, 12/29/04; *American Banker*, Rob Blackwell, 12/22/04)

### **Newspaper editorial boards speak out on Fannie Mae’s scandal:**

*Washington Post*: “Brazen”

*New York Times*: “Fannie Mayday”

*Los Angeles Times*: “Whoa, Fannie Mae”

*Wall Street Journal*: “Fannie the Centaur”

*Investors Business Daily*: “Fannie Mae Is Just Iceberg’s Tip”

*Houston Chronicle*: “Fannie Mayhem”

*Seattle Times*: “Disaster of Dough at Fannie Mae”

*Washington Times*: “Another Blow for Fannie Mae”

*Kansas City Star*: “Scandals Invite Scrutiny of Finances”

*Worcester Telegram & Gazette*: “More Enrons?”

*Pittsburg Post-Gazette*: “Fannie Saved”

*St. Petersburg Times*: “Trouble for Fannie Mae”

*South Florida Sun-Sentinel*: “Don’t Close Books on Mess”

*Raleigh News and Observer*: “A Giant’s Stumble”

Washington Post: “Brazen”

- In its December 17<sup>th</sup> editorial titled “Brazen,” the *Washington Post* wrote, “Bosses at [Fannie Mae] ...formed their own opinion of what an accounting rule should say. They did this not merely before the rule in question went into effect -- but afterward. This arrogance is almost as stunning as the \$9 billion overstatement of profits that resulted. Fannie’s top managers looked at the federal rule on accounting for futures, swaps and other such financial instruments, and they decided they didn’t agree with it. They requested permission from regulators to go their own way, and when this was denied they went their own way anyhow. They behaved like a passenger who sees a ‘No Smoking’ sign, checks with the conductor that the sign means what it says, and then nonchalantly lights up.”
- “...For a long time, critics have raised questions about Fannie’s financial soundness, and Fannie has fired back with firm denials. It was hard to know whom to believe. In September a devastating report on Fannie put the lender on the defensive. But Fannie’s chief executive, Franklin D. Raines, continued to raise the complexity defense, saying that the accounting weaknesses identified in the report were a matter of interpretation. Now the chief accountant of the [SEC] has ruled that the report was right and that Fannie had violated accounting standards, overstating its profit by 38 percent since January 2001. Tough consequences will follow: The Justice Department is pursuing a criminal investigation; the SEC is pursuing a civil one; the House promises hearings; and class-action lawsuits are in the works. The price of Fannie’s accounting hubris is going to be significant.”
- “But the most important response to Fannie Mae’s humiliation goes beyond punishment of individuals. Fannie Mae is the second-biggest financial institution in the country, and its collapse could destabilize financial markets and damage the economy. The September report raised a question about ‘the overall safety and soundness of the enterprise,’ suggesting that a collapse is alarmingly conceivable. Federal oversight of Fannie has traditionally been light, not least because of the lender’s clout in Congress. It is time to invigorate it.” (*Washington Post*, 12/17/04)

New York Times: “Fannie Mayday”

- In its December 23 editorial, the *New York Times* sees the Fannie Mae through Wall Street’s glasses and writes, “Perhaps the most surprising thing about the recent bad news at Fannie Mae is that investors greeted it with a yawn. Citing accounting improprieties, the [SEC] has ordered Fannie Mae ...to make accounting corrections that are likely to wipe out about a third of its reported profits since 2001: some \$9 billion. The Justice Department is also investigating allegations of accounting misdeeds. On Tuesday, the company’s chief executive officer and the chief financial officer stepped down. Yet Fannie Mae’s stock closed yesterday at nearly \$72 a share, higher than it was before the SEC’s bombshell last week, and its debt securities have held steady. Clearly, investors are drawing the right conclusion, at least for now: the

problems at Fannie Mae are more political than economic. The accounting restatement, enormous as it is, may in fact be recouped by subsequent accounting entries. And the departure of the top executives will probably improve Fannie Mae's infamous arrogance and the outside-the-rules exceptionalism it spawned."

- "Politically, however, the threat lingers. Fannie Mae's detractors in the banking industry and their allies in Congress will undoubtedly use the current problems to press for legal and regulatory changes that may not merely strengthen the oversight of Fannie Mae, a necessary step, but could in fact weaken the company by removing some or all of the government benefits it now enjoys. ...Stripping away those advantages or restricting them would be a victory for large banks that have long bristled at the competitive advantages inherent in Fannie Mae's special status. It would also be a victory for lawmakers who believe that unfettered private-sector competition is a better way to meet human and social needs than government involvement in areas like housing."
- "But it would be a loss for home buyers, who benefit from the downward pressure Fannie Mae exerts on mortgage rates. And it would be especially hard for low- and middle-income families and the generally urban communities where they live, where Fannie Mae has been a haven for those commonly shut out of the mortgage market. It's hard to believe that banks want anything really significant to do with the lower-income end of the mortgage business when they are already trying to kill the law that requires them to invest in needy communities."
- "It is impossible to say whether investigators will uncover more mistakes and misdeeds at Fannie Mae and how such a finding might reverberate throughout the financial markets. But it's already clear that opponents of Fannie Mae see this as a chance to pursue a longstanding agenda. Fannie Mae's supporters -- in Congress and elsewhere -- must deal with the company's failings, but at the same time not abandon its defense in what is sure to be a pitched battle." (*New York Times*, 12/23/04)

Los Angeles Times: "Whoa, Fannie Mae

- In a December 17 editorial, the *LA Times* wrote, "The Feds are on to Fannie Mae. The giant mortgage finance company now stands accused by the [SEC] of playing fast and loose with accounting standards and could be forced to book \$9 billion in losses on derivatives trading. This embarrassment finally could embolden Washington to put an end to an even bigger scam -- the implicit subsidy Fannie Mae gets from taxpayers. For starters, Congress can now be expected to create a new regulatory agency capable of riding herd on this company -- and its sibling Freddie Mac -- which has strayed from its mission of lowering homeownership costs. That will mean standing up to Fannie Mae's powerful lobbyists."
- "...Fannie Mae and Freddie Mac helped lower borrowing costs for potential homeowners over the decades, but in today's competitive and highly liquid financial marketplace their role as privately owned but publicly favored entities hardly makes

sense. Even though the companies were sold to private investors years ago, they continue to benefit financially from special tax benefits, looser capital requirements and low borrowing costs. That unfair edge must end.”

- “...The SEC has now given the Bush administration and a growing cadre of congressional critics the ammunition needed to tighten regulation of Fannie and Freddie, so that they are overseen to the same degree that banks are, while cutting them loose from their quasi-public moorings. Taxpayers have a strong interest in seeing this happen. The reason Fannie and Freddie enjoy lower borrowing costs ... is the widespread belief among investors that Uncle Sam won't let either institution fail. If that were to happen, taxpayers, not company shareholders, would be on the hook for a costly savings-and-loan-style bailout.” (*Los Angeles Times*, 12/17/04)

Wall Street Journal: “Fannie the Centaur”

- In its December 17<sup>th</sup> editorial, the *Wall Street Journal* wrote, “In Greek mythology, the Centaur was a monster with the head of a man but the body of a horse. In today's financial system, the Centaurs are Fannie Mae and Freddie Mac, the mortgage giants that are half-public, half-private. Understanding their half-man, half-beast nature is crucial to fixing these two behemoths in the wake of their recent financial scandals. The latest haymaker hit Fannie this week, when the SEC's chief accountant found it had violated accounting rules and that it must restate its earnings to include \$9 billion in losses over four years. ... The SEC judgment reinforces the earlier finding by Fannie's main regulator, [OFHEO], which Fannie executives had resisted with great disdain.”
- “...In any normal company, the CEO running this show would have been sacked long ago. Even at Freddie, the board fired two CEOs and several top executives when its accounting foulups were discovered in 2003. Had Messrs. Raines and Howard repented and pledged reform after the OFHEO report, they might have earned a reprieve. But they resisted instead, betting that their pals in Congress and a John Kerry victory would save them from further scrutiny, and that the SEC would provide an escape route. In poker terms, they went all-in and lost.”
- “...Fannie has long used its political clout to avoid holding as much capital as other financial companies its size. But now the company may have to sell some of its mortgage portfolio to raise capital, and certainly its earnings will take a hit. Given the subsidy it gets from government in the form of an implied bailout guarantee, this is the least Fannie can do to protect taxpayers.”
- “This fiasco also strengthens the hand of those in Congress, the Bush Administration and the Federal Reserve who want to rein in the two mortgage giants. Between them, Fannie and Freddie hold or guarantee about half of the country's \$8 trillion in residential mortgages. That's a huge amount of housing risk to place in just two companies, especially when everyone believes the taxpayer will rescue them if they get in trouble. For years they have resisted more supervision, but now even a

successor to Mr. Raines would have little choice but to cooperate and try to mold any reform.”

- “Which brings us to their half-man, half-beast nature. The roots of the current problem go back to 1992, when OFHEO was created and Fannie and Freddie’s capital requirements were set so low. Able to borrow at below-market rates because of their government guarantee, the two companies expanded into new markets and grew like Microsoft. That growth resulted in huge profits for shareholders, . . . executives [and Wall Street], but at the cost of ever-more-public risk to taxpayers. This game of public risk but private profit is what needs to be stopped.”
- “At a minimum, any reform has to impose a regulator strong enough to resist Fannie’s huge political clout. . . . [O]nly Treasury has the muscle to provide adequate supervision over time. Fannie may try to carve out some special body within Treasury, but it should have to live by the same rules and under the same regulators as everybody else. And that means Treasury must also have the power to block Fannie and Freddie from entering new businesses. Their price advantage in raising capital has allowed the companies to expand faster than competitors, to the point where they now hold most of the financial risk in the entire U.S. housing market. One false step and everybody pays.”
- “Their shareholders will say this isn’t fair to a private company, but the honest reply is that they really aren’t private. They are financial Centaurs. If Fan and Fred want to disavow their favored taxpayer status and privatize, then fine. But as long as they want to have the head of a private company but the body of the government, their risks need to be controlled.”
- “These columns take some pride in having first reported Fannie’s problems three years ago -- a stand that won us no popularity contests. But we take no pleasure in its comeuppance, because our goal all along has been to prevent another savings-and-loan-style bailout. At least now everyone realizes the problem; we still have to fix it.” (*Wall Street Journal*, 12/17/04)

*Investors Business Daily*: “Fannie Mae Is Just Iceberg’s Tip

- In a December 27 editorial, *Investors Business Daily* wrote, “Governance: The firing of Fannie Mae’s CEO after a series of financial irregularities comes as no surprise. But getting rid of Franklin Raines is just the beginning. Raines didn’t do his job, so he got fired. It happens all the time -- at least in the private sector. His No. 2, CFO Timothy Howard, quit shortly after Raines got the boot. Neither Raines nor Howard was actually in the private sector. Each headed Fannie Mae, the massive government-sponsored enterprise, or GSE -- one of more than a dozen in U.S. housing markets -- that competes with private firms for your mortgage business.”
- “...Fannie Mae -- together with its cousin, Freddie Mac, and 12 Federal Home Loan Bank[s]... -- basically control the mortgage business in America today. Of the nearly

\$7.5 trillion in mortgage, the housing GSEs make up nearly two-thirds of the total. Their debts have grown much faster than the mortgage market as a whole. Today, Fannie Mae's nearly \$1 trillion in debt is second only to the U.S. Treasury in size. Bond investors eagerly snap up Fannie Mae and other GSE debt securities, assuming, perhaps rightly, that if something bad happens the government will make it all good. Economists call this "moral hazard" -- when an entity takes big and perhaps inappropriate risks because, if it fails, someone else will pick up the tab."

- "...What's curious is that it took so long for Washington to detect the growing problem -- not just with Fannie Mae, but also with all the GSEs. Well, the time to act is now -- before something worse happens. Recently, a number of common-sense proposals to reform the housing GSEs and protect taxpayers have been put forward. Among them: create one regulatory overseer with authority and responsibility for all the GSEs; and increase market competition among the various housing GSEs to make them do their job better. All good ideas, to be sure. ...[U]ltimately we think privatization is the answer. We recognize that housing -- and home ownership, in particular -- are social goods. But the potential cost of a bailout of Fannie Mae or one of its corporate kin is just too great when weighed against what they do."
- "...Raines deserved to lose his job -- just like any other CEO who messes up. But he's not the problem; a system that encourages and underwrites potentially dangerous financial risks is. And the sooner Congress comes to recognize that, the better."  
*(Investors Business Daily, 12/27/04)*

*Houston Chronicle*: "Fannie mayhem"

- In a December 24 editorial, the *Houston Chronicle* wrote, "Scandal in the nation's twin towers of home mortgages shows that corporate America has yet to take the lessons of Enron to heart. Not so long ago, mortgage giants Fannie Mae and Freddie Mac were sacrosanct pillars of the U.S. economy, providing the financing that allowed thousands of middle class and lower income Americans an avenue to homeownership. After two tumultuous years that have seen the management of both forced out by accounting scandals, perhaps their whimsical name tags should be changed to Bonnie and Clyde."
- "...This [fall], officials of the Office of Federal Housing Enterprise Oversight found that Fannie Mae, like Freddie Mac, had violated standard accounting procedures and manipulated earnings. A scathing report documented how the company booked income in late reporting periods to burnish its books and allow executives to collect millions in incentive bonuses. The upshot is that Fannie Mae will likely be forced to wipe out \$9 billion in profits it reported over the past four years."
- "...Since the Justice Department is pursuing a criminal investigation of the problems at Fannie Mae, Raines may find that his accountability extends beyond simply retiring in disgrace. ...Likewise, board members failed to exercise their fiduciary

duty to control the behavior of self-aggrandizing executives, practices that apparently went on long after Enron's fall put corporate boards on notice.”

- “Rogue behavior in an energy trading outfit like Enron is bad enough. For the two largest sources of home mortgages to engage in it is outrageous. Only a thorough investigation and punishment of those responsible can keep the fiasco from repeating itself, threatening many Americans' dreams of homeownership and a major underpinning of the U.S. economy.” (*Houston Chronicle*, 12/24/04)

*Seattle Times*: “Disaster of Dough at Fannie Mae”

- In a December 26 editorial, the *Seattle Times* wrote, “Turmoil at Fannie Mae calls for a stronger, more exacting regulatory hand, but the zeal for reform should not eclipse the financial institution's singular mission: providing low- and moderate-income Americans with entrée into home ownership. ... The departure of its chief executive, Franklin Raines, is a welcomed start to reshaping the mortgage-financing behemoth. He treated Fannie Mae like his personal bank. Raines' 2003 compensation totaled \$20 million. He can cash in stock options valued at around \$11 million. As though there were a possibility he could ever run out of money, Raines is eligible for a \$1.1 million annual pension. Raines is the highest-paid executive to ever have delivered so little. A *Wall Street Journal* report cites cumulative shareholder returns at Fannie Mae of around 4%, a fraction of the 23% achieved by the private financial sector.”
- “A refocused Fannie Mae would spend its money more wisely. The Federal Reserve has found about half of the government subsidy that goes to Fannie Mae is kept by the company rather than spent purchasing mortgages. When [HUD] proposed a rule to require Fannie Mae, and its brother bank, Freddie Mac, to buy more mortgages from lower-income households, the two banks balked.”
- “The U.S. Senate will hold hearings early next year about a new federal regulator for Fannie Mae. Detractors of the bank will try to strip its special status and make it compete more evenly with other banks. It is true that other lending institutions don't have the special status able to borrow directly from the Treasury as Fannie Mae can. But Fannie Mae is no ordinary bank. It is one with a government-sponsored principle to broaden the opportunity for home ownership. It must be held to a higher standard and still be true to its core mission.” (*Seattle Times*, 12/26/04)

*Washington Times*: “Another Blow for Fannie Mae”

- In a December 22 editorial, the *Washington Times* wrote, “If the end of the election season and the coming New Year didn't provide lawmakers with fresh impetus to consider new regulations for mortgage giants Freddie Mac and Fannie Mae, then the SEC report on Fannie Mae's accounting practices certainly should. Given the overall importance of both companies to the U.S. economy, the findings by the Security and Exchange Commission are indeed worrisome. Still, Congress should be restrained in

its review of the two housing lenders, and resist the attempts by some to strangle the companies with excessive regulation.”

- “...Fannie is the second-largest debtor in the U.S. behind the government. Given the size of Fannie’s and Freddie’s liabilities and assets, any problems at either company sends tremors through the financial system. The tremors could also be going through Congress, if further accounting or other problems are discovered. ...Some in Congress are trying to use the missteps of management to reverse the companies’ government charters. Such a move, however, would have consequences not only on mortgage financing, but the economy as a whole.” (*Washington Times*, 12/22/04)

*Kansas City Star*: “Scandals Invite Scrutiny of Finances

- In a December 23 editorial, *Kansas City Star* wrote, “The mortgage giant Fannie Mae has long relied on friends in Congress to protect it from regulatory scrutiny. But now the company’s accounting scandal problems will strengthen the hand of lawmakers seeking tougher regulation for Fannie and its smaller cousin, Freddie Mac. ...They’ve become classic examples of financial entities deemed ‘too big to fail.’”
- “[T]he days of winking at concerns about the soundness of Fannie and Freddie are over. ...In an appearance before Congress, Fannie CEO Franklin Raines and chief financial officer Timothy Howard discounted any significant accounting problems. In fact, Raines denied every detrimental finding by [OFHEO] and accused regulators of engaging in a public campaign against the company. But last week the Securities and Exchange Commission’s chief accountant issued a devastating report. The SEC said Fannie violated accounting rules dealing with derivatives, financial instruments used to hedge against interest-rate swings. ...Fannie must now restate earnings back to 2001 -- a move that could force it to report \$9 billion in losses, cutting the company’s profits for the period by a third.”
- “Banks hold much of Fannie’s and Freddie’s debt. If the mortgage giants run into trouble, the weakness could spread. As Federal Reserve Chairman Alan Greenspan said earlier, Fannie and Freddie pose a ‘serious’ risk to taxpayers. It’s time these two got the scrutiny they deserve -- or are forced to give up their ‘government sponsored’ status altogether.” (*Kansas City Star*, 12/23/04)

*Worcester Telegram & Gazette*: “More Enrons?”

- In a December 26 editorial, the *Worcester Telegram & Gazette* wrote, “The ouster of two top executives of Fannie Mae deals another blow to public confidence in the integrity of the nation’s financial infrastructure. Fannie Mae is the nation’s biggest buyer and guarantor of home mortgage loans and the second largest financial institution behind Citigroup Inc.”
- “...Misstating finances is a serious violation and betrayal of trust because stock and debt of both [Fannie and Freddie] are held by investors around the world. ...It is

troubling that in both cases [directors] took decisive corrective action only under intense federal scrutiny. Indeed, Mr. Raines was not even fired but allowed to take early retirement. It is disheartening that, even under the cloud of implusions of Enron, Andersen and other once-respected companies, major players on Wall Street evidently have yet to get the message about the value of public trust.” (*Worcester Telegram & Gazette*, 12/26/04)

*Pittsburg Post-Gazette*: “Fannie Saved”

- In a December 27 editorial, the *Pittsburg Post-Gazette* wrote, “Last week Fannie Mae, an institution at the heart of the U.S. home mortgage industry, hit a rock. It didn’t sink, and is not likely to, but the jolt to this important institution raised a serious question about the soundness of America’s financial structure. ... Fannie Mae has been under close scrutiny for over a year by its immediate regulator, [OFHEO], plus the [SEC] and the Department of Justice. Earlier this month the SEC said that Fannie Mae’s accounting procedures were ‘questionable.’ It had overstated its earnings by a possible \$9 billion since 2001, and it was thus \$3 billion short in meeting requirements to be able to cover its loans. The institution was in a mess; changes had to be made and heads had to roll. Fannie Mae’s chairman and chief executive, Franklin D. Raines, formerly director of [OMB] under President Clinton, quit, as did Fannie Mae’s chief financial officer. Its auditor for 35 years, KPMG, was dismissed.”
- “The regulators and Congress promise that Fannie Mae will be fixed and that this train wreck will not reoccur. ... What fixes are needed? Congress is talking about tighter regulation. In fact, regulation already seems to have worked since Fannie Mae’s problems were caught before they reached crisis proportions and put the institution’s operations at risk. ... Given the confidence factor, it is critical that regulators make the necessary repairs to Fannie Mae. This was a close shave in an already nervous American and world economy.” (*Pittsburg Post-Gazette*, 12/27/04)

*St. Petersburg Times*: “Trouble for Fannie Mae”

- In a December 29 editorial, the *St. Petersburg Times* wrote “One of the more infuriating aspects of the corporate accounting scandals of the last few years has been seeing executives walk away with obscene compensation packages while their companies lay in ruins. By reporting rosy profits through accounting tricks, high-level executives were able to inflate the stock price and cash in on stock options and bonuses, while keeping the company’s true financial health from stockholders and employees.”
- “In some cases, such as those involving Enron Corp. and HealthSouth Corp., efforts have been made to recoup some of that money. So too should the stakeholders in the mortgage finance giant Fannie Mae seek the return of any unjustly earned compensation of Franklin Raines, its former chairman and chief executive, as well as other executives. ... In September, a regulatory agency found that Fannie Mae had

finessed expenses so that earnings would match projections, resulting in enormous bonuses and incentive pay for the company's upper management. In concurring that accounting rules were flouted, the [SEC] ordered the company to restate earnings for the last three and a half years, which may mean declaring \$9-billion in losses. Now questions are focusing on Raines, who earned \$14-million in salary and bonuses and an added \$25.6-million in incentive pay over the last three years. He left with stock options valued last year at nearly \$12-million and may receive a pension of more than \$1.3-million annually for the rest of his life."

- "Just how much of this compensation was tied to the cooked books? That question needs to be answered by [OFHEO], the Justice Department or Congress, all of which have either launched or expect to launch investigations. Any undue compensation should be returned and possible fines levied as a warning to other executives who try these tricks as a means of self-enrichment. Congress should also focus on why a company that operates under a quasi-governmental aegis is giving executives such wildly extravagant compensation packages."
- "...This scandal shouldn't be used as an excuse to bring Fannie Mae to its knees. A thorough investigation is called for, as is some additional regulation and oversight. And Fannie Mae executives who are found to have abused their trust and broken the law should be held accountable for their greed and misdeeds." (*St. Petersburg Times*, 12/29/04)

*South Florida Sun-Sentinel*: "Don't Close Books on Mess"

- In a December 27 editorial, the *South Florida Sun-Sentinel* wrote, "The "retirement" of its highest-ranking executive isn't the end of the scandal at Fannie Mae, the largest player in the nation's \$8 trillion mortgage industry. CEO Franklin Raines left the company ...as evidence mounts that the company inflated profits by as much as \$9 billion over the past four years, allegedly so that top officials could reap bonuses. ...If Raines and other Fannie Mae executives did use accounting tricks to overstate profits, then that's fraud. And, in the post-Enron environment, government must seek out and punish corporate fraud aggressively. ...All this supposedly so that well-paid executives like Raines and Howard, who pocketed millions of dollars in salary and bonuses last year, could pad their paychecks? And then walk away with just mea culpas?"
- "...After all, weren't the corporate and Wall Street reforms supposed to improve accountability to deter chicanery and assign responsibility so that cracking down on misbehavior would be easier? A serious and in-depth investigation of the Fannie Mae scandal is crucial. Otherwise, this disaster will make a mockery of the 2002 Sarbanes-Oxley law and other corporate and investment reforms passed at the height of the financial scandals."
- "As for Fannie Mae, the Bush administration should commit itself to finding competent, permanent leaders for the company. And Congress should use this mess

as an opportunity to tighten regulation and oversight of Fannie Mae. The nation's housing market is too important to the U.S. economy and the net worth of all Americans to simply go on, business as usual." (*South Florida Sun-Sentinel*, 12/27/04)

*Raleigh News and Observer*: "A Giant's Stumble"

- In a December 27 editorial, the *Raleigh News and Observer* wrote, "A giant's stumble. Fannie Mae is no ordinary debtor. The larger of two companies that buy up home mortgages and sell them on Wall Street, Fannie owes its investors nearly \$1 trillion. This mortgage giant's accounting has to be crystal clear for regulators to be sure it can cover its debts. For several years, worries about the soundness of Fannie Mae and Freddie Mac have been accumulating. Their origins as government agencies during the 1930s had brought them multiple subsidies, the sweetest of which is the ability to borrow money at bargain-basement rates. There is little doubt among lenders that, if needed, the federal government would bail out companies that fuel the housing industry's growth."
- "While competitors stayed away, Fannie Mae sank untold millions into complex investments in an effort to blunt the impact of interest rate swings. The accounting for those investments -- called "financial weapons of mass destruction" by the likes of investor Warren Buffet -- has been found lacking by two federal regulatory agencies. A recent ruling by the [SEC] that Fannie Mae must recalculate its earnings for the past four years sealed Raines' fate. It's disturbing that the company would be caught with its balance sheets down after Freddie Mac's top executive left similarly red-faced last year. More disturbing still is the possibility that, when the fog clears, Fannie Mae won't have enough money to cover its many obligations."
- "A debt of gratitude is owed the federal regulators who bird-dogged the two mortgage giants. The risks Fannie and Freddie have posed to taxpayers -- while spreading the benefits of home ownership, to be sure -- argue for new leaders committed to prudent management and candor." (*Raleigh News and Observer*, 12/27/04)

Fannie's cheerleaders on Wall Street's remain largely in denial
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- The ability of Wall Street equity analysts to remain firm supporters of Fannie Mae in the face of a \$9 billion earnings restatement, the firing of senior management, and a criminal investigation in to the company is nothing short of remarkable. In the *New York Times*, Gretchen Morgenson wrote, "...[B]ecause shame is simply not in the typical brokerage analyst's DNA, investors were given further assurances that all remained fabulous in the house of Fannie. According to one of the skills, removing \$9 billion in earnings from Fannie Mae's results since 2001 (Fannie's own estimate, by the way) would have 'no economic significance.'"

- Robert Napoli of PiperJaffray held to his view that the Fannie contretemps is largely a mere “accounting issue” and kept his 12-month target price for Fannie’s stock at 95, while shares currently trade in the low 70s. Jonathan Gray of Sanford Bernstein, who dropped his price target to 84 from 86 following the departures of management, has long depicted OFHEO’s investigation of Fannie as a witch hunt by an overzealous regulatory agency. (*Financial Times*, 12/23/04; *Barron’s*, Jonathan R. Laing, 12/27/04; *New York Times*, Gretchen Morgenson, 12/19/04)
- In an appearance right out of Wall Street’s version of “Ripley’s Believe it Or Not,” Tom Brown, CEO of Second Curve Capital, discussed his reaction to recent events at Fannie Mae on *CNBC’s Kudlow & Cramer*. Brown said, “...[F]or the most part, I think it’s another example, frankly, of a regulator [OFHEO and SEC] that’s gone berserk. ...Fannie Mae will probably have to issue more equity. But you know, at this point, ...these guys are just going wacko. They just want to like get Fannie Mae, they want to get Freddie Mac. They’re changing the accounting standards.” Larry Kudlow responded, “You’re so right man. This is Sarbanes-Oxley to the third power.” (*CNBC’s Kudlow & Cramer*, 12/22/04)

Fannie Mae’s biggest risk: Uncollateralized liability to derivative dealers
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- The editor of the website *Capuchinomics.Com* writes, “Financial markets took a vacation from reality in 2004. ...A good example was Fannie Mae (FNM) (Disclosure: I’m short shares of FNM) where despite easily visible and substantial problems in its balance sheet, income statement and cashflow statement, investors chose to see no-evil and hear none of it. FNM has defied the odds and declined by a scant 5% in 2004.”
- “Investors cheered when they thought that the [SEC] would take FNM’s side in the accounting scandal. Then, when that decision went against FNM, investors cheered again as they believed that this reduced the uncertainty surrounding the shares. Next, when [CEO] Franklin Raines and [CFO] Timothy Howard were fired, they cheered the change in management and once again bid up shares. Today [December 30], investors intoxicated at the ease with which FNM was able to raise the funds necessary to fund its regulatory capital requirements, have continued to bid shares up. However, all parties end, and often with a hangover or worse. The FNM hangover will be potent. FNM currently has no financial statements. Purchases of its securities are being made on blind faith. FNM’s new auditor is not likely to provide certified statements for at least a year.”
- “Capital raised through the preferred stock offering yesterday [December 29] is negative for FNM stock holders. The new securities increase required dividend payments at a time when reserve building and cash conservation are the main priorities at FNM. These new payments make it more likely that FNM’s common stock dividend will be cut or eliminated.”

- “FNM’s management changes are likely to generate unusual surprises for shareholders. FNM’s Raines and Howard’s were near oligarchs. They ruled the roost with Congress, OFHEO, the SEC and the housing industry. All sorts of skeletons, previously well hidden may make unwelcome appearances.”
- “However, the biggest problem with FNM is one that is not even mentioned by analysts. It is FNM’s uncollateralized liability to various derivatives dealers (mostly investment banks) through its substantial derivative portfolio. OFHEO, in a report titled “Systemic Risk: Fannie Mae, Freddie Mac and OFHEO,” details this arrangement:

‘When a derivatives counterparty of Fannie Mae or Freddie Mac (referred to as “the Enterprises”) has a positive gross credit exposure to the Enterprise – that is, when the Enterprise’s exposure is negative – the Enterprise does not post collateral to cover that exposure, regardless of its size. That practice reflects the fact that private credit ratings agencies have granted the Enterprises triple-A credit ratings, in large part because of investors’ perception of an implicit federal guarantee of Enterprise obligations. With the growth of the Enterprises’ mortgage asset portfolios and corresponding use of OTC derivatives, the consolidation of the financial services industry, and the decline in the number of major derivatives dealers, the gross credit exposures of Fannie Mae and Freddie Mac to individual counterparties can be substantial. The Enterprises require counterparties to post collateral, making each Enterprise’s net uncollateralized credit exposures to individual counterparties a small fraction of its gross exposures.’

This arrangement while beneficial to FNM shareholders and bondholders, leaves the proverbial bag to be held by its derivative dealers. Forsaking prudence, FNM’s derivatives dealers have instead they have accepted the ‘implicit federal guarantee’ that rating agencies have assigned to FNM’s and Freddie Mac’s securities. A change in perception as to this ‘implicit federal guarantee’ will represent a tangible cash flow shift for FNM. FNM will then be required to put up margin. Remember too, that much of these derivatives are mired in losses due to FNM’s bet on higher long-term rates.”

- “Notice that such a change does not require a change in government but a mere shift in perception by the rating agencies and investors. The first signs of a shift in perception are occurring as Fitch has cut FNM’s preferred stock rating and may do the same for its subordinated debt. Moody’s has indicated it is considering similar action.”
- “...Investors have been remarkably sanguine about FNM’s problems in 2004. Will 2005 be a repeat of 2004? Investors in FNM’s securities past, present and future are certainly betting on it.” (*www.Capuchinomics.com*, 12/30/04)

- Peter Eavis writes in *TheStreet.com*, “[I]n some ways the Fannie mess is much worse than any of the big recent corporate scandals [such as Enron and WorldCom]. Fannie betrayed public trust on a massive scale. And its decline into an accounting scandal endangers the health of the U.S. housing market. Fannie was set up by a congressional charter to provide liquidity to the housing market. It moved way beyond its main business of guaranteeing mortgages to buying them and holding them on its books. It now has over \$900 billion of mortgages on its books. Politicians of all persuasions should be appalled that a company set up to indirectly help people buy their own home should have gone as far afield as it did. And the scores of legislators who benefited from Fannie’s largesse should start to make amends by agreeing to the most stringent reform bill possible for Fannie and Freddie, which was the center of its own, less serious, accounting scandal in 2003.”
- Eavis continues, “What are the next steps for Fannie? Raines and his band of pirates will jump ship . . . , leaving the board the task of finding an interim CEO and management team. Given the pervasive influence of Raines within Fannie, it will take a long time to right the culture there. Capital will have to be raised [perhaps as much as] \$11 billion to cover the \$9 billion of losses, and making up a 30% capital surcharge imposed in September by OFHEO. Given the massive leverage of Fannie, that could mean selling over \$330 billion of mortgages. While it would be tough to offload that amount of mortgages, it’s just as hard to see Fannie being able to sell billions of dollars of stock when it’s not able to file accurate financial statements with the SEC.”
- Eavis concludes, “What an absolute mess. Blame for this debacle should be liberally spread around Washington, Wall Street and in Fannie’s executive suite. And if it weren’t for a couple of savvy short-sellers, OFHEO, a few clear-sighted folk in the Bush administration, and, yes, the press, Fannie would still be going about its main activity for the last five years -- the wholesale destabilization of the U.S. housing market.” (*TheStreet.com*, Peter Eavis, 12/16/04)
- “Look, we have to be honest about Fannie,” said Jim Cramer. “It is a government-sponsored thug. It does whatever the heck it wants to.” (*TheStreet.com*, Gary B. Smith, 12/17/04)
- Bill Mann writes on *TheMotleyFool.com*, “The absolute brazenness of Fannie’s actions dumbfounds me. It asked regulators for permission to account for its derivatives using its own method, was told no, and did it anyway. How did management possibly think it could get away with this? I think the answer is arrogance, and the fact that Fannie Mae has such a powerful lobbying force in Washington. Politicians are terrified of the potential economic upset wrought by hitting Fannie Mae’s credibility -- there may be no more important financial institution in the country save the Federal Reserve. But it wasn’t the politicians or

even the regulators who have pushed Fannie Mae down the path of making its capital situation appear better than it actually was. ...What's clear is that the folks running Fannie have taken the faith of shareholders, the public, and even that of taxpayers, and stomped the life out of it. (*TheMotelyFool.com*, Bill Mann, 12/17/04)

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

Fannie Mae's accounting scandal reinvigorates Congressional interest in GSE reform

- Emboldened by Fannie Mae's accounting troubles, senior leaders of Congress and the Bush administration are expected to press hard in 2005 to pass long-delayed legislation that would create a new federal regulatory agency to oversee the Fannie Mae, Freddie Mac and the FHLBs. The legislation bogged down last spring when Fannie Mae and its allies came to loggerheads with the Treasury and the White House over what powers should be granted to the new agency, such as receivership powers, new product approval authority and the power to set capital requirements. Conventional wisdom in Washington is that now administration officials and its Congressional allies can now get the kind of regulatory reform for the GSEs that was impossible to win in 2004.
- In an interview, Senate Banking Committee Chairman Richard C. Shelby (R-AL) said that the SEC's ruling on Fannie Mae's accounting practices made getting a regulatory reform bill for the housing GSEs passed by Congress even more important. "It is incumbent on us in the Senate and House to do this," said Shelby. "Last year we were able to raise the level of debate. Recent revelations have just compounded what we feared all along." Shelby's spokesman Andrew Gray later said that establishing a new regulator for Fannie Mae was "the top priority for the committee" and that hearings on the proposal are likely to be held in February. However, Gray conceded, when it comes to Fannie Mae, "nothing is ever easy."
- Representative Michael G. Oxley (R-OH), chairman of the House Financial Services Committee, also plans to push vigorously for a regulatory reform legislation for the housing GSEs. "We intend to hold hearings early next year," said Oxley.
- Representative Richard Baker (R-LA), who has spearheaded GSE regulatory reform for years, said he still expects to see a fight over the receivership issue, which Fannie and Freddie oppose. "I will be surprised if they acquiesce to anything. Fannie has never been one to be support of this reform effort," said Baker. Shelby agreed that receivership power was absolutely necessary for the new regulator for housing GSEs. "We have to have a receivership provision," said Shelby. "Every financial regulator has it." (*Dow Jones Newswires*, John Godfrey, 12/23/04; *Washington Post*, Jeffrey H. Birnbaum, 12/20/04)

- The day after Fannie Mae's management resigned, Representative Barney Frank (D-MA) called for tougher regulation of the housing GSEs, though not if they impinged on helping low-income Americans acquire mortgages. "I want them to be better regulated, but not at the expense of housing," Frank said. "I'm afraid that the right wing will use Frank Raines's mistakes and inappropriate actions to go after housing and to restrict Fannie Mae over all in the amount of activity it engages in." While there is room for compromise on oversight of the GSEs, Frank said he and other Democrats draw the line at ending the companies' ties to the government. Frank wouldn't support changing the GSEs' business model, said his spokeswoman Kay Gibbs. (*New York Times*, Katharine Q. Seelye, 12/23/04; *Bloomberg*, 12/23/04)
- Senator John Sununu (R-NH) announced he will join Senators Chuck Hagel (R-NE) and Elizabeth Dole (R-NC) to reintroduce regulatory reform legislation for the housing GSEs. "The recent news of Fannie Mae's accounting failures, undercapitalization, and the departure of its top management executives is a signal to Congress that reform is necessary and now is the time to act," said Sununu. Their legislation would create a single, independent supervisor over Fannie Mae, Freddie Mac, and the FHLBs. The legislation would also give the new GSE overseer the power of receivership during a financial crisis. "Receivership authority is a necessary tool to protect taxpayers should an insolvency occur," said Sununu. (*American Banker*, Rob Blackwell, 12/17/04; *US Fed News*, 12/22/04)
- U.S. Treasury Secretary John Snow said he would renew the administration efforts to get Congress to approve legislation strengthening regulation of Fannie Mae and Freddie Mac. Despite failing to win passage of a proposed regulatory reform in 2004, he said, "I'm encouraged about the progress we've made. Washington doesn't often move in quantum leaps. You've got to build a foundation and broaden understanding....I'm not a legislative forecaster, but we're going to work hard on it, and....I'm optimistic about it." (*Wall Street Journal*, Jackie Calmes and Deborah Solomon, 12/17/04)
- At a December 22 briefing, White House spokesman Scott McClellan said "We've long talked about the importance of making sure that government sponsored enterprises like Fannie Mae have a strong regulator and some of the [accounting] issues that have arisen recently underscore the need for that." McClellan continued, "GSEs, like Fannie Mae, have an important role to play in increasing homeownership opportunities for the underserved and we believe there should be vigorous [regulatory] oversight so that those enterprises serve their public purpose and contribute to a sound and strong financial system." (*The Main Wire*, 12/22/04)

<p>Senator Martinez will take seat on the Senate Banking Committee</p>
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- Former HUD Secretary Mel Martinez will be a member of the Senate Banking Committee with oversight of Fannie Mae and Freddie Mac and the banking industry

as a whole. Martinez will replace Senator Lincoln Chafee (R-RI) on the committee, who is relinquishing this committee assignment to take a position on the Senate's Homeland Security Committee. The committee assignments will formally be made in January and will be approved by the entire Senate Republican Conference. Martinez was elected to the Senate by Florida voters this fall. As HUD secretary he championed the Bush Administration's efforts to pass regulatory reform legislation for the housing GSEs. (*Dow Jones Newswires*, John Godfrey, 12/20/04)

A problem with the housing GSEs' DNA?
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- Jonathan GS Koppell, an assistant professor at Yale School of Management, wrote in the *New York Times*, "...[R]egulatory reshuffling will not fundamentally alter Fannie Mae or Freddie Mac's behavior, because the root of the problem lies in the companies' very DNA. As government-sponsored enterprises, Fannie and Freddie serve two masters with competing priorities: the American public, whose credit implicitly backs their liabilities, and its shareholders, who expect them to maximize profits. Fannie Mae and Freddie Mac work on an intuitively appealing premise: a profit-seeking company can accomplish the same tasks as a government agency with greater efficiency. Moreover, they can provide a public service without spending a dime of government money by leveraging Uncle Sam's top-notch credit rating."
- "But Congress should know that it never gets something for nothing. First, as government-sponsored entities, the companies pose a real risk to the taxpayers. Though their financial obligations are only implicitly backed by the federal government, their mistakes or misdeeds could cost billions. Second, in order for the American people to get something in return for effectively co-signing Fannie and Freddie's paper, the government has to establish clear performance targets and make sure the companies fulfill a public purpose. But defining these goals turns out to be rather tricky: what percentage of their loan portfolio should come from low-income areas, for example?"
- "Of course, fiscal prudence and program performance are radically different imperatives. The cautious executive will resist anything with a whiff of undue risk. The policy-driven executive will focus on making more loans in distressed areas -- regardless of risk. The recently deposed executives seemed to have something else on their minds as well: maximizing financial results. And that, obviously, is the third goal. As enterprises, the companies are trying to make money. Investors expect a competitive return. There is nothing inherently wrong with this; Congress wants them to make money. It is enshrined in their charters. More fundamentally, it is part of the idea. Fannie and Freddie are supposedly more efficient precisely because they are trying to make money."
- "Trouble is, making money can conflict with providing financial security and carrying out a public mission. Keeping larger capital reserves will drag down the return on equity. Taking on riskier, lower-yield loans may do the same. Fannie Mae has been particularly adept at using the tension among this triangle of goals for

political advantage. If critics or members of Congress push it to encourage more affordable housing loans, then Fannie warns that such meddling invites financial insolvency. If they suggest that Fannie Mae keep a little more capital for a rainy day, then they are accused of preventing deserving families from owning a home. To bolster either position, Fannie calls on financially dependent ‘friends’ in the financial industry or at housing advocacy groups to back it up. Such tactics have enabled Fannie and Freddie to resist stricter regulation for years.”

- “All the while, however, management has been able to deliver on bold promises of growth to shareholders. And Fannie Mae executives take home multimillion-dollar salaries. The accounting scandals at Fannie and Freddie may do more than just force the companies to restate their earnings. They may succeed in sapping the companies’ legendary political strength and force them to agree to a regulatory overhaul. It appears that this is exactly what is happening. Fannie recently announced it supports a review of its regulatory arrangement, just as the company did 12 years ago when the incumbent regulator, [OFHEO], was on the drawing board. The office ... was outgunned from pretty much the day it was created. Its support may reflect Fannie’s political savvy more than its sincerity. By supporting that 1992 legislation, Fannie was able to insert a few choice phrases that made OFHEO’s task much more difficult. Most notably, the legislation required an annual appropriations review -- at the hands of Fannie’s staunch Congressional allies -- even though OFHEO is financed not by appropriations but by assessments on the two companies it regulates. As a result, OFHEO’s requests for additional money and personnel were often rejected and agency shortcomings were met with a Trump-like upbraiding in committee hearings.
- “...Fannie and Freddie are the largest, but not the only, quasi-governmental entities creating trillions of dollars in federal liability. This moment of opportunity should be seized to create a single financial regulatory body with oversight responsibility not only for Fannie Mae and Freddie Mac, but also for other quasi-governmental entities. Such a regulator could establish consistent capital standards, accounting rules and examination procedures well suited to these unique enterprises. The new agency’s board could include Treasury Department representatives as well as the leaders of the government departments, like [HUD], with an interest in the policy goals of these companies. Thus mission objectives will be balanced with financial management. When Congress determined that America’s national security was threatened by an uncoordinated array of domestic defense agencies, it placed them under one organizational roof. Recent events have shown that our fiscal security is jeopardized by innovative companies run amok. A financial super-regulator is the only institution that can guarantee both financial security and public benefit.” (*New York Times*, Jonathan GS Koppell, 12/26/04)
- In a December 23 editorial, the *Wall Street Journal* wrote, “...Fannie Mae’s problems should serve as a cautionary tale. Advocates of the notion that government should have a role -- through subsidies or partnerships -- in “helping” market forces achieve public-policy goals (in housing or even health care) need to come to grips with what happened here. They created Fannie as a vehicle to increase American home

ownership, a worthy goal, but the time has come to retire the quasi-public model of doing good on a massive scale. Fannie Mae's managers deluded themselves into believing they could become mammoth, as public entities tend to do, while at the same time reaping all the benefits of modern finance. But modern finance, if it is to work at all, depends crucially on red flags from the market. Fannie's nature softened those signals. Fannie Mae -- a slick, semi-private firm operating with the patronage of politicians -- is the kind of institution one still expects to find in a country like France. It is wholly inappropriate to a modern economy, as here in the U.S." (*Wall Street Journal*, 12/23/04)

- "My personal belief is that Congress has put an apple before the management of Fannie Mae. It's understandable that they bit," said Representative Jim Leach (R-IA), the former chairman of the House Banking Committee in the 1990s. Leach said he was troubled by Fannie's and Freddie's accounting problems because he had always considered the companies well managed. "When you privatize profit and socialize risk, it's a prescription for lack of discipline," he said. (*Washington Post*, Terence O'Hara, 12/20/04)

Has the time come to privatize Fannie and Freddie?
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- At a National Taxpayers Union briefing to lawmakers and their staff, Peter J. Wallison, resident fellow of the American Enterprise Institute for Public Policy Research, argued that the discovery of Fannie Mae's accounting violations makes privatization of Fannie Mae and Freddie Mac more feasible. "Fannie Mae and Freddie Mac add very little to the quality of our housing finance system in the U.S.," Wallison said, while the GSEs with \$3 trillion in liabilities create tremendous risks for the economy, a bill Congress would likely foot in the event of a catastrophic loss. The GSEs also prevent the development of a competitive secondary mortgage market, argued Wallison. Because of their very general charter, the GSEs will likely expand their role beyond the secondary mortgage market one day to compete with other financial institutions in commercial loans and direct-to-consumer mortgages, he said. While the Fannie Mae's accounting scandal will increase calls for regulatory reform of the entities, such efforts "won't do any good because they're too politically powerful to be regulated effectively," Wallison asserted. "By regulating them, we increasingly suggest that they are backed by the U.S. government, so it becomes easier for them to get investors and grow." Wallison called for privatization of Fannie Mae and Freddie Mac, to be phased in over a five-year period to avoid "shocking the market."
- Stephen Moore, president of the Club for Growth, said that housing GSEs' lack of a clear-cut identity as either public or private institutions creates serious risk. "It's a very dangerous situation that they have all the benefits of a private institution and yet, ultimately, the taxpayer is liable for any misbehavior," Moore said. An easy way to privatize Fannie and Freddie would be to simply "start trimming away" at the special privileges the companies are afforded due to their status as GSEs, he said.

Specifically, Moore called for removing the line of credit Fannie Mae has with the federal treasury, the state and local tax exemptions, and the exemptions from SEC regulations and other federal regulations. “You can put Fannie on a par with other organizations by just stripping these benefits with a stroke of a pen,” Moore said. He also suggested requiring Fannie and Freddie to shut down their political activities, especially its six-figure foundation “grants,” which Moore said are used to silence would-be critics. Moore also suggested capping at \$250,000 the home loans Fannie can buy back--since its goal is supposed to be making housing affordable--and capping the amount Fannie can borrow. Also, if the federal government wishes to encourage first-time home buying, it would be much more efficient to provide a credit that would go directly to the homebuyer, rather than going through an intermediary such as Fannie Mae, he said. Implementing even a few of these suggestions would reduce “exposure to this ticking time bomb,” said Moore. “It is ticking and every day it brings us closer to multi-trillion losses.” (*BNA’s Daily Tax Report*, Linda Micco, 12/17/04)

Last man standing: OFHEO Director Armando Falcon, Jr.

- “They sat across from each other in a mahogany and velvet booth at one of those power-lunch restaurants near the White House: the top executive of the nation’s fourth-largest financial institution and the little-known director of an obscure and historically ineffective federal regulatory agency,” writes Eric Lipton in the *New York Times*. “The regulator, Armando Falcon Jr., had just narrowly avoided being ousted from his job, after being ridiculed for running an agency that did little more than rubber-stamp reports from corporate auditors [following Freddie Mac’s accounting scandal]. But this was the moment, in September 2003, that Mr. Falcon intended to make clear to his lunch guest, Franklin D. Raines, chief executive of ... Fannie Mae, that the balance in power between the two men was about to shift. ‘I am not going to be dissuaded,’ Mr. Falcon told Mr. Raines, referring to a broad investigation his agency was just then starting into the accounting practices at Fannie Mae. ‘This is necessary. If there are no problems with the company, the company will be better off, as we will so notify all interested parties. But we are going to go ahead.’ The [recent] announcement ... of the resignation of Mr. Raines, after a year and a half of inquiry by Mr. Falcon and his agency, ... serves as more than adequate proof that Mr. Falcon was not bluffing during that lunch at the Old Ebbitt Grill. David has toppled Goliath.”
- Lipton continues, “How this moribund regulatory agency -- which [certain] members of Congress were trying to strip of its powers as recently as last spring -- transformed itself into a powerhouse that could force so consummate a politician and businessman as Mr. Raines to back down is a testament, several observers in Washington said, to the perseverance of Mr. Falcon, a soft-spoken and often underestimated 44-year-old lawyer. ‘This is not a crusader,’ said Stanley Sporkin, the former head of enforcement at the [SEC], who has advised Mr. Falcon in recent months. ‘This is a very, very deliberate, decent, focused person, who once he makes a decision, he carries it out; he does not vacillate.’”

- When Falcon came to OFHEO in 1999, the agency had a paltry budget of \$16 million and 76 member staff, who were responsible for assuring the financial markets, investors and Congress that that Fannie Mae and Freddie Mac were safe and sound. Falcon lobbied Congress to increase the agency's budget and personnel resources, while Fannie Mae worked behind the scenes to cut proposed budget increases for OFHEO, said congressional aids. Eventually, OFHEO's budget grew to \$59.2 million and its staff to 188. A former legal counsel for the House Banking Committee, Falcon had never been a regulator. But he had a hand in shepherding through Congress legislation that created OFHEO and had witnessed firsthand the shortcomings of the regulatory regime who were supposed to have prevented the savings and loan crisis.
- A former colleague characterized Falcon as a populist who followed in the footsteps of the late Representative Henry B. Gonzalez (D-TX), former chairman of the House Banking Committee and a fellow Texan. "Falcon has never been an apologist for the industry. Is he courageous? I think he wants to do the right thing. He is fair and pragmatic," said Amy Friend, who worked with Falcon on the banking committee's staff and currently serves as assistant chief counsel at the OCC.
- OFHEO's investigation of Fannie Mae ramped up the political heat on Falcon, making him wonder at times if he had taken on too big a target. "You can feel overwhelmed by what you are up against," said Falcon. To assist OFHEO with the Fannie Mae investigation, he brought in a team of seasoned consultants and staff members, including Stephen Blumenthal, a former banking and financial services analyst at Schwab Washington Research Group; Lynn E. Turner, the former chief accountant at the SEC; and Sporkin, who in addition to working at the SEC had served as general counsel to the CIA and as a federal judge for the District of Columbia. Falcon also hired Deloitte & Touche, a "big four" accounting firm, to help examine Fannie Mae's accounting practices. "We could no longer take it on faith that the external auditor and the company were making sure that the accounting was correct," said Falcon said.
- Senator Christopher S. Bond (R-MO), who as chairman of a Senate Appropriations subcommittee has jurisdiction over OFHEO's budget, tried to withhold \$10 million of the agency's funds until Falcon was replaced. Bond also commissioned a report by HUD's Inspector General into whether Falcon's probe of Fannie Mae was motivated by politics. The IG found that OFEO had been so humiliated by missing the accounting problems at Freddie Mac that top agency officials vowed to be particularly aggressive toward Fannie Mae.
- "Unfortunately, this all got caught up in a political tug of war going on at Capitol Hill," Falcon said. "It became, 'Are you pro-housing or anti-housing?', when what we were trying to do was just address safety and soundness." Even before his lunch with Raines at the Old Ebbitt Grill, Falcon said OFHEO's inquiry into Fannie Mae's accounting practices had never been about personalities. "I have no animosity toward

Frank Raines,” he said. “But it is clear that this is bigger than people. This is about the mission of the company and the public interest that needs to be served.”

- While Falcon’s appointment at OFHEO expired in October, he has said that he intends only to remain until his successor, who must be nominated by President Bush, is confirmed. Falcon has now earned a new measure of respect among both his supporters and critics. Representative Richard Baker (R-LA) said Falcon deserves tremendous credit for his accounting investigation of Fannie Mae and for bringing the matter to light despite intense criticism and pressure from the company and its allies. “I think Mr. Falcon came out of this with character and reputation intact,” said Baker. “He has been totally vindicated.” (*New York Times*, Eric Lipton, 12/23/04; *Washington Post*, Cindy Skrzycki, 12/28/04; *New York Post*, Richard Wilner, 12/23/04; *American Banker*, Rob Blackwell, 12/17/04)

## ***Fannie Mae***

Fannie’s board and interim management begin the company’s makeover
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- Fannie Mae’s board of directors faces a difficult task of navigating the company’s transition to the next senior management team. Few executives have experience running a company as large, unusual and complex as Fannie Mae, and the permanent replacement for former chairman and CEO Franklin D. Raines will have to pass muster with OFHEO. Nearly three months ago, the board hired Spencer Stuart, a Chicago-based executive search firm, to calibrate “internal potential successors against the external environment,” said a person close to the situation. While the board wasn’t ready to replace Raines, who retained Spencer Stuart, the directors wanted to become familiar with possible external recruits, this source added. Shortly after the first of the year, Spencer Stuart will begin its full-fledged hunt for Raines’s longer-term successor as chief executive. The board has split the jobs of chairman and CEO, and named Fannie director Stephen B. Ashley as the non-executive chairman. Ashley, who has been a Fannie Mae director since 1995, is the former president of the Mortgage Bankers Association and founded his own real estate firm in 1997.
- Fannie Mae’s board has appointed interim management for the company, naming Vice Chairman and COO Daniel H. Mudd, 46, to be interim chief executive. Mudd, whose father is television journalist Roger Mudd, was with GE Capital eight years before joining Fannie as vice chairman. He held a variety of commercial finance jobs at GE Capital in Europe and Asia, rising to run the company’s Asia-Pacific operations. He will be Fannie’s first CEO with no experience in politics or government, aside from a brief stint at the Pentagon at the end of his Marine Corps

service in the 1980s. Mudd is known as a straight shooter with in-depth knowledge of the company's business. Mudd had served as a member of Fannie's four-person Office of the Chairman, Raines's inner circle, along with CFO Timothy Howard and Thomas E. Donilon, an executive vice president who oversaw Fannie's government relations.

- The board has also named Robert J. Levin, 48, executive vice president of housing and community development, to be interim CFO. Levin, who has been with Fannie Mae since 1981, currently runs the part of Fannie's business that buys multi-family mortgages, and heads all of the company's community reinvestment initiatives. In the latter role, Levin is responsible for making sure Fannie Mae achieves its mission of assuring a stable source of capital for low- and middle-income home buyers.
- Initially, Mudd's and Levin's primary task will be to begin rebuilding relations with the OFHEO, which has had a "starkly adversarial" relationship with Fannie Mae. Mudd said, "A big, number one priority [is to] get ourselves in the right regulatory framework and mind-set." Improving Fannie's regulatory relationship "is important to us, it's important to capital markets, it's important to the company, it's important to our shareholders," he added. Mudd said he has been contacting and trying to reassure a wide array of people involved in the company's mortgage finance business. "What I'm just getting started to doing now is reaching out to customers, our business partners, our partners in the affordable housing front, investors, shareholders, stakeholders, all those constituencies," he said. "I want to do some very careful listening with all of these outside constituencies as well as investors to make sure we're on the right track. We have a lot of folks over the years who have been very helpful and constructive critics. I think they want to help and this is the time to let them do this. We're running a hundred miles an hour to get all of those things moving in the right direction at once."
- When the board chooses a "longer-term" CEO for Fannie Mae, some observers expect the directors to seek a highly visible financial-services veteran such as John Mack, former chief executive of CSFB, the investment banking unit of Credit Suisse Group; John Reed, a former Citigroup Inc. chairman and co-CEO who has led the New York Stock Exchange's board through a tumultuous period; Robert B. Willumstad, Citigroup's president and chief operating officer; Albert L. Lord, CEO and vice chairman of Sallie Mae, a leading source of educational-loan funding; or David A. Coulter, a vice chairman of J.P. Morgan Chase & Co. who oversees its investment-bank, private-equity, asset- and wealth-management operations. Among the names circulating in governmental circles to succeed Raines is Robert B. Zoellick, the United States trade representative. He has worked at Fannie Mae twice before, including a period in the 1990's when he served as senior executive in charge of its affordable-housing business as well as its legal affairs and governmental relations offices. Zoellick is also said to be on the short list of candidates to be the next head of the World Bank. (*Washington Post*, Terence O'Hara, 12/22/04; *New York Times*, Eric Dash, 12/22/04; *Washington Post*, Jeffrey H. Birnbaum, 12/23/04; *Wall Street*

The collapse of a cynical business model popular in the 1990s

- Susan Lee writes in the *Wall Street Journal*, “The slo-mo disintegration of the Fannie Mae myth is a perfect coda to the collapse of a cynical business model that was so wildly popular in the 1990s. That was, you recall, when gangbuster corporate growth depended on murky accounting, inadequate financial disclosure and horrid corporate governance. It was enabled by a group of stock jockeys who constituted an Alfred E. Neuman school of analysis [from *MAD Magazine*]-- sometimes profiting by looking the other way and at all times hewing to a “What, Me Worry?” approach to evaluating companies. And, to put the finishing touch on this sorry story, it involved paying kingly compensation to top executives, mostly by amazingly generous stock options.”
- “Fannie Mae exhibits all these characteristics -- *big time*. As investigations by the [SEC] and ...[OFHEO] reveal, Fannie is nothing more than an over-leveraged hedge fund with substandard accounting and financial numbers so false they have to be restated. Add this to what is already known: that CEO Franklin Raines was paid about \$20 million in salary and options last year while nine of Fan’s top executives made more than \$3 million each, and that Fannie’s board is so craven that it dragged its feet about firing Mr. Raines, who led a company that has now been rebuked twice by regulators. And the quick defense of Fannie’s accounting that was immediately mounted by the Alfred E. Neuman Club makes the match utter perfection.”
- “There are, however, two things that set Fannie apart from the run-of-the-mill private company. She has a congressionally mandated mission to provide affordable housing by buying mortgages from lenders, thus giving them cash to make more mortgages. This mission has allowed Fan to clothe herself in a special sanctimony while engaging in lethal lobbying and heavily advertising herself as being in the business of satisfying ‘the American Dream of homeownership.’ The second distinguishing feature that sets Fannie’s slide from grace apart from the corporate implosion that began with Enron’s collapse in 2001 is the critical one. When those huge companies went into bankruptcy, the chief victims were appropriate for a capitalist economy: investors, bondholders, bankers, culpable top management and innocent workers. The economy burped, sure, but the bankruptcies didn’t generate a financial disaster. If the worst were to happen to Fannie, however, the damage would be more than a burp for the economy -- it would be severe and enduring indigestion. Beyond the usual victims, the list would include the U.S. mortgage market, global financial institutions and -- here’s the hooker -- taxpayers.”
- “Fannie Mae operates under a government charter that makes it both a private and a public company. As a government-sponsored company, Fan is allowed some unusual privileges: She has a special line of credit at the Treasury, can borrow short-term from the Federal Reserve, enjoys lower capital requirements than other financial institutions and, until two years ago, did not have to register her securities with the

SEC. This privileged connection to the government, with its implied federal guarantee, creates a subsidy, allowing Fan to borrow at very low rates. And her lower capital requirements, of course, allow her increased leverage. Fan does not rebate all the profits arising from this arrangement, but keeps one-third for herself.”

- “Simply put, as a government-sponsored entity, Fan enjoys private profits while her risk is assumed by taxpayers. No doubt this is an especially sweet deal for Fannie, but it leaves taxpayers to face the prospect of paying for a bailout that would cost hundreds of billions of dollars. Protecting taxpayers from this nightmare can’t be done without severing -- once and for all -- Fannie’s special relationship with the federal government. There are two possibilities. Congress could get serious by passing legislation to create a new, serious regulator in the Treasury -- one that could restrict both Fannie and her brother, Freddie Mac’s growth by limiting new business activities and function as receiver in the case of bankruptcy. Receivership authority, the power to shut Fan or Fred down if they became insolvent, would also alert investors and bondholders that they would not be bailed out. So would cutting their ties to the Treasury through their special line of credit. (The Fed has already said it would stop giving Fan and Fred overdraft privileges.)”
- “The other, much more sensible option is to privatize Fan and Fred. Some observers have suggested that Congress first shrink their size to avoid the too-big-to-fail problem and ensure that they don’t crush their competitors. Privatization should not be thought of as punishment, either. Once Fan and Fred are free from regulatory restraints -- like being limited to the residential mortgage business, obeying restrictions on the maximum size of mortgages, and being second-guessed by OFHEO and [HUD] -- they could rock-and-roll into all sorts of profitable activities.”
- “Both companies are loaded with experienced and talented people who might find it a liberating challenge to compete on even ground with other companies. Best of all, privatization would transfer the ultimate risk from taxpayers to the private markets -- investors and bondholders. The nice thing about a free market is that eventually snarky business models will fail. No matter how sneaky their accounting, or how misleading their financial statements, or even how benighted their corporate governance, the market will catch up with them. Fan and Fred have just given us a peek at the causes of their potential failures. It’s past time to roll out a solution. Goodness knows, taxpayers deserve one.” (*Wall Street Journal*, Susan Lee, 12/22/04)

“We’re not in Kansas anymore”

- Josh Rosner, an analyst at Medley Global Advisors in New York, said that while Fannie Mae’s regulatory woes are an immediate problem, forces out of Fannie’s control will put significant pressure on its business model in the future. Even after Fannie Mae works out its differences with regulators, Rosner warns that its troubles are far from over because changes in the mortgage market will lessen the company’s

dominance and reduce its future income growth. “We’re not in Kansas anymore,” said Rosner.

- In describing how the landscape around Fannie Mae is forever changed, Rosner points to three major shifts in the mortgage market. First, the 30-year fixed rate mortgage, the Fannie’s highly profitable, stock-in-trade loan, appears to be losing its appeal among homeowners. Today, roughly 30% of the mortgage market is adjustable-rate mortgages. Hybrid adjustables, which provide a fixed rate of interest for a specified period and then move to a floating rate, have been gaining in popularity. Hybrid adjustables make up almost 75% of the adjustable-rate mortgage market, up from 7% five years ago. Rosner believes that consumers will be more likely to choose hybrid adjustable-rate mortgages in the future, because they are cheaper than 30-year fixed-rate loans and are a good fit for the typical mortgage which has an average life of five to nine years. Homeowners will likely find that hybrid mortgages with fixed rates for seven or ten years are preferable, unless there is a significant rise in interest rates. While Fannie Mae could compete in the adjustable-rate mortgage arena, these loans would have a negative effect on the company’s profit margins, said Rosner.
- A second factor that could adversely impact Fannie’s business in coming years relates to new capital requirements expected in to take effect in 2006 from the Bank for International Settlements. In the past, Fannie has served as a conduit for lenders seeking to free up both the capital to make additional loans and the reserves that must be held against those loans. Lenders sold their loans to Fannie Mae so they could lend that money again, generating additional revenue. The banks also swapped loans for guarantees from Fannie Mae so that they have no exposure to the mortgages and do not have to add to reserves. Under the banks’ new rules, capital requirements will move away from the one-size-fits-all approach toward risk assessment. Today, all loans in an asset class have the same capital requirements. In the future, banks will adjust their capital requirement to reflect the risks in its loan portfolio. This change in the capital requirements will significantly increase the economic incentives for banks to hold onto mortgages, particularly those with the most predictable credit and cash-flow characteristics. When the banks portfolio more of their loans, Fannie Mae’s loan growth is restricted.
- Another threat to Fannie Mae’s business model is the prospect for a decline in the fees that company earns from banks for guaranteeing loans, a \$1.5 billion source of the GSE’s income in 2003. Rosner said that if Congress creates a new regulator to oversee Fannie Mae and Freddie Mac, that new agency would also likely supervise the FHLBs, which compete with Fannie and Freddie. The new regulator would probably bring into line disparate practices at the GSEs, including the size of guarantee fees they charge their customers. Today, Fannie Mae charges guarantee fees that are approximately double those assessed by the FHLBs. Rosner believes that this could soon change, which would adversely impact Fannie’s profit margins. (*New York Times*, Gretchen Morgenson, 12/19/04)

### Corporate greed will ruin a brand every time

- Ranking number seven on 2004's annual list of "Biggest Brand Blunders" by the Atlanta-based brand consulting firm Emergence Inc. is Fannie Mae, who recently announced that a restatement of its earnings could lead to a \$9-billion net loss for its third quarter. Kelly O'Keefe, chairman and CEO of Emergence, said, "It's a shame when a company so well respected for so many years strays. Corporate greed hits at the heart of a company's image." (*National Post*, 12/20/04)

### Fannie Mae's portfolio shrinks 0.8% in November

- In November, Fannie Mae said its investment portfolio shrank by an annualized 0.8%, after rising more than 12% in each of the two prior months. Fannie Mae's investment portfolio, a key source of earnings growth, totaled \$912.6 billion at the end of November, the company said. For the eleven months ended November 30, Fannie said its portfolio is up 1.7% on an annualized basis. Fannie said its duration gap was at negative one month in November from zero months in October. Fannie also said its mortgage-backed securities held by outside investors grew 6.2% in November to \$1.393 trillion and increased 7.8% since the beginning of 2004. (*Reuters*, 12/22/04)

### Fannie Mae postpones (again) its economic conference

- Fannie Mae has postponed for the second time its economic and mortgage market outlook press conference. Originally scheduled for December 16, the conference was postponed until December 29. Fannie's conference is now scheduled to take place in mid-January, said a spokesman. (*CBS MarketWatch.com*, Robert Schroeder, 12/27/04)

### Fannie Mae's move to Waterside Mall in doubt

- When the company outgrew its offices on Wisconsin Avenue, Fannie Mae decided to move many of its employees to southwest Washington and signed a letter of intent to move to Waterside Mall at M and Fourth streets SW. Fannie Mae's board of directors, concerned about the costs of fixing accounting problems, may put the project on hold, said sources familiar with the situation. Fannie Mae spokesman Alfred King said the company would not comment on the real estate deal.
- Mitchell N. Schear, president of Charles E. Smith Commercial Realty, the lead developer on the Waterside project, said he does not expect Fannie Mae's turmoil to affect the Waterside deal. He said, "The people that we work with at Fannie Mae have continued to work closely with us and press ahead." Schear said he's "busy

working through the negotiations” with Fannie Mae and hopes to have “something definitive” in 2005. (*Washington Post*, Dana Hedgpeth, 12/20/04)

## **Freddie Mac**

### Freddie Mac hires Timothy McBride as senior vice president of government relations

- Freddie Mac has hired auto industry lobbyist Timothy McBride to run its government relations operations effective January 3. McBride will oversee Freddie Mac’s legislative activities at the federal state, and local levels, as well as its relationship at HUD and other agencies within the executive branch. McBride, who was personal assistant to former President George H.W. Bush from 1985 to 1989, replaces lobbyist Mitchell Delk, who was fired in March after the company investigated and referred to the FEC alleged improprieties in Delk’s personal fundraising activities. McBride, who currently runs DaimlerChrysler’s Washington, DC office, said it was too early to discuss Freddie Mac’s strategy or how he might restructure company’s lobby operations, which relies heavily on outside consultants. His priority will be to “ensure that policymakers considering reform have the full breadth of knowledge in the debate and to ensure that it’s a fact-based debate,” said McBride.
- McBride brings to Freddie Mac valuable personal and professional connections to the White House that had been missing in Fannie and Freddie’s lobbying teams. His wife Anita McBride, was recently named as deputy assistant to President George W. Bush and chief of staff to First Lady Laura Bush. McBride is also held in high regard by the Bush family. (*Dow Jones Newswire*, Dawn Kopecki, 12/20/04; *Reuters News*, 12/20/04)

### Freddie Mac exceeds its third quarter capital requirements by \$28.6 billion

- Freddie Mac’s \$34.4 billion of reserves exceeded its regulatory risk-based capital standards by \$28.6 billion for the third quarter said OFHEO. Freddie exceeded its minimum capital requirements by \$9.823 billion as of September 30, the regulator said. The company also met a 30% capital surcharge levied by OFHEO. Freddie Mac’s capital calculation could change after it completes its financial statements for 2004, which are expected in mid-2005. At that time, OFHEO will determine if it needs to recalculate Freddie’s regulatory capital performance. According to OFHEO, Freddie Mac tests well under both high and low interest rate scenarios. In a high interest rate scenario, Freddie would need \$5.7 billion of capital, and in a low interest rate environment, the company would need \$2.6 billion, said OFHEO. (*Dow Jones Newswires*, Elizabeth Price, 12/30/04)

Freddie Mac's mortgage portfolio grew at an annualize rate of 2.8% in November

- In November, Freddie Mac's total mortgage portfolio grew at an annualized rate of 2.8%, while the company's retained portfolio and total PCs and structured securities issued decreased at an annualized rates of 6.0% and 0.4%, respectively. Freddie Mac's duration gap was zero months, unchanged from November. The company's single-family, non-credit enhanced delinquency rate was 24 basis points, up from 23 basis points in October. (*Freddie Mac Monthly Volume Summary*, November 2004)

## **Federal Home Loan Banks**

S&P downgrades FHLB-Seattle debt

- Standard and Poor's has downgraded the debt of the FHLB-Seattle, which signed a supervisory agreement with the Federal Housing Finance Board on December 10. S&P lowered the long-term counterparty credit rating to AA-plus from AAA and said the outlook for the government-sponsored enterprise was stable. The credit ratings agency said the Finance Board's supervisory agreement that raised the Bank's minimum capital and restricted the growth of the purchased mortgages it holds in portfolio, reinforced the agency's doubts. "This agreement confirms many of the concerns we have had with the growth in the Bank's on-balance-sheet, longer-dated, fixed-rate mortgage loans, and the depth of its risk management infrastructure to support this new business," said S&P credit analyst Victoria Wagner.
- The downgrade of the FHLB-Seattle had no impact on S&P's AAA rating for the senior debt of the consolidated obligations of the 12 FHLBanks, which is based both on the financial condition of the FHLB System and its status as a government-sponsored enterprise. The FHLB-Seattle is the third FHLB that S&P has downgraded since August 2003. The agency downgraded the FHLB-Chicago earlier in 2004 to AA-minus shortly after it entered into a supervisory agreement on June 30 with the Finance Board. The FHLB-New York was downgraded to AA in 2003 after the Bank disclosed losses on its manufactured housing portfolio.
- Moody's Investors Service affirmed the FHLB Seattle's rating at triple-A, saying it "believes that the profoundly negative effect on the U.S. housing market of a default by any one of the Federal Home Loan Banks makes it extremely unlikely that the government would fail to provide support to an FHLBank suffering financial distress." (*American Banker*, Rob Blackwell, 12/14/04; *Dow Jones International News*, Allison Bisbey Colter, 12/13/04)

FHLB-Chicago to restate its earnings (upward) by \$75 million

- The FHLB-Chicago will restate its earnings through 2001 due to errors in how it accounted for its derivatives investments and expects a cumulative net increase to earnings of \$75 million from the restatement. While the amounts of the restatements weren't "significant" on an annual basis, the Bank said investors shouldn't rely on its previous financial statements. In coming weeks, the FHLB-Chicago will issue its fully restated, audited earnings for the year ended December 31, 2003, which will include information for 2001 and 2002, along with the Bank's third quarter and year-end data for 2004. The FHLB-Chicago recently changed the timing of its recognition of income and expenses in accounting for its derivatives transactions under FAS 133, based upon a study of the Bank's accounting practices conducted by KPMG. The study of the Bank's accounting practices was part of a June agreement with the Federal Housing Finance Board.
- The Office of Finance for the 12 FHLBs said it will restate the combined financial results for the FHLB System, predicting a \$75 million cumulative increase to earnings in line with FHLB-Chicago's expectations. The Office of Finance issues debt jointly on behalf of the FHLBs, which are owned by their 8,000-plus member banks, credit unions, thrifts and insurers.
- The FHLB-Chicago has received a 45-day extension to file a new business plan and capital management plan with the Federal Housing Finance Board. "Given the tremendous amount of resources we are using to complete our change of accounting methods for certain derivative transactions, it is prudent for us to take our time to deliberate and finalize a business plan that will firmly position the bank for safe and sound growth in future years," said J. Mikesell Thomas, the president and CEO of the FHLB-Chicago. (*Dow Jones Capital Markets Report*, Dawn Kopeck, 12/15/04; *American Banker*, Rob Blackwell, 12/15/04; *FHLB-Chicago Press Release*, 12/20/04; *American Banker*, 12/21/04)

Ginnie Mae President Rosenfeld sworn in as  
chairman of the Federal Housing Finance Board

- On December 15, Ronald Rosenfeld was sworn in as a member and chairman of the Federal Housing Finance Board. Rosenfeld, formerly the president of Ginnie Mae, received a recess appointment to the Finance Board from President George W. Bush, who also designated him chairman. He succeeds as chairman Alicia Castaneda, who remains on the five-person Finance Board.
- "I take very seriously this obligation as chairman to encourage the safe and sound operation of these important institutions and to create policies that are in the best interest of the public and the homebuyer," Rosenfeld said. He also praised

Castaneda's leadership, saying "we can all look back on 2004 as a year when the Finance Board greatly strengthened its supervisory capabilities and took significant steps to improve the financial disclosures of the Federal Home Loan Banks."

- Rosenfeld served as president of Ginnie Mae, a wholly-owned government corporation within HUD from July 2001 until December 15, 2004. Previously, he was secretary of commerce in the state of Oklahoma. He also served as deputy assistant secretary for corporate finance at the Treasury Department in President George H.W. Bush's administration and held posts at HUD during that administration.
- John L. von Seggern, the president of the Council of Federal Home Loan Banks, applauded Mr. Rosenfeld's appointment. "His credentials are super, his background is good," Mr. von Seggern said. "Not knowing him too well, but having met him, I'm quite impressed. (*American Banker*, Barbara A. Rehm, Rob Blackwell, 12/15/04; *Dow Jones International News*, 12/185/04)

#### FHLB-San Francisco projects dividend rate for fourth quarter

- The FHLB-San Francisco announced that, based on the information available to date, it is projecting that a dividend rate of 3.89% (annualized) for the fourth quarter of 2004. The Bank's dividend rate for the third quarter of 2004 was 3.70% (annualized). The Bank expects to calculate and announce the actual dividend rate once the Office of Finance issues the combined financial statements of the FHLBs for 2004, scheduled for March 14, 2005. (*Business Wire*, 12/27/04)

#### FHLBs announce changes to their boards

- The FHLB-New York has added Ronald E. Hermance, Jr. to its board. Hermance is the president and chief executive officer of Hudson City Bancorp Inc. of Paramus, NJ, and its \$ 18.7 billion-asset Hudson City Savings Bank. (*American Banker*, Christopher Wood, 12/09/04)
- The FHLB-Pittsburgh announced the election of two new and two returning members to its Board of Directors. Elected as new directors to the FHLB-Pittsburg were David M. Applegate, chairman of the board of GMAC Bank, Horsham, PA, and president and CEO of GMAC Residential; and Gerard M. Thomchick, senior executive vice president and COO of First Commonwealth Financial Corporation, Indiana, PA. Returning directors to the FHLB-Pittsburg's board include Marvin N. Schoenhals, chairman, president and CEO of WSFS Financial Corporation; and H. Charles Maddy III, president and CEO of Summit Financial Group, Inc., Moorefield, WV. (*PR Newswire*, 12/16/04)

- On December 30, the Federal Housing Finance Board passed a resolution extending the appointment of directors on a holdover capacity on FHLB boards, whose terms were set to expire on December 31, 2004, until the Board either reappoints that person or appoints a successor director. (*Federal Housing Finance Board Resolution No. 2004-18, 12/30/04*)

FHLB-Dallas names Lockyer General Counsel
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- The FHLB-Dallas announced the promotion of Charles Lockyer Jr. to general counsel for the Bank. Lockyer, a vice president, joined the Bank in August 2003 as associate general counsel. Prior to that, he served as a legal associate with Fried, Frank, Harris, Shriver & Jacobson in Washington, D.C. (*PR Newswire, 12/21/04*)

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

FCS launches its Horizon Project
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- Bert Ely writes in *Farm Credit Watch*, “Not content with FCS’s existing lending authorities, FCS managers have launched a major campaign -- the Horizons Project -- to build phony grassroots political support for expanding FCS’s non-farm lending authority. ...[T]he FCS has unlimited authority to lend to farmers and ranchers, subject only to prudent credit standards. The Farm Credit Council (FCC), the FCS trade association, announced the Horizons Project in advertising its annual meeting next month.”
- “Here is what ..FCC[’s advertising] said about the project: ‘We launched the Farm Credit Horizons project -- Advancing the Farm Credit System’s Commitment to Rural America. This process will involve the System Directors and management and key System stakeholders in a focused effort to build consensus on Farm Credit’s future marketplace. Together, we will develop a clear understanding of what it will take for Farm Credit to efficiently and effectively serve that future marketplace. Once we achieve consensus, we will implement a process to successfully achieve any necessary changes.’”
- Ely writes, “This ‘consensus’ building process will be a charade -- the FCS managerial class already knows what it wants -- unlimited authority to lend to anyone anywhere for any purpose. Wayne Gustafson, president of the Illinois-based 1st Farm Credit Services, let the proverbial cat out of the bag with this quote in a recent issue of the Illinois Farm Bureau’s Farm Week: ‘We need to work together with Congress and other stakeholders and agriculture to modernize the system.’ Gustafson also

suggested that ‘Farm Credit might consider broadening the system’s charter to include rural business investment and expand home lending capabilities.’”

- Ely concludes, “The FCC will orchestrate the meetings to drum up support for expanding the FCS’s charter, as the FCS managerial class has long advocated. In particular, the FCC will be looking for political help from potential FCS customers who now borrow from banks and other private-sector lenders. In order for these meetings to have any credibility, they will have to be open to the public and well-advertised. Bankers should attend them to explain how they are amply meeting rural America’s credit needs. The FCC must not be allowed to build a one-sided case.” (*Farm Credit Watch* , Bert Ely, December 2004)

#### Farm Credit Administration names secondary market oversight director

- The Farm Credit Administration has named Andrew D. Jacob as its new director for its Office of Secondary Market Oversight. Jacob has been acting director since August 2004, responsible for examining and supervising Farmer Mac. In 1986, Jacob joined the Farm Credit Administration as a credit examiner. (*Dow Jones Newswires*, Rob Wells, 12/23/04)

## **Sallie Mae**

#### Sallie Mae completes its privatization four years ahead of schedule

- On December 29, Sallie Mae completed its separation from the federal government nearly four years ahead of schedule, setting aside money to pay off all outstanding debt obligations from its government-sponsored subsidiary. In a special purpose trust, the company deposited cash and U.S. Treasury securities to repay the remaining principal and interest on \$1.85 billion of outstanding bonds left over from its original GSE subsidiary. The Treasury signed documents to retire Sallie Mae’s federal charter, officially separating Sallie Mae from the federal government. The company has successfully refinanced more than \$100 billion of GSE assets in its accelerated privatization plan that began in 1997.
- “We made a fundamental decision about 10 years ago that the right way this company should go was as a private player. We gave up, obviously, a lower cost of funds. I think, ultimately, that was what real benefit we had as a GSE,” said Sallie Mae’s CEO Albert L. Lord, who was the architect of Sallie’s privatization plan. “We concluded that we had to suck it up on that score and move forward as a slightly less profitable entity, at least in terms of our margin, and make up for it in volume... and we’ve done that.”

- Privatization, a plan that is often discussed for Fannie Mae and Freddie Mac, has enabled Sallie Mae to diversify its operations beyond student loans. Sallie has acquired smaller competitors and branched out into consumer finance, debt collection and guarantor servicing and other related areas since initiating its privatization process. “The goal [of Sallie Mae] was never really to go into other businesses; it really was to be able to operate in all facets of our current business,” said Lord. “In order for us to do what we do best required our mission to creep.” (*Dow Jones Newswires*, Dawn Kopecki, 12/30/04, *Associated Press*, 12/30/04)

## **Postal Service**

Postal Service is trying to stay competitive
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- Postmaster General Jack Potter said in an interview the USPS will keep its promise not to raise rates before 2006. In the spring, the Postal Service will begin the process which takes a year. He said that a phased-in increase is a possibility. Potter is hopeful that Congress will pass postal reform legislation to give the agency more flexibility in how it operates. He said that the amount of the postal rate increase will depend on whether the legislation removes the requirement for the USPS to place funds in escrow in 2006, which ties up \$2.9 billion. Potter noted that first-class mail has declined while advertising mail has increased, which alters the finances of the USPS. Transmission and payment of bills via the Internet has reduced first-class mail volume, while other first-class items have been switched to standard rates. While the USPS will not abandon universal service, the agency would like some flexibility in closing smaller offices, many of which serve fewer than 100 people. (*Alliance for Nonprofit Mailers*, 12/17/04)

IRET examines the postal rate setting process and postal reform
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- In a study of the USPS rating setting process, economist Michael Schuyler of the Institute for Research on the Economics of Taxation said, “...[C]urrent law already gives the USPS much of the price flexibility it lacks, provided the agency is willing to work with its rate regulator. This is not to say that legislative reforms are unneeded. Reforms should be made, but in areas where the problems are more real and pressing. An excellent centerpiece for legislation would be cost control reforms. Legal constraints now make it much harder for the USPS to manage its costs than it should be.” (*IRET Congressional Advisory*, Advisory No. 182, 12/08/04)

- In a December 16th American Postal Workers Union update, APWU President William Burrus said, “The advocates of postal reform have failed again in 2004 to deliver on their promise of passing legislation. A group of dedicated legislators addressed the concerns of many disparate groups to write bills that were acceptable to organizations with differing interests. The bills would have addressed fundamental issues that will confront the Postal Service over the next 30 years. Unfortunately the bills died, without consideration by the full House and Senate. Without legislative relief, some analysts predict that rate increases in 2006 could be more than 20 percent. This alarming projection has not gone unnoticed in the mailing community and those who aggressively supported wide-ranging postal reform have now shifted their attention to the short-term affect of the military retirement payments and escrow account on 2006 postage rates. No strategy has emerged to confront [these] most important issues that would require legislative intervention. Given the current chaos, postage rates will explode, while those who could have made a difference wonder what could have been.” (*American Postal Workers Union, AFL-CIO Burrus Update #18-2004, 12/16/04*)

## ***TVA and Rural Electric Co-Ops***

### Senator Alexander urges TVA to reduce its pollution – and TVA responds

- Senator Lamar Alexander (R-TN) has urged the TVA to move forward with its plans to control emissions at its coal-burning plants. In a letter to TVA Chairman Glenn McCullough, Alexander asked the agency to put its plans “in concrete.” The Senator’s letter was in reaction to the EPA’s recent announcement that the Knoxville and Chattanooga areas were in violation of air quality standards for particulate matter, which is soot, dust or other materials produced by burning wood and fossil fuels and vehicle emissions. Alexander said he does not believe Knoxville and Chattanooga could ever pass EPA’s requirements if TVA does not install scrubbers on each unit of the John Sevier, Bull Run and Kingston plants. “TVA is only one part of this problem, but TVA can do more about the problem than any other single entity in Tennessee,” wrote Alexander. “What I am asking is that TVA put these plans in concrete by amending its operating permits and that it do the same thing with the John Sevier plant,” he wrote. Alexander said TVA’s three plants closest to the Great Smoky Mountains National Park put about 210,000 tons per year of sulfur dioxide into the air. “The quality of our air in the Tennessee Valley is unacceptable,” he wrote. “It is damaging to our health, to the scenic beauty of the Smokies and -- because of federal environmental requirements -- to our ability to recruit good jobs and to build good highways.”

- Responding to Alexander’s letter, TVA director Bill Baxter said that the agency is spending \$1 million a day to improve air quality and has “firm plans” to reduce emissions near the Great Smokey Mountains National Park. TVA has plans to install scrubbers at Bull Run and Kingston by 2010. “We have had this discussion with the senator’s staff,” Baxter said. “It’s frustrating that there is the impression that they don’t have these facts.” Alexander’s spokeswoman, Alexia Poe said frustration was not the reaction Alexander was seeking in sending the letter, but “to point out his concerns and desires for TVA to lead the way.” (*Associated Press*, 12/22/04)

Lobbying works its magic for rural electric co-ops
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- Glenn English, the former Republican congressman from Oklahoma who now heads the National Rural Electric Cooperative Association (NRCA), was a big winner in this year’s election. Nobody was more pleased than English, when amid intense competition with John Kerry for Farm Belt votes, the Bush administration announced \$3 billion in government-backed loans for rural development three days before the election. While the announcement got little attention from the national media, Bush’s move was widely trumpeted in the agricultural trade media and in the rural communities that were the beneficiaries of the program. The Bush administration’s willingness to bend its free-market principles for powerful farm groups came despite longstanding criticism of the subsidized loans by the GAO and other government watchdogs. The decision also illustrates the clout of English’s NRCA, an obscure but effective lobbying organization in Washington whose scope extends to issues far beyond electrifying the countryside.
- As a Congressman from 1975 to 1994, English led a campaign on Capital Hill for more rural loans during the 1990s; subsequently, he has maintained access to pivotal players on agriculture and appropriations committees that write farm legislation. English sets up lobbying trips by leaders of NRCA’s members: 900 cooperatives that are nonprofit, consumer-owned organizations originally formed to bring electricity to rural areas. The cooperatives’ 37 million customers vote in almost every rural House district. According to the Center for Responsive Politics, NRCA’s political action committee has made approximately \$8 million in donations since 1989, putting the PAC on a par with Exxon Mobil Corp.’s PAC.
- English sees NRCA’s recent victory in getting subsidized loans for rural electric and telecommunications projects as their first step in an ambitious political agenda. He plans to expand the PAC’s fund raising, which is currently limited to co-ops, to include individual donations from “co-op members”-- the 37 million customers of the rural utilities. English views the upcoming debate over the energy bill as an opportunity to exert more political influence, particularly in decisions about overhauling the nation’s electricity grid where co-ops will likely battle privately owned utilities. “We want to take it to a level where we’ve never been before,” said English.

- In the 2002 farm bill, the rural-loan subsidy was originally authorized; however, it took two years for the Bush administration to agree to create it. “While this has been a difficult experience,” English said, “it has created a new level of trust among some key people in the Bush administration.” In fact, trust among Republican administration officials is a new development for co-op lobbying projects. The Agriculture Department’s Rural Electrification Administration was created by a 1935 executive order signed by President Franklin D. Roosevelt to make low-cost loans to groups bringing power lines and power plants to rural America. In the Nixon, Reagan and first Bush administrations, budget cutters tried repeatedly to abolish the agency. By 1990, President George H.W. Bush led the charge against the co-ops, asserting in a speech that congressional proposals to expand the loan programs “represented unwarranted increases in federal subsidies and risk,” and created a portfolio of loans that was increasingly hard to manage. According to a report issued by the Agriculture Department, “nearly 100% of all farms and rural areas” had reliable electricity and telephone systems and recommended that government-subsidized loans be cut back and reserved for a few hardship cases.
- Consequently, the rural electric co-ops decided to organize their own private bank, called the National Rural Utilities Cooperative Finance Corp.(CFC) in Herndon, VA. The Rural Utilities Service, an Agriculture Department agency, helped the CFC get started by giving co-ops even “sweeter” government-backed loans if they would promise to wean themselves from federal assistance and get future loans at the private bank. The \$3 billion of loans announced by the Bush administration last fall would blur the distinction between private and government lenders, such as the CFC and the Agriculture Department’s Rural Utilities Service. For the first time, the co-ops’ private bank will be able to issue government-backed loans. In exchange for the lower interest rates, the CFC will pay a fee into a new fund, expected to generate \$270 million, which will be used to help communities raise money for projects such as buying new fire engines.
- The CFC and the Rural Utilities Service have both been criticized for straying from their mission. A June GAO report said that the lenders are not targeting their money in the rural areas they are supposed to serve. Because it has a “once a borrower, always a borrower” standard, the Agriculture Department’s bank has 29% of its loans to co-ops in counties now classified as part of metropolitan areas. Three co-ops provide electricity to suburban Atlanta and another offers satellite-television service to residents in Washington, D.C., said the GAO and the Agriculture Department’s inspector general.
- Examiners have said that both banks have engaged in risky lending. According to the GAO, the government bank wrote off more than \$3.2 billion in losses to three borrowers from 1999 to 2003. The co-ops’ private bank has also gotten into trouble by lending more than \$1 billion to a member in suburban Fort Worth, TX. The Denton County Electric Cooperative created a company called CoServ, which formed more than 30 subsidiaries selling telecommunications, real-estate developments, natural gas, home-security systems and cable television. Most of CoServ’s

businesses declared bankruptcy in 2002, leaving the co-ops' bank with collateral properties such as a suburban hotel and golf course. Sheldon C. Peterson, CEO of the co-op's private bank, said that his \$20 billion CFC is in sound financial condition. Calling the CoServ loan "an experiment," he acknowledged it was a failed attempt to develop business opportunities for co-ops. Peterson said he can't talk about two other pending bad loans because of ongoing negotiations.

- While some of the loans go to areas that are partly urban, the agency's "focus continues to be on the rural," said Hilda Gay Legge, administrator of the government lending program. Only 3.6% of the borrowers in the agency's \$50 billion loan portfolio missed payments last year, Legg said. "they may be behind, but they're not bad loans." (*Wall Street Journal*, John J. Fialka, 12/27/04) [Your tax dollars at work.]

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