

The **GSE** REPORT™

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Major Events

Fannie Mae enters into supplemental regulatory agreement with OFHEO

- On March 7, Fannie Mae's board of directors entered into a second written agreement with OFHEO to address the company's deficiencies in internal controls, corporate governance and accounting systems. The agreement adds at least 15 new requirements to a series of commitments made by Fannie Mae's board in a September 27 agreement with OFHEO. This new agreement specifically addresses the development of company policies prohibiting employees from falsifying signatures in journal entries and signing such entries without proper authorization. Further, Fannie Mae agreed to "adopt appropriate internal controls" on "overwriting" of database records by technical support employees at the direction of management to make corrections or changes. The agreement requires Fannie Mae to create a new chief ethics officer, who reports directly to the board of directors and OFHEO, and to permanently separate the chairman and chief executive duties. The agreement also stipulates that the company's general counsel report actual or possible misconduct directly to the board of directors. Fannie Mae's board also agreed not to engage former CEO Franklin Raines or former CFO J. Timothy Howard "whether for compensation or not" and not to employ recently departed employees. The board has also agreed to a formal review of its legal and regulatory compliance procedures. The agreement formalizes Fannie Mae's promise to restate its "prior period financial statements as necessary," and specifically directs the company to focus its attention on FAS 91, 133, 115, 140, 65, 149 and FIN 46 in the restatement process. "While the special examination continues, we must put in place all necessary reforms not just to correct the problems of the past, but to also safeguard against problems emerging in the future," said OFHEO Director Armando Falcon, Jr.
- Neither a spokesman for Fannie Mae or nor an OFHEO spokesman would elaborate on the agreement's reference to "falsification of signatures" in journal ledger entries. "Those are red-flag words," said Dennis Beresford, an accounting professor for the University of Georgia and former chairman of the Financial Accounting Standards Board. "It sounds like, 'Thou shall not commit a crime.'" OFHEO's latest demands seem to indicate that regulators believe Fannie Mae executives may have done more than fail to follow GAAP. "This highlights the possibility that these were intentional manipulations of internal systems and controls and not just incompetence," said Josh Rosner, a Medley Global Advisors analyst.
- Representative Richard Baker (R-LA) has scheduled an April 5th hearing before his House Financial Services subcommittee to review Fannie Mae's March 7th supplemental regulatory agreement, saying it raised "many disturbing questions, especially about tampering with records, and we need to know the nature of the records and the extent of this outrageous practice."

- The requirements of Fannie Mae’s supplemental regulatory agreement underscored fears among analysts that the financial information provided by company in recent years is unreliable. “This is the soul-searching question: What can we believe?” said Friedman, Billings, Ramsey analyst Paul Miller. “What numbers can we believe in that Fannie Mae has released over the last four or five years? That’s a real problem right now.” Jim Vogel, a Fannie Mae supporter and analyst with FTN Financial Capital Markets, said he needs more detail about Fannie’s alleged internal-control deficiencies. For example, were signatures falsified because an employee was on vacation or to circumvent proper procedures, asked Vogel. “This tells me there is sloppy bookkeeping. I’m not happy, but I don’t know if it’s material,” he said. (*Wall Street Journal*, James R. Hagerty, 03/09/05; *Dow Jones Newswire*, Dawn Kopecki, 03/08/05; *American Banker*, Rob Blackwell, 03/09/05; *BNA’s Daily Report for Executives*, Richard Cowden, 03/09/05; *Bloomberg News*, Al Yoon and James Tyson; 03/09/05)

<p>Representative Baker (R-LA) to press for more action on Fannie Mae’s involvement in mortgage fraud</p>

- In a House Financial Services Oversight Subcommittee hearing, Representative Richard Baker (R-LA) said he will press for more action to address Fannie Mae’s resale of fraudulent loans that resulted in \$35 million in losses to the Ginnie Mae. “You made a business decision to dump the fraudulent stuff on somebody else,” Baker told Samuel Smith III, vice president for single family operations for Fannie Mae. At the time, Fannie Mae did not believe the loan activity was fraudulent, said Smith. When Fannie Mae discovered that the loans were fraudulent, it forced First Beneficial to buy them back, which did so; then the broker sold the loans to Ginnie Mae, which eventually suffered \$35 million in losses. But Subcommittee Chair Sue Kelly (R-NY) said a sworn statement from a special agent for HUD claimed Fannie Mae officials knew that funds they received came from the sale of fraudulent loans to Ginnie Mae. Without admitting any wrong-doing, Fannie Mae forfeited \$7.5 million in proceeds it received from First Beneficial Mortgage Corporation in connection with the fraudulent mortgage loans, as part of an October 2004 consent order with the Department of Justice. In the consent order, the Justice Department said Fannie Mae accepted millions in “criminally derived” proceeds from First Beneficial that company officials knew had been pilfered from Ginnie Mae.
- Smith acknowledged that an attachment to an internal Fannie Mae e-mail made a reference to Ginnie Mae, but rejected suggestions that company officials knew that the fraudulent loans bought back by First Financial would end up in the hands of Ginnie Mae. “The file does show, that there was, in an attachment to a single e-mail message, a reference to Ginnie Mae, but none of us at Fannie Mae can recall ever discussing that or having knowledge that James McLean intended to sell loans to Ginnie Mae,” said Smith, referring to First Beneficial’s president, who is currently serving a 21-year prison sentence for the fraudulent loan transactions. Smith said Fannie retained most of its First Beneficial’s mortgages when it directed McLean to

repurchase the selected bogus notes. Fannie's research, he said, "revealed that the entire portfolio was not a bad portfolio." In a sharp rebuke, Baker said, "You did research, that means somebody looked at it, made an examination, went document by document, loan by loan, there was knowledge, somebody made a business decision. And you made a business decision to dump the fraudulent stuff on somebody else."

- Smith said Fannie Mae is overhauling its lender approval and quality control processes and is working cooperatively with OFHEO to stamp out mortgage fraud, by reworking its approval process for lenders that sell loans to the company or service mortgages on its behalf. Fannie has recently established an investigations team focused on mortgage loan fraud reviews, research and reporting and has revised its technology infrastructure and internal controls to more quickly weed out suspicious loans or patterns of lending that might indicate fraudulent behavior.
- During the hearing, Kelly said, "We in Congress expect the people who are operating government-sponsored enterprises to have a moral and ethical obligation to the people of the United States not to defraud and to root out fraud where ever there is a possibility of it. I think this is very clear. The logical thing is to move all of the GSEs into the Bank Secrecy Act." Baker concurred, saying "The current exemption from the Bank Secrecy Act is not appropriate."
- Speaking to reporters after the hearing, Baker called the \$7.5 million payment by Fannie Mae "a slap on the wrist" and said he wants more information on whether Fannie Mae officials knew that Ginnie Mae would be buying the bad loans. "They knew these representations [by First Beneficial] were fraudulent. Those people should be held accountable for unprofessional conduct, whether an attorney, whether an accountant," said Baker. He said he will ask OFHEO to consider a possible referral on the matter to the Department of Justice. During the hearing, HUD Inspector General Kenneth M. Donohue Sr. told Baker that his office considers the case closed. However, OFHEO General Counsel Alfred Pollard said his office considers it still an open case. In response, Baker said forcefully, "GOOD." (*Dow Jones Newswires*, Dawn Kopecki, 03/10/05; *Bureau of National Affairs*, R. Christian Bruce, 03/11/05; *American Banker*, Rob Blackwell, 03/11/05; *Dow Jones Newswires*, Dawn Kopecki, 03/10/05)

FHLB-Seattle plans to exit its Mortgage Purchase Program

- As a part of the Bank's supervisory agreement with the Federal Housing Finance Board, the FHLB-Seattle announced that it is working on its three year business plan and capital plan which focuses on the Bank's traditional mission of providing members advances to support housing. To improve the Bank's financial position by decreasing its exposure to interest rate fluctuations, the FHLB-Seattle is developing an exit strategy for the Mortgage Purchase Program (MPP). The Bank's Chief Operating Officer David Bley said the FHLB-Seattle plans to immediately wind down its MPP trading operations, used by approximately two dozen members. Bley

said the Bank is examining its options for “unloading” its \$11 billion mortgage portfolio to determine “from a pure economic point of view, what’s better for the Bank.” Bley added, “Those [options] range from the sale of the portfolio to an actual runoff.” He said the Bank will honor its outstanding MPP contracts with members and will “make sure that they have an easy transition.” Washington Mutual’s loans comprise well over 80% of the FHLB-Seattle’s MPP assets, with Bank of America Corp., Wells Fargo & Co., and HomeStreet Bank being frequent and large trading partners in the program, he said.

- The FHLB-Seattle’s board is seeking regulatory approval to amend its capital plan to expand the type of collateral that members can use to pledge against advances to free up another \$16 billion for short-term loans. According to the Finance Board, the new capital structure proposed by FHLB-Seattle is fairly common in the FHLB system. In the interim, the Bank’s earnings and retained earnings will be negatively affected, which potentially will limit the FHLB-Seattle’s ability to pay dividends and accommodate stock repurchases. The Finance Board extended the Bank’s filing deadline for its business plan and capital plan from February 28, 2005 to April 5, 2005.
- “Our board basically decided it was time to take a wholesale look at the Bank and (the board) is trying to regain a focus on advances, a returning to our roots,” said FHLB-Seattle spokesman Colin Johnson. The board hopes the proposed changes will reduce the Bank’s overall risk profile and operating costs. Johnson added that the Bank’s CEO and CFO have already stepped down and more management changes are expected in coming months along with a broader reorganization of its 190 employees.
- In an interview with *Dow Jones Newswire*, Finance Board Supervision Director Stephen Cross couldn’t say how long the approval process for the FHLB-Seattle’s business plan might take. “If it’s a well-conceived plan, we will turn it around quickly,” Cross said. “I’ll be happy when we have an acceptable business and capital management plan in place that I can actually look at. Properly carried out, this plan should reduce its risk profile over time.”
- The FHLB-Seattle’s third quarter 2004 net income fell 53% to \$16.8 million from \$35.5 million a year earlier, because the Bank had not adequately hedged its interest rate risk. The Bank voluntarily limited its mortgage growth, while it worked to enhance its risk management infrastructure. In December, the Bank entered into a supervisory agreement with the Finance Board, agreeing to maintain extra capital reserves, limit the growth of its mortgage portfolio, reduce its interest rate risk exposure, and improve its profitability and internal controls.
- The FHLB-Chicago, the pioneer of purchase programs with mortgage assets of \$50 billion, said that it had no intention of giving up mortgage purchases. “We remain committed to the continued development and evolution” of the Bank’s Mortgage Partnership Finance Program “and the benefits it delivers to our member financial institutions and their customers,” said FHLB-Chicago president J. Mikesell Thomas.

The other FHLBs seem to have adopted a similar reasoning and remain committed to the mortgage purchase programs. John von Seggern, the president of the Council of Federal Home Loan Banks, said, “To my knowledge, none of the other [FHLBs] have any intention of getting out of the mortgage business. It’s still a relatively new program, and there are growing pains, but it’s a successful program.” Approximately 1,000 banks and thrifts have sold more than one million loans to FHLBs, said von Seggern. (*Dow Jones Newswires*, Dawn Kopecki, 03/02/05; *Wall Street Journal*, James R. Hagerty and Dawn Kopecki, 03/03/05; *American Banker*, Todd Davenport, 03/04/05; *FHLB-Seattle Press Release*, 03/02/05)

Federal Housing Finance Board chairman Rosenfeld testifies that his agency is keeping close watch over the FHLB system
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- Ronald A. Rosenfeld, chairman of the Federal Housing Finance Board, testified before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises that his agency is closely monitoring the 12 bank system, by recently requiring quarterly risk reports from member banks and increasing the frequency of on-site examinations. In addition, the Finance Board has expanded its use of risk modeling technology to conduct “off-site” analysis of the banks’ exposure to interest rate risk. Monitoring the system’s exposure to interest rate risk is the Finance Board’s top supervisory priority, said Rosenfeld.
- In recent months, the agency has entered into supervisory agreements with the FHLB-Seattle and FHLB-Chicago, directing the banks to improve their controls over interest rate risk, internal controls and corporate governance. “We are continuing to assess the performance and condition of these two banks... [and] are monitoring their progress in addressing their deficiencies,” said Rosenfeld. “I can assure you that we will take whatever additional measures, if any, are needed to maintain the safety and soundness of each of the Federal Home Loan Banks and the system as a whole.” Noting that the FHLB-Seattle recently announced it was developing an exit strategy for its mortgage-purchase program, Rosenfeld said “As so often happens during periods of rapid growth, the Seattle bank paid less attention to sound risk management practices than it should have,” adding that Bank should be able to lower its overall risk profile and operating costs through the disbanding its \$11 billion mortgage program. The five member Finance Board has started to debate the merits of the FHLBs’ mortgage-purchase program and how the programs should be regulated and discussed whether the FHLBs should be allowed to purchase mortgages on a scale to compete with Fannie and Freddie, but has reached no conclusions on these issues.
- Rosenfeld said that the FHLB system is on track to getting the 12 FHLBs to register with the SEC, adding that 10 of the banks have filed draft statements with the agency and nine have received comment letters in response.

- With regard to GSE regulatory reform, Rosenfeld noted that there is broad support for creating a single regulator for Fannie Mae, Freddie Mac and the FHLB system. He said the new GSE regulator should have the “complete arsenal” of enforcement powers, including the authority to set minimum capital levels, approve new products and place GSEs into receivership, if necessary. Rosenfeld added that the new regulator should accommodate the fundamental differences in the FHLBs, which operate as regional cooperatives providing financing to their members, and Fannie and Freddie, which are shareholder-owned enterprises focused on mortgage-securitization.
- Based on his concern about the rapid growth of the GSEs, Subcommittee Chairman Richard Baker (R-LA) said he favors establishing one regulator to oversee the activities of all housing GSEs. Acknowledging that the FHLBs hold only about \$115 billion in mortgage assets compared with Fannie’s and Freddie’s combined total of \$1.5 trillion, he said, “What is interesting to note, as we have seen in the disclosures relative to Fannie Mae and Freddie Mac ...is that similar growth patterns exist among all GSEs.” Representative Ed Royce (R-CA) also voiced support for a single GSE regulator, saying “In my view, this is the right policy because all three present similar risks to the financial system.”
- Representative Paul E. Kanjorski (D-PA) noted that the FHLBs’ current safety and soundness regulatory regime is superior to that for Fannie and Freddie, and that unlike OFHEO, the Finance Board receives its funding outside the congressional appropriations process. Citing a GAO study, Kanjorski pointed out that unlike OFHEO, the Finance Board has powers that are more like those of other bank regulators. “Because the Finance Board already has many of the powers that it needs and because the Federal Home Loan Banks are significantly different from the other housing GSEs, my preference continues to be to consider regulatory changes to these institutions on separate tracks from any regulatory reform bills for Fannie Mae and Freddie Mac,” he said.
- Ranking member Barney Frank (D-MA) agreed with Kanjorski, saying a primary argument for consolidating the regulation for all of the housing GSEs under a single regulator has been that “if we do not include the Federal Home Loan Banks [in the restructuring], the markets would misread this in some way and there could be problems.” Frank said the proposed inclusion of the FHLBs under the same regulator with Fannie and Freddie “fairly cosmetic,” adding that doing so “will probably be of some comfort to investors, and far be it from me to deny these people comfort.”
- Representative Geoff Davis (R-KY) asked Rosenfeld if the FHLBs should be allowed to securitize mortgages, similar to Fannie and Freddie. In response, Rosenfeld defined securitization as “the issuing of a mortgage-backed security for a FHLB, which carries the joint and several liability of the [FHLB] system.” Using this premise, he continued, “Such a development would represent a significant departure from the current structure and practices of the Home Loan Banks. That departure is

so significant in our judgment that it should only be undertaken at the direction of the Congress.”

- When asked by Representative David Scott (D-GA) for his opinion on whether a bank should be able to have membership in more than one FHLB district, Rosenfeld responded, “That question is most frequently put in the context of multi-district membership. It’s the opinion of our general counsel that we at the Finance Board don’t have the authority to offer multi-district membership... Much like securitization, the issue goes to the very core of the creation of the Home Loan Bank System and quite frankly should be determined by Congress.”
- Royce questioned Rosenfeld about the joint and several liability features of the FHLBs’ cooperative structure. If one of the banks defaulted on a bond payment, the others would be liable for it, Rosenfeld said. When asked if the same liability arrangement applies with a default on a derivatives contract, Rosenfeld said, “It is my understanding that they do not.” Noting this apparently ambiguous characteristic of the way the FHLBs are organized, Royce asked Rosenfeld if the 12 banks should improve their sharing of information. Rosenfeld responded, “Congressman, I believe the 12 banks should be given the option of sharing more information with each other. I’m hesitant to use the word ‘require’ because you can perhaps get into areas that it may be inappropriate to share, but I think, quite frankly, we’re headed in that direction.” Baker also raised his concerns about the FHLBs’ cooperative structure, which allows the consolidation of debt among the institutions. “One of the distorting effects... is the consolidated debt obligations and bank X’s ability to borrow on bank Y’s credit,” said Baker. While he is not suggesting a change in the FHLBs’ debt structure, Baker said, “I do believe there should be market discipline in addition to the regulator’s function in evaluating district banks’ creditworthiness in some capacity ...” (*Dow Jones Newswires*, Dawn Kopecki, 03/09/05; *Reuters News*, 03/09/05; *MarketWatch*, Robert Schroeder, 03/09/05; *Bureau of National Affairs*, Richard Cowden, 03/10/05)

Fannie Mae and Freddie Mac

Work on GSE regulatory reform continues:

Senator Shelby says he is considering GSE portfolio limits

Representative Baker hopes to introduce GSE regulatory reform bill later this month

Bush administration applies “slow torture” to Fannie and Freddie

Senator Shelby says he is considering GSE portfolio limits

- Senate Banking Committee Chairman Richard Shelby (R-AL) said he is “carefully” considering recent suggestions by Federal Reserve Chairman Alan Greenspan to limit the portfolio holdings of Fannie Mae and Freddie Mac, given the interest-rate risk that the GSEs’ combined \$1.6 trillion mortgage portfolio poses to taxpayers and the broader economy. “I think Chairman Greenspan knows a lot more about the financial and economic aspects of what [Fannie and Freddie] are doing than most people,” Shelby said. “We will carefully consider his concern.” Shelby also said he is increasingly concerned about the FHLBs’ growing portfolio holdings, which “took off” when the Finance Board approved a new mortgage purchase program through the FHLB-Chicago several years ago.
- Noting the recent disclosure of additional accounting irregularities at Fannie Mae, Shelby said “It shows that perhaps there’s more to come. I’d hoped this would be the end, but no one knows.” He said Fannie Mae’s continuing troubles reinforce the need for a “strong regulator with more power and perhaps more ability to get into the details of what the GSEs are doing.” Shelby said he will hold a hearing later this spring to get Greenspan’s views on legislation overhauling all three housing GSE, but didn’t indicate when he plans to introduce a new GSE regulatory reform bill.
- Shelby also said that he might look into conflicts of interest between Fannie Mae, Freddie Mac, and Wall Street analysts, who rate the GSEs’ securities. Recent analysts’ recommendations for Fannie and Freddie amid the GSEs’ falling stock prices and lack of current financial statements have raised comparisons in the financial media of Wall Street conflicts in failures of Enron and Worldcom. Fannie and Freddie are considered to be two of the largest fee payers on Wall Street, although the exact volume of fees generated by the GSEs is a tightly guarded secret. (*Dow Jones Newswires*, Dawn Kopecki, 03/01/05; *Dow Jones Newswires*, 03/02/05; *Bloomberg News*, 03/01/05; *Dow Jones Newswires*, Dawn Kopecki, 03/01/05)

Representative Baker hopes to introduce GSE regulatory reform bill later this month

- House Capital Markets Subcommittee Chairman Richard Baker (R-LA) said his plans to include portfolio limits in GSE regulatory reform legislation have been buoyed by

comments made in recent weeks by Federal Reserve Chairman Alan Greenspan and Senate Banking Chairman Richard Shelby (R-AL). Baker said, "Given Chairman Greenspan's comments and, more importantly from a political standpoint, Senator Shelby's interest in the matter, I think this presents an opportunity we've not previously had." Baker said he is considering a combination of broad parameters on Fannie's and Freddie's portfolio growth and authorizing the regulator to recommend further growth limits. He anticipates that such growth restrictions would be phased in over time.

- Baker said he is in the midst of discussions with the Federal Reserve on how to structure such caps. "[The Federal Reserve] are the ones most insistent on some sort of limit in the bill and I want to have some study going forward," said Baker. "So it's likely to be a diminimus limit today, so we don't upset the markets, with an obligation going forward of the regulator to study and make further recommendations on how to shrink it." While he's still on track to introduce legislation after Congress returns from its Easter recess, Baker said the bill could be delayed to address new problems that have recently emerged at Fannie Mae. "Every day there's a new allegation and a new thing we've got to add --my staff is passing out," said Baker. He added that he's now considering a new provision that would subject the GSEs to the Bank Secrecy Act in light of his committee hearing on Fannie Mae's involvement in a North Carolina mortgage scheme that defrauded Ginnie Mae of roughly \$35 million.
- Baker said this legislation would address the FHLBs' practice of guaranteeing each other's debt. "One of the distorting effects I think in the market, from the bank system perspective, is the consolidated debt obligation," he said. While praising the FHLB's regulatory structure, Baker said the FHLBs' joint debt undercuts market discipline, since one bank can take significantly more risk than other banks without impacting their cost of funds. While he isn't seeking to end the practice, Baker said some changes are needed. "One approach would be to simply require each bank as a percentage of its own portfolio to issue some amount of debt on some annual basis that would not be secured by the consolidated obligation," he said, which would require the market "to look at the underlying financials." Baker added, "With the complexity of the financial world today and the abilities to innovate, it is not a bad thing to have the market looking over the regulator's shoulder at these district banks as well."
- Baker also confirmed that his bill will address guarantee fees in some way. At the least, the legislation will require Fannie and Freddie's regulator to make regular reports on how the fees are being applied, he said. "I am concerned [about possible g-fees pricing difference]; although I will not make that allegation, I am concerned that they are discriminatory in their application," said Baker. (*Dow Jones Newswires*, Dawn Kopecki, 03/03/05; *American Banker*, Rob Blackwell, 03/10/05; *Bureau of National Affairs*, R. Christian Bruce, 03/11/05; *Dow Jones Newswires*, Dawn Kopecki, 03/11/05)

Bush administration applies “slow torture” to Fannie and Freddie

- As Congress works on GSE regulatory reform, the Bush administration has been largely silent. According to Bethany McLean, writing in *Fortune*, “That’s no accident, says one person close to the furor. ...[I]f Fannie continues to dig itself into a deeper accounting hole, why not wait to create even tougher regulation? ‘Slow torture’ is how this person describes the [administration’s] attitude toward Fannie and Freddie. In some quarters there’s even a belief that new legislation shouldn’t be considered without a real debate about the risks and rewards of Fannie and Freddie’s continued existence as government-sponsored entities. That would be something even Wall Street would have a hard time ignoring.” (*Fortune*, Bethany McLean, 03/21/05)
- The Bush administration continues building its second term team, lining up Randal Quarles to serve as U.S. Treasury’s undersecretary for domestic affairs said administration sources. Quarles, who is currently the assistant secretary on the Treasury’s international side, also served as assistant secretary of domestic finance in the George H.W. Bush administration. In this position, Quarles would take the lead on GSEs. Administration sources warned that Quarles’ appointment was not certain, as it had not been signed-off by President Bush. (*Financial Times*, Andrew Balls, 03/08/05)

NAHB and NAR issue joint statement on GSE regulatory reform

- In a joint statement dated March 1, the National Association of Home Builders and National Association of Realtors warned that “efforts to privatize, withdraw federal support, reduce the capacity, or in any other way diminish the ability of the GSEs to provide low-cost housing finance would undermine confidence in the housing finance system and are inconsistent with the need to assure continuation of their public missions.” The NAHB’s chief executive officer Jerry Howard said, “We do not have a position on any one particular element of the bill.” He added, “Any element of what comes out in this legislation cannot be looked at in isolation but has to be looked at in the entire legislative package.” Howard noted that the Fannie Mae’s and Freddie Mac’s accounting problems have “hobbled them in their ability to influence this debate.” When asked by the Wall Street Journal if this joint statement was coordinated with Fannie or Freddie, Howard responded, “Absolutely, unequivocally not.”
- The NAHB and NAR said they “support strengthened GSE regulation that maintains confidence in the housing finance system and balances safety and soundness regulation and the federal role in housing and the housing finance system.” Regarding the powers of the new GSE regulator, the groups said, “The GSE regulatory regime should authorize the new regulator to establish risk-based capital standards and to require temporary increases in the minimum capital standard for

GSEs to respond to extraordinary adverse financial conditions.” The process for approving new programs should be as streamlined as possible but should also ensure that new programs completely satisfy mission as well as safety and soundness standards, said the NAHB and NAR. “Authority for the regulator to approve programs and activities or establish new regulatory requirements should not unduly delay or prevent the GSEs from developing new programs that support their mission,” said the groups. (*Dow Jones Newswires*, Dawn Kopecki and John Connor, 03/02/05)

Eight mortgage banking and financial services trade groups endorse S. 190

- On March 10, a consortium mortgage banking and financial services groups sent a letter to Senator Richard Shelby (R-AL), Chairman of the Senate Banking Committee, endorsing S. 190, the Hagel-Sununu-Dole GSE reform legislation. The groups wrote, “We believe that [Fannie Mae, Freddie Mac, and the FHLBs] require a new, strong, and independent regulator to ensure a safe, sound and robust housing system. We therefore support S. 190 ...[which] would greatly improve the regulation of GSEs.” The signatories of this letter included the American Financial Services Association, America’s Community Bankers, Association of Financial Guaranty Insurers, Consumer Bankers Association, Consumer Mortgage Coalition, The Financial Services Roundtable, Mortgage Bankers Association, and Mortgage Insurance Companies of America. (*Letter to the Honorable Richard Shelby, Chairman, Committee on Banking, Housing and Urban Affairs*, 03/10/05)

AEI fellow Alex Pollock urges changes to GSE regulatory reform legislation

- In an article in the *American Banker*, AEI resident fellow Alex J. Pollock argues that current proposals for GSE regulatory reform could actually enhance the GSE status and duopoly power of Fannie Mae and Freddie Mac. The next step for GSE reform legislation is to become clearly pro-competitive, suggests Pollock. Specifically, Pollock proposes adding the following four key provisions to the legislation.
 - “Congress could explicitly list ‘enhanced competition’ as one of the goals of the legislation, in addition to ‘safety and soundness’ and ‘mission consistency.’”
 - “[The legislation] could instruct the new regulator’s director that the development of regulations, in addition to other laudable goals, should be pro-competitive. An essential element of this would be for the new agency, to the extent possible, to move toward a ‘level playing field’ for all its regulated entities.”
 - “The bill could adopt the amendment proposed by the Mortgage Bankers Association and the National Association of Home Builders, which would add mortgage securitization to the explicit powers of the FHLBs.”

- “The bill could mandate studies by the new regulator, the Federal Reserve, and the Treasury Department of whether the secondary mortgage market is duopolistic or competitive, and what could be done to enhance its competitiveness.”
- Pollock concludes, “Giving the GSEs a common regulator would be a big step forward. The needed second step is to move to a housing finance system built on competitive secondary markets instead of a government-supported duopoly.”
(*American Banker*, Alex J. Pollock, 03/04/05)

A primer on Fannie’s and Freddie’s accounting problems
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- The following table provides a summary of accounting problems disclosed at Fannie Mae [FNM] and Freddie Mac [FRE].

<u>Partial list of disclosed problems at FNM</u>	<u>Partial list of disclosed problems at FRE</u>
hedge accounting for derivatives	hedge accounting for derivatives
FAS 91 reserve	FAS 91 reserve
manufactured housing impairment	manufactured housing impairment
airline lease impairment	marking-to-market of portfolio securities
marking-to-market of portfolio securities	mortgage revenue bonds
mortgage revenue bonds	dollar rolls
dollar rolls	IO strips
IO strips	income smoothing
income smoothing	held-to-maturity/available-for-sale classification
held-to-maturity/available-for-sale classification	special purpose entities
held-for-sale/held-for-investment classification	mortgage commitments
qualified special purpose entities	internal controls
mortgage commitments	missing pages in David Glenn’s personal journal
internal controls	coupon trade-up giant
false signatures on accounting journal entries	linked swaps
tech support deleting database records	

- Interestingly, former Fannie Mae Chairman and CEO Frank Raines made the following public comments following the disclosure of Freddie Mac’s accounting violations:
 - *Can you assure us that Fannie Mae does not have the accounting issues raised in the 'Report to the Board of Directors of Freddie Mac'?*

“Yes. The report reinforces that the issues do not relate to Freddie Mac's status as a GSE and therefore do not inherently apply to Fannie Mae, and indeed we do not have similar issues.” (Answers from the CEO concerning the Baker Botts Report, Fannie Mae website, July 2003)

- *What about your regulator?*

"We always welcome our regulators to come in anytime they want and particularly here though, because we think that Fannie Mae has been unfairly

tarnished by what happened at Freddie Mac. We don't have the problems they have. We've actually looked at each of the issues that they have mentioned publicly to see if they apply to us and they do not." (*Bloomberg* interview, June 2003)

- *What assurances can you give to investors that Fannie is not in the same situation as Freddie Mac?*

"I'm glad you asked that question. We worked very hard at Fannie Mae to, as I mentioned, be a best-in-class company with regard to corporate governance and disclosures. And Fannie Mae and Freddie Mac are apparently quite different companies in that regard. The best assurance that people have is Fannie Mae is now an SEC registrant. We registered our common stock with the SEC. We produced our first 10-K earlier this year. We do our quarterly submissions to the SEC. Our Chief Financial Officer and our CEO, myself, we certify every quarter to our financial statements. And I think that's the best evidence that anyone can have. Anyone who's seen our 10-K knows we disclose a lot. And the fact that we go through the SEC process, I think, gives a third-party validation to the means by which we have been able to manage our company. So we are a very different company in many, many respects, and I think that has been proven out." (Q&A after speech at George Washington University, December 2003)

- *Ever circumvent accounting rules, Frank?*

"The answer to that is clearly no. We have not. If we had, I would have violated the law in certifying our financial results." (Fannie Mae press conference, July 2003)

SEC appeals to Congress to reform credit rating system
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- SEC Chairman William Donaldson said the SEC would welcome congressional attention on whether credit rating agencies should come under tighter government oversight and whether the SEC should handle it. "We think that, at least so far, what's been offered up by the industry as a voluntary system doesn't get us what we need. Now, [Congress] may change that," said Donaldson. The SEC "loosely" regulates credit raters by designating selected agencies as Nationally Recognized Statistical Rating Organizations (NRSROs). While the SEC recently has proposed a modest rule change to clarify its NRSRO process, Donaldson made it clear to lawmakers at the Senate Banking Committee hearing that the SEC is not legally authorized to do more. "If Congress believes more extensive commission oversight is appropriate ...legislation may be needed," he said.
- Chairman Richard Shelby (R-AL) called the SEC's NRSRO clarification proposal "a first step," but added: "I have additional concerns regarding industry practices, the scope of the commission's authority and the appropriate level of SEC regulation." (*Reuters*, Kevin Drawbaugh, 03/09/05)

FASB considers expanding disclosure rules for derivatives

- Responding to investors' concerns that FAS 133's disclosure rules for derivatives don't adequately convey their risks, the Financial Accounting Standards Board has asked its staff to review what new disclosure requirements may be necessary. "We have received some direct feedback" that existing disclosure isn't sufficient, said FASB member Leslie Seidman. "Disclosures are lacking in this area," she added. Several board members expressed concern that addressing derivative disclosures in isolation would not present a clear picture of the overall risk profile of a company. "I'm a little more skeptical about something that just focuses on derivatives," said FASB Chairman Robert Herz. "That just tells half the story." (*Dow Jones Newswires*, Scott W. Stearns, 03/09/05; *Bloomberg News*, 03/09/05)

Representative Oxley reminds us that Sarbanes-Oxley is still needed

- In a speech addressing the needs and acknowledging the "real costs" of Sarbanes-Oxley Act, Representative Michael G. Oxley (R-OH) said "Along with all of the [recent] positive news [in the stock market], we must remember that just two months ago, earnings smoothing was confirmed at Fannie Mae, which will result in a \$9 billion plus restatement. This should be sobering news for those who think that Sarbanes-Oxley is no longer needed." (*Remarks of Chairman Michael G. Oxley, House Financial Services Committee*, Georgetown University Law Center Corporate Counsel Institute, 03/10/05)

HUD says Fannie Mae should put its mission ahead profits

- When asked if his agency's affordable housing goals provided Fannie and Freddie enough flexibility, HUD Secretary Alphonso Jackson told the House Financial Services Committee, "I've had the opportunity to meet with [Fannie's and Freddie's management]. We've had extremely positive discussions. And what we have said is that we believe that these [affordable housing] goals are [attainable.] But if it is clear that they're not, we are flexible, and we will work with them. But until that's demonstrated to us that they are not obtainable, we believe that they are."
- In an interview with the media, Jackson said he told Fannie Mae's and Freddie Mac's management that they need to put more emphasis on their federal mission to expand homeownership, even if it means lower returns for their investors. "They're going to have to do it, and I told them that," said Jackson. (*House Financial Services Committee FDCH Political Transcripts*, 03/02/05; *Bloomberg News*, James Tyson, 03/02/05)

OFHEO's house price index finally slows in fourth quarter

- Home price appreciation finally slowed in the fourth quarter but remained robust, according to a recently released OFHEO report. The average home price in the fourth quarter rose 1.69% from the previous quarter and the revised third-quarter increase was a record 4.79%, said OFHEO. The fourth-quarter average home price rose 11.2% from a year earlier, compared with a 3.6% rise in the consumer price index. “This report reflects a slowing of the tremendous house price appreciation we’ve seen recently, but it is still growing at a strong pace,” said OFHEO Director Armando Falcon Jr.
- Meanwhile, Freddie Mac expects home prices will probably rise 8% in 2005, representing the third-fastest pace in a quarter century, said the company’s chief economist Frank Nothaft. “We’re not going to fall off a precipice—we’re going to see a gradual slowdown in price appreciation as we see mortgage rates increase,” said Nothaft. (*OFHEO Press Release*, 03/01/05; *Bloomberg News*, 03/08/05)

MBA says there's no talk of compromise on GSE servicing fees

- *National Mortgage News* reports that mortgage companies favoring the reduction of the minimum servicing fee will look to “alternative” measures to help manage their housing receivables if Fannie Mae and Freddie Mac don’t make a change, according to the Mortgage Bankers Association. Among its members, there “has been little discussion” about a compromise over the issue said the MBA. (*National Mortgage News*, 03/08/05)

Deutsche Bank Mortgages is the top Fannie Mae/Freddie Mac servicer in 2004

- According to a new ranking compiled by the Mortgage Bankers Association, Deutsche Bank Mortgage Services was the largest Fannie Mae/Freddie Mac servicer with \$17.5 billion in servicing on December 31, 2004, followed by Washington Mutual with \$17.1 billion and GMAC with \$13.6 billion. (*National Real Estate Online Exclusive*, 02/08/05)

Fannie Mae and Freddie Mac under pressure on all fronts

- Countrywide Financial Corp.’s chief executive, Angelo Mozilo, said the political and regulatory woes at Fannie Mae and Freddie Mac have contributed to their plunging share of the mortgage securitization market. “Rates are rising, requiring creativity and ingenuity in new products, and they just can not react fast enough,” said Mozilo, citing interest-only loans and negative amortization products as examples of market

needs the two GSEs have been slow to meet. He added, Fannie and Freddie have not been “totally focused on the market.”

- Mozilo said that another reason for the shift was the increasing amount of jumbo loans, which Fannie and Freddie cannot guarantee. The private label market, which includes other loans Fannie and Freddie cannot buy such as jumbo mortgages, grew to 46% of the overall mortgage market last year, up from 21.6% in 2003, said the Mortgage Bankers Association. “We have seen the mortgage market explode outside the previous conforming limits,” said Jay Brinkman, vice-president of research and economics at the MBA. (*American Banker*, Jody Shenn, 03/01/05; *Financial Times*, Jenny Wiggins, 03/07/05)

Fannie Mae

Fannie Mae’s scandal could get “markedly worse” if even a portion of the company’s \$1.4 trillion off-balance sheet assets are reclassified
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- In an article on *TheStreet.com*, Peter Eavis said that Fannie Mae’s scandal can get “markedly worse” with OFHEO examining how the company accounts for \$1.4 trillion of off-balance sheet assets under FIN 46. If it were forced to bring even 25% of these assets on balance sheet, Fannie Mae would be severely undercapitalized, writes Eavis. Under the company’s minimum capital requirements, Fannie Mae must hold 2.5% of its on-balance sheet assets in capital and only 0.45% of its MBS and other off-balance sheet assets. If Fannie Mae shifted 25% of its off-balance sheet assets onto its balance sheet (\$355 billion), the company’s capital requirement would increase from \$1.6 billion to \$8.9 billion. With OFHEO’s 30% capital surplus requirement effective September 30, Fannie Mae’s capital requirement would increase to \$11.5 billion for these off-balance sheet assets. On September 30, 2004, OFHEO said Fannie Mae was undercapitalized by approximately \$3 billion, a figure which doesn’t include the 30% capital surplus requirement. To date, Fannie Mae has issued \$5 billion of preferred stock and cut its dividend rate in an effort to raise capital. Clearly, these measures are woefully inadequate if Fannie Mae has to bring on balance sheet a large amount of assets. Eavis concludes, “The irony is that FIN 46 was not supposed to hurt the regular practice of bundling assets and selling them in bond form, a process known as securitization. But given that OFHEO has already unearthed serious-looking misapplications of accounting rules and now has initial doubts about five more accounting rules, it’s worth wondering whether Fannie’s whole modus operandi was to twist accounting to make itself look more profitable than it was.” (*TheStreet.com*, Peter Eavis, 03/02/05)

Wall Street Journal says Fannie Mae faces billions (more) in new losses related to proper accounting for derivative losses under FAS 149

- Fannie Mae could be forced to recognize as much as \$2.8 billion in additional losses on its derivatives portfolio because of new accounting concerns recently raised by OFHEO, said people familiar with the matter. These losses would come on top of the estimated \$9.18 billion in losses related to derivatives that Fannie Mae has estimated it will have to recognize in its pending financial restatement for fiscal years 2001 to 2004. On February 23, Fannie Mae cautioned investors about the prospect of additional losses when it disclosed that OFHEO had identified about a half-dozen significant accounting issues beyond those disclosed last year, but provided no hard numbers and few specifics. Since then, Fannie Mae and OFHEO have declined to quantify the potential impact of any adjustment.
- According to Fannie's second-quarter 2004 10Q, the most recent report it has filed with the SEC, Fannie Mae had \$2.76 billion in cumulative losses on mortgage commitments on June 30, 2004, which were reported as losses on its balance sheet, but were excluded from the company's earnings and regulatory capital. "Mortgage commitments," refers to Fannie Mae's commitments to purchase mortgage loans and mortgage-related securities from lenders, usually 30 to 90 days in advance. Losses on such commitments occur when interest rates move higher after Fannie has agreed to buy a loan at a previously set rate. Depending on the OFHEO's examination findings, it is possible that some or all of the \$2.76 billion loss may have to be charged immediately into Fannie's earnings and regulatory capital, said Stephen Ryan, an accounting professor and derivatives specialist at New York University who reviewed Fannie's financial statements. Since this figure is a snapshot in time, the actual losses would be somewhat different by the time Fannie Mae's restatement is completed. "That would be the best estimate you've got available," Ryan said, based upon the June 30 financial statement.
- OFHEO has questioned whether Fannie qualified for hedge accounting under FAS 149, governing mortgage commitments. "OFHEO has questioned the adequacy of Fannie Mae's methodology, assumptions and documentation for applying cash-flow hedge accounting to these transactions," Fannie said. "OFHEO also questioned whether certain transactions have been accounted for inconsistently since the inception of FAS 149 on July 1, 2003." Since Ryan has no reason to believe that Fannie's documentation practices for mortgage-commitment derivatives would have been any better than its documentation practices for derivatives under FAS 133, he believes it is likely that Fannie would be required to release all of the \$2.76 billion in losses on mortgage commitments, rather than just part of it, into its earnings and capital.
- As the company's losses grow, Fannie will have to strain to increase its regulatory capital up to the levels demanded by OFHEO. In recent months, Fannie Mae already has cut its dividend by 50%, raised capital by issuing \$5 billion in preferred stock and begun shrinking its mortgage portfolio. If its restatement results in losses greater than

the \$9 billion estimate, Fannie Mae may have to cut more deeply into its \$890 billion of mortgage holdings than Wall Street analysts expect, further slash its dividend or both. (*Wall Street Journal*, Jonathan Weil and James R. Hagerty, 03/03/05)

- An analyst who follows Fannie Mae said that the \$2.8 billion loss estimate represents a worst-case scenario, while another analyst said that it is impossible to determine the final outcome of the restatement given the scanty details in the company's disclosure. Edwin Groshans with Fox-Pitt, Kelton Inc., said "The bottom line is we just don't know. This used to be one of the more active communicators [with Wall Street analysts]. Now, they're completely shut down. It's just, 'No comment.' And in the absence of any real information, in an environment like this, the bears always win." In a March 1 research note, UBS analysts wrote, "We view the worst-case scenario, that Fannie needs to take the entire \$2.7 billion capital hit by Sept. 30, 2005, as a virtual impossibility." Even if OFHEO required Fannie to recognize the losses, UBS analysts think the company's runoff from its loan portfolio would cover much of its capital shortfall. "With Fannie accumulating \$1.7 billion in capital per quarter, a later application of additional charges [which increase the company's capital requirement] would be manageable," the analysts wrote. (*The Washington Post*, Terence O'Hara, 03/04/05; *Bloomberg News*, Al Yoon, 03/03/0; *Dow Jones International News*, Allison Bisbey Colter, 03/03/05)

An uncertain future at Fannie Mae

- On Wall Street, Fannie Mae bulls see the stock as "comically cheap," while the bears see the stock's fall as a "prologue to the company's true demise." But the problem with both arguments is that no one has any idea what Fannie Mae is anymore. Fannie was once considered too big to fail – a politically powerful and invincible goliath headed by a Washington power broker and backed by the U.S. government. Over the past year, Fannie Mae has ousted its power broker CEO, Franklin Raines, and the company's "smooth" double-digit earnings growth over the last five years turned out to be fiction. Recently, Fannie Mae curtailed its use of political lobbyists, in an effort to appease its regulator. And, the company has begun shrinking its mortgage portfolio, the source of 66% of its earnings, in an effort to meet its capital requirements. For better or for worse, Wall Street should recognize that OFHEO Director Armando Falcon, Jr. has been running Fannie Mae for the better part of this year. The fate of the company's dividends and mortgage portfolio are in effect in Falcon's hands, whose primary responsibility is to ensure the safety and soundness of Fannie.
- Against this backdrop, lawmakers on Capital Hill are debating GSE regulatory reform and considering stripping away special privileges that Fannie and Freddie enjoy. With Fannie Mae's restatement likely to take a year or more, the center stage for the housing GSEs shifts from Wall Street to Washington, DC. In the aftermath of their respective accounting debacles, both Fannie and Freddie have been largely politically neutered. Fannie Mae's critics are advising prudence in fixing Fannie Mae's

problems, which has cheered bullish analysts who note approvingly that OFHEO has given the company more time to meet its more stringent capital requirements. However, Wall Street's bears question if it actually good news that Fannie Mae needs more time to get it house in order and wonder what problems have yet to surface. (*Financial Times*, Stephen Schurr, 03/01/05)

Is Wall Street Stuck with Fannie?

- Bethany McLean writes in the March 21 issue of *Fortune*, “In truth, no one has a clue what Fannie Mae’s financial statements really look like. If Fannie Mae were a normal company, even diehard believers would be bolting for the exits. But it’s not. For one thing, it’s a top fee payer on Wall Street, and even as its stock price has slid to a four-year low recently, Wall Street analysts have continued to reiterate buy ratings. ‘Opportunities Abound’ was the title of a recent Merrill Lynch report. ... The best (or worst) comes from Lehman Brothers, which earned \$75 million in fees in late 2004 when Fannie sold preferred stock to shore up its capital. Analyst Bruce Harting not only has kept his \$100 price target on the \$59 stock but also defends that target by creating a measure he calls ‘true’ book value, which simply ignores the \$9 billion restatement.”
- It appears that Wall Street analysts can’t afford to admit that they’re wrong about Fannie’s prospects, because they’ve encouraged too many investors to buy the stock to cut that limb off now. Wall Street firms make too much money in dealing with mortgage securities issued by Fannie Mae to endanger their business relationship. These firms also have too much of their own money invested in Fannie Mae stock to issue a “sell” recommendation on the stock. If these firms sold their stock before advising their clients to do so, the SEC would be all over them. And, if they advised their clients to sell Fannie stock before selling their own holdings, they’d hurt themselves. In short, no one wants to be the one to start a run to dump Fannie Mae stock, but no one wants to be the one left holding the bag.
- According to *Thomson Financial*, few analysts ever recommend selling or shorting a stock. Out of the 22 analysts following Fannie Mae on March 4, four analysts have issued “strong buy” ratings; ten have “buys”; seven recommend holding the stock and only one recommends selling the company’s shares. While Wall Street firms, such as Citigroup and Lehman Brothers, have been buying Fannie stock, the company’s falling share price makes it clear that other big institutional investors have been bailing out. (Small investors’ sales can’t be having a significant impact on Fannie’s stock, since 85% of Fannie’s shares are held by institutional investors). The stock’s decline began when Fannie Mae announced a 50% cut in its dividend. Federal Reserve Chairman Alan Greenspan triggered a second round of selling, as a result of his February 17 testimony suggesting that Congress should restrict the GSEs’ growth. On the heels of this testimony, Fannie Mae disclosed additional accounting problems, which may adversely impact the company’s earnings and further deplete its regulatory capital, and entered into a supplement regulatory agreement with OFHEO.

In a very unusual move for Wall Street, Morgan Stanley analyst Ken Posner slashed the target price for the company's stock from \$72 to \$65 and advised clients to short Fannie's stock on March 3. Given the breadth of accounting problems in the company, Posner said, "Investors should at least consider the possibility that fair value might have been misstated." He added, "There is at least some risk that the fair value number we're working with today will turn out to be overstated, at least from the perspective of the new auditor."

- Independent analysts, such as Josh Rosner of Medley Global Advisors, offer cautionary outlooks, which are hard to ignore. "The market is not properly acknowledging or discounting the problems" at Fannie Mae and Freddie Mac, Rosner said, adding it's a "hopeless task" to evaluate the company's stock in light of the regulatory and legislative problems ahead. Rosner assumes Congress will pass GSE regulatory reform legislation this year, perhaps in a more punitive form, and possibly incorporating Greenspan's idea to limit the GSEs' growth. Even if this legislation passes, it would likely take two years or more to get a new agency operational, so Fannie and Freddie will face continuing battles with OFHEO and ongoing investigations by the SEC and others. With Fannie Mae's pending investigations, there is simply no way of knowing whether there are more skeletons to come out of the closet. Fannie still faces the formidable job of restating all its financial reports for the past three years, which will result in a (minimum) \$9 billion write-off. While Wall Street regards that as simply an accounting change, Rosner cautions that re-audits by new auditors could reveal more losses. The argument for buying Fannie Mae's stock is based on the assumption that once the dust settles, everything is going to be all right--and Rosner doesn't buy that. "What comes after the dust settles is more dust," said Rosner. (*Washington Post*, Jerry Knight, 02/28/05; *Dow Jones Newswires*, Dawn Kopecki, 03/03/05; *Fortune*, Bethany McLean, 03/21/05; *Dow Jones Newswires*, Dawn Kopecki, 03/04/05)

Fannie Mae replaces its profit-based executive compensation structure with system based upon achieving affordable housing goals and corporate governance reform

- Under pressure from OFHEO, Fannie Mae has replaced its executive pay structure that richly rewarded its senior officers for rapidly increasing the company's growth in earnings per share with a new system based on non-financial factors related to meeting affordable housing goals, making progress on correcting its books, and implementing an agreement with regulators to increase capital, tighten internal controls, and reform the "company culture." Under the old compensation system in 2003, chairman and CEO Franklin D. Raines was paid \$5.4 million in cash compensation, plus more than \$11 million in long-term incentive payments, as well as stock options. On balance, more than 50% of Raines' total compensation was generated from incentives for meeting Fannie's EPS goals. Fannie Mae didn't pay any cash bonuses or stock options to senior executives in 2004, which resulted in the company's top executives receiving an average cut in pay of 45%, said the GSE.

- In the past, Fannie Mae sought to compensate its senior executives, including Raines, at the 65th percentile of their peers in the financial services industry, the company said; the company's goal now is to pay its executives at the 50th percentile. Joe K. Pickett, chairman of Fannie Mae board's compensation committee, said, "The compensation actions seek to balance two considerations: the company's performance, as well as the need to recruit, retain and maintain experienced and effective leadership as Fannie Mae works through this period." Fannie said it has increased the base salary for interim CEO Daniel Mudd from \$746,209 to \$850,000 to recognize his "increased responsibilities," and has set target bonuses of 235% of base salary for its CEO and 135% of base salary for its executive vice presidents. Fannie Mae also disclosed the restricted stock awards it made to its top executives, which included 95,710 restricted shares for Mudd and 54,149 shares for CFO Robert J. Levin. The board has updated the company's severance policy for management level employees, which imposes caps on the amounts top executives can collect if they leave Fannie Mae under certain circumstances. Fannie Mae said the changes made to its pay policies were reached in close consultation with OFHEO, and that more permanent changes to its executive compensation policies are in process.
- Before the new pay policies were instituted, most of a Fannie Mae senior executive's pay was tied to growth in the company's earnings per share, and most of it was in the form of a cash bonus and stock options. But for at least 2005, earnings growth won't be a factor at all, and all of an executive's incentive compensation will be in the form of restricted stock, rather than stock options. Restricted stock is a direct award of company stock that can't be sold until a period of vesting is complete, typically three to five years. Unlike stock options, which yield a profit for the holder only if a stock price rises, restricted stock fluctuates in value after it is awarded. (*Washington Post*, Terence O'Hara, 03/12/05; *Dow Jones Newswires*, David Enrich, 03/11/05; *Form 8K*, Federal National Mortgage Association, 03/07/05)

Fannie Mae taken off Dow Jones' dividend list

- The Dow Jones Select Dividend Index has dropped Fannie Mae from the index, following the company's recent halving of dividends which caused it to fall below the index's yield requirement. To be listed on the index, companies must be among the top 200 by yield, said Dow Jones Indexes. Additions to and deletions from the Select Dividend Index do not reflect an opinion on the investment merits of the companies, said Dow Jones. (*Mortgage Servicing News*, March 2005)

Fannie Mae's portfolio drop won't hurt mortgage market, says UBS
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- Fannie Mae's reduction in its mortgage portfolio to meet a capital requirement won't have a major impact on the \$5.5 trillion mortgage-related bond market, said UBS Securities. According to the firm's March 1 research note, Fannie Mae may shrink its

portfolio by \$36 billion through September by slowing the replacement of loans that are refinanced or matured. A \$36 billion reduction in Fannie's mortgage portfolio "represents a very small amount of their run-off, and seems like a non-event for the mortgage market," wrote the USB analysts. Fannie Mae could probably meet its capital requirement by reducing the portfolio by less than \$36 billion, although the company won't "cut it that tight," said the analysts. Fannie Mae's current 25% prepayment rate suggests that its \$890 billion loan portfolio could shrink as much as \$148.3 billion in the eight months through September, freeing up to \$4 billion in capital. Fannie Mae won't "cannibalize" its portfolio that much, and will remain a buyer, said the analysts. (*Bloomberg News*, Al Yoon, 03/02/05)

The British view of Fannie Mae, the "paragon of strong corporate governance"

- In an analysis of Fannie Mae's history, Sally Ramage writes in the U.K.'s *Mondaq Business Briefing*, "Fannie Mae highlights the vast multi-trillion dollar unregulated U.S. financial market which has also permeated across borders. It has been play-acting as the paragon of good corporate management, whilst in fact it led the U.S. insurance market in inflating prices, conflict of interest, bid rigging, a complacent regulator, and insufficient capital /liquidity plan. Manipulation of its earnings ratio to lend an air of liquidity and soundness, and poor audit and internal controls. Fannie Mae engaged in high risk synthetic securitization, the use of credit risk mitigation techniques, that is, collateral, guarantees and credit derivatives, for hedging the underlying exposure without collateral. ...In deceit, Fannie Mae misused structured finance vehicles, designed to lower financing costs and spread investment risk, to carry out sham transactions and mislead investors, analysts and regulators about their true financial condition." (*Mondaq Business Briefing*, Sally Ramage, 03/11/05)

Law firms begin investigations of Fannie Mae's ESOP

- Separately, Keller Rohrback L.L.P. and the Law Offices of Charles J. Piven, P.A. have announced that their firms have begun investigating possible claims under the Employment Retirement Income Security Act (ERISA) against Fannie Mae. The firms will investigate the investments made by Fannie Mae's Employee Stock Ownership Plan from October 11, 2000 through the present. (*Keller Rohrback L.L.P. Press Release*, 03/08/05; *PrimeZone Media Network*, 03/08/05)

Fannie Mae's former director of counterparty risk joins newly approved DUS

- Bulls Capital Partners LLC has been approved by Fannie Mae as a Delegated Underwriting and Servicing (DUS) lender, offering a full array of financing solutions to owners of multifamily property. Bulls Capital Partners is a joint venture of SunTrust Bank and Bulls Multifamily LLC, a minority-controlled firm headed by

president and CEO Herman Bulls. Joining Mr. Bulls as a principal in Bulls Capital Partners is Mark Van Kirk, CFO. Van Kirk previously served as director of counterparty risk at Fannie Mae. (*Multi-Housing News*, 02/22/05)

Fannie Mae gives go-ahead for HECM refis

- Purchase refinancings of FHA-insured reverse mortgages, providing seniors a break on the upfront mortgage insurance payment, have finally gotten Fannie Mae's approval. While the FHA reduced its MI requirements for streamlined refinanced home-equity conversion mortgages in April, reverse mortgage lenders waited eight months for the approval from Fannie Mae, the largest investor in HECM loans. (*Origination News*, March 2005)

Freddie Mac

Freddie Mac announces 17% increase in its common stock dividend

- Freddie Mac increased its quarterly dividend by 17% to \$0.35 a share, payable on March 31 to shareholders of record March 14. The company has increased its dividend in every year since at least 1997. A higher dividend reflects Freddie Mac's "much slower growth environment," allowing the company to return more money to shareholders instead of using it for growth, said Bruce Harting, a Lehman Brothers analyst in a research note. "Once the company's financials are current, we believe the company could raise its dividend significantly. Hypothetically, Freddie could afford to raise its quarterly dividend to [\$0.66]," wrote Harting, who rates Freddie Mac and Fannie Mae "overweight." As of September 30, Freddie Mac met its 30% capital surplus mandated by the OFHEO, resulting from the company's revelation in 2003 that it manipulated its earnings through accounting violations. For the first time since 2003, Freddie Mac plans to resume quarterly financial reporting this year. (*Bloomberg News*, Al Yoon, 03/04/05)

Freddie Mac projects lower debt issuance for second quarter

- During the second quarter of 2005, Freddie Mac expects to offer \$6 billion to \$8 billion of its noncallable reference notes. As approximately \$7.4 billion of reference notes will mature during the second quarter, Freddie Mac expects the amount of reference notes outstanding, excluding any repurchases, could change by a reduction of \$1.4 billion to an increase of \$600 million. The company plans to use the 2-3-year issuance date in May and the 5-year issue date in June. During the second quarter,

€4.3 billion Reference Notes will mature. Freddie Mac will continue to monitor the euro market conditions and does not expect the amount of € Reference Notes outstanding by year-end 2004 differ significantly from its current level of €33.4 billion. (*Freddie Mac Press Release, 02/28/05*)

Freddie Mac enters into quiet period before release of FY2004 results

- Pursuant to its corporate disclosure policy, Freddie Mac announced that it has entered a quiet period regarding interactions with the equity investment community in connection with the upcoming release of its financial results for the year ended December 31, 2004. (*Freddie Mac Press Release, 03/09/05*)

ICBA and Freddie Mac beef up their working arrangement

- The Independent Community Bankers of America (ICBA) and Freddie Mac announced new enhancements to their existing alliance agreement to provide ICBA member better access to the secondary mortgage market through Freddie's comprehensive suite of products and services. The updated agreement will provide technology advances including a "mortgagebot" that works with Freddie Mac's Loan Prospector. The alliance's other features include Web-conference training sessions; secondary market sale advantages; increased access to capital markets and portfolio management experts; private-label subservicing through Resource Mortgage Solutions; and guaranteed rural housing loan products. (*PR Newswire, 03/09/05; Inman News, 03/09/05*)

Freddie Mac starts new pilot program to help AH customers stay in their homes

- Freddie Mac has started a new "affordable servicing" initiative, designed to increase the success of delinquency intervention when affordable home loan customers become seriously delinquent, said company vice president Ingrid Beckles. The pilot program is testing ways lenders can provide "high touch servicing" by increasing their contact rate with seriously delinquent borrowers through mailings, telephone calls, and personal visits, she said. (*National Mortgage News, 02/28/05*)

Federal Home Loan Banks

President of FHLB-New York warns that FHLB securitization issue could delay GSE regulatory reform bill

- Alfred DelliBovi, the president and CEO of the FHLB-New York warned that a proposal to give the FHLBs authority to securitize mortgages could bog down GSE regulatory reform legislation. In a recent “president’s report” to Bank members, DelliBovi said lawmakers should fix the regulatory structure and not get sidetracked by secondary policy proposals. While some have called for Congress as part of the reform effort to grant the FHLBs the authority to securitize mortgages, he said this proposal “takes off on a wholly different and very controversial legislative course,” and “will open up a number of attendant administrative issues that would, no doubt, ultimately bog down the bill.” DelliBovi also said proposals to limit FHLB members’ use of advances have no place in a GSE regulatory reform bill. Now is not the time to throw new policy issues on the table, he said, adding that FHLB members are “thoroughly regulated entities.” (*Dow Jones Newswires*, John Connor, 03/01/05)

Finance Board is preparing regulation to address the impact of mergers on AH programs

- To address the impact of bank consolidations on the FHLBs’ affordable housing program, the Federal Housing Finance Board is working on a regulation to ensure that the benefits of the AHP are distributed more equitably across FHLB districts. Under current rules, member banks provide affordable housing funds to the FHLB district where it is headquartered, even when they own depository institutions in other FHLB districts. While permitting banks to be members of multiple FHLBs would resolve this problem, Finance Board chairman Ronald A. Rosenfeld told a House panel that he does not have the authority to approve multidistrict memberships. (*National Mortgage News* 03/10/05)

Senate Banking Committee holds confirmation hearing for Finance Board chairman Rosenfeld and approves his nomination

- On March 1, the Senate Banking Committee held a confirmation hearing for Ronald A. Rosenfeld for Chairman of the Housing Finance Board. Rosenfeld, who was a recess appointee in December to the Finance Board post, told the panel that, if confirmed, he will emphasize the safety and soundness of the FHLB system over promotion of the housing sector. He said that it is “absolutely necessary” to sustain the viability of the FHLB system, which is a “vital source” of financial support for community-based financial institutions. “We want the 12 [FHLBs] to do business, but that goal needs to be tempered in operating in an safe and sound manner, while assuring that the banks carry out their housing finance mission,” said Rosenfeld in his

written testimony. When asked by Senator Allard (R-CO) how he viewed the issue of securitization for FHLBs, Rosenfeld replied that as a general matter he believes competition was good and benefits consumers. That said, he noted, any material changes to the GSE charters must be made by Congress, not the Finance Board. On March 10, the Senate Banking Committee approved the Rosenfeld nomination to a full term as chairman of the Finance Board on a voice vote. (*Bureau of National Affairs*, Richard Cowden, 03/02/05; *Dow Jones Newswires*, Dawn Kopecki, 03/01/05; *American Banker*, Rob Blackwell, 03/02/05; *American Banker*, Michele Heller, 03/10/05)

Farm Credit System / Farmer Mac

ICBA urges Agriculture committees to apply GSE reforms to FCA

- In March 4th letters to the chairmen of the House and Senate Agriculture Committees, the Independent Community Bankers of America said that the same regulatory reforms Congress is working on to oversee the housing GSEs should apply to the regulator of the Farm Credit System (FCS). ICBA called for three major changes to the FCS. First, the group called on Congress to expand the FCA's three member board with two members who have never been borrowers or employees of the system and have expertise in managing complex financial risks. The group urged that Congress require Farm Credit lenders to register with the SEC. And, ICBA also urged Congress to require FCS lenders who want to enter a new activity be required to present a business plan and legal opinion that the activity accords with the FCS's rules. ICBA president and CEO Camden R. Fine said, "The FCA must be reformed to ensure the FCS's original mission is strictly adhered to, and that adequate safety and soundness mechanisms are in place." ICBA believes the housing GSEs "provide community banks with substantial benefits that help them better serve their communities," he said. "All GSEs are granted limited congressional charters to serve specific market needs based on perceived credit gaps that existed at the time of their creation, and in the case of the housing GSEs, exist today." However, "the market gaps the FCS was created to serve in the early part of the last century have largely disappeared," Fine claimed.
- The American Bankers Association has also drawn up a list of "talking points on the FCS and began circulating them around Capital Hill last month. ABA argues that if a new regulator is created for the housing GSEs, it should also have jurisdiction over the FCS and Farmer Mac. To date, the Congressional panels looking at GSE regulatory reform have not shown any interest in addressing FCS along with the housing GSEs. (*BNA's Daily Report for Executives*, Marcia Kass, 03/08/05; *American Banker*, Ben Jackson, 03/10/05)

FCA approves final rule on borrower's rights

- On March 10, the Farm Credit Administration approved a final rule on borrower's rights and proposed new rules related to the Farm Credit System Insurance Corp.'s receivership authorities. The FCA's board approved a final rule that allows borrowers to waive their borrowing rights when dealing with qualified lenders in a loan syndication with non-Farm Credit System lenders. This waiver, which would only be granted if the borrower is knowing and willing, removes impediments to borrowing, said the FCA. "The waiver eliminates instances where borrower rights are an impediment to a borrower receiving credit through a loan syndication," said the FCA. "Borrowers in these transactions generally possess a high level of business sophistication and are in a reasonably equal bargaining position with the qualified lender." To ensure a borrower is aware that their rights are being waived, a borrower must state in writing that he or she was advised by legal counsel before executing the waiver, said the FCA. The final rule will be effective 30 days after publication in the Federal Register.
- In its proposed a rule on receivership repudiation authority, the FCA's objective is to provide the Farm Credit System institutions certainty about how the Farm Credit System Insurance Corp. will treat assets that have been transferred in connection with participations and securitizations when the FCSIC acts as receiver or conservator. "The rule would achieve this by ensuring that FCSIC will not attempt to 'pull back' the subject assets into the conservatorship or receivership if the transaction meets specified conditions," said the FCA. The proposed rule, which would restrict the FCSIC's power to reclaim these assets if the transaction has met the requirements of the Financial Accounting Standards Board's rules, is similar to receivership regulations of the FDIC and NCUA, said the FCA. After the rule is published in the Federal Register, it will be open for a 60-day comment period. (Dow Jones Newswires, Deborah Lagomarsino, 03/10/05)

Postal Service

USPS Board of Governors spells out its vision of postal reform
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- In a February 23rd letter to Senator Susan Collins, (R-ME), chairman of the Senate Committee on Homeland Security and Governmental Affairs, and Representative Tom Davis (R-VA), chairman of the House Committee on Government Reform, the Postal Service Board of Governors spelled out its vision of reform legislation. The letter was written after the Board last month directed management to prepare a rate case filing with the Postal Rate Commission to cover an escrow requirement of \$3.1 billion resulting from changes set forth in the Postal Civil Service Retirement System Funding Reform Act of 2003. In its letter, the Board wrote, “In the Board meetings of January 11, 2005, and February 16-17, 2005, we reviewed with Postmaster General [John E.] Potter the [USPS’] operations, the need for remedial action, and the current state of the legislative process. We believe strongly that to be successful the reform package must incorporate the following elements:”
 - The escrow requirement for the savings in payments to the CSRS should be removed;
 - The portion of CSRS benefits for USPS employees attributable to their military service should not be borne by the USPS. “The requirement that military service count toward USPS retirement is a Federal policy and a national obligation,” said the Board;
 - The legislation should incorporate improvements in the labor area “which accounts for nearly 80 percent of USPS costs” said the Board;
 - The postal service should have more rate flexibility and authority to introduce new postal services. The Board acknowledged that the consumer price index would be an “acceptable, albeit very challenging, price cap on rates.”
 - Future changes in the scope of the postal service monopoly should be considered within the context of the USPS’ universal service mission and other social policy obligations. “We believe that Congress and the Administration, not the regulator, are best positioned to set national policy striking a balance among these dimensions,” said the Board;
 - The USPS should be held fully accountable for the governance of the postal service and the Board should be granted requisite authority. (*DMNews.com*, Melissa Campanelli, 03/04/05)

NALC President Young denounces postal reform move by USPS Board of Governors

- National Association of Letter Carriers (NALC) William H. Young criticized the Postal Service's Board of Governors for proposing to Congressional panels that USPS' employee benefits be subject to collective bargaining and that interest arbitrators be required to consider a selective list of criteria (such as the "present financial health and ability to pay") when issuing their decisions. "Dredging up proposals that were rejected by the President's Commission on the Postal Service and revisiting ideas that even the Postal Service's largest customers opposed last year is foolish," said Young, "especially when we are so close to achieving postal reform." Young warned that the Board's efforts to undermine letter carriers' collective bargaining rights "risked destroying the hard-won consensus on the nature of needed reform." He added, "NALC cannot and will not support these proposals. I sincerely hope that this action by the Governors resulted from the high level of turnover on the Board in recent months and does not reflect a change in direction by the Board and the Postmaster General." While NALC remains convinced that comprehensive postal reform is essential for the long-term viability of the Postal Service and the long-term job security of letter carriers and other postal employees, the union will oppose any postal reform legislation that weakens letter carriers' collective bargaining rights or threatens to undermine the pay and benefits of postal employees. (*NALC Bulletin*, 03/01/05)

How to kill postal reform with one really bad idea

- In an editorial, Association of Postal Commerce President Gene Del Polito and Vice President Kate Muth said, "The administration has proposed that the Postal Service be allowed to 'bank' any inflation-related increases for five years if they do not raise those rates annually. For example, under a banking system, if the USPS didn't raise rates in 2006 and 2007, and the cumulative rate of inflation in those years was 6%, it could add that 6% on top of the next rate increase. Mailers have been saying for years that they want predictable, simple and budgetable rate increases. That is to say, they do not want to get hit with a huge rate increase in one year – even if this is the cumulative rate of inflation over the previous few years. In short, the idea of banking inflationary increases is something mailers cannot tolerate. Including it in any bill would mean the death knell for reform." (*Association for Postal Commerce*, Gene Del Polito and Kate Muth, 03/04/05)

Break in postal reform logjam?

- According to NAPS, the Bush Administration and key lawmakers may be close to a breakthrough in the debate over the postal escrow requirement and the payment of military retirement benefits to postal employees. At a March 3 meeting, House Government Reform Chairman Tom Davis (R-VA) told postal groups that the White

House has shown a willingness to give up its insistence on denying the Postal Service access to billions of dollars in overpaid retirement fund payments, now held in escrow. Davis also said the administration has expressed a readiness to drop its demand that the Postal Service continue to pay the CSRS-related military retirement benefits of its workers. In exchange for the administration's compromises on these issues, Congress would agree to White House demands for greater postal financial transparency and financial stability, according to Davis. (*NAPS Legislative Update*, 03/10/05)

"It's time to privatize the USPS"

- In a commentary on *National Review Online*, Sam Ryan, a senior fellow at the Lexington Institute, said, "It's time to privatize the U.S. Postal Service. Even with a locked-in monopoly, the USPS can't make ends meet. Its accounting is so murky and convoluted it makes our Enrons and WorldComs look like models of financial transparency. [USPS stakeholders] have argued for years about the best remedy for the bloated, inefficient, and union-dominated postal service. Some change may finally come, with postal-reform bills pending in the House and Senate. The draft proposals, however, don't call for busting the monopoly or privatizing the USPS. Yet in its own transformation plan, published in 2002, the USPS envisions itself as a future "Commercial Government Enterprise." Unfortunately, the transformation plan says nothing about ending the USPS monopoly. Although postal officials want the postal service to walk and talk like a private firm, they won't consider making it one. After all, that would mean they'd have to divulge their mysterious accounting system that lumps 40 percent of costs into a murky, "general overhead" slush fund." (*PostalWatch.com*, Sam Ryan, 03/07/05)

USPS work force totals 690,301, down 14,280 from a year ago

- As of February, the USPS career workforce totaled 690,301, down 14,280 from the period year. The biggest reduction in employees occurred in clerks (10,042), followed by mail handlers (1,267), supervisors (1,117, and area HQ (886). City carriers declined by 64, while rural carriers increased by 999. (USPS, 03/11/05)

Deputy Postmaster General Nolan plans to retire in May

- The USPS announced that Deputy Postmaster (DPMG) General John M. Nolan plans to retire in May following a 24 year career with the postal service. In 1970, Nolan joined the USPS and rose through the ranks to become the New York City Postmaster and General Manager of the New York Division. He left the postal service to become a director of private-sector print and mail business for 11 years, before rejoining the

USPS as DPMG. In this position, Nolan has served as a member of the Board of Governors and on its Capital Projects Committee. (*USPS Press Release, 03/08/05*)

TVA

<p style="text-align: center;">TVA supports Bush administration's plan reducing pollution from coal-fired power plants</p>
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- The Bush administration's plan to sharply reduce pollution from America's coal-fired power plants could cost the TVA as much as \$4 billion to \$5 billion over the next decade. However, TVA executive John Shipp said the utility supports the plan because it will require utilities in other states that contribute to Tennessee Valley pollution to make similar cuts. Since the 1970s, TVA has spent about \$4 billion on pollution controls and has nearly \$2 billion in additional projects underway. By 2015, sulfur emissions causing acid rain and haze would be cut by half in Tennessee and nitrogen oxide emissions that lead to ozone and smog would be cut by 80%, under an EPA proposal. (*Dow Jones Newswires, 03/11/05*)

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