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The GSE REPORT ™

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Contents of GSE Report ™

Major Events

- Federal Reserve Chairman Greenspan calls for sever reductions in GSEs' mortgage holdings to fend off "almost inevitable" problems (p. 3)
- OFHEO reports additional problems in Fannie Mae's accounting (p. 5)
- OFHEO approves Fannie's capital plan and extends company's deadline for 30% capital surcharge until September (p. 7)

Fannie Mae and Freddie Mac

- Stars aligning for GSE regulatory reform (p. 9)
- Fitch Ratings "clarifies" its methodology for rating Fannie and Freddie "AAA" (p. 10)
- GSEs supporters reluctantly "accepting" the receivership provision in GSE reform (p. 11)
- Strong GSE regulatory reform on the horizon? (p. 12)
- GAO raises questions about the housing GSEs for Congress to address (p. 12)
- Fannie and Freddie raise $1 million through PAC contributions for political candidates (p. 12)
- Shadow Financial Regulatory Committee urge adoption of four key provisions in GSE regulatory reform legislation (p. 13)
- The implicit federal guarantee of Fannie and Freddie provides the GSEs "enhanced credit quality" in the marketplace (p. 14)
- G-fee debate continues as another lawsuit filed against GSEs over g-fees (p. 15)
- National Alliance of Independent Mortgage Bankers announces opposition to S. 190 (p. 16)
- OFHEO proposes regulation requiring Fannie and Freddie to report mortgage fraud in a timely fashion (p. 16)
- More changes in the Bush Administration's second term team (p. 17)
- Long-term agency debt issuance down 29.3% in 2004 (p. 18)
- An emerging market: Native Americans (p. 18)
- The law of unintended consequences in the AH market (p. 20)

Fannie Mae

- U.S. District Court consolidates Fannie Mae lawsuits (p. 21)
- Former Fannie Mae execs' lawyers argue that their clients should keep their performance-based bonuses despite the company's restatement (p. 21)
- Fannie Mae's mortgage portfolio declines 16.8% in January (p. 23)
- As regulatory headwinds reach "gale force," Wall Street reassesses Fannie (p. 24)
- Peter Eavis argues that Fannie Mae deserves another "haircut" (p. 25)
- Meanwhile, some on Wall Street tout Fannie as a "buy" (p. 27)
- Portfolio managers and brokerage firm analysts rank former Fannie CFO Howard among "the best chief financial officers in America" (p. 28)

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- *Black Enterprise* asks: Was Raines' departure unjust? (p. 28)
- Fannie Mae leaves DC Mayor Williams' administration "at the alter" (p. 29)
- GMAC introduces "Link to Lender" (p. 30)
- Fannie Mae completes construction of its $102 million data center (p. 31)

Freddie Mac

- Freddie Mac braces for regulatory changes, as it retools its lobbying shop (p. 31)
- Former Freddie Mac CEO disputes shareholders' amicus filing (p. 33)
- Freddie Mac's retained portfolio declined an annualized 11.1% in January (p. 34)
- Chairman Boyd promises "new vision" for Freddie Mac Foundation (p. 34)
- Freddie Mac announces expansion of 10-year interest only loans (p. 35)
- Freddie announces new suite of affordable mortgage products (p. 35)
- Freddie streamlines A-minus pricing (p. 37)
- Freddie Mac tackles the language barriers in mortgage lending (p. 37)

Federal Home Loan Banks

- America's Community Bankers "cool" to the idea of FHLBs issuing MBS (p. 38)
- FHLB-Chicago's business plan casts doubts about viability of MPF (p. 38)
- Senate Banking Committee schedules hearing for Rosenfeld appointment of Finance Board (p. 39)
- FHLB-Seattle names former CEO Faulstich as interim president (p. 40)
- FHLB-San Francisco elects new chairman (p. 40)

Farm Credit System/Farmer Mac

- Does FCA chairman Pellett envision expanding the Farm Credit System? (p. 41)
- Farm Credit System reports $2.993 combined net billion income for 2004 (p. 42)
- Ann Trakimas appointed director of the Farm Credit Banks Funding Corporation (p. 43)

Postal Service

- USPS reports first quarter net income of $1.7 billion (p. 44)
- Board of Governors directs management to prepare rate case filing to cover $3.1 billion escrow requirement (p. 44)
- White House and Capitol Hill staff seeking compromise on postal reform legislation (p. 45)
- NAPS urges "expeditious" passage of postal reform legislation (p. 46)
- Changes made to Congressional committees handling postal reform (p. 47)
- Japanese Prime Minister Koizumi plans to work with the country's ruling party to reform the country's postal service (p. 47)

TVA and Rural Electric Co-Ops

- Politicians are speaking out on composition of new TVA board (p. 47)
- TVA reports higher power sales and operating revenue for first quarter 2005 (p. 48)

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Major Events

Federal Reserve Chairman Greenspan calls for severe reductions in GSEs' mortgage holdings to fend off "almost inevitable" problems

- In testimony before the House Financial Services Committee, Federal Reserve Chairman Alan Greenspan called for severe reductions in the mortgage holdings of Fannie Mae and Freddie Mac to fend off problems he sees as "almost inevitable" over the next decade. Greenspan noted that Fannie and Freddie have grown substantial portfolios in recent years and the role of the holdings appears to be "as best we can judge--we've tried to think of all other possible purposes--very largely to create increased profits for these organizations." Greenspan said, "We have found no reasonable basis for that portfolio above very minimum needs," adding that "a $100 billion, $200 billion--whatever the number might turn out to be--limit on the size of the aggregate portfolios of those institutions--and the reason I say that is there are certain purposes which I can see in the holding of mortgages which might be helpful in a number of different areas. But $900 billion for Fannie and somewhat less, obviously, for Freddie, I don't see the purpose of it." Greenspan said, "If [Fannie and Freddie] continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever-growing potential systemic risk down the road." He added, "Enabling these institutions to increase in size—and they will, once the crisis, in their judgment, passes—we are placing the total financial system of the future at a substantial risk." Some observers said that Greenspan's comment struck them as specific, in terms of the message it sends to lawmakers, and at the same time uncharacteristically candid.

- In a press interview, Richard Baker (R-LA), Chairman of the Subcommittee, said he plans to include a provision for limiting the GSEs' loan portfolios in legislation he hopes to introduce by mid-March. Baker said he still is working out the "methodology" so that changes would be gradual to avoid upsetting the markets. Senator Richard Shelby (R-AL), chairman of the Senate Banking Committee, said that Greenspan's concern over the mortgage holdings "deserves careful consideration." While the White House and Treasury Department haven't declared that they will push for such limits, Greenspan's views are likely to influence the Bush administration's thinking on the GSE regulatory reform legislation debate.

- Ann Grochala, director of lending and accounting policy for Independent Community Bankers of America (ICBA), said Greenspan's comments were the first time he suggested a range of limits on the GSEs' growth. "We're looking at it more from the perspective of mandated limitations," Grochala said, noting that ICBA "would be concerned about any sort of limitations" on the GSEs' growth. Policy makers should be careful about advocating these kinds of proposals, Grochala warned, "because it's difficult to determine a particular size for [the GSEs]. There are times when they

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need to expand and times when they need to contract. In recent years people have been looking for mortgages and refinance opportunities. Community banks would have been unable to meet those needs unless Fannie and Freddie, as well as the Federal Home Loan Banks had been given the flexibility to meet the demand." Grochala said she did not take Greenspan's comments to mean he was recommending a specific, numerical ceiling on the GSEs' asset size. "We wouldn't think that [Greenspan] would be in favor of an arbitrary, mandatory cap," Grochala said.

- There are some legitimate reasons why Fannie and Freddie should hold mortgages in portfolio, said Doug Duncan, chief economist for the Mortgage Bankers Association. By holding loans, Fannie and Freddie are able to better understand the market they are serving, said Duncan. He added that the GSEs might want to purchase loans that aren't in demand by other investors but qualify toward their low-income financing requirements.

- Alex Pollock, former president and chief executive officer of the FHLB-Chicago, said it struck him as interesting that so much attention has been focused on the GSEs' portfolios when the most profitable part of their business is in securitizations. The public subsidies that accrue to Freddie's and Fannie's benefit are more generous in the securitizations area than in regard to the companies' equity holdings, he said. "The GSEs' credit guarantee business actually has a higher return on equity than their on-balance sheet business," Pollock said. The annual profits for the GSEs' loan portfolios are in the 20% range, Pollock said, while the returns for their guarantees of loans that they securitize are about 30% per year.

- Freddie Mac spokeswoman Sharon McHale said the company's portfolio helps provide "liquidity and stability to the U.S. residential mortgage market in good and bad economic times" and its purchases of mortgages also help keep mortgage costs low. Limits on the GSEs' mortgage portfolio, which generate more than 66% of the companies' profits, would dramatically curb Fannie Mae's and Freddie Mac's future profitability.

- Greenspan's comments raised the GSE regulatory reform debate to a new level and changed the lobbying game of the GSEs. To date, Congress has only considered restricting certain activities, increasing capital standards, and tightening the GSEs' regulations, but has not contemplated wholesale changes to the GSEs themselves. While limiting the GSEs' portfolio growth may not be politically "possible," the threat of growth restrictions could change what Fannie and Freddie would otherwise settle for in a final bill. Such a strategy for Baker and the administration is a risk, which could backfire and derail the legislation once again this year, according to several policymakers, industry lobbyists and observers. "The GSEs are going to be adamantly opposed to this, the Democrats are going to be adamantly opposed to this and some Republicans...if this provision is in the bill, it's likely to diminish the overall number of individuals that will support the bill," said an unidentified industry lobbyist. While the recent accounting scandals at Fannie and Freddie have diminished the GSEs' ability to attack Greenspan or Congress directly, it hasn't hurt

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their influence with industry allies, said the lobbyist. "What they will do is script their surrogates, the home builders, the realtors...to say [limits on the GSEs' portfolio are] anti-housing," he said. "The traditional arguments are that you will diminish the overall supply of capital, prices will increase and those increases will pass from lenders to consumers." (*Dow Jones Newswire*, Dawn Kopecki, 02/17/05; *Bureau of National Affairs*, Richard Cowden, 02/22/05; *Wall Street Journal*, James R. Hagerty and Dawn Kopecki, 02/18/05; *Dow Jones Newswires*, Dawn Kopecki, 02/17/05; *Bloomberg News*, 02/18/05; *American Banker*, Damian Paletta, 02/18/05)

- According to the February 23 issue of the *International Strategy & Investment Morning Political Report (ISIMRP)*, Greenspan's proposal to limit the GSEs' mortgage portfolio broadens the debate on possible GSE regulatory reforms, providing further evidence that "time is not on the side of [Fannie and Freddie]." In examining possible legislative outcomes, the *ISIMRP* concludes that the GSE regulatory reform legislation is likely to include broad product approval authority for the new GSE regulator, leaving open the question of whether the regulator does in fact have the authority to limit the size of portfolios. The publication adds that the new regulator working with the Department of Treasury, with its current ability to limit the GSEs' debt, would have tremendous leverage over the GSEs to slow the growth of their mortgage portfolios and reduce systemic risk over time. (*International Strategy & Investment Morning Political Report,* 02/23/05)

- In a February article titled "Building the American dream …or nightmare?," *The Economist* wrote, "The Fed's chairman Alan Greenspan, has urged Congress to do something to rein in America's two monster mortgage-finance agencies, Fannie Mae and Freddie Mac, before they put the country's financial system at risk. …Since the two middlemen are now so big [with $900 billion in mortgage holdings], the federal government will in fact be forced to bail them out if things ever do go wrong. …Fannie Mae likes to say that 'Our business is the American Dream.' Homeownership is undoubtedly popular with Americans and their politicians. But if the Fed chairman is right, these two dream-builders should be keeping financial regulators [and Congress] awake at night." (*The Economist*, 02/18/05; *The Motley Fool*, Bill Mann, 02/18/05)

OFHEO reports additional problems in Fannie Mae's accounting

- OFHOEO has identified numerous new problems with Fannie Mae's accounting practices, including deficiencies in recording certain securities and loan transactions and "practices to smooth certain income and expense amounts," which raise new concerns about the company's "safety and soundness." OFHEO has directed Fannie's board and management to examine "several accounting and internal control issues" in its own internal investigation. "OFHEO indicated that it has not completed its review of all aspects of these issues but has identified policies it believes to be inconsistent with generally accepted accounting principles as well as internal control deficiencies it believes raise safety and soundness concerns," said Fannie Mae. The

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issues identified by OFHEO relate to Fannie Mae's securities accounting, loan accounting, consolidations, accounting for commitments and practices to smooth certain income and expenses.

- In September, OFHEO said it found problems in Fannie's implementation of FAS 133 for derivatives and FAS 91 for calculating losses on mortgage prepayments. OFHEO has found new problems with Fannie's use of FAS 91 as well as possible GAAP violations in the company's interpretation of FAS 115 for the classification of securities as either "available for sale" or "held to maturity," which affects when Fannie recognizes income and losses from changes in fair value; FAS 140 for repurchase agreements; FAS 65 for the classification of loans held in Fannie's portfolio as either "held for investment" or "held for sale," which operates similar to FAS 115; Financial Interpretation 46 for Qualified Special Purpose Entities with OFHEO questioning if selected transactions related to these entities "have a valid business purpose;" and FAS 149 for certain purchase and sale commitments of mortgage-related assets as derivatives. OFHEO's allegations cover the gamut of Fannie Mae's business and the company's internal controls and systems, "including questions relating to Fannie Mae's procedures for preparing, reviewing, validating, authorizing, and recording journal entries relating to amortization adjustments."

- While Fannie Mae did not estimate the potential impact of OFHEO's new concerns, the company stated, "Management has initiated a comprehensive review of accounting routines and controls, the financial reporting process and application of GAAP." Deloitte & Touche LLP, which conducted OFHEO's original forensic audit of Fannie, will review all of the issues identified by OFHEO and restate the company's results where necessary, said the company. Michael Granof, professor of accounting at the University of Texas, Austin, said, "The implication that Fannie Mae is classifying certain transactions in a self-serving manner, so as to enable them to manage their earnings." The designation of which securities are to be sold "could have a very significant impact on earnings," said Granof. (*Dow Jones Newswires*, Dawn Kopecki, 02/23/05; *American Banker*, Rob Blackwell, 02/23/05; *PR Newswire*, 02/23/05; *New York Times*, Stephen Labaton, 02/24/05; *Bloomberg News*, Al Yoon and James Tyson, 02/24/05)

- Analysts expressed dismay at the depth and breadth of accounting problems surfacing at Fannie Mae, which stretch down to the very base of the company's accounting practices. "It's surprising," said Edwin Groshans, an analyst at Fox Pitt, Kelton. "You wouldn't expect the accounting issues to be running this deep. It almost makes you think that the lack of accounting controls was prevalent." Josh Rosner, an analyst at Medley Global Advisors, an investment-research firm in New York, said the latest disclosures illustrate that many of the company's problems "are still ahead, not behind." (*Bloomberg News*, Albert Yoon, 02/23/05; *Wall Street Journal*, James R. Hagerty, 02/24/05; *Reuters*, Kristin Roberts, 02/23/05)

- Representative Richard H. Baker (R-LA), chairman of a House subcommittee overseeing Fannie Mae and Freddie Mac, said he wasn't surprised by OFHEO's new

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criticisms. “It’s unfortunate that additional disclosures have been made that reflect on management deficiencies,” Baker said. “Although disappointing, the disclosure could add momentum to the need to consider a new [GSE] regulatory system.” Andrew Gray, spokesman for Senator Richard Shelby (R-AL), said “Until OFHEO completes its ongoing investigation, we really won’t have a full appreciation for the size and scope of the accounting errors [at Fannie Mae].” Gray added, OFHEO’s new questions “just underscore the need for legislation.” (*Washington Post*, Terence O’Hara and Ben White, 02/24/05; *Reuters*, Kristin Roberts, 02/23/05)

OFHEO approves Fannie’s capital plan and extends company’s deadline for 30% capital surcharge until September

- Fannie Mae announced that OFHEO has approved the company’s capital restoration plan and extended its deadline by three months to September 30 to restore inadequate capital reserves and raise an additional 30% surcharge imposed by OFHEO. Fannie Mae’s plan largely centers on reducing its massive mortgage portfolio, maintaining low dividend payments and reducing other costs such as advertising, lobbying, eliminating stock options for senior management, and scrapping its plans for a major relocation to new offices at Waterside Mall in southwest Washington, DC. Fannie Mae said it would “sharply curtail its corporate advertising campaign and use of political consultants.” The company said “as a last resort,” it would cut its stock dividend to preserve cash. The plan relied on Fannie Mae’s financial condition as of December 31, 2004, which may change after Deloitte & Touche reaudits the company’s books. “The restatement process may result in additional adjustments, perhaps material adjustments, to prior and current period financial results that are not reflected in the plan,” said Fannie Mae.

- In December, OFHEO reclassified Fannie as “significantly undercapitalized” for the third quarter of this year; taking into account the company’s estimated $9.2 billion in unreported losses from FAS 133 and 91 corrections that OFHEO recognized at September 30. As a result, Fannie’s core capital fell roughly $3 billion short of its minimum capital requirements. Subsequently, Fannie has issued $5 billion in preferred stock to raise additional capital and cut its quarterly dividend on its common stock in half. Fannie Mae’s plan assumes no increase in its dividend payments from current levels.

- Fannie’s capital plan calls for a small “cushion” of reserves above OFHEO’s 30% surcharge “as a contingency against events that might affect the company’s ability to achieve the 30% surplus level,” said Fannie. “Should this capital surplus cushion be inefficient to cover extraordinary events, the plan also includes other contingency measures to provide additional capital, such as reductions in mortgage portfolio balances, additional preferred stock issuance, and, as a last resort, a further reduction in the common stock dividend.”

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- “Fannie’s board and management believes that by tightly controlling balance sheet size, and applying additional retained earnings to capital, the company could exceed the surplus capital goal with a cushion for contingencies,” said Fannie Mae. At a minimum, Fannie Mae’s management will meet weekly with OFHEO staff to review internal documents and ensure that it was carrying out its new capital plan and will immediately inform the agency of any new developments or business conditions that could affect the plan. (*Dow Jones Newswires*, Dawn Kopecki, 02/23/05; *American Banker*, Rob Blackwell, 02/23/05; *PR Newswire*, 02/23/05; *Associated Press*, Marcy Gordon, 02/23/05)

- In a Fitch Ratings Financial Services Special Report titled *GSEs: Are the ‘AAA” Ratings at Risk*, the ratings agency reviews Fannie Mae’s capital restoration plan and assesses the underlying assumptions of the plan. Fitch writes, “[Fannie Mae’s] plan discusses balance sheet management through normal liquidations and increased core capital levels through retained earnings and cost savings. Given additional costs expected to resolve accounting and control issues, cost savings may be minimal for 2005. …Fannie Mae desires to reach a level slightly above the minimal plus 30% requirement in order to provide some cushion. Fitch believes that this may require the issuance of additional preferred stock.” (*Fitch Ratings Financial Services Special Report: GSEs: Are the ‘AAA” Ratings at Risk,* Marc Yaklofsky and Eileen A. Fahey, 02/23/05)

- In the *American Banker*, Rob Blackwell wrote,” Fannie Mae appeared to be in full-scale retreat …after disclosing a slew of new accounting problems and pledging to reduce its mortgage portfolio, cut advertising and lobbying, and play nice with its regulator. But it remains to be seen whether the moves are a public relations ploy, as some critics immediately charged, or were signs of a truly chastened company.” Fannie Mae’s commitment to “sharply curtail” its use of lobbyists “might amount to the equivalent of a white flag from Fannie,” as Congress debates GSE regulatory reform legislation, wrote Blackwell. According to the Senate Office of Public Records, Fannie Mae spent approximately $9 million on lobbying in 2003 and roughly $4 million in the first six months of 2004, making such spending reductions a “drop in the bucket,” said Bert Ely, an Alexandria, Virginia analyst who supports the privatization of Fannie Mae and Freddie Mac.

- Fannie Mae’s capital restoration plan changes the company’s underlying business plan. “The old days of portfolio growth are done and over with,” said Mike McMahon, a Sandler O’Neill & Partners LP analyst. “That model’s done,” given the possibility of higher capital requirements, rising affordable housing goals, and Federal Reserve Chairman Greenspan’s statement that the GSEs’ portfolios should be capped at between $100 billion and $200 billion, said McMahon. Fannie Mae’s portfolio growth will be replaced with a pure focus on the credit guarantee business, he added. (*American Banker*, Rob Blackwell, 02/24/05)

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Fannie Mae and Freddie Mac

Stars aligning for GSE regulatory reform

- In a February 16 speech at the Exchequer Club, House Financial Services Committee Chairman Michael Oxley (R-OH) confirmed that the committee is working on its own draft of legislation to restructure the regulatory system for GSEs and is not waiting for the Senate to take action on the issue. Oxley indicated that the full committee considers the initiative a high priority, due in large part to a recent spate of accounting scandals at housing financed companies, Fannie Mae and Freddie Mac. Representative Richard Baker (R-LA), a subcommittee chairman and frequent critic of the GSEs, has announced his intention to introduce a reform bill in March. Oxley's approval of such a move would mean that, in contrast to abortive attempts to pass such a bill, both the House and Senate would be looking at legislation simultaneously in 2005. Oxley said he is "not in a race" with Senate Banking Committee Chairman Richard Shelby (R-AL.) to take up reform legislation, adding, "we'll do our due diligence." Oxley said that there is a "great deal of optimism we can get this accomplished this year," likely in the first half of the year.

- With Baker and Shelby working "assiduously" toward GSE reform, Oxley said that he has met with Baker and Shelby and discussed the issues. The accounting irregularities at both Fannie Mae and Freddie Mac—along with a consensus that the FHLBs will be part of this process--will help spur a bill, he added. "I pledged to both of those gentlemen my efforts to come to a conclusion on that legislation hopefully earlier rather than later," Oxley said. He indicated that the markets need "some certainty," including what Congress plans to do in creating a world-class regulator for the GSEs. With regard to other issues concerning capital, housing goals, and receivership, Oxley said, "Let's let the legislative process work. We need a regulator with power and independence and the funding to get the job done and to reassure the markets and that's what we plan to do." (*BNA's Daily Report for Executives*, Karen L. Werner, 02/18/05)

- Legislation to strengthen the regulator the GSEs has a 75% to 80% chance of passing in 2005, said Senate Banking Committee Chairman Richard Shelby "We're looking for a regulator that has a lot of strength to it," said Shelby. "We're looking for receivership in the possibility, remote possibility, if [Fannie or Freddie] ever became insolvent." (*Bloomberg News*, James Tyson, 02/16/05)

- At a recent hearing of the House Financial Service Committee's subcommittee on capital markets, insurance and government-sponsored enterprises, the chief accountant of the Securities and Exchange Commission, Donald T. Nicolaisen, wished Chairman Richard Baker (R-LA) and other committee members luck. "You have a tough undertaking," said Nicolaisen. "But an important one." (*The Baton Rouge Advocate*, Gerard Shields, 02/20/05)

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- In the February 9 issue of the *New York Law Journal*, Clyde Mitchell, adjunct professor of banking law at Fordham Law School, wrote "…Freddie and Fannie are in trouble and steps need to be taken to fix their accounting and management problems. OFHEO also has problems with its image and probably this won't be remedied without the establishment of a new strong regulator with adequate powers that can command respect. …Any congressmen and congesswomen who fail to get the seriousness of this situation and support meaningful GSE regulatory legislation will be accountable to the American taxpayers in the event that a disaster occurs on their watch." (*New York Law Journal*, Clyde Mitchell, 02/09/05)

Fitch Ratings "clarifies" its methodology for rating Fannie and Freddie "AAA"

- In a *Financial Services Special Report*, Fitch Ratings reiterated its view that Fannie Mae and Freddie Mac "warrant the assignment of very high credit rating." Analysts Marc Yaklofsky and Eileen A. Fahey wrote, "Fitch's ratings of Fannie Mae and Freddie Mac reflect our view that both entities possess characteristics that minimize the probability of default and therefore warrant the assignment of very high credit ratings. Those characteristics include limited credit and interest rate risk appetite, quality of risk measurement and management systems and "significant funding advantages," wrote the analysts. Senior debt of the GSEs is also supported by "an assumption of support from the U.S. government," although their subordinate and preferred obligations are not, they said. "There is not one single factor that would likely cause us to adjust our rating. Rather, it would likely take a confluence of events that demonstrate that the government's relationship with the GSEs has been weakened or severed." The analysts indicated that they will not re-evaluate either GSEs' rating watch negative designation until Fitch receives "additional clarity on accounting processes and issues" from Fannie Mae and until Freddie Mac releases financials for 2004, expected in March.

- In addressing the impact of proposed receivership language in GSE regulatory reform on the companies' ratings, the analysts wrote, "Fitch believes that proposed legislation to strengthen regulatory oversight is designed to provide a GSE regulator powers that bank regulators already possess. It allows greater flexibility for determining risk-based capital requirements, appropriate stress tests and actions that provide a basis for safety and soundness. The legislation is not explicit as to the implementation of liquidation decisions. However, Fitch believes similar to the FDIC, the regulator would be obligated to liquidate the enterprise(s) in an orderly and optimal fashion. Current legislation for OFHEO does not provide such flexibility with very specific minimum and risk-based capital rules. Thus, we do not believe that Congress intends to eliminate its support of the mortgage market and expansion of housing in the U.S."

- On GSE regulatory reform for the housing GSEs, the Fitch analyst said "some form of legislative reform will likely be passed in 2005." In the wake of accounting

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"deficiencies" at both GSEs and Fannie's subsequent capital shortfall, opposition to so-called receivership language appears to have abated, said the analysts. While other legislative provisions remain contentious, such issues are not likely to constitute "major roadblocks" to passage this year, said the analysts. "A strong regulator is paramount to ensuring the safety and soundness of the enterprises and Fitch would respond favorably to legislation that creates a strong regulatory framework," the analysts concluded. (*Market News International*, Claudia Hirsch, 02/23/05; *Fitch Ratings Financial Services Report, GSEs L Are the "AAA" Ratings at Risk?*, Marc Yaklofsky and Eileen A. Fahey, 02/23/05)

GSEs supporters reluctantly "accepting" the receivership provision in GSE reform

- Fannie and Freddie officials have told key lawmakers, including Senate Banking Committee Chairman Richard Shelby (R-AL), that they are prepared to accept Shelby's GSE regulatory reform bill from last year, which included a receivership powers for the new GSE regulator. In 2004, this provision was fiercely opposed by Fannie, Freddie, and the National Association of Home Builders (NAHB). Even the NAHB say they will surrender on the issue. "We don't necessarily like it, but we understand that since Fannie and Freddie have accepted it, it's inevitable," said NAHB chief executive Jerry Howard. A spokesman for Shelby said he was pleased about the "coalescing of views" on the issue. (*American Banker*, Rob Blackwell, 02/24/05)

- In a February 16 Prudential Equity Group research report, Charles Gabriel wrote, "In …February 3 comments before the American Enterprise Institute and February 8 Senate Banking Committee testimony, rating agency officials asserted that congressional enactment of receivership language within a GSE re-regulation bill would probably not cause them to change their AAA ratings on Fannie-Freddie debt. This crystallized what over the past year has become a pronounced sentiment change. …With receivership now non-alarming to the rating agencies, seemingly acceptable to the debt markets (who might look forward to clarification of the relative status of GSE debt and MBS's), and now unlikely to be contested by Fannie and Freddie themselves, the administration's scurrying to consider new potential "kill bill" demands [such as placing limits on GSEs' growth]. …[W]e believe the biggest risk for GSE stakeholders is that Washington's deliberations once again yield no legislated resolution, leaving Fannie and Freddie to continue facing a squeezing regulatory environments, compliments of OFHEO, Treasury and [HUD]… Less of a concern would be the enactment of legislation which would materially dilute the value of GSE charters, or empower a new regulator to do the same." (Prudential Equity Group Washington Research Washington World, *"Tapping the Maestro While Awaiting the White House's Card: What's Next for Fannie and Freddie in Washington?"*, Charles A. Gabriel, Jr., 02/16/05)

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Strong GSE regulatory reform on the horizon?

- In its February 23 issue, the *International Strategy Investment Morning Political Report* writes, “Our investment conclusion is that [Fannie’s and Freddie’s] stocks face significant regulatory headwinds during the next year as Congress is likely to pass legislation creating a stronger regulator for the housing GSEs. The issue will stay in the headlines as the legislation moves through the banking committees and then both chambers of Congress, and the uncertainty surrounding the outcome will make investors skittish. Moreover, the bill that emerges from this process will likely end up being tougher on the companies than many investors expect. Usually bills tend to get watered down as they move through the legislative process, but this bill is likely to get tougher, particularly in the House-Senate conference committee when the guardians of the capital markets (the Treasury and Fed) will play an especially important role.” (*International Strategy Investment Morning Political Report*, Tom Gallagher, Andy Laperriere, Melissa Loesberg, 02/23/05)

GAO raises questions about the housing GSEs for Congress to address

- The GAO provided Congress a list of areas for the housing GSEs that could be “ripe for reexamination” as lawmakers review spending and tax programs. As lawmakers review federal government spending, Congress could examine the role and regulation of the GSEs, including whether Fannie Mae and Freddie Mac should be privatized said GAO. The agency said Congress may consider questioning whether OFHEO has the necessary authority to address the companies’ risks. Lawmakers also may consider whether Fannie and Freddie still serve an important public policy purpose, the GAO said. “Should their mission focus be restrained to limit expansion into new activities, or adjusted in any way? Should they be privatized?” the GAO wrote in a report to Congress. The GAO included the housing GSEs among a laundry list of areas in government “that could be considered ripe for reexamination and review,” as lawmakers address the deficit and other fiscal challenges. (*Reuters*, 02/16/05)

Fannie and Freddie raise $1 million through PAC contributions for political candidates

- Adding credence to Representative Christopher Shays (R-CT) observation that Fannie Mae and Freddie Mac “have been able to manipulate [Congress] in a way I have never seen with any other companies,” it was disclosed that the two companies raised more than $1 million last year for political campaign donations, while successfully opposing legislation that would subject the mortgage finance companies to a tougher regulator. According to *PoliticalMoneyLine*, the GSEs gave more than $600,000 to candidates through their PACs and spent $11.7 million on lobbying during the first half of 2004. The rapid increase in PAC funding by Fannie Mae and Freddie Mac “is obviously a concerted effort to ramp up and get as much money as they can for their political goals,” said *PoliticalMoneyLine’s* co-founder Tony Raymond.

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- The companies are building up their PACs -- starting in December 2003 at Fannie Mae and last August at Freddie Mac -- while Congress begins GSE regulatory reform legislation designed to create a stricter regulator with authority to alter the GSEs' capital standards and reject new lines of business. Such legislation, opposed by Fannie and Freddie, stalled in Congress in 2003 and 2004. The PAC buildup coincides with statements by Fannie and Freddie that both intend to cut their spending on outside lobbyists.

- In 2004, Fannie Mae's PAC raised $816,517 and donated $554,606 of it to candidates, according to *PoliticalMoneyLine*. During the five months after the creation of its PAC, Freddie Mac raised $234,855 and donated $80,287 to political campaigns. Fannie Mae's PAC gave the maximum $5,000 both to Leadership PAC 2004 of Representative Michael Oxley (R-OH), chairman of the House Financial Services Committee, and to Defend America PAC of Senator Richard Shelby (R-AL), Senate Banking Committee chairman, said *PoliticalMoneyLine*. According to *PoliticalMoneyLine*, the Fannie Mae PAC also gave $5,000 to Representative Barney Frank (D-MA); $5,000 to Senator Robert Bennett (R-UT) and $5,000 to Snowpac, Senator Bennett's PAC. Fannie Mae's PAC also gave $2,500 to Senator Paul Sarbanes (D-MD) and $5,000 to Senator Christopher Dodd (D-CT). Fannie's PAC gave $2,500 to the PAC of House Minority Leader Nancy Pelosi (D-CA) and $5,000 each to the PACs of Senate Majority Leader Bill Frist (R-TN), House Majority Leader Dennis Hastert (R-IL), and Senator Jon Corzine (D-NJ), said *PoliticalMoneyLine*. Freddie Mac's PAC contributed $3,000 to Oxley's PAC, and $5,000 each to the PACs of Dodd, Bennett, and House Majority Leader Tom DeLay (R-TX). *PoliticalMoneyLine* said in January 2005, Fannie Mae contributed $4,000 to Oxley's PAC and $5,000 to the PAC run by Bennett, whose son is a Fannie Mae employee in Salt Lake City, UT. (*Bloomberg News*, James Tyson, 02/24/05)

Shadow Financial Regulatory Committee urge adoption of four key provisions in GSE regulatory reform legislation

- The Shadow Financial Regulatory Committee (SFRC), a group of academics, former regulators, and other financial services experts, has urged Congress to include four specific provisions in GSE regulatory reform legislation (S. 190). On behalf of the Committee, Peter Wallison said the legislation should make appointment of a receiver mandatory, when a GSE is deemed "critically undercapitalized." Such a provision would mirror the prompt corrective action provisions in the Federal Deposit Insurance Corporation Improvement Act of 1991, which require regulators to shut down a federally insured bank or thrift even if it is not yet technically insolvent. While S. 190 provides the new GSE regulator receivership authority, the appointment of the receiver is discretionary. The bill should be changed to make such an appointment mandatory, said Wallison. "In this respect, the new bill should follow the prompt corrective action requirements that Congress adopted in FDICIA after the savings and loan crisis," said the Committee.

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- The SFRC also urged Congress to incorporate provisions that would allow the new GSE regulator to limit, or order divestment of, the investment portfolios of the housing GSEs. According to the Committee, Fannie Mae and Freddie Mac's borrowing authority allows them to acquire mortgages and MBS, which create interest rate risk and liquidity risk for the companies. While S. 190 provides the regulator some power establish standards "for the management of asset and portfolio growth" of the GSEs, additional authority is needed, said the Committee. "Only in this way…will the risks [the GSEs'] create be substantially controlled," said the group.

- The Committee also said S. 190 should express more clearly that Fannie Mae and Freddie Mac are not guaranteed by the federal government. The group suggested that Congress could make this clear by repealing the GSEs' current exemption from state and local taxes.

- Finally, the SFRC said Congress should consider giving Ginnie Mae responsibility for assisting low-income and affordable housing. While this is Fannie Mae's and Freddie Mac's mission, Wallison said "study after study" shows that banks and other lenders do a better job than the two housing GSEs. If Congress desires to continue to subsidize those loans, Ginnie Mae is a natural choice because it already securitizes mortgages backed by the Federal Housing Administration and the Veterans Administration, said Wallison.

- While the group believes that tougher regulation is not a long-term solution and that privatization of the housing GSEs ultimately must occur, these additional measures will help strengthen the GSE regulatory reform legislation, said Wallison. (*BNA's Daily Report for Executives*, R. Christian Bruce, 02/15/05; *Shadow Financial Regulatory Committee Statement 216*, 02/14/05)

The implicit federal guarantee of Fannie and Freddie provides the GSEs "enhanced credit quality" in the marketplace

- Testifying before the Senate Budget Committee, CBO Director Douglas Holtz-Eakin said Fannie Mae, Freddie Mac and the FHLBank System are perceived in financial markets to be backed by an implied federal guarantee of their debt and other financial obligations. "That implicit guarantee is communicated to investors through a number of provisions of law that create a perception that the GSEs have an enhanced credit quality as a result of their affiliation with the government," he said, saying those provisions include lines of credit at the U.S. Treasury and exemptions from state and local taxes. "In addition, although federally chartered and federally insured banks face a limit on the amounts that they can invest in other types of securities, that limit does not apply to GSE securities," the CBO director said. "Taken together, those statutory privileges have been sufficient to overcome an explicit denial of federal backing that the GSEs include in their prospectuses," Holtz-Eakin said. "Assisted by

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the implied federal guarantee, those three companies have grown into some of the largest financial institutions in the world," he added. (*Dow Jones International News*, John Connor, 02/16/05)

G-fee debate continues as
another lawsuit is filed against Fannie and Freddie over the g-fees

- The fees Fannie Mae and Freddie Mac charge lenders to guard against mortgage defaults have little to do with the credit losses they were designed to insure, said Jay Brinkmann, a top economist at the Mortgage Bankers Association (MBA). Fannie's and Freddie's guarantee fees (G-fees) are primarily driven by the GSEs' desire to generate profits on the capital they are required to hold in reserve, said Brinkmann, who added that their G-fees averaged a return on equity of 26% in 2003, according to the companies' public disclosures. "A key driver of [the G-Fees] has not been the credit losses," he added. Brinkmann, who previously worked as a portfolio manager at Fannie Mae, was speaking at a panel discussion "Do Fannie and Freddie Charge Too Much for Guaranteeing Mortgage-Backed Securities?" hosted by the American Enterprise Institute. According to the companies' disclosures, Fannie and Freddie charge lenders 20 basis points on a loan to guarantee the borrower will pay their mortgage on time; over recent years, the credit losses that those G-fees "insure" have consistently run under a basis point. According to Fannie and Freddie, the G-fees charged to individual lenders are negotiated on a case-by-case basis and greatly vary from lender to lender. Lenders, who don't want to publicly criticize Fannie and Freddie for fear of retaliation, have said they are concerned the companies could raise their G-fees, said Brinkmann. "It is certainly a chilling affect...people don't want to be public," he said. Brinkmann estimates that Fannie and Freddie could have cut their G-fees nearly in half, to 12.4 basis points, and still generate a return-on-equity of about 15%, using publicly available data from the companies and OFHEO.

- In remarks at the AEI session on G-fees, former CEO of the FHLB-Chicago and AEI resident fellow Alex Pollock said that Fannie Mae and Freddie Mac engage in "non-competitive pricing" of g-fees, by setting fees "very high relative to the average loss" of borrowers defaulting. Congress should increase competition and cut costs for lenders and homebuyers by ending the dominance of Fannie Mae and Freddie Mac over pricing the guarantees Pollock added. Fannie and Freddie derive about 33% of their profits from g-fees. "More competition, one way or another, is in fact the only good answer," concluded Pollock. "There is little doubt that in this case lenders and homebuyers would rapidly benefit from competitively priced g-fees, which would more closely reflect the actual risks."

- AEI fellow Peter Wallison said, "The fact that Fannie and Freddie can target a high return on equity and achieve that return through their G-fee pricing, certainly suggests that they are not actually competing. The fact that they are charging unnecessarily high G-fees that directly increase mortgage rates will not increase the sympathy with which lawmakers hear their case for more lenient regulation."

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- Brinkmann said, “I think having competition in the market would go a long way toward addressing the issue,” adding that the MBA is pushing a proposal that would allow the 12 regional FHLBs to more effectively compete against Fannie Mae and Freddie Mac. According to a copy of the proposal obtained by *Dow Jones Newswires,* the MBA will propose an amendment to the GSE regulatory reform legislation that would allow the FHLBs to securitize mortgages just like Fannie and Freddie. (*Dow Jones Newswires*, Dawn Kopecki, 02/15/05;)

- Fannie Mae and Freddie Mac have been sued by California investors claiming the companies charged artificially high g-fees on real estate loans. The two housing GSEs colluded to “fix, raise, maintain or stabilize” the so-called guarantee fees (g-fees) lenders pay on residential real estate loans in California, according to the lawsuit filed in state court in Los Angeles. In 2003, artificially high guarantee rates allowed Fannie Mae and Freddie Mac to charge g-fees totaling $4 billion, the lawsuit said. The moves “had the effect of inflating g-fee rates charged by lenders to members of the class beyond the level that would have prevailed in a competitive market,” the lawsuit concluded.

- G-fees are “voluntary, competitive and appropriate,” said Freddie Mac spokeswoman Sharon McHale. “Fannie Mae and Freddie Mac do not consult with respect to guarantee fees, much less enter into agreements about those fees.” Fannie Mae spokesman Brian Faith had no comment on the lawsuit. (*Bloomberg News*, 02/15/05)

National Alliance of Independent Mortgage Bankers announces its opposition to S. 190

- The National Association of Independent Mortgage Bankers (NAIMB), a newly formed trade group for small- and medium-sized mortgage bankers, announced its opposition to S. 190, saying it would hurt both borrowers and the industry. According to the group, S. 190 would force Fannie Mae and Freddie Mac to “withdraw” their automated underwriting systems that many of the group’s members use, resulting in lenders not knowing for “days or perhaps weeks” whether the GSEs would purchase a prospective loan. (*National Mortgage News*, 02/09/05)

OFHEO proposes regulation requiring Fannie Mae and Freddie Mac to report mortgage fraud in a timely fashion

- OFHEO has proposed a regulation to require Fannie Mae and Freddie Mac to report mortgage fraud or possible mortgage fraud to the agency in a timely fashion. The regulation would also require the GSEs to establish internal controls, procedures and training programs to detect and report mortgage fraud. “This rule will ensure that Fannie Mae and Freddie Mac do their part to help combat mortgage fraud,” said OFHEO director Armando Falcon, Jr. “The Enterprises will now have a clear

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obligation to report fraud and help prevent a repeat of cases like the First Beneficial matter," Falcon said.

- The proposed rule, which is open for public comment, states that a GSE must notify OFHEO if the company is requiring the repurchase of a MBS or other instrument, or if it is declining to purchase an instrument because of suspected fraud. The proposed rule does not, however, stop or severely curtail MBS or loan buybacks, as some industry observers had feared it would. According to the proposal, failure to comply with the requirements of the regulation may subject the GSE or its Board members, officers, or employees to supervisory actions by OFHEO, including the issuance of cease-and-desist proceedings and civil money penalties. The public comment period on the proposed regulation is set at 30 days after publication in the *Federal Register*.

- Separately, OFHEO also issued a Director's Advisory, requiring the GSEs to notify the agency of investigations, legal proceedings, or civil or criminal actions by any governmental authority or private party. The Advisory provides for establishment of procedures and deadlines for making such notifications and goes into effect immediately. (*OFHEO Press Release*, 02/22/05; *American Banker*, Rob Blackwell, 02/23/05)

More changes in the Bush administration's second term team

- Following the resignation of Gregory Mankiw as chairman of its Council of Economic Advisers (CEA), the White House announced the appointment of tax- and government-finance expert Harvey Rosen as chair of the CEA. Rosen, 55, has been a member of the Council since October 2003 and served as deputy assistant secretary for tax analysis in the Treasury Department under President George H. W. Bush from 1989 to 1991. Rosen has also been heavily involved in the administration's drive to tighten regulatory oversight of Fannie Mae and Freddie Mac. Burton Malkiel, author of *A Random Walk Down Wall Street*, described Rosen as someone who combines common sense with in-depth economics expertise and is not ideological in his approach. "He has a very strong belief in the efficacy of the free-market but he is no way an ideologue," said Malkiel. (*Reuters*, 02/16/05; *Reuters*, Caren Bohan, 02/24/05)

- President George W. Bush has announced his intention to nominate John C. Dugan to be Comptroller of the Currency at the Department of the Treasury for a five-year term. Dugan is a partner at Covington & Burling, specializing in banking and financial institution regulation, who previously served as Assistant Secretary for Domestic Finance at the Department of the Treasury. Earlier in his career, Dugan was Republican General Counsel to the U.S. Senate Committee on Banking, Housing, and Urban Affairs. Dugan's nomination was applauded by many in the banking industry. "Not only I, but everybody I've talked to since his name first surfaced, thought he was the ideal candidate," said H. Rodgin Cohen, chairman of Sullivan & Cromwell LLP. "He has the experience, and he's got the judgment, and he's got the

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smarts." Diane Casey-Landry, the president of America's Community Bankers, said, "[Dugan] is extraordinarily well versed in the banking issues. He knows the issues solid. He also has strong relationships within the industry and on Capitol Hill."

- If Dugan, a Republican, is confirmed, his appointment would force one of the FDIC board's three other GOP members to leave, since the law provides that the FDIC board may not have more than three members of the same political party. Dugan's appointment as the comptroller would force FDIC Chairman Don Powell, FDIC Vice Chairman John Reich, or OTS Director James Gilleran to leave. In its press release announcing Dugan's appointment, the White House did not offer any hint about who would leave, and an administration spokesman declined to comment. (*White House Press Release*, 02/22/05; *American Banker*, Rob Blackwell and Todd Davenport, 02/23/05)

Long-term agency debt issuance down 29.3% in 2004

- According to the Bond Market Association, long-term debt issuance by federal agencies, such as Fannie Mae and Freddie Mac, fell 29.3% to $896.7 billion in 2004 from $1.27 trillion in 2003. The BMA said issuance by the three biggest players in federal agency the market - the Federal Home Loan Banks, Fannie Mae, and Freddie Mac - was down appreciably in 2004. FHLB long-term debt issuance totaled $389.7 billion in 2004, down 31.5% from the year before, while Fannie Mae's long-term debt issuance last year was $252.2 billion, down 27.5% for the year. Freddie Mac's long-term debt issuance was $199.2 billion in 2004, down 28.1% from 2003. Other federal debt issuers in the market are the Farm Credit System, Sallie Mae, and the TVA, all of which also saw their long-term debt issuance volume drop last year compared with the year before. At year-end 2004, Sallie Mae completed its privatization and no longer participates in the federal debt market.

- During the fourth quarter of 2004, the BMA said issuance increased 15.5% in the fourth quarter to $164.5 billion from $142.4 billion in the third quarter. "Despite interest rate volatility in the fourth quarter and a substantial decrease in mortgage origination, especially from interest-sensitive refinancing, issuance in the agency market may be turning around after three straight quarters of falling issuance as mortgage rates have subsided in early 2005," said the BMA. The group said its survey of primary dealers forecast approximately $195 billion in issuance during the first quarter of 2005. (*Dow Jones Newswires*, John Connor, 02/16/05)

An emerging market: Native Americans

- *The Economist* reports, "Changes are afoot in Indian country, and financial institutions are taking notice. Recently Wells Fargo and J.P. Morgan Chase were among the sponsors of "Res 2005" in Las Vegas, an annual trade fair focused on economic development for Native Americans. But despite the efforts of big banks

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such as Wells Fargo, which has approved commercial loans and credit lines of about $1.5 billion, as well as mortgages, and Washington Mutual, which is in the mortgage business, tribal leaders contend that most of the nation's 2.4 [million] Native Americans remain underserved. Hence the trend toward native-owned banks."

- "Robert Williams, an expert on tribal law at the University of Arizona, says that Indian country is increasingly divided between the haves (the minority of tribes, like the Comanche, with successful gaming ventures) and have-nots (everyone else). Generally, Native Americans are much poorer and less familiar with banking services than the average American. They are more likely to be denied conventional home-purchase loans. Tribal banks are stepping in to plug the gaps. The North American Native Bankers Association, a trade body, counts 19 banks nationwide that are owned by tribes or by individual Native Americans. Of these, 11 are in Oklahoma, a state with a rich mix of Indian groups but without huge reservations. Most of the banks are small, with average assets of only $79m, but several are growing fast, and serve not only Indians but other Americans too."

- "One tribal bank gaining national attention is Bank 2, based in Oklahoma City. Wholly owned by the 40,000-member Chickasaw tribe and with $62m in assets (on September 30th 2004), it is a growing player in the national market for mortgage lending to Indians, thanks in part to effective use of a federal home-loan guarantee program known as Section 184 and a partnership with Fannie Mae... About half of Bank 2's customers are Indians, and it does business with more than 80 tribes, including the Comanche. So far it has made no loans tied to casinos. Ross Hill, its president, and J.D. Colbert, who runs its Native American business, both former Federal Reserve officials, often criss-cross the country, speaking not only to prospective customers but also to other tribes about starting their own banks."

- "In Denver, a coalition of 18 Indian tribes, two Alaskan native groups and a tribal insurance consortium runs a venture called Native American Bank. The bank, which has assets of $52m, focuses on underserved Indian communities in remote places. Its president, John Beirise, a non-Indian formerly with Continental Bank in Chicago and Mercantile Bank in St Louis, says that one of his unexpected challenges has been 'the pervasiveness of politics' in Native American communities and the way it slows change."

- "Indeed, some say that tribal politics and legal issues hinder Indians' economic advance more than a lack of banks does. "Banks are an effect, not a cause, of economic development," argues Joe Kalt, co-director of a Harvard program on Indian economies. Questions of land trust and sovereignty complicate business dealings with tribes, although a growing number of groups are adopting the uniform commercial code and granting waivers that allow banks and other businesses to recoup damages should things go wrong."

- "Steve Stallings, Wells Fargo's senior executive for native banking, says on the other hand that dealing with tribes is 'no different from doing business with certain kinds of

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regulated industries, doing international business.' Even so, the lending system gets clogged. Mr. Stallings estimates he could double his bank's volume of Indian mortgage lending if trust issues were resolved more easily…" (*The Economist*, 02/19/05)

The law of unintended consequences in the AH market

- With homeownership being central to the American dream, public policy strives to boost homeownership through AH goals for the GSEs and special programs, such as the "The American Dream Downpayment Initiative," which seeks to increase homeownership by paying down payments and closing costs. Supporters say homeownership builds wealth and the poor, who are in most need for it, have the hardest time becoming homeowners. However, critics fear covering upfront costs may lead to long-term problems. "When the economy is booming and home prices are rising, all mistakes get covered up," said Ronald Utt, senior research fellow for Heritage Foundation. "But once the economy flattens or turns down and real estate values begin to fall, as they frequently do, the losses could be substantial and the results for the individual borrowers calamitous." Problems aren't evident in a strong housing market, but in a bad market, default and foreclosure rates tend to rise. The more equity a homeowner has put in the house, the more likely he'll tough it out in lean times. If he gets a down payment gift, he's less likely to stay, Utt says. Money saved over years is different from money handed out, he says.

- Even in a strong housing market, the law of unintended consequences can strike. For example, Kesha James bought a $190,000 townhouse in 1999 in Alexandria, Virginia from Habitat for Humanity for an initial monthly payment of $515. Today, her modest mortgage payment isn't a problem, but her rising property taxes keep her awake at night. Today, her monthly mortgage payment has almost doubled to $954 to cover the real estate taxes for a property now valued at more than $500,000. James has taken a second job and works seven days a week, but is afraid that she might lose her house. Rising property values, which have put the squeeze on many area homeowners, have been acute for owners of Habitat for Humanity homes in Northern Virginia, whose homes have doubled and tripled in value over the past three years. At least a dozen of the 47 Habitat homeowners in Northern Virginia pay more in property taxes and insurance, than they do to pay off their mortgages, said Karen Cleveland, executive director of the non-profit group. "The rising property taxes have truly made it almost impossible for them to stay in their homes," said Cleveland. "We're saying [to the local government], 'Help us to make it appropriate so our homeowners are paying what is fair for them.'" (*Investor Business Daily*, David Isaac, 02/24/05; *Washington Post*, Annie Gowen, 02/14/05)

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Fannie Mae

U.S. District Court consolidates Fannie Mae lawsuits

- The U.S. District Court for the District of Columbia has consolidated shareholder suits against Fannie Mae and its former executives, according to a court order filed on February 14. Judge Richard Leon named the Pirelli Armstrong Tire Corp. Retiree Medical Benefits Trust and the Wayne County Employees' Retirement System as co-lead plaintiffs. The Wayne County, Michigan, pension fund seeks to block payments to the company's former chairman and CEO Franklin Raines and former CFO J. Timothy Howard and has asked the court to put into a trust more than $60 million in incentive-based compensation that the executives received during the restatement period. Pirelli asked the court to force Raines and Howard to return to Fannie Mae all the profits, benefits and other compensation they have received. Seven stockholder actions have been filed by individual and institutional plaintiffs in the U.S. District Court for the District of Columbia, said the court. Any future actions will be included into the consolidated case. (*Reuters*, 02/14/05)

Former Fannie Mae execs' lawyers argue that their clients should keep their performance-based bonuses despite the company's restatement

- Lawyers for Fannie Mae's former CEO Franklin Raines and former CFO J. Timothy Howard say their clients should be able to keep their performance-based bonuses, even though the company is expected to restate earnings downward an estimated $9 billion for fiscal years 2001through 2004. Fannie Mae, its board and former and current executives are the target of numerous shareholder lawsuits and "congressional venom" seeking to recoup executive bonuses based upon the company's "faulty and deeply flawed earnings statements," according to one lawmaker. However, the task of recovering such bonuses may prove to be easier said than done.

- While Fannie has long tied a bulk of its incentive compensation to annual earnings-per-share targets, the bonuses awarded to Raines and Howard and other executives weren't based on financial statements based upon GAAP. Rather, Fannie Mae's performance-based executive pay is instead tied to "an alternative earnings measure" Fannie's board developed in January 2001 called core business earnings - a non-GAAP measurement developed to "counter" the effects of FAS 133, a new accounting rule for derivatives. "Fannie Mae computes its supplemental core business earnings measure without reference to the requirements of FAS 133," said attorneys for Raines and Howard in a recent court filing. According to public disclosures, Fannie excludes FAS 133 adjustments and a few other GAAP requirements from its core business earnings. Under the two accounting rules that SEC and OFHEO directed Fannie to correct last year, the company estimated that nearly all of $9 billion of the projected losses stemmed from FAS 133 corrections.

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Recently, OFHOE identified new accounting problems at Fannie Mae, citing GAAP violations in virtually every major accounting rule applying to mortgage finance. Working with its new auditor Deloitte & Touche, Fannie is conducting a complete reaudit and restatement of the company's GAAP and non-GAAP earnings through 2004. The impact such restatements will have on the company's executive pay remains unclear.

- "U.S. GAAP is an internationally recognized accounting standard," said Jacob Frenkel, a former SEC enforcement attorney and federal prosecutor who now heads the white collar criminal defense and securities litigation group at Shulman, Rogers, Gandal, Pordy & Ecker. "In essence, what they're doing is throwing out that standardized measure for a substitute in which the company totally controls the components that go into the figure."

- OFHEO and disgruntled shareholders are hoping to use untested disgorgement provisions in the Sarbanes-Oxley Act to force, at a minimum, Raines and Howard to forfeit their past bonuses and other incentive-based pay. However, the Sarbanes-Oxley provision and OFHEO's legal powers are limited and largely unproven. Recently, OFHEO approved Fannie Mae's release of millions in payment to Raines and Howard, despite congressional requests to halt such payments. OFHEO Director Armando Falcon said his agency can force Raines and Howard to return "inappropriate payments" and can seek restitution from officers and directors who are "unjustly enriched or engaged in serious misconduct." In 2004, OFHEO lost a court battle when it tried to block approximately $54 million in payments to the former CEO of Freddie Mac, Leland Brendsel, who was forced to retire amid an accounting scandal. "The regulator, OFHEO, does not apparently have the [legal] authority to unilaterally act on behalf of taxpayers or anyone else. Litigation will be required after the fact to reclaim, if possible, any ill-gotten gains," said Representative Richard Baker (R-LA), chairman of the House subcommittee that oversees Fannie Mae.

- According to several securities lawyers, the shareholder lawsuits against Raines and Howard are among the first in the nation to test the ambiguous "disgorgement provision" under section 304 in the Sarbanes-Oxley Act, which requires (only) the CEOs and CFOs to return all bonuses, incentive- and equity-based pay as well as profits from stock sales in the event of an earnings restatement "due to the material noncompliance of the issuer, as a result of misconduct." In 2004, an attorney for Gibson, Dunn & Crutcher LLP wrote in a law journal article, "Section 304 leaves a number of terms undefined that could have a significant impact on how it is applied. The Gibson firm is now representing KPMG LLP, Fannie's former auditor, in the leading shareholder lawsuit filed by pension funds for public employees in Wayne County, MI and workers at the Pirelli Armstrong Tire Corp. in U.S. District Court.

- Judge Leon has already denied the shareholders' request to temporarily block approximately $31 million in severance and other payments to Raines and Howard. Shareholders are also pressing on with their broader lawsuit, seeking possibly billions of dollars in damages from Fannie's board, KPMG LLP and top executives, including

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approximately $100 million under Sarbanes-Oxley in incentive-based pay, stock proceeds and other compensation from Raines and Howard. The total amount of compensation at stake for Raines and Howard is unknown, because Fannie refuses to disclose the executives' compensation prior to March 2003 when Fannie first registered with the SEC, said Wayne County's attorneys at Lerach Coughlin Stoia Geller Rudman & Robbins in San Diego, CA. "There were tens of millions of dollars transferred in the dead of night to executives prior to Fannie's registration, which this board rubber stamped, based upon reported performance which has been admittedly falsified," said Darren Robbins with Lerach Coughlin. "And this restatement is of a magnitude exceeded only once in history, World Com. There's a veritable rats' nest here that's going to be exposed." (*Dow Jones Newswires*, Dawn Kopecki, 02/25/05)

Fannie Mae's mortgage portfolio declines 16.8% in January

- Fannie Mae said its mortgage portfolio contracted at a 16.8% annualized rate in January, after falling 10.1% in December. The portfolio, which provides more than 66% of Fannie Mae's income, decreased by $13.7 billion to $890.8 billion. During the month, Fannie Mae sold $6.4 billion in loans and securities to profit on historically tight mortgage-to-debt spreads, the company said. A Fannie Mae spokeswoman that the company's 30% capital surplus which it must achieve by September 30 under its capital restoration plan was not the reason for its asset sales. Instead, the sales were "driven by economic conditions," she said.

- However in its capital restoration plan, Fannie Mae said it would shrink its portfolio to help the company meet a 30% capital surcharge placed on the company by OFHEO, after the agency determined the GSE was undercapitalized because of accounting errors. "Shrinking its portfolio reduces capital needs and will be one way for them to meet the 30% surplus," said Gerald Lucas, chief Treasury and agency strategist at Banc of America Securities. The company needs to trim the portfolio by about $15 billion a month to meet its capital goal, he said. Fannie Mae's commitments to purchase mortgage-related securities, an indication of future portfolio growth, fell to $797 million in January from $9.33 billion in December. The company's duration gap averaged a minus one month for the third consecutive month. (*Bloomberg News*, Al Yoon, 02/22/05; *Reuters*, 02/22/05; *Dow Jones Newswires*, Allison Bisbey Colter, 02/22/05; *American Banker*, Jody Shenn, 02/23/05)

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As regulatory headwinds reach "gale force," Wall Street reassesses Fannie Mae:

Peter Eavis argues that Fannie Mae deserves another "haircut"

Meanwhile, many on the Street continue to tout FNE as "Buy"

- In the February 21 issue of *Barron's Online*, Michael Santoli writes, "Evaluating the investment merits of Fannie Mae and Freddie Mac was tough enough when the variables were generally financial. It was necessary to take a view on interest rates, the yield curve, hedging strategies, not to mention the relative eagerness of the mortgage-finance duo to shoulder risk. Now, though, the fate of Fannie and Freddie shareholders is largely in the hands of politicians and regulators, thickening an already soupy fog that shrouds the companies' future. By the evidence of the stock action late last week, a number of its stalwart shareholders may have sold into the dimness. Fannie shares dropped 7% from Wednesday [February 16] through Friday [February 18], to $58.90, after they had already slid from $71.00 at the start of the year. Freddie also fell 7% [over the corresponding period] to $61.73. The latest trigger was Greenspan's comments to a Congressional committee, in which he recommended sharply curtailing the size of the companies' mortgage portfolios, perhaps to a small fraction of their current size. This would mean shrinking their balance sheets and likely eliminating the prospect of profit growth for some time to come. Congress is considering various restrictions on Fannie and Freddie, meant to reduce the concentrated financial risk of their huge portfolios."

- "There is a small but passionate short-selling community that continues to gun for much lower prices in these stocks, based in part on the prospect of a potential derivatives blowup." [According to *Bloomberg News*, Fannie Mae ranked 63rd among the 100 largest short interest positions on the NYSE in mid-February]

- "Numerous smart and patient value investors have stood in opposition -- so far wrongly -- sticking by Fannie and Freddie amid loud attacks on the companies, bond-market tumult and the departure of Fannie CEO Franklin Raines. The stocks' valuations long ago lost their growth premium, indicating that the market didn't believe the stated earnings were either fully real or sustainable. Otherwise the shares wouldn't trade at multiples of official 2005 profit forecasts as low as the current eight and nine. Fannie is already shrinking itself, buying back billions of its debt, allowing mortgage holdings to run off its books and bidding less aggressively for new paper. This has helped agency-bond investors. And a voluntary reduction in the companies' targeted profit-growth rates could in fact work to shareholders' advantage, too."

- "But for shareholders now, the burning question is what the real and future earnings base of the company will be. Is the stock dirt cheap, or are the companies about to have their capacity to grow permanently taken away? That's something that won't be answerable until the interplay of Congressional horse trading, lobbyist maneuvering

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and regulatory rhetoric plays out." (*Barron's Online*, Michael Santoli, 02/21/05; *Bloomberg News*, Wendy Soong, 02/22/05)

Peter Eavis argues that Fannie Mae deserves another "haircut"

- In the *Street.com*, Peter Eavis wrote, "On Wall Street, scandal-hit Fannie Mae …never went out of fashion. Not even for a minute. In fact, investment banks are now mounting a zealous propaganda campaign aimed at bringing buyers back to the [GSE], which is likely to recognize billions of dollars of losses in its earnings after its regulator and the [SEC] severely criticized its accounting. But of all the big sales pitches being made by Wall Street now, the 'buy Fannie' campaign is perhaps the most preposterous. Brokerage analysts are using stock price targets that are conjured out of thin air and that ignore the damage to be done by an estimated $9 billion reduction to past earnings. Indeed, the investment banks' pro-Fannie case is often so bizarrely flimsy that investors must cynically assume that they are being put out to win large banking fees from Fannie, whose securities issues have padded Wall Street's profits for years. For example, Lehman Brothers, which has an absurd $100 price target on Fannie Mae, earned a stunning $75 million in fees for handling a giant issue of preferred stock for the company at the end of last year. (Lehman rates Fannie overweight.) Other brokerages in the bullish chorus include Citigroup's Smith Barney and Merrill Lynch, which both issued bullish investment advice on Fannie Tuesday. These two research notes may have been sparked by the recent sharp decline in Fannie's stock, which is now nearly 30% below its 52-week high. Tuesday it fell $1.10 to $57.80."

- "The decline [in Fannie's stock price] is well overdue, and should continue. [Eavis] can easily show that the company's true net worth -- a good yardstick for valuations -- is much less than the net worth (or book value) that Wall Street analysts are using for their price targets. In addition, Fannie has no defense against the many enemies it made in Washington with its heavy-handed tactics. The Bush administration, along with key Republican members of Congress, is compiling tough new reform bills for Fannie and its rival Freddie Mac …that are almost certainly going to pass. And Fed Chairman Alan Greenspan has raised the idea of capping, or even cutting, the size of Fannie and Freddie's mortgage portfolios."

- "It's not that Wall Street can't do the numbers properly. For example, in his Tuesday research note, Smith Barney analyst Matthew Vetto calculates theoretical book value numbers that rightly leave out the $9 billion that Fannie is expected to remove from earnings. But when it comes to setting a price target, Vetto uses what he calls a "pre-restatement" book value that doesn't take into account the $9 billion worth of losses that Fannie wrongfully kept out of earnings. (Vetto rates Fannie outperform, and Citigroup has done recent underwriting for Fannie.) The $9 billion is losses on derivatives. The bulls often like to argue that those losses represent just a "mark-to-market" snapshot of what a derivatives portfolio looks like at a given point in time and that moves in interest rates can reduce the loss. There are many problems with this point of view. First, there is a wealth of evidence that Fannie in the past locked

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in losses on derivatives but made it look like they were still open and thus capable of changes in value. Second, even if a derivative really is truly open, it can just as easily slip further in value, rather than rise. As a result, it makes a lot of sense to feed the losses in question through earnings when they occur. What's strangest is that Wall Street banks themselves have no real problems implementing this type of derivatives accounting and seem quite prepared to reflect these types of derivatives losses in their own income statements. But for some reason they suggest Fannie should be exempt."

- "So where should Fannie trade, then? Well, how about the same multiple-to-book value as Freddie Mac, whose own accounting scandal was nowhere near as bad as Fannie's and which has a much lower-risk portfolio than Fannie? Freddie trades at 1.55 times its end-2003 book value [$41.6 billion], according to generally accepted accounting principles and after subtracting the value of preferred shares. ...But if we add 2004 earnings, its net worth (excluding preferreds) could have been $32 billion at the end of last year, which is only 1.3 times book value."

- "Let's be kind and apply the higher book value to Fannie. The last book value number for Fannie can be gleaned from looking at a report from Fannie's regulator issued December 21. At the end of September, Fannie had so-called core capital of $38 billion. If we then subtract the derivatives losses ($9.2 billion) and the preferred stock ($4.1 billion), we get $24.7 billion. Fannie's market worth of $56 billion is 2.3 times its net worth. How can Fannie have a price-to-book value multiple that is so much higher than Freddie's? Maybe investors could argue that Freddie is woefully undervalued and that it needs to come up to Fannie's multiple. But that argument has been made for months and no big convergence has taken place. Given the fact that Fannie's regulator is not done with its accounting probe and might uncover more abuses, and given the fact that Fannie will be most harmed by a tougher regulatory environment, it is most likely that Fannie's multiple will move down toward Freddie's."

- "If Fannie were to trade at, say, 1.8 times its $25 billion in book value, it would be worth $46 per share, which is 20% below Tuesday's close. No matter what Wall Street says, Fannie is far more likely to be trading at $50 than $100 in a year's time." (*TheStreet.com*, Peter Eavis, 02/23/05)

- According to "The Lex Column" in the *Financial Times*, "Putting a value on Fannie Mae is like shooting in the dark. [The company] has stopped filing financial statements … [and] much of [its] accounting is now suspect. It has yet to announce permanent replacements for departed senior executives, and tougher regulation of Fannie's business is widely expected. Until clarity returns, buying Fannie stock is a gamble."

- Sonic Capital's hedge fund manager Mark Haefele said the things that are happening with Fannie Mae are unprecedented. "Everyone who owns this stock is doing so without audited financials or any sense of what its real liabilities are," Haefele said. He doesn't think that audited financials will be available until early 2006, which will

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continue to force the stock lower. Putting his money where his mouth is, Haefele has had a "sizable" short position in Fannie for over a year. (*Financial Times*, 02/24/05; *The New York Sun*, Roderick Boyd, 02/23/05)

- Jim Cramer muses, "Fannie Mae …reminds me of the New York Stock Exchange. You get what you wish for. Frank Raines defended Fannie the way Dick Grasso defended the NYSE: Hands off, or the publicity would be life-threatening. Now that Raines is gone, the place is a free-fire zone…" (*RealMoney.com*, James J. Cramer, 02/18/05)

- Appearing on Fox News Channel's *Your World with Neil Cavuto* on February 19, Jim Rogers said "I expect Fannie Mae to go down 50% to 60% from now. Rogers, who was a cofounder of Quantum Fund and author of Hot Commodities, said he has shorted Fannie Mae. (*Fox News Channel's Your World with Neil Cavuto*, 02/19/05, 10:35:07 AM)

<u>Meanwhile, some on Wall Street tout Fannie as a "buy"</u>

- In a February 22 analyst report titled "Perspectives on GSE Valuation," Citigroup Smith Barney analysts Matthew L. Vetto, Amarjit Grewal, and Sanjay Sakhrani reiterated the company's "buy" rating for Fannie and Freddie. The analysts wrote, "While we expect volatility, we continue to find the risk/reward trade-off attractive, and maintain our Buy ratings on [Fannie Mae] and [Freddie Mac.]" The analysts assume that the GSEs' portfolio growth will be "mid-single digit" past 2005 and face permanent 20% to 30% capital surplus requirements. Upcoming catalysts for the Fannie's stock include the release of draft legislation for GSE regulatory reform; a potential 50% cut in Fannie Mae's dividend for the second quarter of 2005; and the naming of a new CEO for Fannie Mae. The analysts set a target price for Fannie Mae of $81.00, 37.5% above its trading price ($58.90) on the date of issuance of the report. Further, the analysts rate Fannie Mae "High Risk to reflect [their] view of heightened uncertainty associated with the restatement of FNM's financial statements, ongoing investigations, and turnover of key management." According to Punk Ziegel & Co analyst Dick Bove, Citigroup's first quarter earnings could be reduced by about $490 million or $0.06 per share, by marking-to-market its recently revealed 6.3% stake in Fannie Mae. Bove said, "If there is no recovery in Fannie Mae's stock by quarter end, it would not be amiss to suggest that marking this issue to market could impact first quarter results negatively." (*Citigroup Smith Barney Perspectives on GSE Valuation*, Matthew L. Vetto, Amarjit Grewal, Sanjay Sakhrani, 02/22/05; *CBS MarketWatch.com*, Greg Morcroft, 02/15/05)

- Analysts at Merrill Lynch said they believe the market could be overstating the risks associated with Fannie Mae and Freddie Mac, and that recent price declines of the companies' stock could present a good entry point for buyers. "The recent weakness in Fannie Mae and Freddie Mac shares offers investors an interesting opportunity to capitalize on what we think is a temporary re-assessment of the risks associated with the GSEs due primarily to uncertainties relating to their pending accounting

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restatements, increased regulatory scrutiny of their economic models and potential for meaningful regulatory reform, which could undermine the franchise values of each company," wrote the Merrill Lynch analysts. (*Dow Jones Newswires*, 02/22/05)

- On February 24, Sandler O'Neill analysts upgraded Fannie Mae from "hold" to "buy." (*www.newratings.com*, 02/24/05)

Portfolio managers and brokerage firm analysts rank Fannie's former CFO Howard among "the best chief financial officers in America"

- With Fannie Mae working on its $9 billion restatement for fiscal years 2001 through 2004, the *Institutional Investor Magazine* rated J. Timothy Howard; the company's recently ousted CFO, among the best chief financial officers in America. The magazine's ranking of best CFOs is based on a survey of 1,500 portfolio managers and brokerage firm analysts representing 62 industries. Howard was the only CFO selection in the mortgage finance industry. (*Wall Street Journal*, Gene Colter, Dawn Kopecki, Jed Horowitz, George Stahl, Tom Granahan, Ann Davis, Gregory Zuckerman and Peter A. McKay, 02/18/05)

Black Enterprise asks: Was Raines' departure unjust?

- *Black Enterprise* [magazine] writes, "Was Raines' departure unjust? Like the rules of accounting, it's a matter of interpretation. 'I was raised with the belief that when you're in a position of authority, especially when you're a minority, you've got to be squeaky clean,' says Fred McKinney, executive director of the Connecticut Minority Supplier Development Council and an adjunct professor at the University of Connecticut. 'They should have been very, very conservative in how they state everything and not try to be on the cutting edge of these accounting rules, given that Fannie Mae's opponents were scrutinizing what they were doing.'"

- "The case against Fannie Mae hinged in part upon the testimony of Roger Barnes, a former accountant, who testified that he spent five years trying to convince Raines and others that the company's accounting system was flawed and manipulative. In a statement submitted to a House Financial Services subcommittee, he said, 'Although Fannie Mae is a company that receives accolades for providing a diverse and positive work environment, it is also plagued by a corporate culture that uses threats, intimidation, and reprisal to create an atmosphere where even those employees with great integrity -- employees who rightfully feel duty-bound to report improprieties and irregularities -- cannot risk doing so, fearing the retaliation that they know will follow.' Sources close to the situation report he received a settlement of more than $1 million after threatening a whistle-blower lawsuit citing racial discrimination."

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- "Representative Artur Davis (D-AL), who sits on the House Financial Services Committee, says that OFHEO put Fannie Mae's directors in an untenable position. 'The reality is Frank Raines was forced out, pushed out. The regulator almost dictated his departure before the SEC, the Justice Department, Congress, and the board had a chance to make an assessment of Raines' conduct.'" (*Black Enterprise Magazine*, Joyce Jones, March 2005)

Fannie Mae leaves DC Mayor Williams' administration "at the alter"

- In a February 13 editorial, *The Washington Post* wrote, "It was the kind of marriage every municipality dreams of entering into with a deep-pocketed tenant. After a minimum amount of wooing, the moneyed Fannie Mae in Northwest Washington succumbed to the blandishments of the Williams administration and agreed to a proposal making the mortgage finance giant the anchor tenant in a $500 million to $700 million office, retail and housing complex in Southwest. The announcement caused good cheer all around, especially among developers eager for the chance to tear down the old Waterside Mall and start a lucrative construction project. Unfortunately, an unfunny thing happened on the way to the ceremony. Fannie Mae was charged with accounting violations that could wipe out $9 billion in previously reported profit dating to 2001. As a result, the company called the whole thing off. The Williams administration, understandably feeling jilted, wants Fannie Mae to make good on its promise. The federally chartered corporation, however, is proceeding toward the nearest exit. As the saying goes, "Hell hath no fury," Mayor Anthony A. Williams is considering all of his options, including a lawsuit. Sadly, it could get even messier unless cooler heads prevail."

- "The door to reconciliation, fortunately, has not been slammed shut. Fannie Mae spokeswoman Janice Daue Walker said the company 'is committed to working with the Mayor and city council, and remains committed to working with our partners in the District and its neighborhoods, including in the Southwest and Southeast communities.' That is a welcome expression of continued interest. Of course, city leaders and Fannie Mae have exchanged words of endearment before. Engaging Fannie Mae has cost the city an opportunity to develop a relationship with another suitor, one capable of making good on its word. That alone ought to be worth something, if not another attempt by Fannie Mae to pair up with the city on a project of mutual interest. Outright abandonment should not be an option." (*Washington Post*, 02/13/05)

- Fannie Mae's abandonment of its plan to become an anchor for a redevelopment project in Southwest Washington has reopened an old debate over Fannie Mae's commitment to the city. In the mid-1990s, the D.C. Council sought to repeal Fannie Mae's exemption from District income tax, and Fannie Mae threatened to leave the city. After Congress killed the proposal, Fannie Mae pledged to boost its local philanthropy. When company's decided to abandon the Southwest project, D.C.

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Mayor Williams threatened to use any means at his disposal to get Fannie Mae to reconsider.

- What has Fannie Mae done for the District of Columbia through the charitable contributions of the Fannie Mae Foundation? In 2004, the Foundation gave $25.3 million to District-based organizations, or 41% percent of the $61.4 million its aggregate grants, according to a *Washington Post* analysis of data on the Foundation's website. During Raines's tenure as chairman of Fannie and the Foundation from 1999 through 2004, the Foundation made grants to 663 groups in the District with 50% of the money going to 22 recipients. In 2004, the Foundation estimates that its total charitable spending was $105 million. Beyond grants, that amount includes charitable programs and a national advertising campaign to educate consumers about home buying. In 2003, the Foundation's advertising totaled more than $40 million. The Foundation's estimate of its charitable spending in 2004 pales next to a federal estimate that Fannie Mae's corporate exemption from state and local taxes was worth $848 million nationwide in 2003.

- D.C. officials have not [yet?] geared up to challenge the company's tax exemption again. That said, it isn't clear how much tax Fannie would pay to the District, because its tax liability would be spread across jurisdictions where it does business. "We wouldn't have the foggiest idea of the revenue we're losing," said Edward Blick, a lawyer for the D.C. government, since apportioning Fannie Mae's income among states for tax purposes could be complicated. The company, which employs 3,100 people in the District, paid the District real estate taxes of $1.6 million last year, said a company spokeswoman. (*Washington Post*, David S. Hilzenrath and Derek Willis, 02/21/05)

- A footnote: The president of the Fannie Mae Foundation is Stacey Davis Stewart, a former vice president of housing and community development in Fannie Mae's southeastern regional office in Atlanta. According to the company's records, the Foundation paid Stewart $514,633, *not* including $68,686 in benefits and deferred compensation, in 2003. (*Washington Post*, David S. Hilzenrath and Derek Willis, 02/21/05)

GMAC introduces "Link to Lender"

- Richard Nacht writes on *The Mortgages Weblog*, "The wholesale lending arm of GMAC has introduced an updated version of Link to Lender, a joint effort with Fannie Mae. GMAC says the new tool will significantly streamline the loan submission process by enabling one-click transfers of loan files through DO, eliminating the need for importing, exporting or rekeying data from DO into the wholesaler's website. With the updated version GMAC receives an immediate electronic transfer of an automated underwriting decision and automatically registers or updates the loan file in its system. 'Link to Lender corrects what was a fragmented process for brokers and correspondents. It strengthens an already powerful tool by

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letting DO be the single point of entry for a complete loan registration process,' said Matthew Detwiler, vice president of wholesale lending for GMAC Bank."

Fannie Mae completes construction of its $102 million data center

- Holder Construction of Reston, VA, has completed construction of Fannie Mae's $102 million Data Center in Urbana, MD, within one year of breaking ground. The 250,000-square foot, four story project is located on a 37.5-acre green-field site in an undeveloped industrial area, which required new roads, utilities, power feeds and telecommunication wiring. (*Mid-Atlantic Construction*, 01/01/05)

Freddie Mac

Freddie Mac braces for regulatory changes, as it retools its lobbying shop

- In an interview with *Financial Times*, Freddie Mac's chairman and CEO Richard Syron said he expected serious changes to regulations governing the housing GSEs, but stressed that questions over capital should be addressed on a risk-based basis. One of the most contentious questions being debated in the GSE regulatory reform legislation is the amount of capital the GSEs should hold. Fannie's and Freddie's competitors have argued that the finance providers should be forced to meet similar capital standards to banks, which have higher minimum capital requirements, which would reduce the GSEs' leverage and hurt their future profitability. FM Policy Focus, a lobbying group of financial services companies and trade associations, argues that Fannie and Freddie hold only 20% to 50% of the capital required by bank regulators for depository institutions holding mortgages.

- Syron testified before the Senate Banking Committee last year that the finance providers had a lower risk exposure than banks and that their minimum requirement was "adequate". In his interview with *FT*, Syron re-iterated that a debate over capital requirements for the housing GSEs should be kept to a discussion of risk-based capital. "I think we should address capital on a risk-based basis," he said. "I have no problem, with the type of assets we hold, being required to hold the same amount of capital as competitors."

- Critics of the Fannie and Freddie want the debate over capital requirements to include minimum capital requirements, which are similar to the leverage ratios imposed on banks. "The main battle will be over regulators' latitude to vary the leverage ratios, not the risk-based capital test," said Bert Ely, an Alexandria, Virginia consultant and GSE critic.

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- Syron grapples with GSE regulatory reform legislation that affects virtually every aspect of the company's business, while Freddie Mac retools its lobbying team by cutting ties to roughly 30 outside lobbying firms. Following the negative fallout from its multibillion-dollar restatement of earnings in 2003, Freddie is also trying to burnish its image on the public relations front and shape legislation that could affect how it is regulated. Freddie's new top lobbyist, Timothy McBride, a former public policy vice president at the DaimlerChrysler Corp, is streamlining the company's lobbying operation. Last year, McBride replaced Mitchell Delk, who was ousted over a fundraising scandal.

- McBride comes to Freddie Mac with impeccable corporate experience and contacts within the GOP Congressional leadership and the Bush administration, said several lobbyists, represents a change in strategy and style from Delk. Sources said that Delk operated with more of a flair, while McBride is down to earth, with an unassuming, almost "aw-shucks" attitude.

- "My goal is to engage as fully and constructively as possible in the public-policy debate affecting the GSEs," said McBride. "We share the view that what is needed is a strong regulatory regime, and we look forward to working closely with Members of Congress and the Administration." He added, "I plan to engage Freddie Mac's senior management team, our very talented staff of government relations professionals, outside consultants, as well as industry and consumer groups who share our interest in expanding homeownership opportunities and strengthening the nation's housing finance system. I'm currently conducting a review of our resources to determine the most effective way to leverage them."

- While company spokeswoman Sharon McHale declined to say which outside lobbyists have been let go and which are on retainer, she said that Freddie Mac has downsized its stable of contract workers, including lobbyists, "across the board." Freddie has slimmed down from more than 2,800 consultants last fall to 2,100 today, she said.

- Most lobbyists who are registered to lobby for Freddie Mac did not respond to *Roll Call*'s inquiries, while many who did respond, declined to comment. Jay Velasquez, a former aide to then-Senator Phil Gramm (R-TX), confirmed that he is no longer working for Freddie. Catherine Nolan of Jenner & Block said she is no longer on the Freddie Mac payroll, but had "a very specific contract for the last Congress." Charlie Black, the chief executive of BKSH & Associates, which was paid $60,000 last year by Freddie Mac, said, "We were laid off. My understanding is that a lot of firms were laid off, and we've been invited to make a presentation to represent them again." A spokeswoman for Texas-based lobbyist Ben Barnes said that he still works for Freddie Mac in Washington. Last year, Barnes reported earning $360,000 from Freddie. [This is the same Ben Barnes, who told *CBS 60 Minutes* last fall about the role he says he played in "pulling strings" to get George W. Bush into the Texas Air National Guard during the Vietnam War]. (*Financial Times*, Jenny Wiggins,

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02/22/05; *Roll Call*, Kate Ackley, 02/14/05; *Slate.com*, Eric Boehlert, 09/01/04; www.klru.org, *Texas Monthly Talks with Evan Smith*, Ben Barnes biography).

Former Freddie Mac CEO disputes shareholders' amicus filing

- Former Freddie Mac CEO Leland C. Brendsel told a Washington, D.C., appellate court that two of the company's shareholders should not be allowed to submit amicus filings in the government's appeal over $54 million of his compensation. Shareholders Maureen Henry and E.L. Greenfield are seeking permission from the U.S. Court of Appeals for the District of Columbia Circuit to participate in the appeal on Freddie Mac's behalf on the grounds that the corporation's interests must be protected. The appeal was filed by the OFHEO and its director, Armando Falcon Jr., to contest an order enjoining the agency from directing Freddie Mac to freeze Brendsel's compensation.

- On November 22, Henry and Greenfield filed a motion with the D.C. Circuit requesting to participate as amici on the Freddie Mac's behalf. The shareholders argued that Freddie Mac did not have the chance to be heard in the District Court, which opined "gratuitously" that corporation would not be harmed by Brendsel's requested injunction. Freddie Mac did not intervene in the action, the motion notes. "Yet that it did not is consistent with its inactivity, fueled by cozy relationships and conflicts of interest," the shareholders argue. As a result of the alleged conflicts of interest, the shareholders have filed a derivative action against Brendsel and other former officers and directors alleging breaches of fiduciary duty and seeks damages and indemnification for Freddie Mac.

- In a December 8 opposition brief, Brendsel argued that the shareholders should not be allowed to participate as amici. The interests the shareholders seek to represent are already being represented by the OFHEO, the former CEO argues. Henry and Greenfield have failed to show that the claims they are asserting in the derivative suit "are of sufficient relevance and importance to this proceeding to justify their participation," he said. The derivative suit's fiduciary duty allegations have nothing to do with the OFHEO's alleged power to order Freddie Mac to withhold Brendsel's compensation, the brief says.

- In a December 13 reply to the opposition brief, Henry and Greenfield argue that their input would not be duplicative and would instead be beneficial. Freddie Mac did not seek intervention in the case confirms the allegations in the derivative suit, namely that all of the board members "are complicit in the underlying wrongdoing with Brendsel," argued the shareholders. Further confirmation of this fact is said to be found "in the fact that shortly after the court below issued the preliminary injunction Freddie Mac released the disputed compensation to Brendsel, even though the OFHEO noticed its appeal." Freddie Mac's shareholders need the assurance that will result from the OFHEO having the authority to issue orders to protect the corporation

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and its assets when the directors fail to do so, said the shareholders. (*Corporate Officers and Directors Liability Reporter*, Volume 20, Issue 15, 02/07/05)

Freddie Mac's retained portfolio declined an annualized 11.1% in January

- In January, Freddie Mac said its retained portfolio shrunk at an annualized rate of 11.1%, compared to a 6.1% decline in December and 1.3% increase for 2004. On January 31, Freddie Mac's retained portfolio totaled $647.58 billion. The company's retained portfolio has been declining since September 2004, when Freddie Mac scaled back purchases of mortgages in line with slower growth in the overall fixed-rate mortgage market as borrowers opted for adjustable-rate mortgages. Freddie Mac's total mortgage portfolio, represented by the sum of its own investments and the mortgage-backed securities issued by the company but held by outside investors, grew at an annualized rate of 7.8% and totaled $1.5 trillion at end-January. Retained mortgage portfolio purchase agreements totaled a net $12.25 billion in January, down from $17.08 billion in December.

- Freddie's average duration gap was zero months in January, compared with negative one month in December. Single-family non-credit enhanced delinquency rate was 24 basis points in December, unchanged from the prior month. (*Dow Jones International News*, Madeleine Lim, 02/23/05; *Freddie Mac Monthly Volume Summary*, January 2005)

Chairman Boyd promises "new vision" for Freddie Mac Foundation

- Like its troubled parent Freddie Mac, the Freddie Mac Foundation has had its share of upheaval with the appointment of its fourth chairman in the past two years. As the Foundation's new chairman, Freddie Mac's former general counsel Ralph Boyd Jr. stresses that the Foundation's longtime focus on children and families probably won't change, as he launches a top-to-bottom review of the organization and its philanthropy to see what it can do "more [of] and better." He added, "I'm going to look at everything,"

- During the 23 years of its existence, the Freddie Mac Foundation has donated about $165 million to charity, mostly to area nonprofit groups that work with children and families. In 2004, the Freddie Mac Foundation gave $23 million in grants to more than 100 nonprofit organizations, placing the organization in the top ranks of charity givers in the Washington area, say local philanthropic leaders. "They are such a huge value to the Washington area," said Kae Dakin, president of the Washington Regional Association of Grantmakers, of which the Freddie Mac Foundation is a member.

- Turmoil in top management at the Freddie Mac over its accounting has led to leadership upheaval at the foundation as well. Boyd, who had been general counsel

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of corporate Freddie Mac since last year, was named chairman of the foundation, replacing Freddie Mac CEO Richard F. Syron, who resigned to focus more attention on Freddie Mac's corporate issues. Syron will remain on the foundation's board. Boyd is also in charge of the corporation's other philanthropic efforts, including the high-profile Hoops for the Homeless event in April that raises nearly $500,000 for local homeless programs.

- The Foundation's management issues don't end with its revolving-door board leadership. About a year ago, the Foundation's longtime president Maxine Baker, was removed from day-to-day management after an internal investigation faulted her for having Foundation employees do her personal chores and using offensive language. In an interview this week, Boyd endorsed Baker, who he said remains the "public face" of the foundation. Boyd said he wants to reevaluate the Foundation with an eye toward making it more efficient and more effective. "It isn't as though you're looking at a program that's broken or ineffective or wanting," he said. "But as with anything, you can figure out how to make it better." As for the Foundation, "I'm still in a learning mode," Boyd said. "But I intend to change my level of learning pretty quickly." (*Washington Post*, Jacqueline L. Salmon, 02/12/05)

Freddie Mac announces expansion of 10-year interest only loans

- Freddie Mac announced that it will expand its interest-only payment option to more adjustable-rate home loans to meet demand from borrowers. The company will now allow the 10-year interest-only period with hybrid adjustable-rate mortgages that have fixed rates of interest for set terms of three, five, or seven years. Freddie Mac already allows the 10-year interest only period on hybrid adjustable-rate mortgages with a fixed rate of interest for 10 years. The adjustable-rate, 10-year interest-only mortgages are for "savvy borrowers," said Freddie Mac's senior vice president of mortgage sourcing David Stevens. Interest-only mortgages are "designed for borrowers who fully understand that the monthly payment will rise following the interest-only period," said Freddie Mac. Such mortgages present risks to investors since they are popular with consumers who are stretching financial resources and may not be able to repay the loans when interest rates rise, said Scott Simon, a managing director at Pacific Investment Management Co. The borrowers are at risk of paying about 40% more when the rates are reset in two years, Simon added. (*Bloomberg News*, Al Yoon, 02/17/05)

Freddie Mac announces new suite of affordable mortgage products

- On March 1, Freddie Mac will make available a new suite of "Home Possible" affordable loan products, providing flexible credit requirements, aggressive debt-to-income ratios and minimal cash downpayments through its automated underwriting service. David Stevens, the company's senior vice president of single-family lending, said the products reflect Freddie Mac's shifting focus to harder-to-serve borrowers

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and its new focus on being bold in helping lenders. "We've never rolled a tool like this out to the market," said Stevens, adding it's not possible to estimate how much volume the products would generate. "This will be a mass distribution to the entire marketplace," Stevens promises. "It will be mainstreamed and it will be available everywhere."

- There are two sets of products in the Home Possible suite. One set is for people who help Freddie meet the affordable-housing goals set by HUD and the other set, called "Neighborhood Solution," is for borrowers who serve their communities, including teachers, firefighters, law enforcement officers, and health-care workers. Borrowers with good credit and solid employment but limited liquidity will be able to borrow up to 100% of the property's value. Borrowers, who qualify for financial help from a nonprofit group, employer, or a local, state or federal housing agency, can borrow up to 105% of the value, enough to cover most of closing costs of the loan. Home Possible 100% loans are for single-family residences, and are available as 15-, 20- or 30-year fixed loans or as "hybrids" with fixed rates for seven or 10 years before switching to one-year adjustables. For loans secured by manufactured homes or a two-, three- or four-unit buildings, loan-to-value ratios are limited to 97%. The products will make it easy for realty agents and other intermediaries to understand when borrowers can avoid subprime loans, Stevens added. Several large mortgage insurers have agreed to provide standard rates for accepted borrowers, he added. The Home Possible products do not allow for alternative or lower documentation of income or credit, features many executives say are needed to serve "emerging" markets of minorities and immigrants. Stevens said Freddie Mac wanted to come up with products that would work broadly, and allowing lower or alternative documentation would have limited that ability.

- Aside from political pressure, both Freddie Mac and Fannie Mae face other pressures to serve more borrowers, after losing significant market share last year to private securitizers and balance-sheet lenders. Stevens downplayed the notion that it is offering the Home Possible suite to regain market share. "This is not about market share. It's about mission." By making the products widely available and putting them in its automated underwriting system, more borrowers will have access to prime rate loans, said Stevens. Lenders will notice an increase in acceptance rates for applicants with lower credit scores from its automated underwriting system, he said. "Lenders will see expanded approval rates" for the two sets of borrowers targeted by the programs.

- Unlike some other GSE efforts to reach outside the most creditworthy part of the market, the product suite will not require one-time fees, higher guarantee fees, or recourse to lenders, Stevens said. Putting the products in its automated underwriting system also provides the "assurance" lenders have requested that the loans will be less likely to be forced back on them because of underwriting mistakes, he said. These loans can be sold to Freddie for cash or swapped for single-lender securities or securities created out of pools by multiple lenders. (*American Banker*, Jody Shenn, 02/14/05; *Reuters*, 0214/05; *Chicago Tribune*, Lew Sichelman, 02/20/05)

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Freddie Mac streamlines A-minus pricing

- Freddie Mac announced changes designed to provide lenders greater certainty on pricing for A-minus and Caution loans, when using Loan Prospector®. Lenders will be able to use the Loan Prospector Level returned on the Loan Prospector Feedback Certificate to determine their A-minus fees, since the Loan Prospector Level is identical to the fee rate used to calculate the A-minus postsettlement delivery fee that will appear on the monthly invoice. To provide greater certainty, the new post-delivery A-minus fee assessment process will significantly cut the time lenders' spend reconciling fees for loans sold to Freddie Mac. The changes are scheduled to take effect May 1 and are included in the February 17 Single Family Seller/Servicer Guide Bulletin. "[Freddie Mac's] announcement will help our lenders serve more borrowers and broaden their competitive position in today's post-refinance boom market," said Dave Stevens, Freddie Mac senior vice president of mortgage sourcing. (*Freddie Mac Press Release*, 02/17/05)

Freddie Mac tackles the language barriers in mortgage lending

- Freddie Mac and VMP® Mortgage Solutions are collaborating on the development of bilingual state-specific security instruments, notes, and other mortgage documents in English and Spanish, as well as bilingual consumer education brochures on the mortgage process. The comprehensive educational materials will take a step-by-step approach to the mortgage lending process, based on content from Freddie Mac's award-winning CreditSmart Español consumer financial literacy curriculum. The bilingual materials will be provided by VMP Mortgage Solutions to lenders and by Freddie Mac to community organizations. (*Freddie Mac Press Release*, 02/16/05)

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Federal Home Loan Banks

America's Community Bankers "cool" to the idea of FHLBs issuing MBS

- In an interview with the *National Mortgage News,* America's Community Bankers executive vice president Robert Davis said, "[The MBS proposal] is not ripe for consideration and the need for the amendment has not been demonstrated," which prompted the group's board to decide not to support such a proposal. According to *NMN*, ACB is concerned that the MBS proposal might shift the FHLBs away from their traditional business of providing its members advances and that the proposal would become controversial. The Mortgage Bankers Association and the National Association of Home Builders have proposed an amendment proposing that the FHLBs be allowed to guarantee and issue mortgage-backed securities be attached to the GSE regulatory reform legislation. (*National Mortgage News*, 02/21/05)

FHLB-Chicago's business plan casts doubts about viability of MPF

- When the FHLB System started offering Mortgage Partnership Finance programs (MPF) several years ago, experts predicted they would eventually break Fannie Mae and Freddie Mac's lock on the secondary mortgage market. However, the business and capital plan recently filed by the FHLB-Chicago casts doubt on the growth prospects and viability of such programs. "The idea in the markets' mind was that the Home Loan banks were going to be able to continue on their growth road while the other two government-sponsored enterprises consolidated a bit," said Jim Vogel, an agency debt analyst at FTN Financial Capital Markets. "I think that is no longer a good assumption."

- Observers note that the Bank's plan shows that the Federal Housing Finance Board has serious concerns about how the FHLB-Chicago raises capital to fund its MPF program. Under the Finance Board's guidance, the Bank said that it would reduce the amount of "voluntary" stock owned by its member institutions measured as a percentage of regulatory capital. At the end of 2003, approximately $2.75 billion of the Bank's stock, or 58%, was considered voluntary. The Bank said it would reduce its level of voluntary capital to 43% by the end of 2007. With no further details were available, observers were left to wonder why regulators asked the Bank to take such a step. Several observers speculated that the Finance Board is concerned by the temporary nature of FHLB-Chicago's voluntary stock. To cover the capital needs of the MPF program as it expanded, the FHLB-Chicago had let its members buy voluntary stock that could be redeemed in six months. While the Bank said that its capital structure presented no problems since a FHLB cannot redeem any stock if doing so would render it undercapitalized, observers said the Finance Board thought otherwise. "Under six-month stock, you could imagine if the dividends fell, then people might decide to take their stock back and it could destabilize the bank's

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capitalization," said Bruce Morrison, former chairman of the Finance Board and now the chairman of the Morrison Public Affairs Group. "That is where the concern is." A knowledgeable source agreed, saying "Probably most of the banks will look at this agreement as confirmation of what they already suspected - that the Finance Board isn't likely to allow them to grow their mortgage programs in the same way, using voluntary stock to fund mortgage portfolios."

- The FHLB-Chicago bank said in its new business plan that it would explore "alternative methods of capitalizing" the MPF program. The Bank's plan also raised the issue of finding a means for the Bank to securitize the MPF loans or move them off of their balance sheet, which allows thee MPF programs to continue to grow. To date, the FHLB-Chicago's shared funding program akin to securitization has not been successful, and the Seattle Bank's MortgageChoice has not been approved, leaving the FHLBs with few options short of selling their mortgage assets wholesale, which is unlikely to get them a significant return. The FHLB-Chicago appeared to acknowledge this issue in its new business plan, saying it wants to look into new methods of "funding MPF assets, including techniques to liquefy MPF assets, creating additional capacity for the bank and other FHLBs." Some observers took the statement to mean the Bank may even have had the Finance Board's blessing to pursue some type of securitization. Morrison, who advised the FHLB-Seattle on its proposed MortgageChoice program, said he did not know what the FHLB-Chicago could do "besides securitization." He added, "The mortgage business has stalled for lack of an adequate way of managing the flow of significant amount of mortgages."

- J. Mikesell Thomas, the president of the FHLB-Chicago, made it clear that MPF program is not being abandoned. "The substantial volume of the MPF program clearly demonstrates a desire among mortgage lenders for effective secondary market alternatives," he said. "We remain committed to the continued development of the MPF program in a way that benefits FHLB members and their homebuying customers and supports homeownership."

- The FHLB securitization issue is almost certain to spill over into the political debate surrounding the GSE regulatory reform. The National Association of Home Builders is publicly lobbying for the FHLBs to be allowed to securitize its loan portfolio, arguing that it would bring more competition to the secondary market. It is unclear how the Bush administration and Congress views this issue. (*American Banker*, Rob Blackwell, 02/15/05)

Senate Banking Committee schedules hearing for Rosenfeld appointment to Finance Board

- On March 1, the Senate Banking Committee will hold a hearing on President Bush's nomination of Ronald Rosenfeld to be a director of the Federal Housing Finance Board. Rosenfeld currently serves as the Finance Board's chairman, having received a presidential recess appointment to serve on the board as chairman. Rosenfeld

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previously served as president of Ginnie Mae. Rosenfeld is considered to be a leading candidate to head a new regulator agency for Fannie Mae, Freddie Mac, and the FHLBs, which would be created under new GSE regulatory reform legislation currently being considered by Congress. (*Dow Jones International News*, John Connor, 02/22/05)

FHLB-Seattle names former CEO Faulstich as interim president

- The FHLB-Seattle announced that it is bringing back its former chief executive officer James Faulstich to run the Bank's day-to-day operations effective immediately, while the board seeks a permanent CEO and president. Faulstich, 71, retired after serving as the Bank's president and CEO from 1979 to 1999, when former Seattle mayor Norman Rice assumed the position. On March 15, Rice stepped down as the Bank's CEO in what was described as a "mutually agreed to" decision. As part of a regulatory agreement with the Federal Housing Finance Board, the FHLB-Seattle must maintain at least 4.15% in reserves, up from its current minimum capital requirement of 4.00%, until the Bank submits to the Finance Board a three-year remedial plan addressing its capital reserve targets, asset growth, retained earnings and other core operation issues by the end of February. While the Bank has not yet released its fourth-quarter earnings, the FHLB-Seattle said that it did not pay a dividend for the period and would lower its first quarter dividend rate to build its retained earnings. With its third quarter earnings falling 53% from a year earlier, the Bank said it did not "adequately anticipate the prolonged period of low interest rates and their effect on business." (*Dow Jones Newswires*, Dawn Kopecki, 02/14/05; *American Banker*, 02/15/05)

FHLB-San Francisco elects new chairman

- The FHLB-San Francisco elected as chairman Timothy Chrisman, founder and CEO of executive search firm Chrisman & Co. Chrisman was also elected vice chairman and acting chairman of the Council of Federal Home Loan Banks, comprised of the 12 regional Federal Home Loan Banks throughout the United States. (*San Francisco Business Times*, 02/17/05)

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Farm Credit System / Farmer Mac

Does FCA chairman Pellett envision expanding the Farm Credit System?

- In the February issue of *Farm Credit Watch*, Bert Ely writes, "Nancy Pellett, Chairman of the Farm Credit Administration (FCA) gave a must-read speech on January 17. Her speech …eliminate[s] any illusions about how Pellett wants the FCS to evolve. In an interesting contradiction, Pellett stated 'please remember that we [the FCA] are the arm's length safety and soundness regulator of the System.' But then, just three sentences later, she turned cheerleader, telling attendees that 'when a regulatory solution to your requests is not possible I urge you to go to Congress to further clarify the authorities you think you need to better serve a rapidly changing agriculture, marketplace, and rural America. And I suggest you do so soon.' That kind of exhortation is hardly that of an arm's length regulator. Going on, she said 'overall, I believe you are at a crossroads in deciding what kind of a GSE you will be.'"

- "Pellett then got down to specifics, talking about 'creating opportunities for [the FCS] to invest in rural America. Throughout my term I intend to be a strong advocate not only for agriculture but also for our rural communities.' Ag bankers, of course, are very strong advocates for rural communities because that is where they live, pay taxes, and do business, without any GSE subsidy. Then comes the punch line: 'to better support agriculture, I think you should focus on, and fund or invest in, activities that benefit rural America. A stated intent of the Farm Credit Act is to provide for an adequate and flexible flow of money into <u>rural areas</u> and I believe <u>investments</u> are certainly a logical, supportable way to do so.' The underlined words [Ely's underlining] are key because they signal a dangerous change in direction for the FCS."

- "In fact, the very first section of the Farm Credit Act, 'Congressional declaration of policy and objectives,' states that the FCS is 'designed to accomplish the objective of improving the income and well-being of American <u>farmers and ranchers</u> by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to <u>selected farm-related businesses</u> necessary for efficient <u>farm</u> operations' [Ely's underlining]. Note that this language says nothing about rural areas or investments, for Congress clearly understood that banks and other private-sector lenders are capable of meeting all of rural America's credit needs and that a wide variety of investors stand ready to make equity investments in non-farm businesses. Banks, of course, picked up the slack in lending to farmers during the 1980s ag crisis as the FCS was retrenching following its disastrous lending during the 1970s. Clearly, Pellett is reading into the Farm Credit Act what the FCS wishes was there."

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- "Pellett went on, 'you have been a model GSE for helping and strengthening agriculture. …I believe you could also establish a similar legacy for helping rural communities and rural Americans.' This thought parallels the goal of the FCS, to lend to anyone anywhere for any purpose. She then encouraged the FCS to 'look more at the broad authorities available under your seldom used investment authorities versus your well used lending authorities.' She then referenced an Informational Memorandum the FCA issued on January 11, titled "Investments in Rural America -- Pilot Investment Programs," which is located at www.fca.gov/apps/infomemo.nsf. Here is where Pellett and the FCA are blurring the line as to what the FCS can and cannot do while tilting strongly in the direction the FCS wants to go."

- "The Farm Credit Act does not authorize FCS institutions to invest equity capital in businesses or farms and ranches. The FCS is an agricultural lender -- that is the mission Congress gave it. Regardless of congressional intent, though, regulated institutions do respond to regulatory directives and exhortations. For example, in the early 1980s, S&Ls were encouraged to 'grow their way out of trouble.' Many S&Ls tried to do just that, and grew rapidly in a wild, reckless manner. The S&L crisis, and the costly taxpayer bailout of the FSLIC, was a consequence. The same could happen in the FCS as its managerial class is not equipped to make equity capital investments, something Chairman Pellett is overlooking. The FCA should stop prodding the FCS to take a dangerous step beyond what Congress intended." (*Farm Credit Watch*, Bert Ely, February 2005)

Farm Credit System reports $2.993 combined net billion income for 2004

- The Farm Credit System reported combined net income of $2.993 billion for the year ended December 31, 2004, as compared with combined net income of $1.825 billion for 2003. Included in the 2004 year-end results were one-time reversals of the allowance for loan losses of $1.167 billion, net of related $95 million tax impact, resulting from the completion of studies to refine the System's allowance for loan loss methodologies. Excluding the one-time reversals of the allowance for loan losses, the System's net income for 2004 would have been $1.826 billion for the year, relatively stable compared to the FY2003 income of $1.825 billion. Jamie B. Stewart, Jr., President and CEO of the Federal Farm Credit Banks Funding Corporation, said, "The System continued to achieve favorable results for the year ended December 31, 2004, reflecting a healthy agricultural economic environment. The portion of net income resulting from the reversals of the allowance for loan losses was retained in System capital and has minimal impact on the System's overall level of risk funds -- total capital plus allowance for loan losses. During 2004, the System's risk funds - a measure of our risk-bearing capacity -- increased $1.183 billion to $22.181 billion, which represented 23% of System loans at year-end 2004." Stewart added, "In completing their studies, System institutions accomplished the objective announced in 2004 to refine their methodologies. These methodologies are consistent with the recent direction received from our regulator, the Farm Credit Administration, and with best practices at leading financial institutions, and ensure

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that System institutions continue to reflect credit losses in their income statements when incurred."

- The Systems' gross loans increased $3.577 billion to $96.367 billion at December 31, 2004, versus $92.790 billion at December 31, 2003. Loan growth resulted primarily from increases in long-term real estate loans and short- and intermediate-term loans, offset, in part, by declines in domestic loans to cooperatives and other eligible borrowers. The System's loan growth resulted primarily from increased loan demand, as well as continued marketing efforts and competitive pricing programs.

- The System's nonaccrual loans decreased $403 million to $646 million at December 31, 2004, as compared with $1.049 billion at December 31, 2003. Approximately 62% of nonaccrual loans were current as to principal and interest at December 31, 2004, as compared with 48% at December 31, 2003. During the year, nonperforming loans decreased $443 million to $743 million at December 31, 2004, representing 0.77% of the System's loans, a decrease from 1.28% at December 31, 2003.

- Additionally, other credit quality indicators for the System strengthened. Loans classified as acceptable and other assets especially mentioned as a percentage of loans increased to 97.5% at December 31, 2004 from 96.6% at December 31, 2003. Loan delinquencies, accruing loans 30 days or more past due, as a percentage of accruing loans declined to 0.32% at year-end 2004, from 0.40% at December 31, 2003. Net loan charge-offs of $75 million were recorded during 2004, versus $125 million for 2003. In 2003 and 2004, the net loan charge-offs were primarily associated with a limited number of loans to specific independent merchant power producers and certain wireless communications customers. (*Business Wire*, 02/16/05)

Ann Trakimas appointed director of the Farm Credit Banks Funding Corporation

- The Funding Corporation Board, acting in consultation of the Secretary of Treasury and the Chairman of the Federal Reserve, has appointed Ann E. Trakimas a director of the Federal Farm Credit Banks Funding Corporation. Trakimas is one of two directors selected from outside the Farm Credit System. In 2003, Trakimas retired from Goldman Sachs & Co. as Vice President, head of Financial Institutions Group. Trakimas joined Goldman Sachs in 1996 and had responsibilities within the Credit Risk Management and Advisory Group for policy making and overseeing best practices for credit risk management of the fixed income and commodity businesses; debt rating agency advisory services for investment banking and debt capital markets clients; strategic planning; and regulatory compliance. Prior to joining Goldman Sachs, Ms. Trakimas was with Morgan Stanley & Co. Inc., E. F. Hutton & Co. Inc., and Chemical Bank. (*Business Wire*, 02/22/05)

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Postal Service

USPS reports first quarter net income of $1.7 billion

- As a result in a significant increase in mail volume, the Postal Service reported better-than-expected first-quarter results with net income of $1.7 billion and a 5.5% increase in mail volume. The USPS CFO Richard Strasser told a board of governors meeting that the agency's volume growth was largely driven by what management believes to be a one-time November spike of 15% compared with previous years. Most of the volume increase for the period was in financial mail and catalogs.

- Postal board chairman James Miller said, "The Postal Service's finances are, at the moment, in good order. And service to our customers is being provided at the highest levels in our history." However, Miller cautioned, "With First-Class volumes declining and costs increasing, the success management has achieved over the past few years cannot go on forever." Since the USPS needs new tools to enable it to deliver affordable, universal service in the years ahead, Miller said the board will continue to work with the administration and Congress to achieve postal reform. (*Dow Jones Newswires*, John Connor, 02/17/05; *DMNews.com*, Melissa Campanelli, 02/18/05)

Board of Governors directs management to prepare rate case filing to cover $3.1 billion escrow requirement

- The USPS board of governors directed management to prepare a filing with the Postal Rate Commission to cover an escrow requirement of $3.1 billion resulting from changes in the Postal Civil Service Retirement System Funding Reform Act of 2003, which must be established by September 30, 2006. The board asked the Postal Service's management to prepare a rate case that will involve settlement agreement among mailers and interested parties on the proposed increase. "We're preparing an across the-board rate increase," said Richard J. Strasser, Jr., CFO of the USPS. The Postal Service is counting on an agreement by all parties, including mailers, mailing associations, competitors, and trade associations, in order to expedite the process that typically takes a year. "If we can't come to some settlement, we may have to decide at some point to file a regular rate increase, which would probably be higher for everyone," said Strasser.

- Industry experts estimate that rates will need to rise 5.5% to 6.0% to cover the escrow requirement, rates smaller than initially forecast due to the USPS' strong first- and second-quarter results Some members of the mailing industry also fear that next year's rate increase will be followed by a second rate increase in 2007.

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- Neal Denton, executive director of the Alliance of Nonprofit Mailers, said, "Not one thin cent of this proposed increase is going toward the collection, processing, transportation and delivery of the mail. This 6% increase is purely to pay into deficit-reduction stamp taxes that are being imposed upon the postal service. Too many folks are going to blame the postal service for this increase, when the fact is, it's clear the postal service could have gone yet another year without another rate increase if it hadn't been for these congressionally mandated obligations." Denton added that USPS senior management and the board must be frustrated by having to file for a rate increase when one isn't needed to cover mailing costs. "We are seeing that efficiencies [have been] rescued in the industry, that mail volumes are holding steady," Denton said. "To have to increase rates now, when it is as unnecessary as this, is a shame. It begs us to make sure Congress takes the issue of postal reform and fiscal reforms of the postal service much more seriously this year." (*DMNews.com*, Melissa Campanelli, 02/18/05; *GovExec.com*, Denise Kersten, 02/23/05; *B to B Online*, Carol Krol, 02/24/05)

White House and Capitol Hill staff seeking compromise on postal reform legislation

- According to sources, the White House might compromise on postal overhaul legislation in time to avoid a possible double-digit postal rate increase. Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins (R-ME) and Senator Thomas Carper (D-DE), the chief proponents of last year's postal reform bill, are leaning toward backing administration requests intended to provide financial transparency, said Senate aides. In exchange, the White House might allow more flexibility in allowing the Postal Service to tap a retirement escrow account that the Postal Service contends is overfunded, they said. To date, the White House has opposed that approach and the way the bill shifts the cost of military pensions to the Treasury Department. Negotiations over the postal reform legislation began as the board of the Postal Service took the first step toward seeking a rate increase for 2006. The White House has been meeting regularly with majority and minority staff of the House Government Reform Committee, said the aides. While most participants expect the Senate bill to be closer to the final version, the House likely will need to adopt some administration proposals to win the support of the chamber's leaders, said a lobbyist for the mailing industry.

- At the White House's request, the Senate measure, which is expected to be introduced next month, likely will limit or strike provisions giving the USPS leeway for banking and investment practices, said Senate aides. The bill also might include language requiring the Postal Service to file SEC-like reports to a regulatory board. In addition to the escrow negotiations, the Senate measure might give the Postal Service greater flexibility in negotiating work-sharing agreements, which allow the USPS to offer discounts to large mailers for presorting mail and other tasks normally done by postal workers. Collins championed a broader work-sharing provision last year, but committee Democrats, joined by Senator Arlen Specter (R-PA), who is no longer on

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the Governmental Affairs panel, opposed it. Proponents say the new work-sharing language probably will be a compromise between Carper and Collins.

- It is unclear whether the White House will be willing to make similar concessions on military pensions. The White House wants the Postal Service to assume responsibility for the benefits of its military retirees. While nearly all stakeholders, including the Postal Service, unions and the mailing industry, oppose the idea, the White House has stood firm, said lobbyists. "I don't know of anyone that likes it, other than the people in the administration," said Cooper. "That doesn't mean that some people aren't ready to throw up their hands." (*CongressDaily*, Alyson Klein, 02/18/05)

NAPS urges "expeditious" passage of postal reform legislation

- In its February 14 *Legislative Update*, NAPS wrote, "The National Association of Postal Supervisors [NAPS] recently urged House and Senate Postal leaders to move expeditiously to pass postal reform legislation. NAPS joined with 131 other postal associations and companies in a February 5 letter from the 'Coalition for a 21st Century Postal Service' to Congress, calling for Congress to pass meaningful postal overhaul legislation. 'The United States Postal Service operates under a severely outdated 34-year old business model and faces significant challenges in the future,' the letter said. 'Without meaningful reform, American jobs will be placed at risk as companies are forced to compensate for the additional but avoidable rate increases likely to occur. We consider the matter urgent …We are committed to assisting you in any way that we can to make postal reform a reality this year.'"

- "There is cautious optimism that Congress, building upon the ground-breaking progress achieved last year, will pass landmark postal legislation this year, possibly as early as this spring. But obstacles yet remain, particularly over the White House proposal to use the Postal Service's CSRS overpayment, currently held in escrow, to satisfy unfunded postal retiree FEHBP liabilities. The postal community continues to urge Congress and the White House to release the escrow, permitting the Postal Service to use the ratepayer-provided funds to modernize postal infrastructure and diminish the need for postal rate hikes."

- "Senate Homeland Security and Governmental Affairs Committee Chairman Susan Collins (R-ME) and Senator Tom Carper (D-DE) are expected to introduce a postal reform bill in the Senate in early March. In the House, mark-up in the House Government Reform Committee of a revised postal bill (H.R. 22) is expected later in March. In the meantime, NAPS continues to meet regularly with Congressional staff, the Administration, the Postal Service, mailers and other employee groups on the terms of the legislation." (*National Association of Postal Supervisor*s *Legislative Update*, Bruce Moyer, 02/14/05)

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Changes made to Congressional committees handling postal reform

- The rosters of the House and Senate committees that oversee the Postal Service are now final, and it appears that the membership of both committees has substantially changed, although the chairmanships remain the same. Eight Republicans and one Democratic member have been added to the House Government Reform Committee, chaired by Representative Tom Davis (R-VA). In the Senate, several Republican veteran members have joined the Committee on Homeland Security & Governmental Affairs, chaired by Senator Susan Collins (R-ME). (*PostalWatch.com*, 02/14/05)

Japanese Prime Minister Koizumi plans to work with the country's ruling party to reform the country's postal service

- Japanese Prime Minister Junichiro Koizumi said he will work out a plan to reform the country's postal service with the ruling party. The Prime Minister and his own Liberal Democratic Party have proposed competing plans to privatize Japan's postal service. Koizumi told reporters that the government hopes to come up with a final plan as soon as possible.

- According to a February 11-12 telephone survey of 1,069 voters by Japan's leading newspaper *Mainichi Shimbun*, 21% of the Japanese polled believe Prime Minister Junichiro Koizumi should pass legislation to privatize the nation's postal system during the current Diet session. The premier does not have to be rigid about enacting the bills at the session which runs until June, said 48% percent of those surveyed, while 23% said postal privatization is unnecessary. Separately, the support for the premier's cabinet stood at 41%, up 4% points from the last survey in December. (*Bloomberg News*, Neha Kumar, 02/13/05; *Bloomberg News*, 02/23/05)

TVA

Politicians are speaking out on composition of new TVA board

- Lawmakers are pushing to give ratepayers in their states a voice on the new TVA board. "We have a large part of the TVA infrastructure, and we have a significant number of ratepayers," said Senator Jeff Sessions (R-AL). "I certainly think that Alabama should have representatives on it, really two." Senator Trent Lott (R-MS) said he hopes to have at least two Mississippians on the utility's board, while Tennessee lawmakers also are pressing for "adequate" representation. Representative Zach Wamp (R-TN) believes Tennessee should have "at least four" board members, said spokeswoman Rachel Carter. Senator Lamar Alexander (R-TN) said because more than 60% of the TVA's ratepayers are in the Volunteer State, "a significant

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number" of board members should be Tennesseans. The president will be naming a new part-time, nine-member board that sets policy and selects a CEO, which will replace the current three-member, full-time governing board later this year. Senate Majority Leader Bill Frist (R-TN), who pushed the legislation changing the TVA governing structure, said, "I will pay very close attention in my recommendations to the president of the United States to have geographic diversity and adequate representation from throughout the Valley." Frist said he believes the first round of appointments will be made by mid-May.

- Two of TVA's current directors, Tennessee's Bill Baxter and Kentucky's Skila Harris, will become part of the new board. Mississippi lawmakers are pressing for the re-appointment of current Chairman Glenn McCullough of Mississippi, whose board term expires May 18.

- Historian Erwin C. Hargrove, professor emeritus at Vanderbilt University and author of a book on TVA, said that while the new board structure "looks good on paper," it could be vulnerable to "politicians who care about pork for their states." Hargrove said the "great danger with the new board is that it will be politicized in various ways." (*Chattanooga Times Free Press*, Andy Sher and Dave Flessner, 02/25/05)

TVA reports higher power sales and operating revenue for first quarter 2005

- During the first quarter of the 2005 fiscal year, TVA power sales increased more than 5 %, operating revenues increased more than 3% to $1.83 billion, and net income totaled $90 million, an increase of $22 million, compared to the first quarter of 2004. An increase in sales to large industries and an increase in sales to federal agencies and others contributed to the increase in operating revenues. A decrease in TVA's net interest expense, resulting primarily from a lower outstanding balance of long-term debt, contributed to the increase in net income. Operating expenses for the 2005 first quarter ending December 31, totaled $1.4 billion, an increase of almost 4% from the same quarter a year ago. Higher fuel costs resulting from higher coal prices and increased generation at fossil and nuclear plants were contributing factors. (*TVA Press Release*, 02/11/05)

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