

The **GSE** REPORT™

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Major Events

GSE regulatory reform takes center stage in 109th Congress:

Republican Senators introduce tougher GSE reform bill

GSE regulatory reform is the Senate Banking Committee's top priority in 2005

Representative Baker poised to introduce comprehensive GSE reform bill

Republican Senators introduce tougher GSE reform bill

- On January 26, Senators Chuck Hagel (R-NE), John Sununu (R-NH) and Elizabeth Dole (R-NC) re-introduced the Federal Housing Enterprise Regulatory Reform Act of 2005 (S. 190) to improve the regulatory oversight of Fannie Mae, Freddie Mac and the FHLBs. "Since we first introduced this legislation in 2003, the gross mismanagement of GSEs Fannie Mae and Freddie Mac has become glaringly apparent and dangerous. The need for a world-class regulator to increase the safety and soundness of the GSEs has never been clearer. A new independent GSE regulator is critically important and in the best interests of the housing and finance markets, investors and the American taxpayer," said Hagel. "We cannot allow this real problem to continue to drift any longer. The Congress must act this year to pass responsible GSE reform legislation." Dole said, "Considering Fannie and Freddie's debt level, and interest rate and operational risks being what they are, additional problems such as unexpected interest rate fluctuations could have devastating repercussions. We cannot tolerate a regulator that was intentionally made to be weak when the stakes are so high for the American people and our economy."
- S. 190 would create an independent regulator, called the Federal Housing Enterprise Authority (FHEA), to oversee the safety and soundness of the housing GSEs. The legislation provides FHEA the authority to close down a failing GSE and protect against a taxpayer bailout. The new regulator would also be provided greater discretion in raising capital standards to protect against insolvency and approval power over new programs and activities proposed by a GSE. The regulator would also have greater authority to limit exit compensation packages or golden parachutes for executives removed for cause. To ensure that the GSEs support their affordable housing mission, S. 190 requires annual audits of Fannie Mae's and Freddie Mac's affordable housing programs. Under the bill, FHEA can require the GSEs to report mortgage loans that they suspect could be fraudulent, even after the loans have been sold. The legislation also ends presidential appointments to the board of directors of Fannie Mae and Freddie Mac, and requires all FHLB directors to be elected. The bill also directs the new regulator to set parameters on the GSEs' secondary market activities so that they do not participate "directly or indirectly" in the "underwriting of a loan for origination."

- According to people involved in the legislative process, lawmakers considered limiting Fannie and Freddie's purchases of their own mortgage-backed securities, but didn't include the provision in the final bill. Lawmakers plan to hold hearings on GSE regulatory reform later this year and haven't ruled out such a provision, said Senate aides.
- Fannie Mae spokesman Chuck Greener said, "We will be reviewing the bill and are committed to working constructively and cooperatively throughout the process." In a recent conference call with analysts, Freddie Mac COO Eugene McQuaid said that it was vitally important that the GSEs' "capital requirements be tied to risk as the regulatory community is seeking to do under" proposed international banking rules. "To require us to hold capital beyond the risk of our business ...compromises our ability to fulfill our housing mission," McQuaid added. GSE critics and policymakers have long argued that the capital standards for Fannie Mae and Freddie Mac are too low. "It's the GSE strangulation act of 2005," said a person following the legislation.
- The Mortgage Bankers Association (MBA) applauded the introduction of S. 190 to significantly improve oversight of the housing GSEs. "MBA has long supported legislation to ensure effective and well-funded regulatory oversight of the GSEs, which are critical to ensuring a healthy housing finance system," said Kurt Pfothauer, MBA senior vice president of government affairs. "We commend Senators Hagel, Sununu and Dole for introducing [S. 190], and encourage the Senate Banking Committee to act quickly to advance this bill." Pfothauer added, "Our primary concern ...is to ensure that any new regulatory structure does a better job policing the border between primary and secondary markets." Robert R. Davis, executive vice president of America's Community Bankers said, "We expect to be in a position to be very supportive of the bill Senators Hagel, Dole, and Sununu are working on."
- The introduction of S.190 had little impact on risk premiums in the agency debt market. Many of the changes contemplated in the bill were widely expected by Wall Street analysts, and some believe that they have lost their original shock value. "After four years, people are used to all of these noises," said an unnamed pension fund manager. While the market isn't entirely comfortable with the concept of receivership, the fund manager said setting higher capital standards would be positive for agency debt because it would limit new issuance. (*US Fed News*, 01/26/05; *Dow Jones Newswires*, Dawn Kopecki, 01/27/05; *Bureau of National Affairs*, Linda Micco, 01/27/05; *Dow Jones Capital Markets Report*, Allison Bisbey Colter, 01/26/05; *MBA Press Release*, 01/26/05; *CongressDaily/PM*, 01/27/05; *American Banker*, Rob Blackwell, 01/26/05; *National Mortgage News*, 01/28/05)

GSE regulatory reform is the Senate Banking Committee's top priority in 2005

- Senate Banking Committee Chairman Richard Shelby (R-AL) stressed that GSE regulatory reform is his top legislative priority for 2005 and plans to hold a series of hearings on GSE regulatory reform starting in February. "The climate has improved

very much for regulation,” said Shelby. While braced for opposition, he vowed to oppose any watered-down reform saying, “I don’t want a bill that is meaningless. I would not want to be any part of it –the administration won’t either. I think the time has come for meaningful reform legislation.”

- Shelby said that the timetable and content for GSE regulatory reform legislation will depend upon the hearings. On February 16, Federal Reserve Board Chairman Alan Greenspan is scheduled to testify before the Senate Banking Committee and before the House Financial Services Committee the following day, where Greenspan is expected to testify about GSE regulatory reform. Shelby said that the Senate Banking Committee will also review former Fannie Mae CEO Franklin Raines’s sworn Congressional testimony that the company’s prior accounting was sound, in light of a subsequent federal ruling that the bookkeeping was flawed. “There seems to be a discrepancy in what he said and what came out” of the accounting investigation, said Shelby. “We’ll be looking at that and so will the [SEC] and others.”
- Shelby said he will reintroduce the legislation that he offered last year and will not back down from his support of three controversial provisions key to real reform, including receivership powers, authority to set capital requirements, and power to approve new products by the new GSE regulator. “We’ll use the bill as a floor, not a ceiling, and build on that,” he said. The bill should require Fannie Mae and Freddie Mac to reveal more about their operations, including how they determine the fees they charge for guaranteeing mortgages and the compensation and other benefits the company provides to its directors, said Shelby. The bill should also grant a new regulator receivership powers, or authority to sell off assets of a company in event of default, he added. Shelby also said he believes a new regulator should “supercede” the current regulator, OFHEO. Shelby said that he is not seeking to privatize the GSEs and is not trying to regulate the GSEs’ executive compensation.
- Shelby said he expects the GSEs to fight key reforms. “I’m sure there will be opposition to any meaningful legislation to reform the way GSEs work by various people, including some at the GSEs themselves,” he said. Last year, the GSEs “hired everyone in town” and they were “obviously against the bill,” said Shelby. While Fannie and Freddie say they are “eager” to help a bill succeed this year, Shelby does not appear convinced. Asked if he thought the GSEs’ behavior had changed from last year, he responded, “We hope that has changed, but we aren’t sure. If they say they want a bill, we will give them the opportunity to participate and hope they will. We are going to test that statement.” Shelby said that while the GSEs might oppose any “meaningful reform,” he said he believes the White House and House Financial Services Chairman Oxley (R-OH) “will be working with us very strongly to bring about a strong product.” Declining to comment on a timeline for GSE legislation to move through his committee and the full Senate, Shelby said he intends to hold hearings and markups as soon as possible. “The time has come for meaningful reform legislation,” Shelby said. “[The GSEs] should be well-capitalized, well regulated and well managed.” (*American Banker*, Rob Blackwell, 01/20/05; *American Banker*, Rob Blackwell, 01/26/05; *Bureau of National Affairs*, 01/20/05;

National Journal's CongressDaily, Molly M. Peterson, 01/19/05; *CQ Today*, Michael R. Crittenden, 01/19/05)

Representative Baker poised to introduce comprehensive GSE reform bill

- Representative Richard Baker (R-LA), chairman of the House subcommittee that oversees the GSEs, said he plans to unveil a comprehensive proposal to overhaul federal regulation of the housing GSEs in February. Baker said his bill will contain “meaningful” receivership language, granting the new regulator the authority to dissolve a failing enterprise. Receivership language is “essential,” as is the authority for the regulator to set GSE capital levels, said Baker. The new regulator would oversee Fannie Mae, Freddie Mac and the FHLBs, replacing OFHEO and the Federal Housing Finance Board. “This will probably be the most comprehensive bill we’ve ever proposed, simply because the environment is so dramatically different from prior sessions when this subject was considered,” said Baker, referring to Fannie Mae’s recent accounting scandal. “Most ...defenders of Fannie have reevaluated their positions and are either going to remain quiet or, frankly, are even going to be supportive of some sort of reform,” he added.
- Baker said he and House Financial Services Committee Chairman Mike Oxley (R-OH) plan to unveil the GSE regulatory reform bill by mid- to late-February. The legislation would also require greatly enhanced financial disclosure by the GSEs to investors and the financial markets, but may stop short of requiring full registration of all GSE securities with the SEC, said Baker. The GSE reform bill would codify the regulator’s authority over executive compensation, he said. The bill will likely contain language granting either the new regulator or HUD the power of “prior approval” of new GSE products, said Baker, adding the provision is still a “work in progress,”
- The legislation is unlikely to sever the GSEs’ limited lines of credit with Treasury, said Baker, adding that the new regulator may be asked to study the issue. Instead, he said the regulatory receivership power and enhanced GSE disclosure would “overcome the (symbolic) effect of that small line of credit.” While the bill probably won’t contain language that would limit banks’ holdings of agency securities, it will likely require the regulator to report its own recommendations on the matter to Congress, said Baker. He anticipates that the House proposal will not differ substantially from S. 190, introduced by Senators Chuck Hagel (R-NE), John Sununu (R-NH) and Elizabeth Dole (R-NC). Baker said he and Oxley worked with Hagel during “construction” of the House proposal. Baker said Congress will probably resist calls to privatize the quasi-governmental enterprises, adding privatization is a “premature judgment to reach,” despite recent accounting scandals at both Fannie and Freddie. (*The Main Wire*, Claudia Hirsch, 01/27/05)

- OFHEO will attempt to retrieve all bonuses Fannie Mae's officers earned in past years as a result of flawed accounting. In a January 14 letter to Representative Richard Baker (R-LA), chairman of the House subcommittee over Fannie Mae and Freddie Mac, OFHEO Director Armando Falcon Jr. said, "OFHEO will take all actions appropriate to recapture excessive bonus payments [to Fannie Mae employees], in addition to other amounts, that OFHEO finds were based upon false or misleading financial information or are otherwise excessive." Falcon said his agency has at least three supervisory tools in recovering illegitimate bonus payments. "First, Fannie Mae may be directed to seek rescission of any applicable employment contracts and restitution or reimbursement of inappropriate payments through any available means," said Falcon. "If Fannie Mae does not comply or its attempts are ineffective, OFHEO has the authority, through its cease and desist powers, to seek restitution and reimbursement directly against any executive officer or director to the extent that person was unjustly enriched or engaged in serious misconduct." Falcon continued, "Additionally, if the SEC determines that any of Fannie Mae's executive officers are required to forfeit bonuses or other compensation under Section 304 of the Sarbanes-Oxley Act of 2002, OFHEO will take appropriate enforcement actions, if necessary, against the company and those officers to ensure compliance."
- From 2001 until 2003, Fannie Mae awarded total bonuses of \$154.3 million, including \$10.6 million for former CEO Franklin Raines, \$3.28 million for interim CEO Daniel Mudd, \$2.65 million for former CFO J. Timothy Howard, and \$2.06 million for interim CFO Robert Levin. According to data supplied by Baker, Fannie Mae paid \$65.1 million in bonuses to 749 employees in 2003, an average of \$86,953 per employee. Urging recovery of "unearned" compensation, Baker said, "I believe it touches upon a basic question of fairness not to tolerate financial rewards made under false pretenses." (*The Baton Rouge Advocate*, Gerard Shields, 01/20/05; *Bloomberg News*, James Tyson, 01/19/05; *The Frontrunner*, 10/20/05; *Dow Jones Newswires*, John Connor, 01/19/05; *Washington Post*, David S. Hilzenrath, 01/22/05)
- Through litigation, Wayne County [Michigan] Employees' Retirement System (WCERS) is trying to block lucrative severance payouts to ousted Fannie Mae CEO Franklin Raines and CFO Timothy Howard. Attorneys for the pension fund asked the U.S. District Court in the District of Columbia for a temporary restraining order prohibiting Fannie Mae from releasing millions of dollars in compensation to the Raines and Howard. Calling the earnings overstatement one of the largest accounting frauds in history, WCERS accused Fannie Mae's board of a "reckless breach of fiduciary duty" in letting Raines and Howard walk away with fat severance packages estimated to total at least \$31 million in stock options and other benefits. The lawsuit also seeks to force Raines, Howard and other Fannie officials to disgorge tens of millions of dollars in bonuses paid over the previous five years that were linked to Fannie's false financial statements. It also seeks damages from Fannie's long-time accounting firm KPMG LLP, which was recently fired by the company.

- “Such misbehavior by the officers, board and accounting firm of this unique company created during the New Deal to make it easier for ordinary Americans to own their homes cannot be tolerated,” said WCERS pension attorney Darren Robbins of Lerach Coughlin Stoia Geller Rudman & Robbins LLP. “These officers have subverted that lofty public purpose and turned Fannie Mae into a veritable treasure trove for senior insiders.” WCERS serves more than 5,800 retired county employees in and around Detroit, MI. (*Dow Jones Newswires*, Dawn Kopecki, 01/19/05)
- In a December 31 editorial, *The Tennessean* writes, “Franklin D. Raines has been forced out as CEO at Fannie Mae, the nation’s largest buyer of home mortgage loans. But fear not for Franklin. He didn’t walk away empty-handed... If [Fannie’s] outrageous generosity to failed executives had occurred within a private business, stockholders would storm the boardroom. As it is, the outrage should come from U.S. taxpayers, who subsidize Fannie Mae and ...Freddie Mac. ...[T]he importance of Fannie Mae to the housing market doesn’t give the institution free rein to allow its failed leader to sail off on a boat-load of money. Fortunately, federal regulators say they want to review the compensation packages before any money changes hands. An equally important step is for Congress to review Fannie Mae to determine how a government-subsidized lending institution has operated in a way that makes millionaires of its officials. (*The Tennessean*, 12/31/04)
- Fannie Mae announced that its top 43 executives will not be awarded performance bonuses for 2004 and potentially lucrative stock awards for the group will be postponed until the company sorts out its accounting records. Fannie Mae spokeswoman Janis Smith could not say how much the executive group received in bonuses last year. Smith said, “Based on its assessment of the company’s performance in 2004, the board didn’t believe it was appropriate to pay bonuses to the top 43 executives.” Still unresolved is how much money former chairman and CEO Franklin D. Raines and former CFO J. Timothy Howard receive in various forms of compensation. Fannie Mae said it is deferring stock awards under a long-term incentive pay program “until reliable financial data for the relevant periods are available.” In 2003, Raines and Howard and three other top executives received long-term incentive payments totaling \$24.4 million last year.
- The board’s decision to deny Fannie Mae’s top executives bonuses is the latest step in a series of efforts to overhaul the company’s culture and to restore its credibility with lawmakers. “With Fannie Mae anticipating going on the Hill in the near future, they didn’t want the executives who would have to defend the company’s record to defend multimillion dollar bonuses,” said Jonathan G. S. Koppell, a professor at the Yale School of Management. “Now they won’t have to.” Koppell added, “I don’t think you have to be a Machiavellian genius to realize that it’s bad politics to be handing out bags of cash when the company is experiencing serious problems and is being investigated.” (*Washington Post*, David S. Hilzenrath, 01/22/05; *Dow Jones Newswires*, Dawn Kopecki, 01/21/05; *New York Times*, Eric Dash, 01/22/05)

Fannie Mae slashes its dividend rate by 50% to rebuild its capital

- In an effort to rebuild its capital depleted by losses on derivatives, Fannie Mae halved its dividend to \$0.26 per share payable February 25 to shareholders of record January 31. This first dividend cut for Fannie since 1981 will save the company about \$250 million a quarter. In recent quarters, Fannie Mae had paid dividends of \$0.52 per share for a dividend yield of approximately 3%, well above the 1.88% average dividend for the S&P 500 Index. Fannie's dividend cut doesn't affect first quarter dividends on its preferred shares, which will be paid in accordance with their respective certificate of designation terms. As required under its regulatory agreement with OFHEO, Fannie Mae obtained advance approval for the dividend from the agency. In a prepared statement, OFHEO director Armando Falcon, Jr. said that the dividend cut "demonstrates the board's commitment to taking necessary measures to increase the company's capital."
- "The board of directors believes this is a prudent and responsible action to take as the company moves expeditiously to increase its capital," said Stephen Ashley, the board's non-executive chairman. Ashley said the board will continue to assess dividend payments for each quarter; OFHEO has indicated that it will continue to review dividend payment requests for each quarter, based on the facts and conditions existing at the time.
- Fannie Mae's dividend cut caught many mortgage bond analysts off guard. "It was a surprise," said Gerald Lucas, Banc of America Securities' chief Treasury and agency strategist. After Fannie Mae issued \$5 billion in preferred stock at the end of 2004, Lucas said, "It was thought they wouldn't be forced to cut the dividend," in an effort to meet regulatory capital requirements agreed on with OFHEO. Senior vice president of FTN Financial Capital Markets Jim Vogel said, "[Fannie's] common dividend cut ...should remind debt investors not to take the status quo for granted. He added, "There does not appear to be a capital plan in place yet, which means all steps - including a real reduction in assets," or a cap on the size of assets, "could still be on the table."
- In an interview with *Dow Jones Newswires*, Vogel said he believes that Fannie Mae would need to hold approximately \$41 billion of capital by the end of June 2005 to meet its higher minimum capital requirements. Assuming a \$9 billion loss at the end of September 2004 resulting from accounting restatements, Fannie's regulatory capital today would be approximately \$28 billion to \$29 billion, plus the \$5 billion from the sale of preferred stock, bringing the capital level up to \$33 billion to \$34 billion. Cutting of the dividend adds another \$500 million over two quarters, leaving Fannie Mae needing to raise another \$7 billion or \$8 billion by the end of June, according to Vogel's calculations.
- Gary Greenberg, a mortgage strategist for investment firm Payden & Rygel Investment Management, views Fannie's dividend cut as "more of a symbolic move." While surprised by the decision to cut the dividend, Greenberg said the surprise was

really the timing. “We already know they’re not going to grow their portfolio, they’ve already indicated that,” he added. The one question he’s still evaluating is whether Fannie Mae will need to sell assets as well, Greenberg said. “I think they want to weigh all their options at this point.” (*Wall Street Journal*, James R. Hagerty, 01/19/05; *Bloomberg News*, Al Yoon and James Tyson, 01/19/05; *Dow Jones Newswires*, Allison Bisbey Colter, 01/19/05; *Dow Jones Newswires*, Danielle Reed and Allison Bisbey Colter, 01/20/05)

Fannie Mae and Freddie Mac

The drumbeat for GSE reform begins

- In a January 28 interview on *Bloomberg News*, Senate Banking Committee chairman Richard Shelby (R-Al) said, “[GSE regulatory reform is] very important legislation. The timing is right, right now. ...I believe there’s going to be a lot more support for meaningful legislation than there was last year, especially because of the ...accounting debacle at Fannie Mae. When asked by *Bloomberg News*’ host if a clause allowing regulators to sell off assets is a necessary one in any legislation, Shelby responded, “Absolutely. Every banking financial institution has that. Freddie Mac, Fannie Mae, Federal Home Loan Bank[s], they don’t have it. Chairman Greenspan says it’s absolutely essential that we do that.” When asked if anything in the legislation would hamper Fannie and Freddie’s ability to go to the debt markets, Shelby responded, “...I believe that any financial institution, GSEs included, that are well capitalized, well regulated, and well managed, should continue to grow. And, that means they’re subject to the market like everybody else.” When asked if there was anything in the legislation that is “not negotiable,” Shelby said, “Well, I think that you have to have a ...regulator that can set capital standards. You’ve got to have receivership and you’ve got to be able to be in the product approval. Those three things [are not negotiable].” (*Bloomberg News*, 01/28/05; 14:11:04)
- In a January 27 interview with *Bloomberg News*, Representative Christopher Shays (R-CT) discussed the critical need for regulatory reform for Fannie Mae and Freddie Mac. Shays said, “...[C]learly, [Fannie and Freddie] need a regulator that’s going to oversee them well. They need to be under, ultimately, not just the ‘34 Act but the ‘33 Act like everyone else. Play by the same rules as everyone else. And, they need to make sure that they have enough reserves. They’ve avoided any oversight and have been arrogant about it. And their arrogance, I think, [will] ultimately result in the legislation.” When asked if he was pleased with the new direction that Fannie Mae is now taking under its new management, Shays responded, “I am.” He added, “There’s a bit more humility. But, you know, Fannie Mae, basically, used to tell us how to write the laws. They would tell us when they would comply with them, when they wouldn’t. And they had worked the Congress so well that they had enough support to kill anything they didn’t want. They don’t have that same kind of leverage.” When

asked if Fannie Mae's restatement process "guarantees" a re-regulation bill going through this year, Shays responded, "Nothing is guaranteed when it's Fannie Mae and Freddie Mac. But, it's very likely." (*Bloomberg News*, 01/27/05, 14:46:43)

- In a January 27 speech at a real estate conference, U.S. Treasury Secretary John Snow renewed the Bush administration's push to establish greater regulatory oversight of Fannie Mae and Freddie Mac. "We need a strong, credible and well-resourced regulator with a clear mandate and all the powers of other world-class financial regulators," said Snow, adding that the administration will "be coming forward with legislation" later this year. Any new regulator should be able to set capital standards, approve additional ventures and deal with any default through a receivership process, said Snow. "Those are the critical issues any strong regulator ought to have," he added. Fannie and Freddie own or guarantee almost half the \$7.6 trillion mortgage market in the U.S, making these GSEs the second- largest debtor in the country after the federal government. Snow said lawmakers should examine the GSEs' "potential to create systemic risk" and ensure they "are operating safely, prudently and efficiently." He added, "While GSEs have continued to grow in size, complexity, and importance, the regulatory structure governing their activities has not. The new regulator should have at heart two guiding principles: promoting a sound and resilient housing financing system and increasing homeownership for less advantaged Americans." (*Bloomberg News*, Simon Kennedy, James Tyson, David Plumb, 01/27/05)

Has the environment changed for GSE reform?

- At the National Association of Home Builders conference, the contrast between the reversed roles of Fannie Mae and Freddie Mac couldn't have been sharper. Fannie Mae's interim chief executive officer, Daniel Mudd, told the homebuilders that his company has a lot of work to do to put its house in order and restore confidence in the firm. Mudd said, "It's like the old Peanuts cartoon where Charlie Brown is lying awake at night asking, 'Where have I gone wrong?' And the voice answers, 'This is going to take more than one night.'" In contrast, Freddie Mac's chairman and CEO Richard Syron declared to the homebuilders that "the Mac is back," and warned those pursuing GSE regulatory reform to beware of the law of unintended consequences. Syron said that "like doctors caring for a patient, we should obey the Hippocratic Oath: first, do no harm." Mudd and Syron made their remarks before an audience of homebuilders, with Mudd sounding "humble, contrite and non-aggressive," and Syron sounding like he's ready to "play the old housing card for all it's worth" to block regulatory reforms he deems inappropriate, according to *Dow Jones Newswire*. Warning the homebuilders and Congress, if you mess with Fannie and Freddie, mortgage rates will rise and who knows what other "bad stuff" might happen, he said. Freddie's Syron cautioned the homebuilders, long-time allies of the GSEs, that "if we are not engaged and united on GSE reform, we risk seeing damaged the most successful system of housing finance the world has ever known." (*Dow Jones Newswires*, John Connor, 01/18/05)

- In a key reversal in policy, the NAHB called for stricter oversight of Fannie Mae and Freddie Mac. The trade group said that it wants a new “independent” regulator with a board including representatives from the U.S. Treasury, Federal Reserve, SEC and HUD, said NAHB chief Jerry Howard. In 2003, the NAHB had favored keeping regulatory oversight of the housing GSEs under HUD. In what is viewed by some as a more accommodative approach, the NAHB’s new GSE policies show a “willingness to compromise,” said Howard, adding the trade group no longer wants to act as an apologist for Fannie and Freddie. “We think we are holding out an olive branch and we hope we can work with the Bush administration to come up with a world-class, independent nonpolitical regulator,” said Howard. Despite the shift, NAHB continues to oppose any steps which would undermine the government’s implied guarantee of the housing GSEs, particularly providing the GSE regulator with the power to place an enterprise in receivership. The trade group called for the FHLBs to become more involved in mortgage securitization, thus providing more competition for Fannie Mae and Freddie Mac. Northern Virginia builder Gary Garczynski, who headed up NAHB’s task force on housing finance reform, said his panel tried to “take an aggressive stance” regarding GSE oversight. “Congress is going to come right out of the box on this, and we want to be at the table,” said Garczynski. (*NAHP Press Release*, 01/12/05; *NAHB Task Force on Housing Finance Reform: Executive Summary of Final Report*, January 2005; *National Mortgage News*, Lew Sichelman, 01/17/05; *The Miami Herald*, 01/15/05; *National Mortgage News*, 01/24/05)

<p>Freddie Mac’s CEO Syron warns that the GSEs will fight receivership provisions in GSE regulatory reform</p>
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- During the company’s market update with analysts, Freddie Mac chairman Richard Syron signaled the GSE could fight any fresh regulatory reform efforts that include receivership language, an issue which helped doom a Senate committee-passed GSE regulatory reform bill in 2004. When asked by an investment analyst if Freddie might be flexible on the issue of receivership, Syron argued that it was “important” that the GSEs retain its current access to capital markets. “It is essential that we continue to have access to the capital markets that we have now,” he said. Freddie Mac has “unique” responsibilities and burdens, and “it’s the matching of the two that allows us to do for the housing and mortgage market what we do.” This job requires the kind of access to capital markets that Freddie now enjoys, he reiterated. Syron said Freddie Mac is focused on working with the administration and Congress to achieve regulatory reform legislation. “Our principles on this matter really haven’t changed,” he added. (*Market News International*, Claudia Hirsch, 01/19/05)

- As Fannie Mae and Freddie Mac have helped millions of Americans buy and refinance homes, they've helped themselves to huge profits from little-known fees tucked into most monthly mortgage payments. Now the fees, which may total thousands of dollars over the life of a mortgage, are emerging as a new battleground in the GSE regulatory reform debate. In a letter to Representative Howard Baker (R-LA), OFHEO director Armando Falcon, Jr. acknowledged that the guarantee fees (g-fees) that Fannie and Freddie charge for buying mortgages far exceed their credit losses. According to OFHEO's analysis, Fannie set its g-fees at roughly four times its credit losses and Freddie's fees were set at three times its credit losses in 1994. In 2003, Fannie's g-fees were 20.2 times higher than its credit losses and Freddie's were 23 times higher. Falcon noted that there are many reasons for wide differences in g-fees. For example, Freddie Mac's g-fee rates increased three to four basis points for the last four years, due to corrections made in the restatement period. Interest rate declines have also caused faster amortization of up-front fees paid to Fannie and Freddie. Credit losses have also been much lower in recent years due to an exceptionally strong housing market. "However, guarantee fee rates are forward looking. A prudent level of guarantee fee rates must protect against expected future losses, not past losses," said Falcon. Factoring in all components of the G-fee, including credit losses, administrative costs, the cost of the GSEs' capital, OFEHO estimates that the GSEs "need" a guarantee fee of roughly 11 to 19 basis points. "The wide range reflects the difficulty of measuring costs precisely, their sensitivity to product mix, and their dependence on subjective forecasts of interest rates, house prices, prepayment behavior, and other factors," said Falcon. "The Enterprises are able to price at the high end of the range because their GSE status makes their guarantee more valuable to investors than those of other financial institutions and significantly inhibits competition in the secondary mortgage markets for conforming loans. Thus, while the fees received prudently cover costs and provide essential risk protection, they also contribute to the Enterprises' unusually high rates of return."
- Responding to OFHEO's analysis indicating that Fannie's and Freddie's g-fees, a Freddie spokesman said, "We don't think [the fees] are hidden and excessive; we think they are efficient, competitive, and above board." (*Bureau of National Affairs*, 01/17/05; *Wall Street Journal*, John R. Wilke, 01/18/05; *Bureau of National Affairs*, Linda Micco, 01/17/05)
- Citing a January 14 article on g-fees appearing in the *Wall Street Journal*, three homeowners in Connecticut and Wisconsin filed class-action, antitrust lawsuits against Fannie Mae and Freddie Mac for allegedly conspiring to charge excessively high fees "tucked inside" monthly mortgage payments. The lawsuits, filed in the U.S. District Court in the District of Columbia, accuse Fannie and Freddie of "holding conspiratorial meetings between themselves in private, and affirmatively representing that the (companies) unlawfully established prices and business practices had been arrived at independently. (Fannie and Freddie) also held conspiratorial meetings with

lenders and required them to sign confidentiality agreements, thereby concealing the true nature of the conspiracy.” The homeowners’ attorneys asked the court for threefold the amount of actual damages, punitive damages, attorney’s fees and “further relief the court may deem just and proper.”

- Freddie Mac spokeswoman Sharon McHale disputed the litigants’ charges, saying the companies don’t consult with each other on g-fees, “much less enter into agreements.” She added, “The case appears to be a misguided attempt to allege an antitrust complaint by cutting and pasting together a series of vague and misleading comments that appeared in a newspaper article. McHale pointed out that the fees are paid by the lenders, which the *WSJ* said are passed on to consumers; borrowers don’t pay g-fees directly. Confident that the GSE will prevail in both cases, McHale said, “The amount of those fees is established in a perfectly lawful manner pursuant to negotiations between Freddie Mac and the individual lenders with whom it does business. The fees are competitive and appropriate.” (*Wall Street Journal*, Dawn Kopecki, 01/28/05)
- In a January 20 editorial, the *Kansas City Star* wrote “Congress is considering how best to regulate Fannie Mae and Freddie Mac. ...In doing so, lawmakers should look closely at the fees imposed by Fannie and Freddie. ...The most significant of these is the so-called ‘g-fee,’ which finances a guarantee that mortgages will be paid on time. Critics say g-fees have become excessive relative to the default rate. ...The fee-setting process occurs during secret talks between mortgage lenders and Fannie and Freddie. Institutions that win low g-fees enjoy an edge against their competitors. Smaller banks complain about being stuck with higher levies. Some banks accuse Fannie and Freddie of using lower fees to reward banks that support the mortgage giants’ Washington policy agenda.”
- “Fannie and Freddie are odd crossbreeds -- privately owned, for-profit corporations that operate from government charters. They’re exempt from state and local taxes. They’re exempt from some securities laws. They enjoy a line of credit at the Treasury. And because the markets assume Fannie and Freddie are backed by the federal government, the two giants can borrow at below-market rates -- a huge subsidy. That subsidy created a national mortgage market and helped make homeownership more widely available. But it also increased what Fed Chairman Alan Greenspan called ‘systemic risk.’ In a financial panic, taxpayers would be on the hook for Fannie and Freddie’s debt. Studies have shown most of the federal subsidy’s benefits flow to Fannie and Freddie’s shareholders and executives. Homeowners get only a tiny break on mortgage rates. Considering the fees the mortgage giants are charging, the justification for Fannie and Freddie’s ability to borrow at below-market rates begins to look thin.”
- “The issue is the mismatch between private profit and public risk. Congress should either appropriately curb the mortgage giants’ growth or put them on a path to full privatization.” (*The Kansas City Star*, 01/20/05)

If Fannie and Freddie don't use their "edge" to help consumers – they shouldn't keep it

- In a January 26 editorial, the *Atlanta Journal-Constitution* writes, "It turns out that on top of fudging profits and bestowing gaudy pay packages on its executives, mortgage giants Fannie Mae and Freddie Mac deliver fewer benefits to home buyers than most had believed. Recent studies and news stories reveal that the firms charge consumers unnecessary fees, and that the widely held assumption that Freddie Mac and Fannie Mae hold down mortgage rates may not be valid. All the more reason for Congress to revisit the government's relationship with the two companies, as well as reconsider whether it's wise to have two firms control such a big part of the mortgage market.
- "...Despite ...their unique breaks [as GSEs], Federal Reserve researchers have concluded that the savings Fannie Mae and Freddie Mac create for home buyers is too small to make a difference. Separately, one of the agencies that regulates the companies has found that Freddie Mac and Fannie Mae charge fees that appear to have no relationship to the potential losses they are meant to cover. (Lenders are charged the fees, but pass them onto unsuspecting home buyers, *The Wall Street Journal* reported.) Since their formation, Fannie Mae and Freddie Mac have helped to make homeownership an option for more Americans. But if the companies no longer use their government-provided edge to help consumers, they should not keep it. (*Atlanta Journal-Constitution*, 01/26/05)

Collateral damage: Banks booking losses in their GSE preferred stock

- Fannie and Freddie securities issued were once touted as a safe investment, but some commercial banks are finding that the GSEs' accounting woes and management changes have eroded the value of the companies' preferred stock that the banks own. Charles Viater, CEO of MBR Corp., said "[With] Fannie or Freddie you have to understand credit risks today that you would not have considered five years ago." MFB Corp. recorded a non-cash "other than temporary" impairment charge, because of a drop in the value of Fannie and Freddie floating rate preferred securities. Peoples Holding Co., based in Tupelo, Mississippi, also booked an impairment of its Fannie and Freddie securities, at a cost of \$0.07 a share. Similarly, Astoria Financial Corp. recorded a \$9.6 million charge related to losses in Freddie preferred stock, and Sovereign Bancorp Inc. booked a \$21 million after-tax charge for losses in Fannie and Freddie preferred stocks.
- How much was the value lost in the Fannie Mae and Freddie Mac preferred securities at year end? Before the GSEs' accounting scandals, fixed-rate preferreds traded at 25 basis points over the 30-year U.S. Treasury yield currently at 4.60%, according to a Wall Street trader. Today, the spread between fixed-rate preferreds over Treasuries has widened to a range of 95 to 110 basis points, bringing the preferred stocks' yield to as high as 5.70%. The change in value for floating rate preferreds is even greater, partly because interest rates have risen. Some of the poor performance in floating

rate preferreds is also tied to Fannie Mae's \$5 billion debt sale on December 30. Looking back at Fannie's the mammoth sale that hurt his bank's investments, Johnson said, "We felt like: 'why did they do this to our paper?'" (*Reuters*, Aleksandrs Rozens, 01/30/05)

OFHEO's quiet chief – Armando Falcon, Jr.

- A low-key San Antonio native who learned the ways of Washington at the side of legendary House banking chairman Henry B. Gonzalez, OFHEO Director Armando Falcon Jr., 44, is credited with humbling Fannie Mae, which conceded last month that it might have overstated profits by \$9 billion in the last few years. Falcon's investigation and congressional testimony last fall led to the Fannie Mae upheaval and made him a very unpopular guy in Washington.
- "The company has built almost a political machine which, through all of its activities, it uses to generate a lot of support in Congress and in business, political and social circles," said Falcon in a recent interview. "Trying to go up against Fannie and Freddie doesn't always generate a lot of allies," he said. Few people outside Congress and the mortgage industry have heard of OFHEO, let alone its 44-year-old director.
- Falcon denies any particular agenda in the agency's review of the accounting practices at Fannie Mae and Freddie Mac. "Our approach was to follow the path wherever it leads. If changes had to be made at the top, so be it," he said. While lawmakers in both parties accused him of being incompetent, irresponsible and overzealous, he shrugged off the criticism by taking a lesson from his old hero. Falcon recounted an incident when Gonzalez and Federal Reserve Chairman Alan Greenspan were at odds. Gonzalez insisted on tighter credit policy to mitigate the savings and loan crisis and Greenspan resisted, arguing that the economy was too shaky. Gonzalez held firm, and Greenspan agreed to compromise on a piece of legislation addressing the issue. "He was a guy of the highest ethics and integrity, and I've tried to emulate that. That's why in the face of all the political opposition, the criticism, attacking my motives and judgment - as long as I think we're doing the right thing, I'm not going to waver," Falcon said. "That's exactly the way Henry Gonzalez always conducted himself." (*Dallas Morning News*, Todd J. Gillman, 01/20/05)

OFHEO's corporate reform regulations still "on hold"

- OFHEO is meeting resistance from the Bush administration to proposed rules that would bar Fannie Mae and Freddie Mac from letting the same person serve as chief executive and chairman, said people familiar with the matter. The White House OMB wants the proposed ban dropped, along with a requirement that the GSEs change auditing firms every 10 years and the audit partner every five years, said

sources. The proposed rules run counter to the “interests” of the U.S. Chamber of Commerce, Business Roundtable and other corporate groups, who are trying to persuade the Bush administration to roll back governance laws enacted following the collapse of Enron Corp. and WorldCom. Resistance to these rules “fits into the broader picture of backlash to the corporate accountability movement,” said Brandon Rees, a research analyst at the AFL-CIO’s office of investment, which offers governance advice to union-sponsored pension funds with \$400 billion in assets. “It’s a sign of retrenchment, of CEOs trying to draw the line.” The rule has been under review for twice the usual time. “We want to make sure [OFHEO] have time to work through the issues,” said OMB spokesman Chad Kolton, who declined to detail reasons for the unusually long review period. (*Bloomberg News*, James Tyson and Robert Schmidt, 01/17/05)

OFHEO seeks rule to requiring notification of mortgage fraud
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- OFHEO is seeking Bush administration approval for a rule requiring notification of mortgage fraud, seven weeks after Fannie Mae agreed to pay a \$7.5 million penalty for not reporting bogus loans made by First Beneficial Mortgage Co., Charlotte, NC. OMB is reviewing a proposed rule submitted by the OFHEO detailing how Fannie Mae and Freddie Mac must report mortgage fraud, said budget office spokesman Chad Kolton.
- “We are actively reaching out to regulators and others in the industry to work toward a common proposal for a safe harbor” provision giving the GSEs legal protection when flagging mortgage loan fraud, said Fannie Mae spokesman Brian Faith. In a January 18 letter to three Republican lawmakers, interim CEO Daniel Mudd said Fannie Mae supports “mandatory reporting of mortgage fraud, including a safe harbor for reporters of suspected fraud and increased government and industry communication.” Fannie Mae is “committed to working with Congress, [HUD], and others to put in place appropriate information-sharing procedures,” said Mudd in a letter to Representatives Sue Kelly (R-NY), Representative Richard Baker (R-LA), and Representative Robert Ney (R-OH). Fannie Mae and other companies need “safe harbor” protections because “reporting just a suspicion of fraud or making unfounded allegations of fraud raise potential privacy and confidentiality concerns and can expose the reporting entity to liability for defamation, breach of contract, and other claims,” he said. “There is more that Fannie Mae can do to improve its practices to prevent losses from mortgage fraud to the company, its partners, and taxpayers,” Mudd added.
- In his letter to lawmakers, Mudd acknowledged that in November 1998 an investigator with the North Carolina Banking Commission asked Fannie Mae’s Atlanta office for assistance in investigating First Beneficial, stating that the company “was attempting to get Ginnie Mae to buy loans.” The official didn’t refer to loans specifically held by Fannie Mae and he never followed up after the call, Mudd said. A First Beneficial employee specifically told Fannie Mae employees that the

mortgage company's only investors were Fannie and Ginnie, he added. Another First Beneficial employee "speculated that First Beneficial might be trying to buy loans back from Fannie Mae and sell them to Ginnie Mae," Mudd said. "A review of the totality of the facts in hindsight suggests that Fannie Mae may have been able to take further steps to investigate and determine whether First Beneficial was engaging in conduct that amounted to fraud. At the time, Fannie Mae did not have a formal policy in place to address potential instances of fraud," Mudd concluded. (*Bloomberg News*, James Tyson, 01/28/05; *Dow Jones Newswires*, Dawn Kopecki, 01/18/05; *Washington Post*, David S. Hilzenrath, 01/19/05)

Freddie Mac CEO Syron says housing price rise doesn't pose risk

- Freddie Mac chairman and CEO Richard Syron said he's not concerned that rising property prices threaten the national economy. "Is this a major economic question? No," Syron told reporters at the World Economic Forum meeting in Davos, Switzerland. Syron's view is in sharp contrast with Morgan Stanley's chief economist Stephen Roach, who said that higher interest rates threaten to send home prices lower and slow economic growth in the U.S. "Asset-dependent consumers are extracting value from property, which has entered a clear bubble stage" said Roach. "The U.S. consumer is an accident waiting to happen." According to the National Association of Realtors, the nationwide increase in average home prices in the 12 months ended Sept. 30 was 7.7%. Prices have surged in some markets, such as Washington, where the median home price has risen 69% in the past three years. (*Bloomberg News*, John Fraher, 01/27/05)

Fannie Mae

Turnaround work begins with the hiring of Richard Breeden, demotion of members of its accounting staff, and scrapping of plans for new corporate offices

- Fannie Mae has hired Richard Breeden to assist in the company in its financial restatement and to help improve its corporate governance. Breeden, who served as the chairman of the SEC from 1989 to 1993, was brought in as a “strategic counsel as the company works through its restatement and reaudit,” said a Fannie spokesman. An aggressive securities lawyer, Breeden has made a career of helping to clean up corporate messes, most recently overseeing an internal review at Hollinger International Inc. (*Wall Street Journal*, 01/28/05)
- Fannie Mae has demoted its chief accounting officer, but will keep her on the payroll to help the company clean up its books. Leanne G. Spencer, a 13-year veteran of Fannie Mae who serves as controller, will “step down” from that post on January 31. Spencer has agreed to remain with the company for as long as a year as an adviser to Michael Williams, who is overseeing a restatement of Fannie Mae’s results for the past four years. A Fannie spokesman said Spencer “will be available to provide such counsel as [Williams] may need. She has historical knowledge that will be important as we move forward.” Spencer reported to Fannie Mae’s former CFO J. Timothy Howard and was involved in accounting policies that were denounced both by the SEC and OFHEO. White collar defenses lawyer David Gourevitch said, “It’s a smart move” to keep Spencer on the payroll, citing the complexity of the restatement and the need for her to be available to the company’s lawyers, who are handling a barrage of investigations and shareholder suits.
- Fannie Mae named David C. Hisey to succeed Spencer as controller. Hisey, 44, previously was a managing director at BearingPoint Inc. [formerly KPMG Consulting] and also has worked as an audit partner at KPMG LLP [which Fannie dismissed as its auditor in December]. The company said Hisey wasn’t involved with auditing Fannie’s financial statements during his tenure with KPMG.
- Three Fannie executives who shared responsibility for the company’s accounting have stepped down from their positions. The three senior accounting executives who have stepped aside, include Sam Rajappa, the senior vice president for operations risk, who reported to the audit committee and to the CFO; Janet Pennewell, a senior vice president for financial reporting; and Jonathan Boyles, the senior vice president responsible for accounting policy. While these executives will remain with the company as special advisers, with full salary, benefits and plan coverage, Fannie Mae has not determined their exact daily responsibilities. “Ms. Pennewell, Mr. Boyles and Mr. Rajappa are stepping aside from their current positions into roles as special advisers as the company works through its restatement and re-audit,” said spokesman Chuck Greener. “Their historical knowledge will be important and they will be

available to perform such duties and assignments as the company requests.” The reassignments reflect the board’s efforts to change Fannie Mae’s culture and improve its financial reporting. These actions may also signal that the board is taking OFHEO seriously, since the managers moved were cited in the regulator’s 211-page report on the company’s accounting. Boyles was described in testimony in OFHEO’s report as Fannie Mae’s expert in GAAP. Rajappa and Pennewell were both alerted to a low-level accountant’s concerns about accounting problems at Fannie Mae, according to the accountant’s testimony to regulators. (*Wall Street Journal*, James R. Hagerty, 01/24/05; *New York Times*, Eric Dash, 01/25/05; *Washington Post*, David S. Hilzenrath, 01/25/05; *CFO.com*, Stephen Taub, 01/25/05)

- When the company’s former chairman and CEO Franklin Raines “retired” in December, Fannie Mae named real estate executive and longtime board member Stephen B. Ashley to the new position of non-executive chairman. In a recent SEC filing, Fannie Mae disclosed that it will pay Ashley an annual fee of \$500,000. The board of directors has also amended its bylaws to eliminate a requirement that its chairman and chief executive be the same person. (*New York Times*, Eric Dash, 01/22/05)
- Fannie Mae’s board of directors has decided to scrap its plans to build new corporate offices. Fannie Mae spokesman Chuck Greener said, “Fannie Mae has decided to withdraw its non-binding letter of intent for the development of new corporate offices at Waterside Mall in Southwest Washington. The decision is one of several actions Fannie Mae has taken to reduce future costs in order to accelerate the increase in the company’s capital.” According to a source close to Fannie Mae, the project was in its early stages, “and this didn’t seem to be a good time” to be embarking on “what essentially would be a major transaction with obviously a certain amount of cost to it, both in money and in time.” The roughly two million square foot facility was expected to cost between \$500 million to \$700 million. Greener said, “Fannie Mae will explore other alternatives to handle our growing employee population at the appropriate time.” (*RISMEDIA*, 01/24/05; *Washington Post*, David Hilzenrath, 01/21/05; *Associated Press*, Martin Crutsinger, 01/22/05)

Fannie’s high stakes poker

- In an interview on CNBC’s Kudlow & Kremer, *Fortune Magazine*’s senior writer Bethany McLean discussed her article, “The Fall of Fannie Mae.” Co-host Larry Kudlow noted to McLean, “[Fannie Mae] was a kind of politically oriented government-sponsored company and kind of developed this political arrogance and hubris which eventually kind of got them undone. Is that where you’re going on your thought process?” McLean responded, “Absolutely. There are people who would tell you that Fannie Mae is the most politically powerful company in the country. On top of that, the company had this sense that its mission, its mission of providing affordable housing and helping people get mortgages really gave it a sort of moral

superiority and ...gave the company a sense that it was both right and righteous and that it was entitled to any sort of behavior it could get away with.”

- Co-host Jim Cramer said, “Well, Bethany, I want to--first of all, I totally agree with that. ...[W]hat I don’t understand is these guys [Fannie and Freddie] had two qualities. One was that they felt that incredible sense of mission and entitlement. But they’ve always been credited with being incredibly savvy, ear to the ground, kind of knowing when to juke and when to jive, knowing when to, like, step up to the plate and when to back down. But they came in with a very Nixonian defense of their strategy. Basically, they just stonewalled. Could they ...with the same set of problems and the same set of books, been able to survive?” McLean responded, “It’s interesting. As one person told me, that what happened over the last couple of years or really the last year, was the greatest political miscalculation... the greatest political malpractice... that he’d ever seen. And it’s funny because this company that did have its ear to the ground so intensely over the last decade really just played the game wrong over the past year. ...And you look at it and it seems like they made an all-out gamble, either that their regulator wouldn’t find anything in the investigation or that perhaps a new Kerry administration would come in and change the course of events. And it’s funny that--when you see that gambling mentality take hold at a company... Well, what’s scary about Fannie Mae is that you look at a company with almost a trillion dollars of debt, and really, because of it’s government-sponsored status, with this incredible responsibility to the public--and that’s what to me makes what we’ve seen happen there in the past year almost kind of worse than other corporate scandals because it was a company with a special responsibility.” (CNBC, *Kudlow & Cramer*, 01/13/05)

Former Fannie Mae CEO Raines vacates two other board seats
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- Fannie Mae’s former chairman and CEO Franklin D. Raines is relinquishing two of his three outside board seats. In a statement, Raines said he offered to not stand for re-election at Pepsi. A Pepsi spokesman said that the company’s directors have accepted Raines’ offer. He has also stepped down from Pepsi’s audit committee, which he had chaired. Raines will remain a Pepsi director until the company’s annual meeting in May. Raines has also quit the TIAA-CREF overseers board, a spokeswoman disclosed. [Overseers own TIAA’s stock and elect its trustees, while CREF has its own board.] Raines said he also will offer to not stand for re-election to the Pfizer board. The board will consider Raines’s offer to resign at its February meeting, said Pfizer spokesman Paul Fitzhenry. The drug company’s corporate governance principles call for directors to resign when their “principal occupation or business association changes substantially.” Raines’ departure isn’t a certainty, said a person close to the situation. “He’s very highly regarded privately within the Pfizer board,” the individual added. (*Dow Jones & Company*, Joann S. Lublin, 01/28/05; *Washington Post*, David S. Hilzenrath, 01/29/05)

Fannie Mae's board to blame for the company's "imbroglios"

- In a letter to the editor of *Business Week* regarding the magazine naming Fannie Mae's former CEO Franklin Raines as one of the year's worst managers, B. Morosin from Albuquerque, NM writes "Worst managers? You have it wrong! Franklin Raines was able to talk the board into a tidy retirement and \$110,000 per month for the rest of his life! The worst managers were the directors who allowed such imbroglios, raping the stockholders." (*Business Week*, B. Morosin, 01/31/05)

Fannie Mae's executive compensation:

A case study of perverse incentives, nonperformance pay and camouflage

- In a January 2005 case study of Fannie Mae's executive compensation, Lucian Bebchuk, Professor of Law at Harvard University, and Jesse Fried, Professor of Law at University of California, Berkeley, identify four problems with the company's executive compensation for the 2000-2004 period. In this study, the professors conclude that Fannie Mae's compensation arrangements provide "perverse incentives" which richly rewarded its executives for reporting higher earnings without requiring them to return the compensation if the earnings turned out to be misstated, thus providing incentives to inflate earnings. The company's compensation structure also provided a "soft and generous landing" to executives who were pushed out by the board for failure. The authors note that "expectation of such an outcome adversely affects ex ante incentives." Further, "most of the executives' retirement payouts were totally unrelated to firm performance, thus greatly increasing the fraction of their total compensation that was completely decoupled from the managers' own contribution to firm value," write the authors. Finally, Fannie Mae "obscured [or camouflaged] the total values of the executives' retirement packages, rather than [making them] transparent" for the shareholders and stakeholders.
- The authors conclude, "The case of Fannie Mae thus highlights how important it is to reform current compensation practices. Given most companies' failure to make pay any more transparent than is required by law, the SEC should adopt tighter disclosure requirements that, among other things, require companies to put a dollar figure on any retirement benefits that companies promise their executives. Institutional investors should press companies to improve the link between pay and long-term shareholder value by, among other things, not tying compensation to short-term earnings figures and stock price movements and adopting contractual provisions that reduce termination payoffs to failing executives. Most importantly, we must adopt reforms that make boards more accountable to shareholders and more attentive to the costs imposed on them by flawed pay arrangements." (*Working Paper: Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, Lucian Bebchuk and Jesse Fried, January 2005)

- In a January 26 appearance on CNBC's *Kudlow & Cramer*, Bebhuk said Fannie Mae's "incentives that were in place [for former CEO Franklin Raines and former CFO J. Timothy Howard], ...did not provide incentives to focus on long-term value. But, rather to the contrary, provided incentives that are preverse by rewarding higher, short-term earnings figures." Bebhuk said, "[W]e should have in all executive compensation contracts straight forward, give-back provisions that require the paying back of money that was based on figures that have to be restated. And, that's something that we should have expected to have happen already, because restatements are not really a rare event. We have had in recent years hundreds of restatements by public companies. A significant percentage of public companies have gone through this process. So contracts should reflect this..." Bebhuk is also co-author of the book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (with Jesse Fried), published by Harvard University Press, November 2004. (CNBC, *Kudlow & Cramer*, 01/26/05, 17:37:43)

Fannie Mae debacle shows Wall Street's reforms haven't worked

- Appearing on the *Charlie Rose Show*, *Newsweek* reporter Charles Gasparino said, "... [The]Fannie Mae [debacle] shows that the reforms that were implemented by Eliot Spitzer on the analyst rules really haven't worked. I mean, what is fascinating about Fannie Mae, we have a massive accounting probably fraud -- I don't want to say fraud yet, because no one has been convicted of anything. There is definitely a problem there. Yet every major Wall Street firm continues to promote this stock. Now, why is that? Because Fannie Mae still issues billions of dollars in debt. They do all sorts of financial sort of arrangements with Wall Street. It really is a scary situation, where a public company like that can be accused of -- can be under investigation for fraud, take a major accounting hit, I mean, billions of dollars, and still be promoted by Wall Street. (PBS, *Charlie Rose Show*, 01/21/05)

Fannie Mae: A train wreck moving in slow motion

- In *Contrarian Chronicles*, Bill Fleckenstein writes "When companies implode slowly, folks often erroneously conclude that all is well. When Enron came unstuck, it unraveled slowly at first, before dropping from about \$38 to \$4 in two weeks. To my eyes, Fannie Mae is a train wreck moving in slow motion when -- in this modern world of finance, and given Fannie's balance sheet -- one would think the wreck would occur at the speed of light. No sane person can now draw any other conclusion about Fannie Mae than that its business is forever changed, from what is believed to have been and what it was."
- "As Jim Grant said in the most recent issue of *Grant's Interest Rate Observer*, 'Before the scandal, Fannie's business model was one part simplicity, another part privilege and a third part audacity: Borrow at a government-advantaged rate; invest at a slightly higher rate. Leverage the balance sheet as no private enterprise could.

Grow and grow. Deliver predictable, stair-step earnings growth.' That pretty much sums up what Fannie Mae's business plan used to be. Any time it was threatened, it invoked the sacred word, "homeownership." That got anyone hassling the mortgage lender off its back."

- "...That, of course, has all changed. [OFHEO] has questioned Fannie's earnings calculations, and Fannie has recently been forced to raise capital in a fairly expensive fashion, via a preferred offering. It has cut its dividend in half -- from 52 cents a quarter to 26 cents. The stock is off more than 9.7% so far in January and 25.8% from its all-time high in December 2000. It is no longer business as it once was for Fannie, the second-largest U.S. company in terms of assets. That change will have far-reaching ramifications which, to my mind, have not yet been felt." (*Contrarian Chronicles*, Bill Fleckstein, 01/19/05)

Fannie's mortgage growth slows to 17-year low

- Reporting its slowest growth in the mortgage portfolio since 1987, Fannie Mae grew by \$6.1 billion to \$904.6 billion for a 0.7% growth for 2004, compared to 13.1% the previous year. In November, the company said growth for the year would be "close to zero" as prices on mortgage securities remained expensive relative to its cost of money and its capital crunch made it difficult for Fannie Mae to expand. The portfolio will probably decline in coming months, said Fox-Pitt, Kelton analyst Edwin Groshans. "We believe that a decline in retained portfolio, all else being equal, will put some pressure on earnings in the coming quarters," he said, "[which] could limit Fannie Mae's ability to meet its new capital requirements through earnings."
- Fannie contracted to buy \$256.1 billion in mortgages and mortgage securities in 2004, roughly half of its purchases of \$489.1 billion in 2003. Mortgage liquidations fell to \$240.2 billion in 2004 from \$451.5 billion the previous year. Fannie Mae's portfolio's net yield dropped to 4.22% in 2004 from 5.00% in 2003, as the company bought more adjustable-rate securities and loans during the period. Fannie's duration gap was negative one month for a second straight month. (*Bloomberg News*, Al Yoon, 01/21/05; *American Banker*, Jody Shenn. 01/24/05)

<i>National Mortgage News</i> reports Fannie may be closer to slashing its servicing fee
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- According to *National Mortgage News*, Fannie Mae could be "moving closer to slashing its minimum servicing fee to as low as 13 basis points." A Midwestern-based Fannie Mae seller/servicer told *NMN* that there is "serious momentum" at Fannie to cut the current servicing fee of 25 basis points. If Fannie makes such a change, Freddie Mac is expected to quickly follow suit. (*National Mortgage News*, 01/24/05)

Fannie Mae “works against urban neighborhoods”

- David Hudson, executive vice president of the Congress for the New Urbanism, writes in the *Chicago Tribune*, “...Fannie has long operated a secondary mortgage market that undermines one of the foundations of America--the urban neighborhood. For centuries traditional urban design in America has helped create walkable communities and vibrant downtowns. ...Yet new development tends to take a different form--sprawl--and that’s where Fannie Mae’s role in the marketplace creates a problem. ...Fannie has strict underwriting guidelines, and property type is one of the conditions that determines whether a loan is ‘conforming’ or ‘non-conforming.’ These guidelines have an inherent bias favoring tract housing and other single-use projects. Their strict limits on a property’s non-residential revenues essentially exclude many of the mixed-use buildings that line some of the most popular streets in and around Chicago. To see the consequences, walk the streets of Chicago, Evanston or Oak Park to see the mix of activity all in the same building. This complexity concentrates economic and social opportunities ranging from affordable housing to local entrepreneurship. Fannie plays virtually no role in these types of neighborhoods.”
- “...Fannie is chartered and its debt is supported by the federal government. Urban taxpayers support Fannie Mae, yet it discriminates against urban development. Fannie should either play fair or lose its debt guarantee and state and local tax-exemption--benefits not enjoyed by private banks that compete for this business. Whether you want to live in a four-bedroom colonial in Barrington or a two-bedroom walk-up above a bookshop in South Shore is really not the government’s business. If Fannie Mae is actually in the American dream business, as it claims, it should treat all dreams equally.” (*Chicago Tribune*, David D. Hudson, 01/17/05)

Fannie Mae and Blackfeet Tribe reach agreement which will allow conventional lending on tribal lands

- Prospective homeowners on the Blackfeet Reservation will soon have conventional mortgage financing available for the first time on the tribal lands, thanks to an agreement with Fannie Mae. Leaders from the Reservation and Fannie Mae have spent two years ironing out language for foreclosure rules on mortgages secured by property on tribal trust land, making conventional lending possible. The new agreements protect Fannie Mae’s interests while respecting tribes’ sovereignty, said Philip Williams, managing director of Fannie Mae’s Western Regional Office. The Blackfeet Tribe partnership is one of 21 partnerships with tribes nationwide and the second in Montana. Previously, mortgage loans were limited to government programs, such as the U.S. Department of Agriculture Rural Development. (*Great Falls Tribune*, JoDee Black, 01/25/05)

Freddie Mac

2005's top priorities: "The Freddie Five"

- In a speech at the Smith Barney Citigroup Financial Services Conference, Freddie Mac's president and COO Eugene McQuade outlined his company's top five areas of primary focus for 2005. Freddie Mac's top priority is "to address legislative reform with the Administration and the Congress in a way that strengthens public confidence and promotes our housing mission," said McQuade. "The executive management team at Freddie has been actively focused on the effort to achieve GSE regulatory reform. This is a critical issue, and our Chairman, Dick Syron, has been devoting his time and effort accordingly. ...It's up to the policymakers, of course, to decide whether America wants to continue treating homeownership as a national priority. But if they do, we respectfully believe we are essential to what is the world's best housing finance system, and should be going forward. Most critically, we believe that any legislation should enhance the confidence of domestic and global financial markets in the GSEs. It ought to strengthen our regulator and promote our housing mission. And it should maintain our ability to innovate and serve emerging markets."
- "...The structure of the regulator is important. Wherever it is located, it must provide strong, independent oversight and be committed to housing. Strength and independence are key attributes to maintaining the confidence of the capital markets. As for capital, no one disputes the need to ensure safety and soundness. But it's very important that capital requirements be tied to risk, as the regulatory community is increasingly seeking to do with our global financial service counterparts through Basel II. Requiring us to hold capital beyond the risk of our business simply limits our ability to execute our housing mission."
- "Ultimately, we believe that any sound reform ought to reflect the unique status and role in the housing markets of the GSEs. We have special and growing mission obligations and special privileges to help us achieve them. It's the mix of those obligations and privileges that makes housing finance in the U.S. work, and the markets understand this. The key for us is that we continue to have access to these markets the way that we do now."
- "So these are three of the important elements to us: a strong regulator that values housing; capital requirements tied to risk; and provisions that maintain our GSE status and role. We welcome reform and intend to work constructively for it."
- Regarding the company's second priority of getting its financial statements current, McQuade said, "As critical as it is to achieve regulatory reform, it is equally critical that we regain the confidence of the financial community by getting our financial reporting current. Last week, we recommitted to our timetable for getting current and

delivering a non-GAAP supplemental measure. ...I can again confirm that our timetable for financial reporting has not changed. We continue to expect a release date for our 2004 financials toward the end of March. We will get back to quarterly reporting later in the year and be fully current with our full-year 2005 results. The same early '06 time frame is also when we expect to release our supplemental non-GAAP measures.”

- “[Freddie Mac’s third] ...key goal is to improve our execution of mission-related business. Dick Syron has made this a major priority since his first days at the company, and the entire senior management team is united in this effort. We’re going to work incredibly hard to meet our new HUD goals. They are very ambitious, particularly in the out years. But we will do everything possible to meet them, ...as we have in the past. ...Based upon our year-end estimates, we expect to report to HUD that we have met each of the affordable housing goals for 2004 – with the final determination being made after we submit full-year data to HUD.”
- “While the housing goals will be challenging going forward, I want to emphasize one thing. We do not view our mission goals as inevitably a drag on our business, but if we approach them properly, as an opportunity for our business. ...[W]hat is good for our mission really can be good for our business. ...In the years to come, nearly two-thirds of all household growth will come from minority and immigrant families – at the same time when the number of white first-time homebuyers actually declines. The upshot is clear: the emerging markets of today will be the surging markets of tomorrow. That means a major opportunity for our mission AND for our business. It’s our job to figure out how to serve these constituencies, manage and distribute credit risk – meeting both mission and return objectives safely and soundly. And that’s what we’re doing with a number of new products and outreach initiatives.”
- “[Freddie Mac’ fourth] ...priority ...from a business perspective has been to increase our focus on the customer. My banking experience taught me that if you really take care of your customers, then a lot of other good things will follow. In 2004, that’s exactly the kind of progress we made. As a result, we saw significant improvements in both market share and securities performance. [A]fter a period of relative stability, our [market] share took a sharp fall during our period of crisis in 2003. I’m pleased to say that last year – prior to Fannie’s problems – we reversed that fall and brought Freddie Mac back into a much more competitive position. I can also state that we expect some further gains in our market share in 2005. One of the issues we were experiencing with a lower market share was poor liquidity for our security. With better market share comes better securities performance... We ended the year with Gold PC prices improving by 5/32nds of a percentage point, which in this highly liquid market represents a major change in relative value. So, it now costs customers roughly the same to finance a Freddie or Fannie security. That’s significant progress, particularly considering the guarantee fee adjustments we’ve had to provide customers to make up the security price difference in the past.”

- “The last [priority] of the “Freddie Five” is better organizing our company. Going forward in 2005, we will continue to make significant changes in our organization and culture so as to achieve greater operational integration and efficiencies. First, we’re working to create a stronger operating company. That translates into streamlining a too-complex business model into one that’s easier for customers to deal with and makes us more nimble, more responsive and better able to bring new products and initiatives to market. We’re doing this by minimizing internal barriers and improving coordination along functional lines of business. ...Second, we’re moving from a decentralized – vertically integrated – model to a more centralized model. ...These changes will free up our key business people and let them focus on serving customers and generating revenue. Simply put, we want to let our business people do business, and let the infrastructure pros worry about the infrastructure. Third, we’re putting the right people in the right place at the right time. We’ve brought in a number of strong new senior people to help us in critical areas, [including Joe Smialowksi, the head of Freddie’s new combined Operations and Technology division; Jim Witkins, SVP of Technology and Chief Information Officer; and Tim McBride, Senior Vice President of Government Relations]. ...[W]e are integrating operations and platforms – all while reducing the cost and time of developing new ones. Finally, we’re working hard to maintain a strong control environment and risk management. We will continue to tighten our belt, bring more discipline to the budget process and reduce our use of external consultants.”
- “...Freddie Mac is definitely turning the corner. This is a company working from some traditional strengths and adding new ones: a strong balance sheet and capital position, low and rigorously managed levels of risk, market share and security performance on the upswing, and more customers coming our way. We’re doing more on mission. And we’re poised this year to resolve our two big overhanging issues – GSE legislation and our financial reporting. Going forward, we’ve got the right people working on our most critical challenges; the right people deepening the virtuous cycle with our customers; and the right plan to keep improving our operations and getting costs under control. Above all, we’re keeping our eye on the ball. Namely, working to house this country. Attending to the health of this franchise. And building lasting value for our shareholders that will hold up over the long term.” *(Prepared remarks of Eugene McQuade, president and COO of Freddie Mac, 01/26/05)*

Freddie Mac provides market update for 2004

- During Freddie Mac’s market update with analysts, chairman and CEO Richard Syron said, “It’s a new year and I’m happy to say we made substantial progress in 2004 to get the company back on track. We are on track to report 2004 results by the end of March.” Management expects the company to return to regular reporting of quarterly financial data in August.

- Freddie Mac's mortgage loan portfolio grew at an annualized rate of 7.2% in December, bringing growth for the year to 6.5%. The company's retained portfolio fell at an annualized rate of 6.1% in December, compared with a decline of 6.0% in November. For 2004, its retained portfolio grew 1.3% to \$653.64 billion, in line the company's most recent forecast for little if any growth for year. In 2003, Freddie's retained portfolio grew over 13% in 2003.
- Freddie Mac's commitments to purchase mortgage-related securities rose to \$17.1 billion in December, net of sales, while liquidations, in recent months ranging from \$14 billion to \$15 billion, will likely offset most of these purchases. Analysts don't expect to see any real growth in Freddie's investment portfolio until the second half of 2005, which will limit the company's ability to increase its earnings and its need to sell debt for new funding. Jim Vogel, senior vice president at FTN Financial Capital Markets, estimates Freddie's retained portfolio will fall by \$12 billion to \$18 billion during the first quarter. "If rates remain low and prepays continue, (the decline) could easily exceed \$20 billion," said Vogel.
- For 2004, Freddie Mac reported a duration gap of 0 months. Freddie predicted that its single-family credit losses and multi-family delinquencies and losses would increase in 2005 from the "very low levels" experienced in 2004, but remain low. Freddie Mac expects its administrative expenses to total \$1.5 billion in 2004, compared to \$1.3 billion in 2003. The company's objective is to keep administrative expenses "relatively flat" in 2005. (*Freddie Mac Supplement*, 01/18/05; *Bloomberg News*, James Tyson and Al Yoon, 01/18/05; *American Banker*, Jody Shenn, 01/19/05; *Dow Jones Newswire*, Allison Bisbey Colter, 01/25/05; *Reuters*, 01/18/05)

Freddie Mac announces the "Neighborhood Solutions" program for A- loans

- With downpayments as low as \$550, 45% debt-to-income ratios and other "very flexible" terms, Freddie Mac announced that its newly redesigned A-minus loan initiative, called the "Neighborhood Solutions" program, will be launched in February. Freddie Mac's director of housing supply Tim Hathaway said that it is his job to move the A- loan initiatives "to scale" and make certain that lenders have "specialized mortgage products aimed at credit-quality-challenged homebuyers." (*National Mortgage News*, 01/24/05)

Freddie Mac names Robin Grieves head of market risk oversight

- Freddie Mac has named Robin Grieves, a former director in its financial-research division, to head its market risk oversight department. Grieves, 57, will be responsible for measuring interest-rate risk; creating and enhancing risk-management reporting and management controls; monitoring compliance with internal risk-management policies; and for external legal and regulatory requirements. He will

report to David Andrukonis, chief enterprise risk officer. Most recently, Grieves taught fixed income, global portfolio management and financial engineering at Thunderbird, The Garvin School of International Management in Arizona. He also worked for investment-banking firms HSBC Securities and Salomon Brothers, and for Freddie Mac from 1987 to 1992, developing mortgage-pricing models. (*Freddie Mac Press Release*, 01/18/05; *Dow Jones Newswires*, 01/24/05; *Bloomberg News*, 01/24/05)

Federal Home Loan Banks

Federal Housing Finance Board is assessing the risk of the FHLBs mortgage programs

- In an interview with *National Mortgage News*, Finance Board chairman Ronald Rosenfeld said he is working with the agency's supervisory staff to analyze the risks and rewards of the FHLB-Chicago's Mortgage Partnership Finance program and the FHLB-Seattle's Mortgage Purchase Program. "Given our purpose of regulating for safety and soundness, it is implicit that you consider risk," said Rosenfeld. "If we find that these assets create an overwhelming problem, then we have to do something about it. On the other hand, they may be very attractive." (*National Mortgage News*, 01/17/05)

FHLB-New York announces 3.05% dividend for 4th quarter

- The FHLB-New York's board of directors has approved a dividend rate of 3.05% annualized for the fourth quarter of 2004, payable to member financial institutions on Jan. 31, 2005. "The fourth quarter dividend represents a payout of 66% of core earnings for the quarter," said Alfred DelliBovi, president of the FHLB-New York. "Retained earnings after the dividend payment are approximately \$196.5 million, which meets the optimum level of retained earnings as of year-end. Our success in rebuilding retained earnings reflects the Bank's low-risk profile and conservative financial management practices. With adequate retained earnings now accumulated, we anticipate paying out higher dividends the remainder of 2005." The FHLB-New York paid a dividend of 2.22% annualized for the third quarter of 2004. (*Dow Jones Newswires*, John Connor, 01/21/05)

FHLB-Indianapolis elects new chairman and three new board members

- Paul Clabuesch, Chairman, President and CEO of Thumb National Bank in Pigeon, MI, was elected chairman of the board of directors of FHLB-Indianapolis, replacing William White, Chairman, President and CEO of Dearborn Federal Savings, whose

term expired at the end of 2004. Three new directors were elected to the board to serve three-year terms, including Ray D. Tooker, Senior Vice President, Loan Administration at Macatawa Bank in Holland, MI; Timothy R. Gaylord, President and CEO of Mason State Bank in Mason, MI; and Michael H. Price, President and CEO of Mercantile Bank of West Michigan in Grand Rapids, MI. Charles Crow, Chairman, President and CEO of Community Bank, Noblesville, IN, will serve another term on the board as Vice Chairman. (*FHLB-Indianapolis Press Release, 01/21/05*)

FHLB-Chicago announces its 2005 board changes

- The FHLB-Chicago announced that James K. Caldwell has been elected Vice Chairman and Gerald Levy is newly elected to the board of directors for 2005. Caldwell, the President and CEO, The First Citizens State Bank of Whitewater, Whitewater, WI, will serve the remainder of a two-year term begun last January by Richard W. Graber. Levy, the Chairman of the Board, Guaranty Bank, Milwaukee, WI, replaces H. Lee Swanson, State Bank of Cross Plains, whose term expired on December 31, 2004. Also re-elected to the FHLB-Chicago board is P. David Kuhl, Chairman of the Board and CEO, Busey Bank, Urbana, IL, and Kathleen E. Marinangel, CEO, President and Chairman of the Board, McHenry Savings Bank, McHenry, IL.
- The FHLB-Chicago's board appointed Thomas L. Herlache, President, CEO and Chairman of the Board, Baylake Bank, Sturgeon Bay, WI to serve the remaining year of the three-year term begun by Jack C. Rusch, First Federal Capital Bank, La Crosse, WI. Rusch left the Board last fall when First Federal was acquired by Associated Bank.
- Scott K. Heitmann, Vice Chairman, LaSalle Bank N.A., Chicago, Ill., who recently announced he will retire from his positions at LaSalle Bank and its parent ABN AMRO, effective April 1, 2005, will leave the FHLB-Chicago board in the coming months. Heitmann has served on the board since August, 2000. Upon his retirement, the Board will select a replacement director from Illinois. (*FHLB-Chicago Press Release, 01/27/05*)

FHLB-Chicago awards \$15.7 million in affordable housing project awards

- In the second of its two funding rounds for 2004, the FHLB-Chicago awarded \$15.7 million to assist 52 affordable housing projects, primarily in Illinois and Wisconsin. Combined with the first round funding, the FHLB-Chicago contributed a record \$42.8 million of grants during 2004 to assist in the development of affordable housing units and provide downpayment and closing cost assistance to eligible homebuyers. "During each of our two competitive application rounds for AHP funding, we identify and support projects that provide affordable housing for a variety of low- and moderate-income families and individuals in our district of Illinois and Wisconsin,"

said Eldridge Edgecombe, Senior Vice President and Community Investment Officer at the FHLB-Chicago. “We are especially pleased that more than half of the housing units created or rehabilitated through the projects we are funding will be financially accessible to families who often have the most difficult time finding decent, affordable housing – families who earn less than half of their area median income.” (FHLB-Chicago Press Release, 01/26/05)

Farm Credit System / Farmer Mac

Former FCA chairman Reyna recommends that the Farm Credit System be included in GSE regulatory reform

- In interviews with the *American Banker* and *Bankers News*, former Farm Credit Administration chairman Mike Reyna suggested that the FCA should be included in the regulatory reform legislation for GSEs. By having all GSEs, including FCA, under a new regulator would reduce the likelihood that any GSE could “capture” its regulator, said Reyna. Similar to Fannie Mae and Freddie Mac, taxpayers are “on the hook” he said, if FCA experiences any financial difficulties, which in fact occurred in 1987 when Congress provided the enterprise a \$4 billion line of credit from the U.S. Treasury. Reyna said, “To be intellectually consistent, if you were starting from ground zero designing a regulatory scheme for the GSEs, you would not leave out Farmer Mac or the Farm Credit System.”
- In an interview with *Bankers News*, Reyna pointed out that the FCS is evolving along two lines with one segment of the FCS containing institutions embracing their cooperative roots, and a second segment of FCS institutions “pay[ing] lip service to and minimally embrac[ing] their cooperative roots.” Reyna added, “There has been a longstanding debate about the scope and eligibility of lending that can and should be done by the FCS. This debate comes from the fact that the Farm Credit Act is woefully outdated and somewhat ambiguous.” Reyna asked, “Does Congress want the FCS to be a full-service lender and financial services provider to agriculture and rural America or, as a GSE, should the FCS . . . more closely target [its] government support to those who need it most?”
- In *Farm Credit Watch*, Bert Ely points out that FCS banks and associations are not keen about merging the FCA into a new GSE regulator because “the FCS knows that a new regulator would not be as responsive to their parochial desires as the FCA traditionally has been.” Ely adds, “[*Farm Credit Watch*] knows what Congress should do -- sharply rein in the FCS until it is privatized. (*American Banker*, Ben Jackson, 12/29/05; *Farm Credit Watch*, Bert Ely, January 2005)

- In a speech at the Farm Credit Annual Meeting, FCA chairman Nancy C. Pellett said, “The Farm Credit System and its institutions are safe and sound [in all material respects] and are effectively working towards accomplishing their public policy mission. ...From a financial and asset quality perspective, the institutions of the [FCS] have probably never been in better shape than they are today. System capital is at the highest level it has ever been, and credit quality is similarly sound, reflecting the improved financial condition of borrowers and a positive agricultural economic environment. ...[I]nstitutions continue to make significant positive efforts in serving the credit and related services needs of our young, beginning, and small farmers.”
- “[Y]ou have more clearly defined your goals for these important programs and have improved your ability to monitor and report on whether your goals are being achieved. ...[E]xaminers are reporting a consistent good-faith effort by institutions to ensure these programs meet the special credit needs of these borrowers.
- “A third area our examiners are reporting on is continued improvement in all aspects of management at System institutions. Board governance and transparency of your operations must remain a high priority for the future. ...However, political and public pressure in this area is certain to increase due to accounting irregularities found at other Government-sponsored enterprises (GSEs).”
- “As you know, the FCA Board recently proposed a rule on governance. It is currently under Congressional review but should be published in the Federal Register soon. ...At a time of mounting criticism and skepticism about GSEs, and governance in general, I believe it is important to have a regulatory framework in place that assures the public, stockholders, and investors that the System is properly governed by a set of consistent standards.”
- “I have ...learned a lot from the recent termination experience [Rabobank/FCS of America]. ...From a regulatory perspective, we identified the need to address several aspects of our termination regulations and we will do so shortly.”
- “...I realize that you have reversed a significant amount from your loan loss allowance accounts at yearend, enhancing even further the capital levels of most institutions...”
- Commenting on her goals for FCA, Pellett said, “First, I am committed to improving communication internally as well as externally with all interested parties but in particular with the System. ...When it comes to regulations, ...we will make every attempt to not surprise you. While we may not always agree on every issue, we will make you fully aware of our intentions and we will provide you ample opportunity to weigh in on the regulatory matters we bring forth. ...[W]here appropriate, we will eliminate or revise those regulations that unnecessarily impair your ability to

accomplish the mission for which you were created. I am committed to following President Bush's agenda of reducing the regulatory burden on those whom we regulate. But please remember that we are the arm's length safety and soundness regulator of the System..."

- "...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. Your statute has not received a general update since 1971. As a result, it does not address the needs of rural America today, nor does it accommodate many of the market conditions and economic forces that exist today..."
- "My second goal is a commitment to ensure that FCA accomplishes its mission more effectively. I have initiated several internal projects that are intended to streamline FCA operations, make us more responsive to your needs, and better manage the cost of our operation to the System. ...Our work in this area supports President Bush's initiatives to achieve greater efficiency and effectiveness within the government..."
- "...Overall, I believe you are at a crossroads in deciding what kind of a GSE you will be. And we in turn are deciding how best to structure ourselves as your regulator. As we progress through our studies and address the issues before us over the next few years we will all be working very hard to better ourselves..."
- "...The last goal I want to talk about involves creating opportunities for you 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. In my opinion, supporting rural communities is vital to the success of agriculture and to those who engage in it. While there are only about 2 million farmers and ranchers nationwide, there are about 65 million people living in rural America. ...So, to better support agriculture, I think you should focus on, and fund or invest in, activities that benefit rural America. ...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."
- "...Just last week we issued an Informational Memorandum that provides you with additional guidance on the development of pilot investment programs that could be used to meet the varying needs of agriculture and rural areas. The Memorandum includes specific guidance on what factors we will consider when we evaluate your requests to approve pilot investment programs. It also includes examples of programs that you might consider to help agriculture and rural communities meet their ongoing debt and equity financing needs. ...If my message strikes a chord of innovation in your mind about how you might reach 65 million rural Americans, how you might improve the well-being of 65 million rural Americans, or how you might become a GSE that rewrites the landscape of rural America....then come talk to me and my staff and we will do what we can to help you achieve such a vision." (*Remarks by the Honorable Nancy C. Pellett at the Farm Credit Council Annual Meeting, 01/17/05*)

FCSA launches “patronage refund”

- FCS of America (FCSA) has launched a “patronage refund” or dividend program for its members for 2004 and 2005, which will provide partial refunds of interest paid on FCSA loans. The promise of instituting patronage dividends was used to build opposition to the Rabobank acquisition, in lieu of a Rabobank’s liquidating dividend. FCSA’s 2004 dividend is \$52 million, equal to 0.75% of an eligible customer’s 2004 annual average loan and lease balances. Bert Ely writes in *Farm Credit Watch*, “How long FCSA’s patronage refunds continue at that level cannot be predicted, but this action could lead to a substantial increase throughout the FCS of patronage dividends paid in cash. That, in turn, could lead to an unhealthy decapitalization of the FCS. Congress should take note.” (*Farm Credit Watch*, Bert Ely, January 2005)

The Privatized GSE -- Sallie Mae

Sallie Mae 4th quarter results

- Sallie Mae’s fourth quarter profit more than doubled, as loan originations by the company and affiliated brands increased 18% for the full year. Sallie Mae reported net income of \$650 million or \$1.40 per share versus \$264 million or \$0.54 per share a year earlier. The spread the company earns on its loans, net of interest expense on borrowings, came under pressure, due in part to Sallie Mae’s payoff of its GSE debt and an increase in its lower yielding consolidation loans. The company’s “core cash earnings” fell 37% to \$180.4 million or \$0.39 per share from \$284.7 million or \$0.59 per share. The termination of Sallie Mae’s government-sponsored debt reduced “core cash earnings” by \$0.17 per share and accounting rule changes related to contingently convertible bonds lowered those earnings by \$0.02 a share. Excluding these items, “core cash earnings” would have been \$256 million or \$0.58 per share. The company’s return on assets increased to 3.52% from 1.86% a year earlier, while its net interest income increased 14% to \$332 million.
- In a teleconference with analysts, Sallie Mae CEO Albert L. Lord said, ““In the waning days of ‘04, the U.S. Treasury gave Sallie Mae its walking papers -- you might call it an honorable discharge, [or] as I would characterize it better, as graduating from our GSE status, with honors, cum laude. We are a fully private company. We are proud of that. It feels very good. It’s been a long road.” Sallie Mae officials said they were particularly pleased with 2004’s strong results, which come at a time when students were consolidating their loans at historically low fixed rates and the company was completing its shift to higher-cost private borrowing. Officials noted that the company’s originations of both guaranteed student loans and private education loans were growing strongly, and diversification had added revenue. (*Dow Jones Newswires*, Christine Richard, 01/19/05; *Washington Post*,

Albert B. Crenshaw, 01/20/05; *Dow Jones Newswires*, Yolanda E. McBride, 01/19/05; *Associated Press*, 01/19/05)

- Sallie Mae continues its effort to expand its loan origination activities, by courting Pennsylvania lawmakers directly with their \$1 billion offer to acquire the state's not-for-profit student aid agency, Pennsylvania Higher Education Assistance Agency (PHEA), which provides "cut rate" college loans and grants to students in the state. Representative John Perzel (R), the state house speaker, along with several other lawmakers, met informally with several Sallie Mae officials in recent days, said Perzel's spokeswoman Beth Williams. Sallie Mae CEO Albert Lord met with Appropriations chairman Brett Feese (R) to discuss his company's offer for PHEA. To date, no appropriations hearings have been scheduled on the issue, said the panel's policy director AL Bowman. (*Pittsburg Tribune Review*, Thomas Olson, 01/25/05)

Postal Service

Stars in alignment for postal reform?

- The *E-NAPUS* Newsletter wrote, "[T]he USPS Board of Governors selected James C. Miller III as its new chairman. ...The selection of Jim Miller places at the helm of the USPS an influential conservative economist with strong ties to President Bush and the Republican Party. ...[T]he change in the Board's leadership and composition places almost every star in alignment for postal reform. All the major institutional players are reading from the same playbook. The same political party controls the White House, the House of Representatives, the Senate, and the USPS. That does not mean, however, that they will agree on every detail in postal reform. ...A decade ago, Chairman Miller expressed strong support for privatizing the USPS, and repealing its monopoly. However, his statements as a Governor have not reflected his past views. At his April 2003 Senate confirmation hearing, James Miller testified that he intended to take a "fresh assessment" of the USPS. ...As has happened in the past, familiarity with the institution and the extraordinary service it provides yields immeasurable dividends. (*E-NAPUS Legislative Newsletter*, January 14, 2005)

USPS rumored to be filing a 6% average postal rate increase this spring

- According to the Association for Postal Commerce, "the rumor at a recent mailers meeting was that the Postmaster General now was of the mind that the USPS is looking at filing a 6% average postal rate increase request with the Postal Rate Commission some time in March. This includes whatever the USPS would need to cover the expenses associated with a FY2006 escrow imposition." (*Association for Postal Commerce*, 01/25/05)

USPS reports net income of \$59.7 million for November

- In the month of November, the Postal Service reported a net income of \$59.7 million from total revenues of \$6.02 billion. Total revenues were up 12.3% and total expenses increased by 5.8%, relative to November of last year. (*USPS.com*, 01/19/05)

GAO assesses the USPS's service transformation and long-term outlook

- In its January 2005 analysis of the Postal Service's transformation efforts and long-term outlook, GAO wrote, "The Postal Service's financial viability is at risk because its business model—which relies on mail volume growth to mitigate rate increases and cover its costs—is not sustainable in an increasingly competitive environment, given new and emerging technologies. Financial, operational, governance, and human capital challenges threaten the Service's ability to remain self-supporting while providing affordable, high-quality, and universal postal service. Key trends that demonstrate the need for reform include declining mail volume, particularly for First-Class Mail; changes in the mail mix from high-margin to lower-margin products; changing demographics of the aging postal workforce; growing competition from private delivery companies; and projected revenue declines while expenses increase. The Service continues to face challenges in addressing its large financial liabilities and obligations (e.g., retiree health obligations), as well as in restructuring its infrastructure and workforce to become more efficient and performance based."
- "The Service has recently cut costs and improved productivity, but it is not clear how the Service will realign its outdated infrastructure and modernize its workforce policies and practices to achieve additional long-term productivity gains. The Service has stated that it is using an evolutionary approach to transform its infrastructure and workforce. However, little information is available about its plans for this important effort. Many questions remain as to whether such an incremental approach will be sufficiently comprehensive, integrated, and responsive to the increasing pace of change in technology and competition affecting the Service's core business. ...[T]he Service risks falling short of achieving the major productivity gains needed to offset rising costs and maintain quality service and affordable rates. Further, the Congress has not yet enacted comprehensive postal reform legislation that addresses the Service's key structural and systemic deficiencies, including its unfunded obligation for retiree health benefits and the escrow requirement. Without such action, the accessibility and affordability of postal services to the American people is at risk, which could result in dramatic increases in postal rates or a costly taxpayer bailout." (*High Risk Series: An Update*, GAO, January 2005)

- In an issue brief for Congress on postal reform, the Congressional Research Service wrote, “Although its short-term financial prospects have unexpectedly brightened by discovery that retirement obligations are less burdensome than presumed, the U.S. Postal Service (USPS) faces severe financial straits in the long term. Business use of the mails is declining as alternatives such as e-mail, faxes, and cell phones substitute for hard copy letters. The economic slowdown that began in 2001 has cut into advertising mail. On top of this, the anthrax attack of October 2001 has affected volume and added billions in costs for mail sanitization. Despite three rate increases in 18 months, USPS lost well over \$2 billion in FY2001 and FY2002, and built up a \$11.9 billion debt to the Treasury. It has a negative net worth and mounting obligations for retiree health benefits. USPS would be bankrupt but for the fact that it is a government entity, with Treasury borrowing rights.”
- “USPS, its board of governors, GAO, mailers’ organizations, and most recently a presidential blue-ribbon commission have said that the Postal Reorganization Act of 1970 no longer provides a viable business model. It is dependent on rising mail volume to cover the ever-increasing cost of arbitrated labor settlements, legislated benefits, and the addition of 1.7 million new delivery points each year, yet volume has begun to fall. The rate setting process is cumbersome and tendentious.”
- “At congressional request, USPS developed a “Transformation Plan” that briefly considered, and rejected, the alternatives of privatization and a return to regular agency status with appropriations to cover the costs of universal service. Instead, it asked Congress for authority to change rates more flexibly, close post offices and processing centers, and negotiate tailored service agreements and volume discounts for big mailers. Most postal stakeholders think that the USPS monopoly lines — first class, periodical, and advertising mail — are a declining business, and want USPS to compete in other markets that are growing. Competitors in those markets resist because USPS pays no taxes and is immune from most government regulation. USPS has had little success to date in developing commercially competitive products.”
- “Passage of P.L. 108-18, the Postal Civil Service Retirement System Funding Reform Act of 2003, enabled USPS to pay down its debt by about \$3 billion per year, and defer further rate increases to 2006. However, Congress recognized that two of its provisions must be revisited. One requires USPS to set aside future pension savings in an escrow fund; that will require a 5.4% increase in postal rates with no operational benefit. The other transferred the obligation to pay pension benefits for military service from the Treasury to USPS, costing ratepayers \$27 billion.”
- “On July 31, 2003, a blue-ribbon commission appointed by President Bush issued a report recommending changes consistent with reform legislation that has been brewing for years and with the transformation plan, but also including controversial workforce changes. H.R. 4341, a comprehensive bipartisan postal reform bill, has been reported by the House Committee on Government Reform, and a similar bi-

partisan bill, S. 2468, was marked up and reported by the Senate Governmental Affairs Committee on June 2. Both bills draw more on previous postal reform efforts in Congress than on the recommendations of the President's Commission. Both would relieve USPS of the military pension and escrow requirements, but this would add to the budget deficit and is opposed by the Administration. The most sweeping postal reform legislation in 30 years was reported unanimously by the House Government Reform Committee on May 12, 2004, and by the Senate Governmental Affairs Committee on June 2. Despite support from mailers, unions, and even USPS competitors like FedEx and United Parcel Service (UPS), neither bill has been scheduled for floor action in the 108th Congress."

- "Stakeholders have advanced several reasons why H.R. 4341 and S. 2468 have failed to move. The end-of-session preoccupation with appropriations measures and intelligence reorganization is one cause. Another is that short-term financial performance has improved. Last year's enactment of the Postal Civil Service Retirement System Funding Reform Act of 2003, P.L. 108-18, allowed USPS to reduce its annual payments to the Civil Service Retirement Fund by \$3.5 billion in fiscal year (FY) 2003, and \$2.6 billion in FY2004."
- "The savings, a June 2002 rate increase, and elimination of 70,000 jobs since mid-2001 allowed USPS to finish FY2003 and FY2004 in the black, and to nearly eliminate its \$11.9 billion debt to the Treasury. But the act also imposed new costs on USPS for military retirement and building an escrow fund that could not be used for operations, and the Postmaster General said in September that mailers could expect a new rate case to be filed that would raise postal rates by double digit percentage points early in 2005. Both reform measures would remove those obligations. Because there would be a cost to the unified federal budget from removing the requirements, the Administration has opposed doing so, and by some accounts questioned whether the reforms in H.R. 4341 and S. 2468 are significant enough to justify a budget cost from reduced postage collections."
- "As a result, some mailers groups are urging a short-term fix for the escrow and military retirement problems, most likely through a rider to an appropriations measure after the election, and revisiting broader postal reform in the 109th Congress." (Congressional Research Service, *CRS Issue Brief for Congress: Postal Reform*, 11/01/04)

<p>Bush administration sends Congress the nominations for the Board of Governors of USPS and Postal Rate Commission</p>

- The White House has sent to the Senate the nominations of Carolyn L. Gallagher of Texas to be a Governor of the United States Postal Service for a term expiring December 8, 2009; Louis J. Giuliano, of New York, to be a Governor of the United States Postal Service for a term expiring December 8, 2005; and Tony Hammond, of Virginia, to be a Commissioner of the Postal Rate Commission for a term expiring

October 14, 2010 (Reappointment). One open seat still remains for a Democratic nominee to the Board of Governors. (*Alliance for Nonprofit Mailers*, 01/25/05)

TVA

TVA appoints new president and COO

- The Tennessee Valley Authority appointed Tom Kilgore as its new president and chief operating officer. Kilgore, the chief executive of Progress Ventures Inc. in Raleigh, NC, will succeed the retiring O.J. “Ike” Zeringue in the top staff position at TVA, effective March 3. Kilgore will be paid an annual salary of \$140,000, plus bonuses and deferred compensation, said TVA spokesman John Moulton. “How could I not be interested in this job?” Kilgore said. “TVA is a great organization. After working in a variety of utility jobs across the South, this is like coming home.”
- Kilgore, 56, started his career performing power tests at TVA’s Widows Creek plant in North Alabama. He served as director of fossil and hydro operations for Arkansas Power and Light, chief executive of Oglethorpe Power Corp. in Atlanta and senior vice president of power operations for Progress Energy, formerly Carolina Power and Light in North Carolina. TVA Chairman Glenn McCullough, Jr. said Kilgore brings “more than 25 years of industry experience to TVA and a proven track record achieving a wide breadth of success in the energy sector.” Kilgore was chosen from among candidates recommended by a national executive search firm hired by TVA last May. During the executive search, Congress approved a reform plan pushed by Senate Majority Leader Bill Frist (R-TN) in December, to replace TVA’s three-member, full-time management board with a nine-member, part-time, policy-making board. The new board will hire a chief executive to run TVA.
- Zeringue has served as president and chief operating officer of TVA since 1998 and is the highest paid federal employee with an annual compensation package of \$1.5 million. Zeringue plans to remain at TVA through majority of this year to help in the leadership transition. (*Chattanooga Times Free Press*, Dave Flessner, 01/26/05)

Auditors urge TVA to write-off \$5.3 million of bad loans

- The TVA inspector general wants the TVA to write off approximately \$5.3 million in bad business loans and improve the management of its \$65 million portfolio of economic development lending. In the September 27 IG’s report, the auditors found numerous problems with TVA’s “managerial follow-through” on loans made to “promote economic expansion, encourage job creation and foster the increased sale of electricity.” The auditors found the TVA failed to “verify personal financial

information on loans where personal guaranties (such as assets and income) were required.” In addition, “The agency made no attempt to update applicants’ financial information before closing a loan,” said the auditors. TVA also failed to secure tax information to support applicants’ financial claims or require annual financial statements to ensure “on an ongoing basis if the company can continue to meet its financial obligations.” The auditors’ sampling of 190 loans outstanding on Jan. 21, 2004, found 17 potentially uncollectible. Three loans totaling \$829,644 were immediately written off. Three other loans with balances of \$842,951 may yield at least partial repayment, said the IG report. The remaining 11 loans worth nearly \$5.3 million were “likely losers and headed for default,” said the auditors, recommending they be written off as well. “The primary reasons for loan defaults were undercapitalization, inability to obtain sufficient market share and-or fraudulent actions by the business owners,” said the IG.

- TVA’s economic development program “concur with the findings,” said John Bradley, senior vice president for economic development. “Process improvements in each area are either already completed or well underway,” he added. The TVA has yet to write off the remaining 11 loans. TVA spokesman John Moulton said, “We still want to exhaust all means of collecting them before we write them off,” but refused to comment on whether legal action is contemplated. Since 1995, Moulton said TVA has loaned more than \$172 million and leveraged an additional \$3.2 billion in investment capital. TVA claims a role in creating more than 50,000 jobs in its seven-state region in fiscal 2004 alone.
- “If it were a bank, these levels of loss would be unacceptable,” said Harold Black, a former bank regulator, who teaches finance and banking at the University of Tennessee. “TVA is not a bank and as such the controls they have in place and also the standards by which they make loans could be quite different than those for banks,” he said. Black said that TVA’s economic development loan program was begun in the 1980s to target job creation in “the region’s poorest, least developed rural areas” and minority-owned businesses. “The program is intended to improve lending opportunities for businesses that are traditionally underserved,” Black said. “And there is a reason why many of them are underserved - they are less credit worthy, more risky than loans that banks traditionally make.” (*Associated Press*, Duncan Mansfield, 01/21/05)

Environmental and American Indian groups appeal to TVA to protect its public lands
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- Environmental and American Indian groups have appealed to TVA to protect its public lands, including sites in Marion, Rhea, and Meigs counties proposed for residential and resort developments. Last month, the Tennessee Commission on Indian Affairs unanimously adopted a resolution against a proposal from developer John “Thunder” Thornton to swap 832 acres of land in Marion County for 637 acres around the Little Cedar Mount on Mickajack Lake. “The land we are giving to TVA is more archaeologically significant than what we want to purchase,” said Thornton.

“We certainly want to be environmentally and archaeologically sensitive. We think we can do that and use a small piece of the public lands in Marion County to help bring a major new development into a relatively poor county.”

- The Tennessee Wildlife Resources Commission (TWRC) expressed concern that TVA sales of public shoreline to residential and resort developers could harm wildlife along the Tennessee River. TWRC, which oversees the Tennessee Wildlife Resources Agency, unanimously approved a resolution saying it “strongly objects to the proposed transfer-sale of TVA public lands, pending a thorough review and consideration of the comprehensive impact of such transfer-sale to wildlife resources.” The resolution also said that moving forward with planned land sales, swaps or giveaways could “result in permanent damage to our wildlife resources.” Legally, TWRC has no say in what TVA does with its property, but commissioner George Akans of Knoxville said it was important for the commission to take a stand.
- TVA directors said they are trying to balance the competing interests for development and conservation in the Tennessee Valley and have made no decisions to sell off more public lands. The public utility, which controls about 230,000 shoreline acres along the 652-mile Tennessee River system, is considering golf courses and residential developments proposed at Watts Bar Lake south of Knoxville and Nickajack Lake south of Chattanooga. (*Dow Jones Newswire*, 01/24/05; *Chattanooga Times Free Press*, Dave Flessner, 01/19/05)

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