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# The GSE REPORT ™

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# *Major Events*

## Fannie Mae and Freddie Mac exceeded their affordable housing goals in 2004

- HUD announced that Fannie Mae and Freddie Mac exceeded their official affordable housing goals in 2004. However, the agency penalized Freddie Mac for failing to get HUD's approval before counting some of its mortgage purchases contained in REITs toward the goals. As a result, HUD allowed Freddie Mac to count just half of those purchases toward its low-income financing targets.

- After adjusting for Freddie Mac's error, HUD said that 51.6% of the units the GSE financed in 2004 qualified toward its low- and moderate-income housing target; 22.7% qualified toward its very low income goal; and 32.3% met its target for financing homes in underserved areas. HUD said that 53.4% of the homes Fannie Mae financed in 2004 qualified towards its low- and moderate-income housing target; 23.6% qualified toward its very-low income housing goal and 33.5% met its goal for financing homes in underserved areas. In 2004, the GSEs' goals for low and moderate income buyers, very low income, and underserved areas, were 50%, 20% and 31% respectively. (*US Fed News*, 12/12/05; *Dow Jones Newswires*, Dawn Kopecki, 12/12/05)

## Treasury inspector general concludes that Secretary Snow didn't break law by owning GSE debt

- U.S. Treasury Secretary John Snow did not violate the law when he inadvertently owned $10.87 million of GSE debt, concluded the agency's inspector general (IG). In 2004, Snow asked the IG to review his February 2003 purchase of Fannie Mae and Freddie Mac bonds to determine whether the purchase represented a conflict of interest. Last year, Snow said that he did not know that he owned the debt, which financial advisors had purchased for him. The IG concluded that Snow's financial advisors made few distinctions between Treasury securities and GSE debt. During the 15 months that the Secretary owned the GSE debt, Snow urged Congress to create a new regulator at Treasury for Fannie and Freddie. Soon after learning in early May 2004 that he owned the GSE bonds, Snow sold them at a loss of $478,000. "As soon as we discovered the mistake, we corrected it," said Snow.

- The IG report concluded, "No evidence or information was developed in the course of the investigation which would suggest Secretary Snow knowingly held GSE securities. …Interviews and related document reviews reasonably suggest misunderstanding and/or miscommunication." The Treasury's office of Inspector General referred its findings to the Justice Department, which concluded that no crime had been committed. "The Secretary is committed to the highest ethical behavior and he cooperated fully in this matter," said Treasury spokeswoman Brookly



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McLaughlin. (*BNA's Daily Report for Executives*, Brett Ferguson, 12/12/05; *Bloomberg News*, Alison Fitzgerald, Brendan Murray and James Tyson, 12/09/05; *Dow Jones International News*, Deborah Lagomarsion, 12/09/05)

- Senator Max Baucus (D-MT), ranking member of the Senate Finance Committee, said, "I'm concerned by the conclusion that Secretary Snow had no knowledge about a $10 million personal stake in institutions he's sworn to oversee. The Secretary of the Treasury should know when his private investments intersect with his public responsibilities to the American people." (*US Fed News*, 12/09/05)

# *Fannie Mae and Freddie Mac*

Likelihood of GSE reform in '06? Depends on who you talk to…

- With the holiday season in full swing, pundits are already declaring GSE regulatory reform legislation "dead on arrival" for 2006 – unless, of course, something dreadful happens at Fannie Mae or Freddie Mac. While Fannie Mae has warned shareholders to expect "bad news" in Senator Rudman's report on accounting improprieties, some observers note that the report's findings have already been leaked. "We're not expecting any unexpected revelations in the Rudman report or the OFHEO report," said Jaret Seiberg, an analyst for Stanford Washington Research Group. Without the catalyst of a bombshell in one for the reports or an unexpected bad news from one of the GSEs, sources say that neither critics nor supporters of Fannie and Freddie have reason to moderate their stance and strike a deal on GSE regulatory reform legislation. (*American Banker*, Michele Heller, 12/05/05)

- On the other hand, U.S. Treasury Secretary for Domestic Finance Randal Quarles said he remains optimistic about GSE regulatory reform legislation being passed next year and adds that the administration has "not reduced" its priority on GSE reform. "I continue to believe that that is a threadable legislative needle," said Quarles. "I continue to believe that we can come to something obviously closer to the Senate bill than what came out of the House. I continue to believe that that is an achievable legislative outcome." When asked by reporters if he was optimistic that the White House would succeed in getting GSE regulatory reform, Quarles responded, "Yes, actually I am. …I think there is an opportunity for the environment in which these bills are being considered that will be affected by the facts that develop [over the next few months]. I'm not necessarily referring to anything specifically, but we'll be looking at the facts that develop in the immediate term. That changes the environment in which these bills operate." (*Dow Jones Newswires*, Deborah Lagomarsino, 12/14/05)



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- With regard to the Fannie Mae-Freddie Mac "waiting game," Erick Gustafson, the vice president of government affairs for the Mortgage Bankers Association, takes a practical and reasoned approach. "In the legislative process, your moment of greatest strength is in conference," Gustafson said, calling it a "get-together with 15 of your closest friends." He believes that chances for Senate movement on GSE regulatory reform legislation in 2006 as greater than 50 percent, adding, "It would be a bummer to see all the work of the past couple of years come to nothing because we're unable to get a bill out of the Senate." (*The Hill*, Elana Schor, 12/13/05)

- On a housekeeping note, the Senate Democratic Caucus appointed U.S. Senator-designate Robert Menendez (D-NJ) to the Banking, Housing and Urban Affairs Committee, as well as the Energy and Natural Resources and Budget Committees. On December 9, New Jersey Governor-elect Jon Corzine announced that he will appoint Menendez to fill the remainder of his Senate term. On January 17, Menendez will take office after Corzine is sworn in as governor. (*Congressional Quarterly*, 12/15/05)

Former OFHEO director Armando Falcon discusses the need for GSE regulatory reform

- In an interview with *Forbes'* reporter Matthew Swibel, former OFHEO director Armando Falcon answered questions about the pending GSE regulatory reform legislation. When asked what he thought about the GSE regulator being given the power to scale back the size of Fannie's and Freddie's holdings, Falcon responded, "It's very important that Congress pass legislation to strengthen powers of the regulatory agency. But it's not helpful for regulators to have their hands tied behind their backs on the issue of portfolio limits. I never really considered that was a final point to the legislation until the problems came up with Fannie and Freddie in accounting areas. Many of those problems arose because of the vast amount it took for the companies to manage the risk associated with the retained portfolios. [That is, the loans they keep instead of reselling in the secondary market.] Since the retained portfolios really don't contribute to the fulfillment of the mission of the companies [to promote housing and easy access to mortgages], it is time to get the companies to scale back their portfolios." When asked if he had a specific size in mind, Falcon said, "I wouldn't want to see a hard number in legislation, but the number mentioned [$100 billion to $200 billion] is within the ballpark of what's necessary for the fulfillment of Fannie's and Freddie's mission."

- Swibel asked, "How did you react to [incoming Federal Reserve Chairman] Ben Bernanke's comments that …[OFHEO] possesses 'constrained capital authority' and 'ineffective receivership' powers to take over Fannie's or Freddie's operations and liquidate their assets if necessary?" Falcon responded, I agree with [Bernanke's] statement. We have no receivership powers now. It's still inadequate for what's needed. If one of these companies ever became insolvent, the agency would need all these tools to handle the liquidation of the company. …Irrespective of whether the powers are ever needed, the notion that one of the companies might become insolvent



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isn't too far fetched. In the 1980s, Fannie was losing $1 million a day and was technically insolvent."

- Swibel asked, "Based on your experience, what do you see as responsible for Congress' seeming reluctance to tighten rules on GSEs?" Falcon said, "It's a reflection of the long-standing political alliance between GSEs and members of Congress. There are members of Congress who start out supporting solely the mission of the two companies, however, because the companies do a lot for members of Congress through campaign contributions, ribbon cutting ceremonies, support for charities of members of Congress, they're beholden to the companies' full agenda. If the money was turned off, at least then we would have an honest debate about the policy issues."

- Swibel asked, "What do you think is the likelihood that if and when the Securities and Exchange Commission comes down hard on Fannie and Freddie's accounting failings, defenders of GSEs will say the problem has been dealt with and, therefore, no additional legislation is necessary?" Falcon responded, "That's a false hope. When I left, we had an agenda to make sure these problems don't occur again. These include putting the right culture and controls in place at the two companies and strengthening the authorities of the regulator. You have to give the regulator all it needs to do its job. It's imperative. If Congress says it will do 'all it can' to prevent another accounting scandal at Fannie and Freddie, it should pass strong legislation." (*Forbes Magazine*, Matthew Swibel, 12/14/05)

### Freddie Mac CEO Syron "demystifies" the GSEs' systemic risk—or does he?

- In a December 6 speech to the Executive Club of Chicago, Freddie Mac chairman and CEO Richard F. Syron said, "For the past several years, the debate in Congress about GSE regulatory reform has rightly focused on the most effective oversight structure, the regulator's discretion over capital, and so forth. But while the GSEs were effective, they were also arrogant. So as time went by, this debate became seen, by some, as a perfect opportunity to cut the GSEs down to size. The chosen vehicle has been the notion of 'systemic risk' – the claim that the GSEs pose a looming threat to the nation's housing finance system, indeed to our financial system as a whole. The proposed solution? Shrink the GSEs and you eliminate systemic risk. Well, competitive issues are at work here. And unfortunately, the truth is not nearly so convenient. The risks inherent in mortgage lending are real. And they don't disappear so easily. …Because mortgage risks are inherent in our system, you can't eliminate them just by forcing the GSEs to sell all their mortgages. All you do is shift them to someone else's balance sheet. And these days, that 'someone else' is very likely to be one of the nation's largest banks. …*Already, 40 percent of mortgage-backed securities are held by just three big banks.* [Freddie Mac later corrected Syron's prepared remarks to read, "…40% of all U.S. banks' mortgage-backed bonds are owned by three banks."] With that kind of increasing concentration in banking, if the GSEs are forced to sell off our mortgage holdings, it's likely these mortgages will



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end up on the balance sheets of the nation's largest banks. And so the risk associated with mortgage investing will be shifted – but it will not be reduced. In fact, systemic risk may well actually be increased."

- Syron continued, "I'd be the first to agree that the GSEs grew at an unsustainable pace in the late 1990s. …Today things are very, very different. First, competition for mortgages is fierce, and not just from banks and thrifts. Now, relatively new players like private label issuers and hedge funds are vying for conforming mortgage assets. Second, there is better information. More institutions have the better prepayment models and information needed to deal with mortgage risks. The result is that market forces are working quite well, and the GSEs' growth has slowed dramatically. Since the beginning of 2000, total mortgage debt outstanding has grown by 80 percent. The retained mortgage portfolios of Freddie Mac and Fannie Mae together have grown by 75 percent. By contrast, the portfolios represented by the five largest banks and thrifts have grown by 132 percent. However, the fact that we could step in and buy mortgages as needed provides a critical financial and psychological backstop to the entire market. And should market demand for mortgages begin to wane, we are always there to provide liquidity and keep costs low for consumers. Sacrificing the GSEs' ability to purchase mortgages and issue debt will only weaken housing and the broader economy. It will destroy our housing finance system's equivalent of a "Strategic Petroleum Reserve" for when times get tough. And to solve yesterday's hypothetical problem, it will cause tomorrow's very real unintended consequences."

- Syron concluded, "Does Freddie Mac want strong oversight? You bet. Let's have a strong regulator and reinforce market confidence, with accounting beyond reproach. But this is the worst possible moment to make the GSEs play permanently with both hands tied behind our backs. Congress and the president got it right in 1970 when they set up a secondary market, with two competing GSEs, that attract private capital to serve a public mission. For more than three decades now, the results have been clear: it's working. That's why, at the end of the day, I have faith in the wisdom of our political system to do the right thing for America's families and our nation. So we can keep on being a force for stability and opportunity…as part of the finest housing finance system in the world." (*Prepared Remarks for Richard F. Syron, chairman and CEO of Freddie Mac*, 12/06/05; *Dow Jones Capital Markets Report*, John Connor, 12/14/05)

## CBO Director Holtz-Eakin says that AH Fund would help low-income homebuyers

- In an interview with *Bloomberg News*, CBO Director Douglas Holtz- Eakin said that assessing an affordable-housing portfolio fee would better advance the GSEs' federal mission to expand homeownership than what is achieved through Fannie's and Freddie's current lines of business. "Targeting [the GSEs'] subsidy to low-income borrowers in just the usual mortgage market is too blunt an instrument," said Holtz-Eakin said. The AH fee "is a way to more carefully target" for low- income homebuyers the benefits that Fannie Mae and Freddie Mac derive from government



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sponsorship. A portfolio fee may also encourage Fannie and Freddie to scale back their portfolios, he added. [On November 11, *CQ Today* reported that Holtz-Eakin will leave CBO at year-end to join the Council on Foreign Relations.] (*Bloomberg News*, James Tyson, 12/15/05; *CQ Today Midday*, 11/14/05)

## White House continues its search for new director for OFHEO

- With GSE regulatory reform legislation "on hold" in Congress, the Bush administration has stepped up its efforts to name a new director for OFHEO. According to sources familiar with the search, the White House is considering at least four candidates to head the regulatory agency for Fannie Mae and Freddie Mac. Among the candidates being considered are Jonathan Fiechter, a deputy director at the International Monetary Fund; Edward DeMarco, assistant deputy commissioner at the Social Security Administration; Mark Sullivan, the U.S. representative to the European Bank for Reconstruction and Development; and Steve McMillan, an adviser to White House Chief of Staff Andrew Card.

- In 2003, Fiechter joined the IMF as deputy director of the monetary and financial system department after three years as senior deputy comptroller at the Office of the Comptroller of the Currency. Prior to joining the IMF in 2003, DeMarco was director of the Treasury's Office of Financial Institutions Policy, where he helped developed regulations for Fannie Mae and Freddie Mac. McMillan, a former aide to retired Senator Phil Gramm (R-TX), became an adviser to Card in November after serving in the office of White House Budget Director Josh Bolton. Sullivan became the U.S. representative to the EBRD in 2002, rejoining Treasury where he served as general counsel from 1988 until 1989.

- In May, the White House began actively seeking a successor for former director Armando Falcon, Jr. In a November 23 interview with *Bloomberg News*, OFHEO's acting director Stephen Blumenthal said, "The administration is interviewing people, and they have been interviewing people since before Director Falcon left. You are looking for people who are dedicated to carrying out the mission of the agency expressed by Congress [to ensure the safety and soundness of the GSEs]." In a December 7 article appearing in *Dow Jones Newswires*, Dawn Kopecki reported, " …[A]dministration officials stepped up that [selection] process in recent weeks after receiving calls from several current and former federal regulators, including officials at the Treasury Department and the Securities and Exchange Commission, who said they lost confidence in the acting director, according to government officials and other people close to the matter." Apparently, Blumenthal "hit a nerve" among policymakers, when in a November 16th speech before the Bond Market Association's Global Bond Summit, he said that the arguments to shrink the GSEs' mortgage portfolios by the administration and Federal Reserve were not "terribly persuasive" and that reducing the GSEs' assets could result in a "massive sell-off" of the GSEs' stock. Blumenthal also irritated administration and Federal Reserve officials by voicing support of the House of Representative's GSE regulatory reform



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legislation at the BMA forum. [With the approval of OFHEO's lawyers, Blumenthal's travel expenses to Hong Kong to attend the BMA conference were paid for by the trade group.] White House spokeswoman Erin Healy, said, "Mr. Blumenthal is serving in the acting capacity. We will move forward [on appointing a replacement] as soon as possible, but we don't speculate on the timing or the content of those announcements." There is speculation that the White House will appoint the OFHEO director after Congress adjourns on December 20, through a recess appointment.

- Josh Rosner, an analyst at Medley Global Advisors said, "Anyone offered the position is going to have to ask themselves whether they want to take a job that may be overseeing the unwinding of [the agency]." (*Dow Jones Newswires*, Dawn Kopecki, 12/07/05; *Bloomberg News*, James Tyson, Robert Schmidt, 12/07/05; *National Mortgage News*, Brian Collins, 12/12/05; *Wall Street Journal*, John Harwood, 12/09/05)

## OMB issues rare "return letter" to OFHEO regarding its proposed regulation to weaken legal protection for GSEs' management

- In a rare "return letter," OMB told OFHEO that its proposal to restrict the GSEs' ability to indemnify their directors and officers against certain legal liabilities failed to consider alternatives and to examine the potential impact of the rule. "The draft rulemaking does not sufficiently consider its consequences," said John Graham, the administrator of OMB's Office of Information and Regulatory Affairs, who asked OFHEO to prepare an analysis of the proposal's effect. Additionally, Graham asked the agency to brief OMB staff before it "makes a decision as to whether resubmission is appropriate." An OFHEO spokeswoman said that the agency "will continue to work with OMB and will provide a response as requested in the letter." (*Dow Jones Newswires* , Dawn Kopecki and Henry J. Pulizzi, 12/09/05)

## Fannie and Freddie concede that their business models must change in the face of stiffer competition and changing consumer demands

- As they contend with the aftermath of multi-billion dollar accounting scandals, Fannie Mae and Freddie Mac officials say that they also must face a choice between moving into riskier types of mortgage investments or acknowledging to shareholders that their potential for growth is limited. In either case, officials concede that their business models must change in the face of stiffer competition in the mortgage market and increasing consumer demand for non-conforming mortgages. On balance, the GSEs are having to adapt to a mortgage industry, which is much freer in lending and much more likely to hold mortgages in-house for longer periods of time. Moreover, customers are more willing to take on riskier, adjustable-rate loans to keep their monthly mortgage payments down. Fannie's and Freddie's options are to become more deeply involved in the adjustable-rate mortgage market which has



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boomed in recent years; to change the standards for granting mortgages to accommodate customers with "spotty" credit records; and/or to finance more multi-family developments.

- The GSEs are even concerned about sustaining their dominance in securitizing mortgages, now that large institutions such as Countrywide Mortgage and Leman Brothers have moved successfully into this space. As a result, Fannie's and Freddie's share of the MBS market has fallen from more than 60% in 2000 to about 40% in 2005, according to *Inside Mortgage Finance*. Patricia L. Cook, Freddie Mac's executive vice president for investment and capital markets, said, "The challenge for us is to reassert our presence in those areas where we've lost a bit of competitive advantage."

- "So much of the new [popular] mortgages don't fit into [Fannie's and Freddie's] framework," said William C. Apgar Jr., a former assistant housing and urban development secretary, who is now with Harvard University's Joint Center for Housing Studies. "Fannie and Freddie did a big service taking a relatively unorganized system and saying, 'If you present a mortgage of this type, we can bundle them together and sell them to investors.' Now the flow of product is so much more complex and requires so much information," Apgar said. "Fannie and Freddie haven't figured out a way to get into that segment of the market. They're constrained because of their concern about how well they can manage that risk."

- While demand for adjustable-rate mortgages has begun to taper off as interest rates have risen, housing finance experts say adjustable-rate mortgages are here to stay. "It's unlikely Fannie Mae and Freddie Mac will ever see the market shares they saw in the early 2000s," said Dale Westhoff, senior managing director of mortgage research for Bear Stearns. "We will continue to see a higher share of adjustable-rate mortgages than we've seen historically."

- Fannie Mae and Freddie Mac officials argue that they will have to adapt to these market changes to fulfill their government-chartered mission to keep money flowing into the housing market. "The market is so competitive that even if our favored and friendliest customer sees us as being off by a [tenth of a] point, they're going to sell the business somewhere else," said Fannie Mae CEO Daniel Mudd. "We've got to build the company to manage that and be ready for it." (*Washington Post*, Annys Shin, 12/05/05)

## Hurricane recovery efforts on Capitol Hill continue and fallout continues

- The drive to rebuild communities devastated by Hurricane Katrina has slowed, hampered by worries in Congress about the cost of reconstruction and confusion about which of the regions to fix first. In a push to rebuild the levees around New Orleans "better and stronger" than before Hurricane Katrina breached them in August, President Bush has pledged an additional $1.5 billion to strengthen New



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Orleans levee system. Earlier, Louisiana Governor Kathleen Blanco announced her support for consolidating southeast Louisiana levee districts in an effort to reform the levee agencies system that has long been criticized as "dens of political patronage." Blanco's proposal has attracted broad support from business groups and others involved in the recovery efforts. (*Associated Press*, Brett Martel, 12/12/05; *USA Today*, Oren Dorell, 12/15/05; *Washington Post*, Joby Warrick and Peter Baker, 12/16/05)

- Meanwhile, debate in Congress has heated up over the role of the Federal government and the American taxpayers in rebuilding the Gulf Coast. To date, Congress has approved $62 billion in emergency spending for hurricane relief and FEMA has spent about $22 billion. Congress continues to work through the allocation process of the remaining funds. The Bush administration proposed reallocating $17 billion of previously approved emergency spending toward the repair of highways, levees, and federal facilities and for economic development and housing programs. Over the administration's objections, Senate Appropriations Chairman Thad Cochran (R-MS) proposed to more than double the hurricane recovery funds requested by the President. On December 17, the *Associated Press* reported that Congressional Republicans have agreed on $29 billion in additional aid for the victims of Hurricane Katrina and the other storms victims, more than 150% above the Bush administration funding request. "We have a good agreement," said Governor Haley Barbour (R-MS), who spearheaded negotiations with lawmakers for aid for hurricane victims. Officials stressed the additional relief funds would not add to federal deficits, since the agreement included a 1% reduction of funds for a "wide swath of federal programs" including domestic, defense and homeland security programs, said Representative Jerry Lewis (R-CA), chairman of the House Appropriations Committee. (*USA Today*, Oren Dorell, 12/15/05; *Associated Press*, David Espo; 12/17/05; *Wall Street Journal*, David Rogers, 12/06/05)

- On December 15, the House Financial Services Committee approved H.R. 4100, which would create the Louisiana Federal Recovery Corp., a federal agency to purchase destroyed homes in Louisiana and resell them to the original owners or developers. Representative Richard Baker (R-LA), the bill's sponsor, said he hoped to meet with House leaders to discuss passing the bill this year. "I'll throw my saddle on anything that's breathing," said Baker. "We're down to hours, not days." Before winning approval on a 50-9 vote in committee, Baker had to overcome a number of amendments from fiscal conservatives on the panel, foreshadowing a floor fight regarding provisions of the bill that would increase federal spending. Under this bill, banks would receive a maximum of 60% of the mortgage value, while homeowners would receive in return a minimum of 60% of their equity. In a step to appease Democrats on the committee, committee chairman Michael G. Oxley (R-OH) proposed a substitute amendment that would authorize the redistribution of $17 billion in Hurricane Katrina aid with $13 billion of that amount going to the Community Development Block Grant program. The amendment was adopted by a voice vote. Privately, congressional aides and industry lobbyists said that the bill prospects for passage this year are slim, largely because conservatives oppose the



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legislation. (*American Banker*, Michele Heller, 12/15/05; *CQ Today*, Tim Starks, 12/16/05)

- Private charity to hurricane victims along the Gulf Coast ranks as the largest in the nation's history according to the University of Indiana's Center on Philanthropy. Donations to hurricane victims exceeded more than $2.97 billion, well above the charitable donations ($2.8 billion) that poured in following the September 11, 2001, terrorist attacks. The "true" level of giving isn't even reflected by the $2.97 billion figure, since the Center arrived at that estimate by surveying 175 charitable organizations. The Center's analysis doesn't account for the volunteers who've come in large numbers or for supplies donated by individuals and groups. (*The Times Picayune*, 12/18/05)

- Meanwhile, home mortgage delinquencies are rising in the Gulf Coast region, three and a half months after Hurricane Katrina. According to estimates by the Mortgage Bankers Association, mortgage loan delinquencies at the end of September have increased more than three fold in Louisiana to 24.6%, while delinquency rates in Mississippi have doubled to 17.44%. Governor Kathleen Blanco has announced that 205,000 homes in Louisiana were damaged or destroyed in the storm. (*Dow Jones Newswires*, Campion Walsh, 12/14/05; *Orlando Sentinel*, Jack Snyder, 12/15/05; *The Times Picayune*, Bruce Alpert and Bill Walsh, 12/18/05)

- A debate is playing out along the Gulf Coast, as storm victims, coastal engineers, mortgage lenders, the insurance industry, and local state and federal government officials argue about how the region will be rebuilt and to what building standards. FEMA ignited this debate, when it issued in late November 228 new flood plain maps, which cover the entire 80 miles of Mississippi coast and as much as 22 miles inland, representing the biggest simultaneous proposed expansion of federally defined flood plains in the history of the National Flood Insurance Program. (Maps for the Louisiana coast will be published early next year.) While the maps reflect the damage caused by Katrina and other hurricanes over the past 20 years, it will take FEMA at least a year to confirm their accuracy. Until the maps are finalized, local governments will have flexibility in determining building standards for the recovery effort. For example, local officials are having to balance the cost of raising a new house off the ground to comply with FEMA standards, which ranges from $2,000 to $30,000 depending on the improvement, against the limited resources of hurricane victims and the need to minimize additional financial burdens at this time. Some local officials say that the new FEMA maps call for unreasonable standards that will drive up housing costs and threaten the survival of whole neighborhoods. (*New York Times*, Eric Lipton, 12/12/05)

- Tulane University, New Orleans' largest employer, has announced plans to lay off 230 faculty members and is dropping some sports and eliminating several undergraduate programs such as electrical engineering and computer science. With approximately 66% of its facilities flooded by Katrina, the private university estimates its cost of recovering from the storm to exceed $200 million. Tulane



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expects to resume classes in mid-January and anticipates 33% drop in its enrollment. Before the hurricane struck on August 29, the university has roughly 2,500 faculty members, a total student enrollment of 13,200, and annual budget of $593 million. (*Associated Press*, 12/09/05)

- So far, barely 60,000 of New Orleans' pre-hurricane population of 450,000 have returned home, where devastation and limited public services make life difficult. The majority of New Orleans evacuees are concentrated in Dallas-Forth Worth, Houston, Atlanta, Baton Rouge (LA), and Memphis. In an interview with evacuees, *Dallas Morning News*' reporter Jacquielynn Floyd noted, "What struck me most …was that so much of the unhappiness a lot of these [evacuees] felt has roots that go back much further than Katrina. Well-to-do and poor, black and white, these residents sounded as if long, weary experience has taught them a reflexive mistrust of their own public institutions. 'Why should we move back to New Orleans and put up with graft and corruption when we can stay here in Dallas and have a decent life?' asked one man, a small-business owner who said he has had to pay bribes to obtain routine city services. 'Why should we come back?' another man asked. 'We do not plan to return to New Orleans until people are held accountable.' Another said bluntly that he's not returning until he has assurance that 'the stealing' will stop." (*Dallas Morning News*, Jacquielynn Floyd, 12/09/05)

- An in-depth analysis of New Orleans and the challenges the city faces post-Katrina can be found in an article titled "The Storm Over Katrina" appearing in the December 2005 issue of *Commentary Magazine* by Dr. Wilfred M. McClay, a member of Tulane University's faculty from 1987 to 1999, who currently teaches history and humanities at the University of Tennessee at Chattanooga. McClay's article can be found online at www.comentarymagazine.com. (*Commentary Magazine*, Wilfred M. McClay, December 2005))

- At the annual meeting of the National League of Cities, New Orleans mayor Ray Nagin said, "Everybody in this room should be concerned. Everybody knows there's a certain amount of constipation in Washington. We need to be the ExLax to bust through that." (*Associated Press*, 12/10/05)

- The New Orleans' city council voted unanimously to delay the acceptance of FEMA trailers for hurricane victims, citing plans to place makeshift homes in historic areas and playgrounds unsuitable for such development. The city council voted unanimously to override Mayor Ray Nagin's veto of an ordinance providing the city council the power to block temporary trailer parks in their district. FEMA spokesman James McIntyre said that the city council's actions would likely delay or stop some trailer park plans. "We can only place the units where local and state officials approve," McIntyre staid. FEMA is installing or has plans to install 22,500 trailers for returning evacuees in New Orleans. (*Associated Press*, Kevin McGill, 12/15/05)

- Louisiana Governor Kathleen Blanco has postponed indefinitely the New Orleans mayoral election. In an order signed on December 9, Blanco cites the



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recommendation of Secretary of State Al Ater to postpone the election. Blanco's order, which affects primaries for mayor, sheriff, and city council seats, does not set a new election date. On December 9, a lawsuit was filed against Blanco, seeking to force her to hold New Orleans' elections as scheduled in February. The attorney filing the suit, Toby Couhig, said Blanco cannot postpone elections indefinitely because the city's charter requires that elections take place before May 1, the date that the newly elected officials are scheduled to take office. (*Associated Press*, 12/12/05; *Associated Press*, 12/09/05)

- On December 10, *Louisiana Political News Service* reported, "Three independent sources have informed us that former U.S. Senator John Breaux is telling political insiders that he is in fact running for Governor. Breaux …is seen by Democratic Party operatives as the only hope of keeping them in the mansion and shoring up the down ballot statewide incumbents' political futures." (*Louisiana Political News Service*, 12/10/05)

- Senator Trent Lott (R-MS) said that the personal losses he suffered from Hurricane Katrina will factor into his decision whether to run for re-election in 2006. During the August 29th storm, Lott said his family lost their waterfront home in Pascagoula MS and incurred a $400,000 loss after flood insurance. "It was about half my net worth." Lott said. "From a personal standpoint, I need a little more income. But the people I care most about, those on the coast are hurting and need help." Lott said his family is divided over his running again. Another consideration, Lott said, is that he is "so disappointed with the [Bush] administration's response to this disaster that I'm almost embarrassed." He added, "I won't be complicating anybody's Christmas by making a decision [before the first of the year]. Hinting that if he seeks re-election, he might seek another leadership post, he said, "I might do it just to make everybody nervous." Representative Chip Pickering (R-MS) is expected to run for the Senate if either Lott or Senator Thad Cochran (R-MS) retires. (*Associated Press*, 12/18/05; *Sun Herald* (Biloxi, MS), Greoff Pender, 12/17/05)

- Also, Senator Lott and his wife are suing State Farm Fire & Casualty Co. to force the insurance company to pay for wind damage to his coastal Mississippi home. Lott's case is part of on-going litigation between insurance companies and thousands of storm victims who cannot agree on whether a wind-driven storm surge is the same as flooding, which is not covered in standard homeowners' policies. Lott's lawsuit was filed by Richard Scruggs, a plaintiff's lawyer who has battled companies over tobacco and asbestos claims, is Lott's brother-in-law and neighbor in Pascagoula, MS. (*Wall Street Journal*, Liam Pleven, 12/16/05)

## Subprime housing bubble "bursts" in U.S. bond market

- Bonds backed by mortgages to the riskiest borrowers have lost about 2.5% since September on concern that an 18 month rise in interest rates may force more than 150,000 consumers into default. According to The Bond Market Association, the



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amount of bonds backed by these high risk loans has more than doubled since 2001 to a record $476 billion, accounting for approximately 19% of home loans nationwide. According to the Mortgage Bankers Association, 10.3% of subprime mortgages are in default and about 3.5% were in foreclosure. "We've been hearing about risks of a house price bubble, easy credit and loans to borrowers that really don't qualify, and now in the last couple of months we're starting to see things turn for the worse," said Joseph Auth, a bond fund manager for Standish Mellon Asset Management in Boston. "We don't know if it's going to be a hard or soft landing."

- In a December 6 report, Fitch Inc. said it expects subprime mortgage delinquencies to increase 10% to 15% in 2006, as higher interest rates will slow home price growth and slow cash-out financings. Fitch expects adjustable rate payments to rise and defaults to increase, as consumers are no longer able to tap their home equity for more cash. In contrast, the ratings agency said its outlook for prime loans is favorable. Credit scores and loan-to-value ratios have "generally improved to compensate for the increased risk in loan attributes" for prime mortgages, said Fitch, concluding that the performance of prime mortgage bonds should be stable in 2006. (Bloomberg News, Al Yoon, 12/07/05; *Dow Jones Newswires*, Danielle Reed, 12/07/05; *American Banker*, Erick Bergquist, Matthew Quinn, and Jody Shenn, 12/08/05; *Washington Post*, Kirstin Downey, 12/07/05)

## Concept of 50 year amortizing loan floated

- Mark Douglass, senior director of Fitch, Inc., said "one or two issuers" of securities have recently told his rating agency that they were considering 50-year amortization schedules. "Not that that has gone anywhere yet, but we've certainly had some inquiries," said Douglass. In 2005, the number of 40-year offerings increased rapidly, particularly in the subprime sector. [According to a recent survey, 60% of California mortgage brokers expect 40-year fixed rate mortgages to be more popular among homebuyers in 2006 due to affordability reasons.] (American Banker, Jody Shenn, 12/16/05)

## National City finds fewer "extremely overvalued" U.S. homes in its third quarter survey

- A National City Corp. housing survey for the third quarter found that the number of extremely overvalued housing markets declined to 65 in the third quarter from 67 in the second quarter. However, 38% of the top 299 metropolitan markets remain at risk of a price correction, said National City. "Whether the most extremely overvalued markets will have an orderly price correction to more normal, historic levels remains to be seen," said Richard DeKaser, chief economist at National City Corp. (*Reuters*, 12/09/05)



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## Hedge funds placing their bets on a downturn in housing values

- As cracks appear in the housing market, a growing cadre of hedge funds are looking for a means to profit from a downturn in housing through a derivative product called credit-default swaps. The new product "allows us to express a bearish option" on the housing market, said Steve Persky, managing partner at Dalton Investments. "The market has taken off," said Dan Ivascyn, a portfolio manager at Pacific Investment Management Co. "It's become a big story." In the context of the broader $4 trillion market for mortgage-backed securities, it is a small but rapidly growing market. Dealers estimate that investors have bought and sold insurance on a face value of as much as $100 billion in bonds in 2005. (*Wall Street Journal*, Mark Whitehouse and Gregory Zuckerman, 12/12/05)

## President Bush's push to overhaul of tax code slips to 2007

- According to administration officials, President Bush is likely to postpone an all-out push to overhaul the federal tax code until 2007. While Bush remains committed to overhauling the tax code, Treasury Department spokesman Tony Fratto said, "We don't have a timetable" for making specific recommendations regarding the tax code to Congress. Instead, President Bush is focusing his efforts on getting Congress to extend his tax cuts from 2001 and 2003. (*New York Times*, Edmund L. Andrews, 12/06/05)

## New war on mortgage fraud: revised mortgage appraisal forms

- Fannie Mae and Freddie Mac are rolling out a new weapon in their war on mortgage fraud: updated property appraisal forms, requiring sales details on all home transactions. "We expect these forms will result in more accurate and fully supported appraisals," said Fannie Mae spokesman Joseph L. Minnich. By requiring detailed market research and the disclosure of concessions made by the buyer and seller, the lending process "will at least raise a red flag" about possible fraudulent activity, Minnich said. On November 1, stricter appraisal reporting requirements took effect November 1 for Fannie Mae and Veterans Affairs Department loans and will become mandatory on January 1st for Freddie Mac and HUD loans, said Minnich. "This is a step in the right direction," said Alan Hummel, government relations committee chairman of Appraisal Institute. "This puts the appraiser and [lender] on notice that they're accountable." (*Washington Post*, Michele Derus, 12/10/05)



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Ground set to shift again for investment analysts,
as regulators look for new ways to make the cost of investment research transparent

- With regulators and fund managers devising new ways to make the cost of research transparent, the effects of the latest change are being felt in Europe as acutely as in America, but in different ways. On January 1, Britain's Financial Services Authority is introducing "unbundling", which requires brokers to tell its clients how trading commissions are split between the price of executing trades and fees for analysts research. In Paris, a working group sponsored by the French markets regulator is evaluating the merits of tighter standards, which it may raise with the European Commission. This group is concerned that "buy" ratings on French shares outnumber "sell" ratings by two-to-one, reflecting a bias among sell-side analysts and raising concern about "cyclical momentum" that might inflate asset prices, as it did in 1999. In America the pressure on Wall Street analysts continues to mount. For example, Fidelity Investments recently negotiated a fixed subscription fee deal with Lehman Brothers' research in return for lower commissions on trades. Many believe that more such agreements will follow. (*The Economist*, 12/10/05)

Illinois poised to become the second state to assist
undocumented immigrants to buy homes

- Illinois has announced the "Opportunity I-Loan," which will allow illegal immigrants with a taxpayer identification number issued by the IRS to qualify for state-guaranteed mortgages. With the introduction of this program, Illinois become the second state in the country to help undocumented immigrants buy homes, even as critics seek to overturn a similar program in Wisconsin. State housing officials hope the Opportunity I-Loan Program, which will finance 30-year mortgages with below-market interest rates, will give immigrants alternatives to predatory lenders. In the Chicago area, undocumented immigrants who aren't homeowners represent about $4.5 billion in potential loans, said Mark Doyle, president of Second Federal Savings in Chicago, IL. (*Chicago Tribune*, Antonio Olivo, 12/11/05)

- In a December 13 editorial, the *Chicago Tribune* wrote, "Governor Rod Blagojevich plans to copy the Wisconsin initiative, ignoring the concerns about creating special benefits for illegal immigrants that prompted lawmakers in Wisconsin to intervene so rapidly. Under Blagojevich's plan, the state will back below-market-rate loans for people who have little or no credit history, no bank account and no Social Security number. The loans wouldn't be limited to those who are here illegally, but that's clearly the primary target. That means if the borrower defaults on the mortgage--say, the borrower is arrested and deported--the state's taxpayers would be on the hook for the balance of the loan. There are believed to be as many as 11 million illegal immigrants living in the U.S. Eyeing the big market potential of this population, some lenders have begun extending mortgages to workers despite their inability to document their legal status. Assuming that risk is a business decision that lenders make. But there's no reason for the state to shift the financial risk away from



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participating lenders and onto taxpayers, which is what Blagojevich's program would do. …This page has strongly supported immigration reforms that would provide better border enforcement and help some of those who have been living and working here to earn legal status. But the government should not be creating special benefits for those who are here illegally--benefits that could wind up costing taxpayers." (*Chicago Tribune*, 12/13/05)

# *Fannie Mae*

Day of reckoning on the horizon for Fannie Mae?

- A report is due next month on Fannie Mae's accounting troubles from former Senator Warren Rudman (R-NH), who is spearheading a 15-month external review by his team of lawyers from Paul, Weiss, Rifkind, Wharton & Garrison conducted on behalf of the company's board of directors. In an interview with *Dow Jones Newswires*, Rudman said, "It will not be a small report. I will tell you that. It will be a substantial report. It will contain a lot of issues, some of which have already been made public and some of which have not." He added, "There are a number of these things that we've come across that have no relevancy at all to the safety and soundness or the operation of the company" which will not be included in the report. Such findings are omitted because Fannie's board "largely" limited Rudman's examination to issues raised by OFHEO in reports delivered to the board in September 2004 and February 2005. "There are other tax issues that might be issues, but they aren't relevant to our inquiry, and aren't in our report," he said. "We're not doing an [IRS] audit." Rudman said his report will address all accounting and governance issues identified by OFHEO, as well as new issues his examination has uncovered but have not been disclosed by Fannie Mae or OFHEO, but declined to give any details. He told *Dow Jones Newswire* that there is "an outside possibility" that a supplemental report may be issued at a later date.

- Rudman told *Bloomberg News* that his team faces only a "slight" chance of postponing the January release of their report on Fannie Mae's accounting problems. The prospect of postponement "is slight right now," Rudman said. "I just hope that nothing happens in the next 30 days that may change that." (*Dow Jones Newswires*, Dawn Kopecki, 12/16/05; *Bloomberg News*, James Tyson, 12/05/05)

Out of sight – but not out of mind

- In the December 4 "The Week's Winner & Losers" column, the *New York Post* wrote, "Franklin Raines: Disgraced former head of Fannie Mae pocketed more than



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$40 million in bonuses and extra pay because of the agency's cooked books, a study reveals." (*New York Post*, 12/04/05)

- TIAA-CREF, the largest manager of retirement funds for university and college employees in the U.S., wants to force companies to fully disclose to shareholders how much they pay top executives. "There's a burden on the board of directors to justify its compensation choices and explain them, so that shareholders can be confident that these are the right decisions," said John Wilcox, senior vice president of TIAA-CREF. The average CEO in the U.S. makes $10 million a year, compared with about $22,000 for an entry-level employee, according to the Council of Institutional Investors (CII). The group has made compensation its top governance issue as a growing number of companies, including Morgan Stanley and Fannie Mae, were criticized by shareholders for excessive pay. It's the "No. 1 issue," said Ann Yerger, CII's executive director. Incentives in pay packages can cause executives to take steps to boost the stock in the short-term and then sell their shares at the expense of other investors, said Yerger. In December 2004, Fannie Mae fired CEO Franklin Raines after the SEC ruled the company failed to comply with GAAP in an effort to inflate earnings by more than $9 billion from 2001 to mid-2004. By meeting its profit targets, incentive bonuses were paid to Fannie Mae executives including Raines, who earned $20 million in 2003. (*Bloomberg News*, Hui-yong Yu and Margaret Popper, 12/08/05)

## Fannie Mae Foundation "prolifically funds" anti-Alito groups

- Foundations are aligning with liberal groups to wage war against the nomination of Judge Samuel Alito to the Supreme Court – and the Fannie Mae Foundation is no exception. According to the December 15th issue of *Human Events*, "The Fannie Mae Foundation, the philanthropic arm of the secondary mortgage giant Fannie Mae -- officially a Government-Sponsored Enterprise -- also prolifically funds anti-Alito groups. The Fannie Mae Foundation funds the CBC [Congressional Black Caucus] Foundation and NAACP. In the past, the Foundation has also funded the Alliance for Justice and MALDEF [Mexican American Legal Defense and Education Fund]. A Fannie Mae spokesman responded by e-mail to *Human Events'* queries, writing, 'Support for these and other grantees is never for the purpose of engaging in political activity of any kind.'" (*Human Events*, Timothy P. Carney, 12/15/05)

## Effective January 1st, Fannie Mae will reduce servicing fees for ARMs

- Effective January 1, Fannie Mae will reduce its standard minimum servicing fee for most single-family, first-lien, conventional adjustable rate mortgages to 0.25%. As a result of this change, the servicing fees for ARMs will now match the standard servicing fee for fixed-rate mortgages delivered to Fannie Mae. According to the Fannie Mae Guide Announcement 05/08 released on December 16, "Fannie Mae may approve qualified lenders to deliver ARM loans with minimum servicing fees as low



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as 0.125 percent. Fannie Mae requires a minimum servicing fee to ensure that mortgage servicers have an ongoing economic incentive to fulfill their servicing responsibilities, such as collecting mortgage payments as well as tax and escrow contributions." (*The Main Wire*, 12/16/05)

## *Freddie Mac*

Congressional Research Service report released on Freddie Mac's accounting problems

- On December 8, the Congressional Research Service (CSR) released a report concerning the accounting problems at Freddie Mac and the resulting public policy implications. CSR's analysis concludes that in spite of the seriousness of the misconduct of Freddie Mac's senior management, prospects are "slim" for criminal actions against the parties involved. Following an investigation of Freddie Mac by federal prosecutors, CSR said, "[N]o indictments have been handed down, and there are no indications that any will be." While the media reported that investigators had focused on one Freddie Mac official's possible withholding or destruction of critical pages in a personal notebook, CRS concluded, "... it is not clear that such actions would violate any federal securities law." CRS also said that Freddie Mac's accounting problems have also raised concern about what might have occurred under different circumstances. "The fact that Freddie Mac's former management's conduct may not constitute criminal fraud and that the institution appears to remain financially sound do not suggest that the episode should be dismissed lightly," said CSR. "If Freddie's management cut corners with accounting rules to conceal an inconvenient excess of earnings, how might it respond to a shortfall in earnings that presaged serious trouble in the company?"

- Although the report was confined to Freddie Mac's accounting problems, CSR's analysis alludes to worries that lawmakers and GSE critics recently expressed about what the accounting and management scandals at Freddie Mac and Fannie Mae imply about their potential risk to the housing finance sector. "The size of the housing GSEs and the volume of their debt securities held by other financial institutions make management and regulatory reform important public policy issues," said the CSR. (*BNA's Daily Report for Executives*, Richard Cowden, 12/09/05)

Acting OFHEO director is recused from civil proceedings
against Freddie Mac's former CEO Brendsel and former CFO Clark

- The attorneys for Freddie Mac's former CEO Leland Brendsel and former CFO Vaughn Clark pressed for the dismissal of OFHEO acting director Stephen



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Blumenthal from the agency's civil charges, according to sources close to the matter. In late October, Blumenthal was recused from any involvement in OFHEO's civil charges against the defendants. In an email to *Dow Jones Newswires*, OFHEO spokeswoman Corinne Russell said that Blumenthal recused himself "because of this earlier position as head of the Freddie Mac special examination." Blumenthal has appointed Leonard Reid OFHEO's associate director, Office of Capital Supervision, "to make any substantive decisions in the administrative proceedings that would otherwise be decided by the acting director." (*Dow Jones Newswires*, Dawn Kopecki, 12/07/05)

## The "capital play" at Freddie Mac?

- With Freddie maintaining about $12 billion in excess regulatory capital on September 30, Wall Street analysts are keeping a close watch on the company's efforts to return shareholder value, once OFHEO releases the GSE from its 30% excess capital requirement. Paul A. Hamilos, an A.G. Edwards analyst estimates that the capital "trapped" by the surcharge equals $17.34 per common share. Hamilos said he expects Freddie to "take more aggressive action on the capital management front" once OFHEO lifts that requirement.

- Paul Miller, a Friedman, Billings, Ramsey analyst, said he is recommending Freddie's stock as a "capital play." Miller warned that OFHEO could end up wanting more than just one quarter of timely reporting by Freddie Mac before it lifts surcharge. Freddie Mac's recent disclosure of an accounting error caused by a legacy software system heightens the risk that OFHEO will "seek more comfort," he said. "Have they proven" that Freddie Mac's accounting and controls can be trusted, Miller asked. "I'm not sure, and I'm a little concerned about it."

- Meanwhile, the possibility that the Bush administration may eventually replace OFHEO's acting director Stephen A. Blumenthal, could provide another roadblock, said observers. A new OFHEO director may want to maintain the capital surcharge, while assessing the GSEs' situation, or to advance the Bush administration's desire to limit the GSEs' portfolios. "The real wild card is what happens here at OFHEO," said Miller.

- Edwin Groshans, an analyst at Fox-Pitt, Kelton, said he sees "little benefit" for OFHEO in lifting surcharges on Freddie Mac or Fannie Mae ahead of GSE regulatory reform. While the GSEs might complain, OFHEO will probably want to "keep them under wraps until the new regulator is in place," Groshans said. (*American Banker*, Jody Shenn, 12/05/05)



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## Freddie Mac amends offer for its Step-Down Preferred Stock

- On December 7, Freddie Mac amended its cash offer to purchase all of the outstanding shares of the Step-Down Preferred Stock issued by the Home Ownership Funding Corporation (HOFC) and Home Ownership Funding Corporation II (HOFC II). The company increased the offer prices for HOFC shares from $258.66 to $305.00 per share and for HOFC II shares from $258.75 to $305.09. Freddie Mac has extended the expiration date for the tender offer to midnight (New York City time) on December 20, 2005. Settlement is expected to occur on December 21, 2005. These 1997 REITS had preferred shares, which paid dividends of 13.331% and 13.338% for ten years and then drop to 1%, said Ray Powers, director of Freddie Mac's capital management. The REITS are being "wound down" in conjunction with the shares' rate drop, Powers added. (*Freddie Mac Press Release*, 12/07/05; *Washington Post*, 12/08/05)

## American Property Finance becomes an approved lender in Freddie Mac's Delegated Underwriting Initiative for tax-credit properties

- American Property Finance became the third approved lender for Freddie Mac's Delegated Underwriting Initiative for tax-credit properties. The initiative gives qualified lenders expedited processing and more flexibility when underwriting mortgages secured by properties with low-income housing tax credits. (*Freddie Mac Press Release*, 12/13/05)

## Freddie Mac's survey finds that delinquent borrowers are unaware of workout options

- Freddie Mac and Roper Public Affairs and Media conducted a national survey of delinquent borrowers to learn why late-paying borrowers risk losing their home rather than contact their mortgage servicers. While 75% of delinquent borrowers recall being contacted by their servicers, 28% surveyed said that there was no reason to talk to the servicers because they couldn't help them; 17% said that they could take care of their payment problems without help; and 7% said they didn't call because they didn't have enough money to make the payment. Roughly 6% of those surveyed said they didn't call due to embarrassment, fear (5%) or not knowing whom to call (5%). The lack of borrower follow-up reflects why 61% of late-paying borrowers said they were unaware of the variety of workout options that are available to them to help them overcome short-term financial difficulties. While the likelihood of a successful foreclosure avoidance depends upon each individual borrower's financial situation, a 2004 Freddie Mac study concluded that repayment plans could lower the probability of home loss by 80% among all borrowers and by 68% among low-to-moderate income borrowers. Over the past two years, Freddie Mac and its servicers have helped more than 100,000 troubled borrowers avoid foreclosure and stay in their homes. (*Freddie Mac Press Release*, 12/12/05)



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Freddie Mac Foundation awards $100,000 grant

- The Freddie Mac Foundation has awarded the National Center for Missing & Exploited Children a $100,000 grant for its efforts in locating and reuniting more than 4,850 children missing or displaced from their families due to Hurricane Katrina. (*Freddie Mac Press Release*, 12/08/05)

## *Federal Home Loan Banks*

FHLB-Seattle reports its second quarter results

- On December 13, the FHLB-Seattle reported second quarter 2005 financial results, which were delayed due to accounting and disclosure issues that have been resolved. The Bank reported a $15.7 million net loss for the second quarter of 2005, as compared with net income of $25.5 million for the same period in 2004. The second quarter net loss was due primarily to mismatches in the cash flows of the Bank's assets and liabilities and costs associated with downsizing its operations. "We will continue to see earnings fluctuations through the end of 2005," said James E. Gilleran, the Bank's president and CEO. "However, based on the current interest-rate environment and the progress we've made in implementing our three-year business and capital management plan, it now appears that we have turned the corner in our business transition sooner than we originally expected." The Bank expects that short-term and long-term mismatches in assets and liabilities will continue to depress earnings, most significantly in 2005 and 2006 and to a lesser extent in future years, but expects to break even or earn minimal net income in 2005 and to increase earnings in 2006 and 2007. Previously, the FHLB-Seattle projected net losses for fiscal years 2005 and 2006, with the Bank returning to profitability in 2007. (*BusinessWire*, 12/13/05)

FHLB-Cincinnati files its Form 10 with SEC

- On December 5, the FHLB-Cincinnati filed its Form 10 Registration Statement, becoming the fourth FHLB to register with the SEC. The Cincinnati Bank said it will not have to restate its historical financial statements. During the third quarter, the Bank's net income fell 14.8% to $55.8 million, due to a reduction in its prepayment fees over the period. During the first three quarters of 2005, 16 member institutions purchased membership stock, while 30 were lost due to mergers or relocations, resulting in a net loss of 14 member stockholders.



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- In its Form 10 filing, the FHLB-Cincinnati detailed the steps taken by its board of directors to ensure propriety of stock redemptions during the year. Specifically, the Bank disclosed that Charter One Bank, its largest stockholder, sought to redeem $125 million of the stock in June, representing the largest redemption request since the Bank adopted its new capital plan in 2002. Charles J. Koch serves as chairman of Charter One and also chairs the FHLB-Cincinnati's board of directors. Koch recused himself, while the board carefully considered Charter One's request. According to the filing, the Bank said its board gave "due consideration of the likely implications [of the] request in the context of the current and anticipated trends in our business activities and Charter One's business reasons" for seeking it, because of "the size of this request, and the position of Mr. Koch on the board." After considering the Bank's liquidity, earnings profile, excess capital, capital-to-assets ratios, capital plan provisions, and "prospects for future business activities," the board of directors concluded that the redemption "would not have a material impact on [the Bank's] ability to manage these items" and voted to authorize an immediate redemption. (*American Banker*, 12/07/05; *Form 10 Federal Home Loan Bank of Cincinnati*, 12/05/05; *American Banker*, Jody Shenn, 12/09/05)

## FHLB-Chicago re-files its Form 10 with SEC

- On December 14, the FHLB-Chicago re-filed its Form 10 Registration Statement with the SEC. During the third quarter, the Bank's net income fell 14.8% to $55.8 million, due to a reduction in its prepayment fees over the period. The Bank's Mortgage Partnership Finance Program assets totaled $43.2 billion at September 30, 2005, down 9.2% from the program's balance of $47.6 billion on December 31, 2004. At the end of the third quarter, the Bank had 885 members, down eight from December 31, 2004. While the Bank added 17 new members, three members voluntarily withdrew from membership and 22 members were acquired by other institutions. The FHLB-Chicago's capital stock decreased $399 million or 9.3% from December 31, 2004 because of voluntary redemptions related to membership withdrawals. (*Form 10 Federal Home Loan Bank of Chicago*, 12/14/05)

## Federal Housing Finance Board proposes to streamline its affordable housing regulations

- The Federal Housing Finance Board is proposing to streamline its affordable housing regulations to make it easier for the FHLBs to run their affordable housing program. According to Finance Board director Franz Leichter, the rule will "improve and streamline the AH program." Since there has never been any scandals or misuse of the AH funds, the regulations no longer need to be so restrictive, said Leichter. (*National Mortgage News Online*, 12/14/05)



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## *Ginnie Mae*

Ginnie Mae may force lenders to repurchase 2,360 ineligible loans

- In a quality control review, Ginnie Mae identified 2,360 mortgages in 1,693 of its securities that might be buyback loans which are ineligible for the pools. In the next phase of this review, Ginnie Mae will work with its issuers to determine if these loans are in fact buydowns or were misreported by issuers. If the loans were buydown mortgages, the issuers will have to swap eligible loans into the pools or buy the loans out of the pools, said the agency. On its website, the agency has posted a list of the securities along with the balance of the possible buydown loans, which will be updated as issuers work with Ginnie Mae regarding the status of these loans. As a result of this review, Ginnie Mae formalized its quality control function in its office of program operation, which will conduct periodic post-issuance reviews of outstanding securities. Based upon the average size of loans in Ginnie Mae pools, the value of the ineligible mortgages may approximate $236 million said Art Frank, an analyst at Nomura Securities International Inc. (*Bloomberg News*, Al Yoon, 12/05/05; *American Banker*, Jody Shenn, 12/06/05; *Asset Securitization Report*, 12/12/05)

## *Farm Credit System / Farmer Mac*

FCA board approves rule to amend regulations for termination of FCS membership

- Farm Credit Administration (FCA) board approved a proposed rule that would amend regulations under which a FCS bank or association may terminate its FCS status and become a financial institution under another Federal or state chartering authority. The FCA board determined that certain revisions to the regulations would provide the FCA, the institution's board of directors, and stockholders sufficient time and information to deliberate whether or not to terminate FCS status. The most significant regulatory change would be to separate FCA's review of stockholder disclosure information from its review of the actual termination, which would occur *after* a stockholder vote approving the termination. The proposed rule would also amend the existing regulation in the areas of: communication with stockholders, special analyses and studies, director protection, quorum requirements, and FCA's reasons for disapproving a termination. A fact sheet more fully describing the proposed changes is available on FCA's Web site at www.fca.gov. The proposed rule will be published in the Federal Register for a 60-day comment period. Comments may be submitted by electronic mail to reg-comm@fca.gov, through the Pending Regulations section of FCA's Web site at www.fca.gov, or through the Federal



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government Web portal at www.regulations.gov. (*Farm Credit Administration Press Release*, 12/08/05)

## CoBank's CEO to retire after 37 years service in the Farm Credit System

- On June 30, Douglas D. Sims, CEO of CoBank, will retire after 37 years of service in the Farm Credit System and 21 years with CoBank. Sims managed the CoBank through 15 mergers and acquisitions, the establishment of its first representative office outside the U.S., and its first issuance of preferred stock, which raised $500 million of new capital into the bank. During his tenure as CEO, CoBank nearly tripled its assets to $31 billion from $12 billion. Robert B. Engel, CoBank's president and chief operating officer, will succeed Sims. (*The Denver Business Journal*, 12/14/05)

## Community banks find FCS members are tough competition

- In an interview with the *American Banker*, R. Daniel Blanton, president and CEO, Georgia Bank and Trust in Augusta, GA said "The Farm Credit system … [does] not pay taxes, they were formed to provide lending into the agricultural community, which is a high-risk business, and therefore they were granted that status. In Statesboro, GA, the largest originator of mortgage loans is a farm-credit system down there." H. McCall Wilson Jr., president and CEO, Bank of Fayette County in Moscow, TN, said, "We just lost a loan. It was a personal weekend farm. And they started 30-year fixed rates at 5.8% or 5.9%. We can't touch that. Craig A. Meader, chairman and CEO, First National Bank of Kansas in Burlington, said, "Farm Credit Services were brought about to bring capital to farmers, not to businessmen. Now anyone with 10 acres, a horse, and a John Deere tractor can go to Farm Credit for a $1 million home in the suburbs and get a 30-year loan." (*American Banker*, 12/06/05)



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# The Privatized GSE -- Sallie Mae

## The privatized Sallie Mae: A hot stock

- *Fortune Magazine* describes the newly privatized Sallie Mae as "radically different than it was even five years ago—an aggressive, highly profitable lender and a stock market superstar. Since 1995 its stock has returned over 1,900%, trouncing the S&P 500's 228% gain. Today Sallie's stock sells for 22 times earnings and almost ten times tangible book value, 'an almost unheard-of valuation for a financial institution,' as a Criterion Research report noted. Sallie's dividend has risen at an average annual clip of 18% over the past ten years. And thanks to hefty helpings of stock options, Sallie's top executives have earned fortunes."

- "…Under CEO [Al] Lord, Sallie's growth was nothing short of phenomenal. Net income more than quadrupled between 2000 and 2004, from $465 million to $1.9 billion. Citigroup analyst Brad Ball, who rates the stock a buy, calls the company a growth machine. Today Sallie, which earns a return on equity of about 35%, is one of the most profitable financial services firms in the world, and it has told the Street that it will continue to grow its earnings at a 15% to 20% annual clip. Gabriel described Sallie's business as 'high-growth, profitable, recession-proof, and almost 100% federally guaranteed.' …Perhaps the biggest benefit of privatization of Salllie Mae has been the freedom to make its own loans. It has eclipsed many of the nation's banks to become one of the top originators of new student loans…(*Fortune*, Bethany McLean and Christopher Tkaczky, 12/12/05 "

## Sallie Mae will face more competition in the student loan space with J.P. Morgan's acquisition of Collegiate Funding Service

- J.P. Morgan Chase has reached an agreement to acquire Collegiate Funding Services for approximately $663 million in cash. In early 2006, the companies expect to complete the acquisition, pending regulatory and shareholder approval. Following the acquisition, J. Barry Morrow, Collegiate's president and chief executive, will become president of the combined Chase Education Finance unit, which will be headquartered in Fredericksburg, MD. In 2004, J.P. Morgan's Chase Education Finance unit originated $7.9 billion in loans, while Collegiate funded $4.4 billion. On September 30, Collegiate serviced about $12.1 billion of student loans. (*Washington Post*, 12/16/05)



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# *Postal Service*

Protests staged at Senator Bond's offices

Senator Bond "loosens" his hold on postal reform legislation

- On December 6, active and retired Missouri-based members of the National Association of Letter Carriers (NALC) demonstrated at the offices of Senator Christopher S. Bond, R-MO, in four Missouri cities to protest his hold on postal reform legislation. Bond placed a hold on S. 662, because he wants language inserted that would allow mailers to challenge the cost of First-Class mail if they think the rates are not "fair and equitable." NALC president William H. Young said that his group plans to stage similar protests in other Missouri cities in December. (*DMNews.com*, Melissa Campanelli, 12/07/05)

Senator Bond "loosens" his hold on postal reform legislation

- According to the December 9 issue of *e-NAPUS Legislative Newsletter*, "Earlier this week, the Associated Press …reported that Senator Kit Bond (R-MO) predicted that a vote on S. 662, the Postal Enhancement and Accountability Act, would take place in February. This positive statement was first posted on *TheKansasCityChannel.com* and hints that Senator Bond accepts the notion that the Senate would vote on the postal bill; and, more importantly, that he would not object to the vote. Up until now, Senator Bond has placed a 'hold' on the bill, which denies the Senate the opportunity to vote on S. 662." (*e-NAPUS Legislative Newsletter*, 12/09/05)

Accountability matters

- In a letter to the editor of the *St. Louis Post-Dispatch*, Robert S. Walker, chairman of Postal Reform in the Public Interest, wrote, "In his commentary on postal reform, "Kit Bond is Holding Up Progress," [National Association of Letter Carriers President] William H. Young gets his facts wrong. He says 'nothing could be more fair and equitable than the pending bill's provision to index the postage rates of all types of mail to the Consumer Price Index.' Yet, this very indexing would allow gross discrimination between types of mail within a class, as long as the revenue for the class as a whole remains within the CPI cap. Nothing in the Senate bill prevents the Postal Service from raising rates for small newspapers and magazines by 10 or 100 times the price-cap percentage as long as it reduced the rates for large-circulation magazines such that the overall revenue from the periodicals class do not exceed the cap. The same can be said for first class rates." (*St Louis Post-Dispatch*, Robert S. Walker, 12/13/05)



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## Postal reform blues

- The *Alliance for Nonprofit Mailers* writes, "With Congress preparing to adjourn for the rest of the year, we express again our disappointment over the failure to complete postal fiscal reform legislation in time to prevent the January 8 postal rate increases. Because no reforms were enacted, the USPS must increase rates 5.4% to generate $3.1 billion in revenue. That sum would not have been necessary if the escrow fund were resolved and the unfair military service retiree obligations were returned to the Treasury. It's a $3.1 billion stamp tax that will be charged to customers of the USPS. (We note with some interest the announcement yesterday that the Bush administration plans to spend $3.1 billion on repairs and strengthening of New Orleans levee system. Why does it feel like mailers have been tasked to Give a Dam?)" (*Alliance for Nonprofit Mailers*, 12/16/05)

## USPS is in best financial condition since the 1970s, according to PMG

- At the December 6 Board of Governors meeting, Postmaster General John Potter proudly announced that the agency is financially in "the best position we've been since 1970s." Potter said, "We kept our focus on the customer for the past four years. It has paid off in record revenues, record volumes, and positive customer satisfaction." The USPS reported net income of $1.4 billion for fiscal year 2005, $1.7 billion *above* what the agency's projections at the beginning of the fiscal year, on revenues of $70 billion. Fiscal years 2004 and 2005 last are the only two years the Postal Service reported overall surpluses since the agency was reorganized in 1971, said CFO Richard Strasser said. Moreover, the USPS paid-off all its debt off last year and now has "zero dollars in debt," he added.

- The Postal Service's outlook for 2006, however, doesn't appear to be as rosy; The agency is projecting a net deficiency of almost $2 billion in 2005 due to the $3.1 billion escrow requirement that is mandated by the 2003 Postal Civil Service Requirement System Funding Reform Act. As a result, postal rates set to go up 5.4% across the board in January. The USPS is likely have to ask for another rate increase to go into effect in 2007 to cover higher operating expenses, said Strasser. (*Federal Times*, Dan Davidson, 12/14/05; *DMNews.com*, Melissa Campanelli, 12/07/05)

## Street-side mail delivery on the way out?

- According to the *Birmingham News* (Birmingham, AL), the USPS plans to eliminate house-to-house mail deliveries in newly built subdivisions and require developers to build central mail stations, according to postal officials. While the rule has existed in Alabama for a few years, the Postal Service has not implemented it in the state of Alabama until recently, said Russell David, vice president of the Home Builders Association of Alabama. Larry Dingman, Postal Service manager of field



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communications in Alabama, "[The use of central mail stations] keeps costs down and it's more efficient." (*Birmingham News*, Joseph D. Bryant, 12/10/05)

Flooded mail to be delivered soon, says USPS

- Some New Orleans and south Louisiana residents may soon begin receiving three-month-old mail that sat in floodwaters in deluged post offices and collection boxes. The Postal Service recently recovered about 90,000 pieces of damaged mail from parishes affected by Hurricanes Katrina and Rita, said spokesman Dave Lewin. Only about 30% of the recovered mail has been deemed deliverable. The rest will be destroyed, including letters that tested positive for mold spores and others that were so saturated as to render their addresses unreadable, said Lewin. (*The Times-Picayune*, Michelle Hunter, 12/02/05)

# *TVA*

Cashing in at TVA

- On the heels of a 7.5% rate increase to TVA customers, the utilities' December bonuses have come under harsh criticism. In a December 5th editorial, *the Commercial Appeal* (Memphis, TN) wrote, "It rankled a bit …to learn that rank-and-file [TVA] employees got year-end bonuses averaging $3,895 last week, at a cost of $50 million… They apparently did their jobs last year too, when $45 million was passed out. The bonuses for managers, who got $11.5 million last year, weren't immediately announced -- perhaps to let the complaints die down a bit first. The skeptical consumer can't be blamed for wondering if bonuses, car allowances and other perks are handed out by utilities to obscure what employees are really being paid." (*Commercial Appeal* [Memphis, TN], 12/05/05)

- *The Tennessean* (Nashville, TN) wrote in a December 12th editorial, "The [TVA's] generosity to its employees takes a big chunk out of the agency's budget and its credibility. … [H]anding out year-end bonuses across the board, as is TVA's tradition, raises questions about whether the bonus pay is really a tacit supplement to TVA's salary scale. That's no way for a quasi-governmental agency to do business. And TVA is not a private business with robust competition. For the most part, it remains a monopoly. …The five new members chosen as part of TVA's new part-time board have been ballyhooed for their business acumen. TVA's ratepayers in the seven-state region can only hope all TVA board members devote themselves to the long-term interest of the region.' (*The Tennessean*, 12/12/05)



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TVA inspector general questions $6.4 million of expenses and
$5 million in recovered funds in his semi-annual report

- TVA inspector general Richard Moore released a semiannual review of the utility, which questions $6.4 million of expenses and identifies $5 million in recovered funds, attributable primarily to overbillings. Moore also identified $5.6 million of funds that could be put to better use and $6 million in funds realized by TVA. As a result of TVA investigations of the IG's findings, a Browns Ferry Nuclear Plant employee was indicted for misusing his TVA purchasing card by accepting $14,500 of kickbacks to purchase overpriced janitorial supplies in quantities beyond what TVA needed. This former employee has been convicted of conspiracy and sentenced to five years probation. (*Knoxville News Sentinel*, Rebecca Ferrar, 12/17/05)

In 2005, TVA's pays $365 million (in lieu of taxes) to eight states

- The TVA paid a record $365 million in lieu of taxes to eight states in 2005, an increase of more than $27 million over the prior year. "TVA's tax-equivalent payments benefit local communities that use the funds for schools, roads and other important programs and services," said TVA Chairman Bill Baxter. "The total payments are up 8.1 percent from the previous year, reflecting continued economic growth in the TVA region and increased power sales." The payments are made on a monthly basis, based on TVA's power sales in 2004 and the property it owns in each state. During fiscal year 2005, TVA paid $218.2 million to Tennessee, $89.2 million to Alabama, $29.5 million to Kentucky, $19.6 million to Mississippi, $5.9 million to Georgia, $1.8 million to North Carolina, $347,929 to Illinois and $128,991 to Virginia. (*Associated Press*, 12/08/05)

Reactor pipe corrosion discovered at Browns Ferry Unit 1

- Federal regulators have asked more questions about corrosion discovered in pipes in the lower portion of the reactor vessel of Browns Ferry Unit 1, which TVA mothballed in 1985 due to safety concerns. The Nuclear Regulatory Commission's staff and TVA officials said the corrosion seems to be from bits of older pipes. TVA used a sophisticated camera to probe the corrosion and remove a sample for analysis. To date, TVA has invested $1.8 billion to restart process, which is approximately 73% complete. When Browns Ferry Unit 1 is restarted in (or around) May 2007, the unit is expected to generate enough power for 650,000 homes. (*The Huntsville Times*, Brian Lawson, 12/08/05; *Decatur Daily*, Holly Hollman, 12/08/05)



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## TVA's BLEU project earns the Platts Global Energy Award for 2005

- On December 1, the TVA's Blended Low Enriched Uranium (BLEU) Project was recognized recently as the world's top energy-related engineering project for 2005 at the Platts Global Energy Awards. In 1998, Erwin's Nuclear Fuel Services, Inc. (NFS) and Framatome ANP of Lynchburg, Va., teamed with TVA to execute this innovative concept in conjunction with the U.S. Department of Energy (DOE). According to the *Business Journal for Tri-Cities Tennessee/Virginia*, "The TVA has an agreement with DOE to accept highly enriched uranium (HUE) from DOE and to have the uranium downblended into low enriched uranium for use as a reactor fuel. NFS and FRamatome ANP convert the DOE HUE to usable uranium fuel assemblies for TVA." (*Business Journal for Tri-Cities Tennessee/Virginia,* 12/08/05)

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