

The **GSE** REPORT™

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Major Events

St. Louis Federal Reserve President Poole warns that a GSE crisis could cause
“Tsunami-like” impact on financial markets

Three Federal Reserve studies question the GSEs’ benefits and subsidies

- In a speech before the St. Louis Society of Financial Analysts, St. Louis Federal Reserve President William Poole said, “Almost two years ago, ...I argued that Government Sponsored Enterprises (GSEs) specializing in the mortgage market, especially Fannie Mae and Freddie Mac, exposed the U.S. economy to substantial risk, primarily because their capital positions are thin relative to the risks these firms assume. ...An understanding of the risks facing Fannie Mae and Freddie Mac... is important from two perspectives. First ...although many investors assume that [the GSEs’] obligations are effectively guaranteed by the U.S. Government, the fact is that the guarantee is implicit only. I will not attempt to forecast what would happen should either firm face a solvency crisis, because I just do not know. What I do know is that the issue is a political one, and political winds change in unpredictable ways. A second reason... is that sound public policy decisions depend on such understanding. To reduce the potential for a financial crisis, risks need to be mitigated.”
- “Fannie Mae and Freddie Mac face ... six risks ...: credit risk; prepayment risk; interest-rate risk from mismatched duration of assets and liabilities; liquidity risk; operational risk; and political risk.
- “...Even though default rates on mortgages in the United States are low, in recent years less than one percent, they are not zero, and vary considerably across regions. ...In assessing credit risk, it is important not to focus just on national average conditions. For example, although average house prices in the United States have not declined year to year since the Great Depression..., prices have declined in particular significant markets. Some examples would be Boston 1989-92, Los Angeles 1991-96, San Francisco 1991-95, and Texas 1987-88. More formally, the dispersion of changes in house prices and not just the national average is relevant for judging mortgage default risk. ...Therefore, to determine the capital a firm needs to hold against credit risk requires not only analysis of the geographical diversification in the portfolio but also an analysis of risks and likely losses given foreclosure in various housing markets.”
- “Fannie Mae and Freddie Mac issue mortgage-backed securities against pools of conforming mortgages... All such mortgages have no prepayment penalties, and are therefore subject to prepayment risk. ...When Fannie and Freddie issue mortgage-backed securities to be held by the investing public, buyers of the bonds assume the

prepayment risk. Fannie and Freddie service the MBSs and guarantee them, thus assuming the credit risk. However, for many years [the GSEs] have been accumulating a portfolio of their own MBSs and directly owned individual mortgages. For the two firms together, these portfolios are very large, amounting to over \$1.5 trillion at the end of 2003. Thus, [the GSEs] assume prepayment risk by holding these assets. ...In practice, Fannie and Freddie make limited use of long-term callable bonds [to offset prepayment risk]...They issue non-callable long-term bonds and a significant amount of short-term debt. Doing so exposes [the GSEs] to prepayment risk and interest-rate risk from a mismatch of duration of assets and liabilities. They then use various devices to manage the risks created. ...The GSEs... have the benefit of the implied federal guarantee, which makes their financial engineering profitable. Because of the implied guarantee, [the GSEs] can operate with a small capital position and issue their own obligations at rates that are little above those paid by the U.S. Treasury. The spread over Treasuries is smaller at the short end of the maturity structure than at the long end, which is why [the GSEs] issue large amounts of short-term debt. This financial engineering has little to do with the mortgage market, except that [the GSEs] are authorized to hold mortgages rather than corporate bonds in their portfolio.”

- “Fannie and Freddie create interest rate risk for themselves by financing their portfolio through a mixture of long-term non-callable bonds and short-term obligations. Both firms have obligations due within one year in the neighborhood of 50 percent of total liabilities. Having created prepayment and interest-rate risk by not matching the characteristics of their obligations to the characteristics of their mortgage assets, [the GSEs] must then pursue sophisticated hedging strategies. ...Like many large financial firms, Fannie Mae and Freddie Mac employ a strategy of imperfect dynamic hedging, which involves three steps:
 - Maintain very complete hedges against the likely, near-term, interest rate shocks;
 - Use less complete hedges, or even choose not to hedge, longer-term and less likely rate shocks; and
 - Implement additional hedges as interest rates change, and the unlikely becomes more likely.
- “The term ‘dynamic hedge’ refers to a strategy that involves continuous rebalancing of the firm’s portfolio in an attempt to maintain acceptable risk exposures. The advantage of using derivatives and imperfect dynamic hedging to manage interest-rate risk is that these strategies are less costly than the perfect hedge and perform equally well when the interest rate volatility is moderate. The disadvantage is that potential losses associated with the unlikely risks can be very large. Because of imperfect dynamic hedging, [the GSEs] may suffer a significant loss whenever there are unexpected and large interest rate movements in either direction. Formal models of dynamic hedging assume price continuity and do not work well when prices jump discretely by large amounts. Fannie Mae and Freddie Mac are exposed to the counterparty default risk in their derivative contracts. The counterparty default risk

per se may be small because both firms require all counterparties to post collateral on a weekly basis. However, at a time of disrupted financial markets, it would be very costly to replace the swap positions of a defaulting counterparty because the other counterparties are likely to have similar problems. “

- “The fact that hedging is incomplete raises warning flags. The reason is that standard hedging strategies rely on the assumption that changes in securities prices follow a normal distribution—the familiar bell-shaped curve. ...To judge risk, we start by computing the standard deviation from a long history of price changes in some particular market. ...What we in fact observe are ‘fat tails,’ by which we mean that there are many more large price changes—changes out in the tails of the distribution—than expected with a normal distribution of the calculated standard deviation. Failure to take adequate account of fat tails is responsible for many failures of financial firms over the years, such as the 1998 failure of Long Term Capital Management.”
- “A key security in the context of the mortgage market is the 10-year on-the-run Treasury bond. Long-term mortgages are priced off the 10-year Treasury and Treasury bonds themselves, because they are traded in a highly liquid market, are employed extensively in hedging strategies. [A chart] of price changes for the [10-year] Treasury bond for about 25 years ...shows that there are 16 times more price changes in excess of 3.5 standard deviations than expected with the normal distribution. The normal distribution provides a grossly misleading picture of the risk of large price changes. Really large changes of 4.5 or more standard deviations—the ones that can break a highly leveraged company—occur only 7 times in a million under the normal distribution, but there are 11 such changes in the 6573 daily observations in the chart.”
- “...Large changes tend to cluster together. ...Clustering is important because a firm may be rocked several times in quick succession by large, unanticipated price changes. Incomplete hedges against large price changes expose a firm to cascading failure.”
- “In my speech... almost two years ago, I emphasized the risk of systemic, world-wide financial crisis should either Fannie Mae or Freddie Mac become insolvent. The argument was the same as that stated ...by Richard Posner in his recent *Wall Street Journal* op-ed article on the Indian Ocean tsunami. Posner writes, ‘The Indian Ocean tsunami illustrates a type of disaster to which policy makers pay too little attention—a disaster that has a very low or unknown probability of occurring, but if it does occur creates enormous losses. ... The fact that a catastrophe is very unlikely to occur is not a rational justification for ignoring the risk of its occurrence.’ ...In the case of the risk of financial crisis, the key policy intervention is to reduce the probability of the event, by such methods as increasing the amount of capital firms hold.”
- “I am also arguing that the risk of financial problems at Fannie Mae and/or Freddie Mac are not as remote as it might seem, because of the fat tails of the distribution of

price changes in asset markets. These two observations—enormous potential costs and a probability of failure higher than commonly realized—imply that the risks of very large events must be identified and carefully analyzed through extensive ‘stress testing.’ Then, adequate controls must be instituted to mitigate the identified risks. ...By this criterion, incomplete hedging of longer-term and less likely interest rate shocks is not an adequate risk management strategy for GSEs. Capital ratios that are not tested against extreme events do not adequately mitigate the interest rate risk faced by such institutions.”

- “Fannie Mae and Freddie Mac must roll over roughly 30 billion dollars of maturing short-term obligations every week. At a time of disrupted financial markets, the credit markets might refuse to accept the [the GSEs] paper. Fannie Mae and Freddie Mac recognize this risk and both firms indicate that they maintain sufficient liquidity to survive for some time (3 months or longer) without access to rollover markets. [However], if Fannie Mae and Freddie Mac are unable to sell new debt, then they may also be unable to carry out sales of the “liquid” securities [some their own paper] from their investment portfolio. ... [T]he bottom line is simple: The Federal Reserve has adequate powers to prevent the spread of a liquidity crisis, but cannot prevent a solvency crisis should Fannie or Freddie exhaust their capital. In the event of a solvency crisis, the market would become unreceptive to Fannie and/or Freddie obligations; they would have difficulty rolling over their maturing debt. Moreover, their outstanding obligations would decline in price and their markets would become less liquid. Beyond that, it is hard to say exactly what else might happen.”
- “In the past two years, there have been surprising news reports of accounting irregularities, first at Freddie and more recently at Fannie. ...Both firms have been required to restate earnings for a number of years. ...The recent revelations are another example of our inability to predict shocks that will impact our financial system. The accounting problems provide an example of operational risk... It remains to be seen how the accounting restatements will affect the market’s view of [the GSEs’] earnings and capital adequacy. Clearly, though, [the GSEs] need to hold capital against operational risk.”
- “From a narrow market perspective, a key issue is whether the federal government would bail out Fannie Mae and/or Freddie Mac... But that is too narrow a perspective, even for a holder of [the GSEs] obligations. ...Even if the federal government bailed out [the GSEs], their obligations might be redeemed eventually but cease to trade actively in liquid markets. Finally, there is of course no guarantee that the federal government would in fact bail out [the GSEs]. Many observers, myself included, believe that a bailout would not be a good idea. The bottom line is that there is substantial uncertainty over the future regulatory structure that will apply to Fannie Mae and Freddie Mac. If there were a solvency crisis, the outcome would certainly involve extensive changes in the powers and characteristics of the firms and over the likely behavior of the government should the solvency of either firm come into question.”

- “My purpose has been to provide an outline of all the risks facing Fannie Mae and Freddie Mac. ...I’ve particularly emphasized the importance of facing up to the implications of low-probability events. A low probability must not be treated as if it were a zero probability. ...The probability of large price changes is much higher than suggested by the familiar normal distribution. In the case of the 10-year Treasury bond, changes of 3.5 standard deviations or more are 16 times more frequent than expected under the normal distribution.”
- “More generally, the probability of shocks of many sorts may be higher than one would think. The accounting problems that surfaced at both Fannie and Freddie would surely have been assigned a very low probability two years ago. ...For this reason, I believe that the capital held by [the GSEs] should be at a level determined primarily by the cushion required should an unlikely event occur rather than by an estimate of the probability itself. It may be that the highly volatile interest rate environment of the early 1980s is extremely unlikely to recur, but I would like to see [the GSEs] maintain capital positions that would enable the firms to withstand such an environment anyway.” (*Speech of William Poole, President of Federal Reserve Bank of St. Louis, 01/13/05*)

Three Federal Reserve studies question the GSEs’ benefits and subsidies

- In two studies released January 13, Federal Reserve economists conclude that GSEs make a negligible contribution to homeowners’ interest rate reductions, while benefiting greatly from implicit government guarantees. A third study concludes that the GSEs’ participation in the conforming mortgage market accounts for only 7 basis points of the 15- to 18-basis-point difference between interest rates for loans the GSEs buy and rates for non-conforming home loans.
- In “GSEs, Mortgage Rates, and Secondary Market Activities,” Federal Reserve economists Andreas Lehnert, Wayne Passmore, and Shane M. Sherland noted that Fannie Mae and Freddie Mac are the primary purchasers of conforming mortgages up to \$359,650 for single-family home loans and a “handful” of large mortgage originators account for a high percentage of sales of these conforming mortgages, suggesting that the price of the loans results from a “complicated dynamic strategic interaction” among a few large mortgage market participants. “The negotiated nature of GSE mortgage purchases suggests that there may be long and variable lags between GSE actions and any potential impacts on primary mortgage rates,” the paper said. “If secondary market prices are not transmitted automatically into the primary mortgage market, GSE secondary market interventions may not be an effective policy tool for influencing mortgage rates.”
- The study also assessed the role of the GSEs during a 1998 liquidity crisis to determine if the enterprises reduced the effects of market stress on interest rate spreads. The anticipated benefit would be minimal, if the GSEs simply adopted a strategy of maximizing profits by purchasing mortgages when the spreads between benchmark Treasury instruments and the mortgage rates are particularly high, said the economists. Significant purchases by the GSE were not followed by unusually large

declines in mortgage interest rate spreads, the economists noted. “Instead, the time-series evidence suggests that unusually large increases in spreads are followed by faster than normal portfolio growth,” said the authors. The study examined earlier research that found mortgage securitizations by the GSEs, as well as the enterprises’ portfolio purchases, appeared to help narrow the spreads. Using more recent data, the Fed study showed a much smaller effect of GSE market activities on rates paid by consumers. “Our main finding is that GSE actions (whether portfolio purchases or gross mortgage-backed securities issuance) have negligible effects on primary or secondary mortgage spreads,” the authors said.

- In a second study entitled “The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates,” Federal Reserve economists Wayne Passmore, Shane M. Sherlund, and Gillian Burgess assessed the significance of Fannie Mae’s and Freddie Mac’s role in reducing mortgage interest rates by comparing the cost of conforming loans which they buy to “jumbos loans” which exceed the GSEs’ purchase limit. The economists found that the markets for conforming loans and jumbo loans have different funding costs, which help to explain the 15- to 18-basis-point spread between the two classes of loans. The authors said that jumbo-conforming spread tightens when mortgage demand is low and core deposits are sufficient to fund mortgage demand, as the mortgage market becomes more liquid and realizes economies of scale. The study asserted that the GSEs convey about 16% of their 40-basis-point debt advantage to borrowers, which reduces mortgage rates by 7-basis-points. “This result provides evidence that the jumbo conforming spread provides only an upper bound for the amount that GSEs lower mortgage rates. That is, the GSE funding advantage accounts for 7 basis points of the 15-18 basis point jumbo-conforming spread,” the economists conclude.
- In a third study titled “The GSE Implicit Subsidy and the Value of Government Ambiguity,” Federal Reserve economist Wayne Passmore argues that the market’s perception of an implicit guarantee of the GSEs’ debt amounts to a significant subsidy to Fannie’s and Freddie’s shareholders and the companies’ market value. Passmore calculated the value of the federal government’s implicit subsidy to the GSEs at between \$122 billion and \$182 billion and estimated that Fannie Mae’s and Freddie Mac’s stockholders retain between \$53 billion and \$106 billion of that amount. “Under my ‘middle-of-the-road’ assumptions, GSE shareholders retain roughly 53% of the gains from their ambiguous government relationship or about \$79 billion,” said Passmore. He also estimated that between 44% and 89% of the GSEs’ market value can be attributed to the government subsidy. Passmore discounted the prospect that privatization of the companies would cause a dramatic drop in their market value “because they would reorganize themselves.”
- Passmore concluded that the GSEs, by controlling their debt issuances, manage the size of the government subsidies to the enterprises. As privately owned companies, the GSEs’ shareholders have an incentive to maximize the value of their stock, which tends to diminish the value of benefits to borrowers. Other considerations include the prospect that a change in government policy could mean an abrupt end to the subsidy,

as well as the fact that the implicit subsidy reaches borrowers only after passing through several hands, said Passmore. “These four concerns suggest that more research is needed about the relative efficiency of different institutions for delivery of subsidies to homeowners,” he said. “In particular, the success of the GSEs in meeting public policy goals should be examined more closely and measured more formally, given the large implicit subsidy that is captured by GSE shareholders.” (*Bureau of National Affairs*, Richard Cowden, 01/14/05; *Federal Reserve Finance and Economics Discussion Series: The Effect of Implicit Subsidy and the Value of Government Ambiguity*, Wayne Passmore, January 2005; *Federal Reserve Finance and Economics Discussion Series: The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates*, Wayne Passmore, Shane M. Sherlund, and Gillian Burgess, January 2005; *Federal Reserve Finance and Economics Discussion Series: The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates*, Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, January 2005)

- When the Federal Reserve economists presented their preliminary findings of “GSEs, Mortgage Rates, and Secondary Market Activities” at an academic seminar at the annual meeting of American Economics Association, Paul Kupiec, an associate director at the FDIC, immediately criticized the study’s findings and said its conclusions were too influenced by politics and questioned the researchers’ conclusions and methods. The study was the latest in a line of research that argues “GSEs are bad,” said Kupiec. He said he could see little evidence of an implicit government subsidy of Fannie or Freddie. Kupiec added that he was unpersuaded that the firms are inadequately regulated. He also suggested that GSEs benefit financial markets because they buy mortgages even when other investors show little appetite for them, noting that in the fall of 1998, GSEs continued their purchasing activities “when nobody else wanted to be in the market.” Kupiec said the study incorrectly presumes that “GSEs react with the wit of an iguana on a cold winter morning. They buy (MBSs) looking at last month’s market rates.” (*Dow Jones Newswires*, Joseph Rebello, 01/07/04; *Reuters*, 01/07/05; *American Banker*, Damian Paletta, 01/11/05; *Dow Jones Newswires*, Dawn Kopecki, 01/13/05)
- Speaking at a breakfast discussion on American housing, Federal Reserve Governor Edward Gramlich said, “There are a lot of economists studying the impact of Fannie Mae on mortgage rates. ...What one can come up with, both theoretical and empirical arguments, is that the impact of Fannie Mae and Freddie Mac on the actual level of mortgage rates is rather modest.” (*The Main Wire*, Chris Middleton, 01/13/05)

<p>OFHEO tells Congress that Fannie and Freddie use their market clout and government privileges to keep guarantee fees high at the expense to millions of homeowners</p>

- In an analysis provided to Congress in December, OFHEO concluded that Fannie Mae and Freddie Mac use their market clout and government privileges to keep loan guarantee fees (g-fees) high, yielding excessive profits to the enterprises at the expense of millions of homeowners. Current g-fees exceed the cost of providing the

service and yield excessive profits and the GSEs are able to keep fees high because of the advantages of their federal charter, OFHEO concluded in a preliminary analysis sent to Representative Richard Baker (R-OH), chairman of the House Financial Service subcommittee on Capital Markets and Government Sponsored Enterprises. The GSEs' special status "significantly inhibits competition" in the secondary mortgage market, OFHEO concluded. While the fees should be high enough to cover costs, earn a profit and provide adequate risk protection, they are excessive at current levels and "contribute to the enterprises' unusually high rates of return," the agency said, according to people who have seen the document. Since Fannie and Freddie sometimes move in lockstep on setting the guarantee fee, OFHEO said their actions may also raise antitrust issues.

- Lenders and other GSE critics have long complained that the GSEs have kept the fees far above cost, arguing that g-fees should rise and fall with the companies' actual losses from mortgage defaults. Instead, in 2003 g-fees were 33 times the companies' actual losses on mortgage defaults, a substantial jump from 4.4 times credit losses in 1995, according to OFHEO's analysis. Despite falling losses due to defaults, Fannie Mae's and Freddie Mac's guarantee-fee rates remain high. Lenders argue that consumers should be paying hundreds of millions of dollars less in g-fees and other charges.
- Consumers have a big stake in the debate over the GSEs' g-fees. For a typical \$250,000 home loan, the g-fee is about \$500 a year and totals \$11,350 over the 30-year loan term. Fannie and Freddie also impose many other charges, including fees for the use of proprietary technology. Since 1996, Fannie and Freddie have sharply increased their income through proprietary technology that mortgage brokers and banks must use in order to do business with them. Fannie's revenue from lenders' use of its technology soared to \$274 million in 2003 from \$3 million in 1996. Other transaction charges have become an increasingly important source of revenue for the GSEs, including a recently created fee on "cash out" refinancings. Within weeks of each other in 2002, Fannie and Freddie added a fee on popular "cash out" refinancings, allowing consumers to tap into their home equity by taking out a larger loan than they currently hold. The fees, which averaged \$1,000 on a \$200,000 loan, were hugely profitable for the GSEs, who defended the new fee by saying that such loans are "inherently more risky." The various fees charged by Fannie and Freddie generally aren't broken out in any of the statements the borrower receives, since banks "tuck the fees" into interest rates when they grant a mortgage, knowing they will sell the mortgage to Fannie, Freddie or other investors.
- Fannie and Freddie have dominated the business of pooling mortgages and selling them as mortgage-backed securities, which is now a vast global market. According to Mortgage Bankers Association, Fannie and Freddie handled 70% of this \$2.7 trillion business in 2003. As consumers moved to adjustable-rate mortgages in 2004, Fannie's and Freddie's overall market share fell. Critics claim that Fannie's and Freddie's market clout gives the GSEs great leverage when setting their fees or in other interactions with players in the mortgage business. "They have enormous

power, and can dictate what lenders can and can't do," said retired CEO of PNC Mortgage Corp. Seymour Naqvi. "No one wants to cross them."

- In "high stakes, secret talks" with many banks each year, Fannie and Freddie set the terms, conditions and costs under which the GSEs will buy the lenders' loans. The GSEs require the lenders to sign a confidentiality agreement, vowing to keep their terms with the GSE secret and are contractually forbidden to reveal their g-fee rates. Banks that "win" a low g-fee get a competitive edge in the marketplace, while lenders with higher g-fees can lose market share and their growth will slow. Bank management complains that in these make-or-break negotiations, Fannie and Freddie hold the cards. "It's a statutory duopoly -- they play the music, and everyone else has to dance along," says David Olson, an economist with mortgage-research firm Wholesale Access Inc. No one can compete, "because they carry Uncle Sam's credit card," said Olson. By raising fees a fraction of a cent or toughening loan-purchase terms, "[the GSEs] could put anyone out of business," he added.
- Small banks complain that they pay higher g-fees than large institutions, driving local lenders from the market and forcing borrowers to deal with megabanks. The big banks complain that Fannie and Freddie give some lenders a competitive edge by charging them lower fees and more favorable loan terms. Critics claim Fannie and Freddie reward firms who support the GSEs' policy goals in Washington and their efforts to enter new markets, while charging higher fees to companies that don't go along. Representative Christopher Shays (R-CT) calls Fannie Mae "a bully in the marketplace" that is abusing its public charter.
- Freddie Mac spokeswoman Sharon McHale said the company's g-fees "are appropriate and competitive in today's market" and that investors "expect a reasonable rate of return or profit." Freddie's chairman and CEO Richard Syron said, "It's very hard to make the argument that we are being rapacious." The GSEs also insist they face plenty of competition. "The secondary [mortgage] market is highly competitive, and lenders have numerous options available in the marketplace," said Fannie Mae spokesman Charles Greener. The GSEs also defend the level of the g-fees, saying they should be set prospectively -- looking ahead at future losses, not at current minimal loss rates. They also note that a growing number of banks are bypassing Fannie and Freddie by selling loans in "private label" secondary markets.
- While a spokesman for Baker declined to discuss OFHEO's report, he said that Fannie's and Freddie's market power and fees "deserve a close look" by lawmakers. As Congress prepares to write GSE regulatory reform legislation this year, lenders are mobilizing to seek limits on Fannie's and Freddie's ability to use their GSE status to enter new markets such as mortgage insurance. They are also seeking prohibition on retaliation through tough nondiscrimination and transparency rules, which would force Fannie and Freddie to standardize their fees and end secret contract terms. For too long, Shays says, "they've played by their own set of rules." (*Wall Street Journal*, John R. Wilke, 01/14/05)

The political underbelly of the GSE system exposed in
Fortune Magazine's "The Fall of Fannie Mae"

- In the January 24 issue of *Fortune Magazine*, Bethany Mclean describes the rise and fall of Fannie Mae in an 8,000 word exposé. Mclean writes, “The Fannie Mae saga is also about a company that lost sight of its original mission. It’s about power politics run amok, and the combustible blend of politics and business. It’s about a company whose huge debt terrified top government officials, and whose very existence drew ideological opposition. It’s about an orchestrated, behind-the-scenes campaign to rein in a financial powerhouse. It’s about a regulator who learned to fight back against a much more formidable foe. It’s about all these things and one more. Fannie Mae thought itself so different, so special, and so powerful that it should never have to answer to anybody. And in this, it turned out to be very wrong.”
- Mclean leaves no stone unturned, taking the reader through the rise of Fannie, under the leadership of former chairman and CEO Jim Johnson, tracking his creation of the myth of Fannie being the protector the American Dream of homeownership; his establishment of the Fannie Mae Foundation and the company’s Partnership offices as the cornerstones of Johnson’s political machine; and his establishment of close alliances with the National Association of Homebuilders, the National Association of Realtors, and other groups; and his creation of one of the most powerful lobbying shops in the country. Under Johnson, Fannie Mae developed a reputation for being invincible, and as former Clinton administration HUD Secretary Andrew Cuomo noted, “You did not question Fannie Mae. Fannie did as Fannie wanted.”
- McLean then tracks the reign of Howard Raines, as the company’s chairman and CEO. She notes that early in his tenure in 1999, Raines set a trap for himself and his company by promising investors to double Fannie’s EPS over the following five years. During his tenure, Raines’ promise was at the heart of everything the company did, Mclean writes. She tracks the creation of OFHEO, the “underfed watchdog,” and the post Enron era, in which the accounting and disclosure rules changed the GSEs’ world forever and hastened their fall. Determined not to have another Enron scandal on their watch, the Bush administration took on the Fannie Mae political machine in a way that no other administration had and war against the housing GSEs was engaged. Mclean tracks OFHEO’s special examination of Fannie Mae’s accounting practices issued on September 22, 2004; the congressional hearings two weeks later on OFHEO’s report; and the SEC finding that Fannie’s accounting practices did not comply with GAAP in December. Mclean notes, “Wall Street, of course, was every bit as blind[ed]” by their loyalty to Fannie. And then, Raines overplayed his hand one last time. For anyone interested in an inside look at what a Fannie Mae lobbyist described as “the greatest political malpractice ever committed,” Mclean’s article is a “must read.” (*Fortune Magazine*, Bethany Mclean, 01/24/05)

HUD proposes rule to release private GSE data

- Ramping up the pressure on Fannie and Freddie, HUD has proposed a new rule that releases certain confidential mortgage data submitted by the GSEs. The proposed change would result in the public disclosure of two categories of information from Fannie Mae and Freddie Mac. One category of information would include some aggregated information derived from loan-level data that HUD determines is nonproprietary. HUD said the proposal was designed to permit it to determine that some types of data that have been considered proprietary for Fannie and Freddie should no longer be withheld from public release. The second category of data to be released includes certain information that was reported at least five years earlier. HUD will release in 2005 data on the GSEs' 2004 mortgage purchases, along with data from 1993 through 2003. "This proposed change will facilitate research on affordable housing issues across a number of years. It will also apply to any data that the Department has determined are not proprietary when aggregated in larger groups of data," said HUD. The new rule also increases the frequency of the GSEs' disclosures to HUD from an annual basis to quarterly. (*BNA's Daily Report for Executives*, Richard Cowden, 01/11/05; *Dow Jones Newswires*, Dawn Kopecki, 01/10/05)
- In an interview on *Bloomberg News*, HUD Secretary Alfonzo Jackson said, "But while they are still under our domain [HUD], we are moving now to make sure that their books are open and transparent to the whole public, but it hasn't been in the past. Because I think that once that happens, they will look at the market and be more responsive to the market. And that market I'm talking about is serving low and middle income people in America." When *Bloomberg News*' host asked what "greater transparency" of the GSEs' books means, Jackson responded, "That means that their books will be open. They can no longer close their books. People will be -- you, Bloomberg and others-- will be able to see. We will not permit them again to fight us, as they've done in the past, by keeping their books closed." (*Bloomberg News*, 01/07/05; 2:37 PM)

Fannie Mae hires Deloitte & Touche as its external auditor

- Fannie Mae announced that it has hired Deloitte & Touche (D&T) to audit its books for fiscal year 2004 and reaudit prior years results, which will be restated. Previously, D&T had been working for OFHEO in its special examination into Fannie's accounting practices. OFHEO approved the GSE's hiring of Deloitte and immediately began severing its ties with the firm. The agency will continue its investigation into Fannie's accounting practices and is evaluating its need for additional outside consultants. Washington mortgage consultant Howard Glaser said Fannie's hiring of D&T was "a shrewd move that signals the company's seriousness in addressing the issues raised by OFHEO and the SEC."

- Fannie Mae also announced that J. Timothy Howard, the CFO who resigned effective January 31, 2005, has resigned from the company's board of directors effectively immediately. In accordance with the Board's agreement with OFHEO, Fannie Mae also announced that it has named Adolfo Marzol to serve as interim Chief Risk Officer (CRO) for the company. The *Wall Street Journal* reported that Fannie's promotion of Marzol to serve as interim CRO seemed "peculiar," since he relinquished those duties on September 1 when he stepped down from the chief credit officer post, which also oversaw risk. Fannie said at the time that Marzol was stepping down for "personal reasons" and that it was decentralizing its risk policy to give individual departments more authority over risk decisions. Fannie Mae officials noted that Marzol's "interim" appointment was approved by OFHEO. (*PR Newswire*, 01/04/05; *Dow Jones Newswires*, Dawn Kopecki, 01/04/05; *Reuters*, 01/04/05; *National Mortgage News*, Paul Muolo, 01/10/05)

Ohio retirement funds named lead plaintiffs in Fannie Mae class action law suit

- U.S. District Judge Richard Leon in Washington, D.C., has granted the motion of the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio to be named lead plaintiffs in the class-action suit alleging that Fannie Mae and some of its officers and ex-officers issued numerous false and/or misleading statements and financial reports. (*Dow Jones Newswires*, John Connor, 01/13/05)

Sovereign Bancorp and Astoria Financial record \$21 million and \$9.6 million charges, respectively, for "other-than-temporary" impairments of their Fannie Mae and Freddie Mac preferred stock

- Sovereign Bancorp Inc. expects to record a fourth-quarter charge of \$21 million, or \$.06 a share, for an "other-than-temporary impairment" related to certain Fannie Mae and Freddie Mac preferred stock in its portfolio. Sovereign Bank's parent company calls the charge a conservative estimate, which covers impairments on \$260 million of mostly fixed-rate securities with an effective yield of about 7.2%, which are rated an investment grade by both Moody's Investors Service and Standard & Poor's. Sovereign believes the charge doesn't reflect the long-term value of the securities, said James Hogan, the company's CFO. Sovereign's write-down of the preferred shares had nothing to do with the company's concern about the issuers' creditworthiness. Rather, the bank holding company decided to recognize the impairment because they had been valued in the company's books well above their current market value "for some time" and it couldn't forecast when their prices would recover. "Once regulators and the SEC have completed their review of the accounting practices of [Fannie Mae] and [Freddie Mac] and restated financial information is available, we believe the market value of these securities will improve," said Hogan

- Sovereign’s write-down comes as FASB is working on the new rules governing when companies must recognize less-than-temporary impairment on “available for sale” securities in their portfolio. To date, losses on securities has been recorded only when they are actually sold below cost. Some see Sovereign’s move as a sign that the bank holding company’s auditor, Ernst & Young – and perhaps the entire auditing industry—is gearing up to implement the controversial new rules. (*Dow Jones Newswires*, Allison Bisbey Colter, 01/06/05; *Dow Jones Newswires*, Jerry Abejo, 01/05/05; *Dow Jones Newswires*, Allison Bisbey Colter, 01/06/05)
- Astoria Financial Corp, the holding company for the Astoria Savings and Loan Association said it will record an other-than-temporary impairment non-cash charge of \$9.6 million, or 14 cents a share, in the fourth-quarter related to perpetual preferred stock issued by Freddie Mac. (*Dow Jones Newswire*, Anajali Cordeiro, 01/14/05)

Fannie Mae and Freddie Mac

Déjà vu: GSE regulatory reform

- Given Fannie Mae’s recent accounting problems, one might expect the GSEs to act quickly to cut a deal with the Bush administration on reform legislation. In reality, a compromise may be “a long way off.” Fannie and Freddie appear to be headed down a path similar to that taken last year--expressing support for the bill, while contesting key aspects of it. Most observers believe a major fight will be over whether a proposed new regulator should have the power to close down the GSEs if they are in a severe financial crisis, the issue which helped scuttle a bill last year. In the 109th Congress, the White House has even less reason to negotiate with the GSEs. Fannie’s accounting scandal and management shakeup have given the Bush administration more leverage, and more allegations are possible as OFHEO’s special exam of the company continues.
- Things have also changed on the GSEs’ side of the table. Given Fannie Mae’s ongoing accounting problems, sources say that Freddie Mac hopes to raise its own profile and take a lead role in Congressional negotiations. Led by chief of staff Hollis McLoughlin, Freddie is poised to take Fannie’s place behind the scenes, say sources. “I think you will see Freddie Mac take an active role and a much higher profile” than Fannie, said Camden R. Fine, president of the Independent Community Bankers of America. Such a move may be risky, since Freddie chairman and CEO Richard Syron has angered some in the administration with his public comments on GSE regulatory reform. In a speech last month to the National Home Builders, Syron said that GSE critics “can’t have it both ways.” He added, “They can’t demand that we

meet ambitious goals and at the same time strip away what makes us unique and treat us as if we were just another couple of private-sector financial institutions. Those kinds of changes would make it all but impossible for us to serve our mission.” He added that he hoped that the reform debate could “be based on the facts.” Sources said some in the Bush administration found Syron’s statements presumptuous, since Freddie Mac is still attempting to return to timely reporting after its \$5 billion restatement in 2003. “It’s a bit arrogant given that his company doesn’t even have up-to-date financial statements,” said an anonymous government source. Freddie Mac is “trying to be a constructive force,” said a company spokeswoman. “We very much want to see legislation.”

- In an opening salvo in the GSE regulatory reform debate, HUD Secretary Alphonso Jackson signaled that the Bush administration was very willing to discuss eliminating some of the GSEs’ unique attributes. On *Bloomberg News*, Jackson indicated that the time may have come to sever Fannie and Freddie’s combined \$4.5 billion line of credit with the Treasury. “Whether they need to have the perceived guarantee by the government, no I don’t think they need that,” said Jackson. “I think that they should in essence look to the open market like everyone else.” If such a proposal, which requires congressional approval, were put into a bill, many believe that passage of the bill could become less likely.
- Some industry representatives said they believed Fannie would approach the bill differently this year and attempt to forge an agreement on the most controversial items. “My sense is the battle lines will be less rigidly drawn from the standpoint of the GSEs this time around,” said Robert R. Davis, the managing director of government relations for America’s Community Bankers. “That will make it easier to reach some compromises.”
- While Fannie and Freddie officials have pledged to work harder to win a bill, critics remain skeptical. “I’m not sure they understand it is a different world,” said Bert Ely, an independent consultant and proponent of GSE privatization. “Fannie and Freddie don’t appreciate the seriousness of the situation, and the fact that the administration’s hand is a lot stronger than it was a year ago.” The GSEs’ arguments that a GSE regulatory reform bill could harm the housing market may have lost some steam, following the market’s calm after Fannie’s disclosure of its estimated \$9 billion loss stemming from its restatement, coupled with OFHEO’s classification that the GSE was “significantly undercapitalized.” Many investors appear to be shrugging off any problems because of their perception of Fannie and Freddie as government-backed.
- While the White House has steadfastly argued that the new regulator must have the power to shut the GSEs down if they run into severe financial difficulty, Fannie and Freddie have countered that such a provision in the legislation could spook debt investors and cause a downgrade in their debt and loss of their funding advantage. Sources said Fannie and Freddie are still concerned about the receivership language, with some suggesting that they are trying to work out a compromise. It is unclear

where such middle ground is and the Bush administration apparently has little incentive to give them leeway.

- The biggest stumbling block to GSE regulatory reform may be how much leeway to give the GSEs in offering new products. Many private-sector competitors fear that Fannie Mae and Freddie Mac can undercut them at will and take over lucrative lines of business, such as mortgage insurance. Representative Barney Frank (D-MA) and Senator Charles Schumer (D-NY) have warned that critics could endanger the bill's prospects by excessively restricting the GSEs' activities. Some expect the Bush administration will begin to lay its cards on the table some time in February with a shopping list, which could include restraints on growth; business restrictions, receivership provisions and perhaps restrictions on executive compensation. (*American Banker*, Rob Blackwell, 01/13/05; *Wall Street Journal*, John D. McKinnon, 01/11/05; Bloomberg News, Michael McKee and James Tyson, 01/08/05; *Dow Jones Capital Markets*, John Connor, 01/06/05)

NAHB supports implied guarantee: "More competition would help keep Fannie and Freddie honest"
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- Fearing interest rates will rise if investors lose confidence in the government backing of GSEs, the National Association of Homebuilders (NAHB) approved a resolution stating that it will oppose GSE regulatory reform that would undermine the government's "implied guarantee" of Fannie Mae's and Freddie Mac's \$1.7 trillion in debt. The NAHB called for limiting the power of any new GSE regulator to force the companies into receivership. The home builders also urged Congress to create more competition for Fannie and Freddie, arguing that the 12 regional FHLBs should have the power to create and sell mortgage-backed securities, as Fannie and Freddie do. The NAHB argued that by allowing the FHLBs to compete in the secondary market would "help keep Fannie and Freddie honest" and pressure them to lower mortgage costs for consumers, said NAHLB chief executive Jerry Howard. Additionally, the group wants Fannie and Freddie to set aside a "reasonable percentage" of profits to support low-income housing through grants as the FHLBs do. The NAHB also wants to limit the regulator's ability to raise minimum capital requirements for the GSEs and want the President to resume the practice of appointing directors to the boards of Fannie and Freddie. With 220,000 members who contributed \$7.9 million to federal candidates in the 2004 election, the NAHLB has a loud voice in Washington. According to the Center for Responsive Politics, about three-quarters of the homebuilders' contributions in the 2004 election cycle were made to Republican candidates. (*Wall Street Journal*, James R. Hagerty, 01/12/05)
- The home builders suggested that the White House and Congress should focus more energy on increasing competition for Fannie Mae and Freddie Mac. More competition would "help keep Fannie and Freddie honest" Jerry Howard, chief executive of the association, told the *Wall Street Journal*. (*CNNMoney*, 1/17/05)

GSE regulatory reform has become a referendum on the GSEs, Freddie CEO Syron tells the NAHB, and Fannie interim CEO Mudd apologizes for his company's transgressions

- In a speech before the National Association of Homebuilders, Freddie Mac's chairman and CEO Richard F. Syron warned the builders that the debate on regulatory reform has been broadened into a referendum on the GSEs. Syron said, "Some of [the GSE criticism] is for philosophical reasons – for those who object to the idea that we still have government-sponsored enterprises to spur investment in housing. And it's for economic and competitive reasons – for those who would profit greatly from a diminished GSE role in the secondary mortgage market. These GSE critics ignore our benefits and exaggerate our risks. They also rely on two major claims I hope you disagree with. One, that the housing finance market would perform just as well without the GSEs providing stability, liquidity and affordability. And two, that in any case, the housing mission in this country is pretty much complete."
- Syron argues, "... The GSEs are vital to the American Mortgage – the long-term, fixed rate instrument that is prepayable, without penalty, any time interest rates go down. This remarkable vehicle smoothes out spending on housing, fosters mobility, and helps families from all walks of life to build wealth. ... What about the claim that the housing mission can now take care of itself in this country and should no longer be a government concern? I flatly disagree. A homeownership rate in the 70s for white families and in the 40s for minorities and new immigrants is NOT good enough. Inequities still remain: barriers of race, culture, language and geography. Too many borrowers are still consigned to the subprime market. And too many minority and immigrant families are still being overlooked, overcharged and underserved."
- "... Freddie Mac has worked hard to do more, especially on affordable housing. It's still the first quarter of the game, but we're moving the ball downfield. We've launched a major initiative called Project Greenlight, with new mortgage products to green light more loans and a redesigned A-minus program that lifts more families out of the subprime market. Now we're about to roll out a new mortgage suite called Home Possible that will provide new credit flexibility – and reach more eligible families, taking out more types of loans, buying a wider range of homes. We're making our automated underwriting decisions good for six months rather than four – so that home builders can put the finishing touches on a new construction home without risking the loss of a qualified buyer. We're also making a major push to increase the supply of affordable housing – starting with multifamily housing. That includes helping to create new apartments; supporting small loans; and investing aggressively in low-income housing tax credits. Make no mistake. Freddie Mac is building real momentum in our housing mission. But our ability to continue doing more is at real risk in this debate."
- "... And like doctors caring for a patient, we should obey the Hippocratic Oath: first, do no harm. Am I suggesting that reform is not really needed? To the contrary. Freddie Mac looks forward to working with the Administration and the Congress to

make sure that our regulator has all that it takes and all that it needs to do the job right. And we are committed to working closely with the Home Builders throughout this process.”

- “...Our foremost hope, of course, is that policymakers will decide that homeownership deserves to remain a national priority. If they do, we would respectfully suggest that any resulting new regime should maintain the GSEs’ ability to innovate and tap emerging markets. It should maintain the confidence of domestic and global markets. It ought to strengthen our regulator instead of weakening our charter. Bottom line, it should reinforce rather than weaken our nation’s commitment to housing.”
- “Beyond these general principles, let me just touch on a few of the key specifics. The structure of the regulator is important. Wherever it is located, it must provide strong, independent oversight and be committed to housing. As for capital, no one disputes the need to ensure safety and soundness. But capital requirements must be tied to risk. Requiring us to hold capital beyond the risk of our business simply limits our ability to fulfill our mission. We keep that risk very low. And through the monthly measures we publish, we provide as transparent a view of our risk as any financial institution. Finally, a brief word on receivership – the whole issue of what happens in the remote event of a financial crisis at a GSE. This is far more than a matter of semantics. However we resolve this issue, let’s work hard to reflect the unique role and status of the GSEs. The markets must have continued confidence in our ongoing operation. Remember, we have a focused and limited mission. If we are treated like an ordinary financial institution, and are so perceived by the markets, we will soon lose the ability to fulfill the goals and special responsibilities of a GSE. These are responsibilities that no purely private institution has. So those again are three key elements we believe would advance the cause of GSE reform: a strong regulator that values housing; capital requirements tied to risk; and receivership provisions that maintain our GSE status. If reform is handled badly, there’s a real Catch-22 here. The GSEs can’t be expected to meet ambitious mission goals if we have stripped away what makes us unique and are treated as if we were simply two more private-sector financial institutions. That’s one of the unintended consequences I worry about.”
- “[As] I said ...last month that ‘the Mac is back.’ We have turned the corner and we are determined to uphold the value of the GSEs in a nation that values homeownership. But I’m not going to stand here and pretend that the past has never happened. I know that there have been breaches of trust by the GSEs in recent years. Nonetheless, 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. So I hope that in this coming effort, we will have you at our side. Not because I expect us to agree on every last detail of the legislation. And not even because of our longstanding friendship. But because...I believe you will place the common good – and the good of housing – above the disappointments and unpleasant surprises of the past year. If you do, I make you this promise. Freddie Mac will consult with you

throughout this process. We will work with you. And we will always be straight with you. On that you have my word. If we go in to this effort united in this way, I am convinced the foundation of America's housing finance system will remain as solid as one of your best-built homes. And that is a structure we know is built to last." (*Speech by Freddie Mac chairman and CEO Richard F. Syron, 01/14/05*)

- Speaking to the NAHB, Fannie Mae interim CEO Daniel H. Mudd said, "There was a moment recently when Bobby Rayburn wasn't so happy with us. There was no ambiguity as to what Bobby thought. We didn't feel too good hearing about it and we didn't want to listen. But Bobby [Rayburn], I've got something to say to you and everybody in this room. Thank you. And to you and all of our partners who we let down, we are sorry. We took our partnership for granted. I come here today with the responsibility to work to restore your faith in Fannie Mae, and a commitment to do that. ... As interim CEO, I have made a pledge. We need to create a safer, sounder Fannie Mae by carrying out the remedies set forth by our financial regulator. We need to restate our earnings. Restore our capital. Reinforce our internal controls and our corporate values. Reexamine our corporate culture. Redouble our commitment to our mission. And return to the road of constant improvement. And that means to listen. To learn. And to let our actions speak louder than our words. ... I'm here today in a role I would not have imagined even four weeks ago. But I am here to assure you that as we get our house in order, Fannie Mae will be there for you. We have organized to have one unit, with one leader, and one set of objectives -- focus on our regulatory plan, our capital plan and our accounting. The purpose is clear -- to free up the rest of the organization to fulfill our mission and work with our partners, every day. And when we get our house in order, Fannie Mae will be strong, responsive and prepared to serve America's housing needs more than ever." (*Speech by Fannie Mae interim CEO Daniel H. Mudd, 01/14/05*)

Times have (finally) changed

- Speaking at the Strategies for Success in Construction Lending conference, former HUD Secretary in the Clinton administration Andrew Cuomo said, "Congress is right when it says it wants more accountability" over Fannie Mae and Freddie Mac. "The political appetite in Washington has turned," he said. "It's not going to be the way it was for the last 20 years. You can't have a monopoly forcing the entire primary market to do business with you." He also said that if given the wherewithal to be an effective regulator, OFHEO is the proper agency to oversee Fannie Mae and Freddie Mac. OFHEO "was never designed to be an effective regulator in the first place," Cuomo said. "It never had the resources or the mandate. It had 30 people to watch over two of the largest corporations in the country. And the GSEs are the epitome of power in Washington, so whatever they said happened," he added. (*Origination News, Lew Sichelman, January 2005*)

- AEI’s resident fellow Alex J. Pollock writes in *The Washington Times*, “... [I]t’s time for Congress to address some fundamental issues about the structure of the federally chartered ...GSEs. ...The fundamental problems are structural, but the time has not yet come for the true structural answer: Privatization of Fannie, Freddie and the Federal Home Loan Banks (FHLBs). Legislative ideas are focusing instead on a regulatory reorganization that brings all these housing GSEs under a single new ‘world class’ regulator. Although this would be a less fundamental step than privatization, a well-designed regulatory restructuring could have broad, beneficial effects on mortgage finance. A new housing GSE regulator could improve oversight, promote greater competition, create greater market discipline and foster improved value to mortgage borrowers. It could also enable reducing the duopoly pricing power and duopoly profits from which Fannie and Freddie have benefited so grandly for so long.”
- “Here is what needs to be done. First, Congress should create a new, single regulator for Fannie, Freddie and the FHLBs as proposed by the Bush administration and by the Senate Banking Committee in a bill last spring. That step would replace the existing, separate regulators – [OFHEO] and the Federal Housing Finance Board -- which have regulatory domains too narrow to make sense. The new regulator would have oversight responsibility for Fannie, Freddie and the 12 FHLBs. ...Next to the U.S. Treasury, they are the world’s most important and widely held issuers of fixed-income securities. The new regulator would be able to develop an understanding of the sector as a whole, of individual GSEs in context, and of the overall health of the U.S. housing finance system.”
- “Second, Congress should direct the new regulator to foster as competitive a GSE sector as possible. ...Today the secondary mortgage market dominated by Fannie and Freddie is a well-known duopoly, and it is probably the least competitive of any financial sector in America. A pro-competitive GSE sector would produce more price competition, innovation and customer choice. As they do whenever markets become more competitive, consumers will win.”
- “Third, the legislation should eliminate the government-appointed directors of Fannie, Freddie and the FHLBs. Since such directors have the fiduciary duty to represent shareholders, their public appointment has little, if any, meaning.
- “...Fourth, the legislation should address receivership. For more than a decade, the debt of all housing GSEs has grown far faster than the mortgage market or the overall economy. This growth reflects the fact domestic and international investors provide little market discipline because they firmly believe they will be protected by the government if the GSEs get into financial trouble. The Bush administration has consistently maintained legislation must have ‘effective receivership language’ so GSE debt investors exert more market discipline. If Congress thinks GSEs most resemble banks, the legislation could provide for banklike regulatory receiverships.

If GSEs are viewed as financial corporations such as G.E. Credit and GMAC because they take no deposits from the public, a second alternative would be for legislation to address receivership simply by providing the GSEs become subject to the bankruptcy code like other debt issuers. This would be the most straightforward kind of effective receivership language.”

- “Through this four-step approach, the U.S. secondary mortgage sector -- an essential element of the world’s largest credit market -- can be made better regulated, more competitive and less subsidized.” (*Washington Times*, Alex J. Pollock, 01/12/05)

The GSE system “works well”

- In the *Washington Times*, James C. Miller, III writes, “Over the coming decade, Americans will create more than a million new households each and every year. Add to that the historical increase in homeownership rates and the rise in the price of housing (partly from the gradual upgrading of homes), and it is clear we will need about \$1 trillion more each year to fund new mortgages. Where will the money come from? Enter a world market for capital and the efficient U.S. arrangements for housing finance, which attract low-cost capital in all economic environments with low transaction costs. ...One reason [for the GSEs’ low-cost capital] is that Freddie Mac’s and Fannie Mae’s debt- and mortgage-related securities have become a prime choice for many foreign investors. These two government-sponsored enterprises (GSEs) have transformed the American mortgage ...into simple, transparent and easy-to-price securities. In so doing, Freddie Mac and Fannie Mae have made our national supply of mortgage credit more liquid, stable and affordable.”
- “They have also converted a large part of our current account deficit ... into a powerful engine to generate capital for mortgages for American families. ... [T]he flip side of the trade deficit in goods and services is the trade surplus in capital. That is, the inflow of capital from abroad makes up the difference between imports and exports, and this inflow, plus our own domestic savings, provides the capital we need for investments here at home.”
- “Where this capital from abroad goes is critically important. ... [A] lot of it enables people to build and buy homes - one of the reasons why the U.S. economy held firm over the last three years despite the loss of \$8 trillion in stock market wealth and other shocks following the terrorists’ attacks of September 11, 2001. Aided by the Federal Reserve’s commitment to low interest rates, the secondary mortgage market created by Freddie Mac and Fannie Mae - its size, strength and flexibility - proved a bulwark of economic strength and stability when the U.S. needed it most. ...What these two GSEs do is bundle mortgages and create ‘mortgage-backed securities’ (MBS) that are then traded on the open market. When investor appetite for MBS dwindles, the GSEs issue similarly liquid and transparent debt securities that are especially attractive to foreign investors who may be unfamiliar with the nuances of MBS.”

- “The system works well. ... Freddie Mac’s and Fannie Mae’s securities have proven so attractive to foreign investors that those securities routinely “insource” between 20 percent and 25 percent of all the dollars our current account deficits send abroad. In part because of Freddie Mac’s and Fannie Mae’s operations, foreigners invest their dollars in one of the most important and productive sectors of the U.S. economy, providing more and better housing than domestic investment alone could provide...”
- “Of course, the two GSEs must hold sufficient capital to protect their mortgage portfolios against real economic risk, and they must account for their assets and liabilities in a transparent fashion that assures both regulators and investors. But the model is sound and provides very large benefits to homeowners, investors, and the global economy.” (*Washington Times*, James C. Miller, III, 01/07/05)

Fannie and Freddie an anachronism?

- In an article exploring the creation of a GSE system for the EU, Geraldine Lambe writes, “The arguments against a European Freddie Mac [or Fannie Mae] are convincing. If Europe has increasingly liquid, if varied, MBS and covered bond markets, what can be gained by the introduction of a synthetically-created, government-backed entity? Europe is not facing the market failure that spawned the creation of the U.S. agencies – they emerged in 1937 to address a reluctance by private companies to provide mortgages during the Depression and later served to end regional disparities and bail out the Thrifts during the crisis in the 1980s. ‘[The GSE’s are] a throwback,’ said Karen Lissakers, adviser to George Soros and U.S. executive director on the executive board of the International Monetary Fund from 1993-2001... Even [Larry] Dyer [director and head of agency strategy at Credit Suisse First Boston in New York], who champions the benefits [GSEs] have provided to the U.S., believes they are now something of an anachronism. But as long as Congress believes that the GSEs are run in a safe and sound manner, [Dyer] says, they will be treated like the appendix: ‘It is an organ you no longer need but you are not going to volunteer to have it removed.’” (*The Banker*, Geraldine Lambe, January 2004)

Bush Administration’s team taking shape for the second term 109 th Congress Committee appointments
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- U.S. Assistant Treasury Secretary for Financial Institutions Wayne Abernathy has submitted his resignation to President Bush to work in the private sector. “It has been my great honor and privilege to serve you and the people of this nation for a little over two years as a member of your administration,” Abernathy wrote the President. Treasury Secretary John Snow said Abernathy had done “terrific work” during his tenure and will be missed. He is currently the Treasury’s chief architect and public spokesman on GSE regulatory reform. On February 1, Abernathy will join the

American Bankers Association as the executive director for financial institutions policy and regulatory affairs, who will oversee the ABA groups which deal with policy development, bank general counsels, economics, and tax and accounting issues. (*Dow Jones Newswires*, Deborah Lagomarsino and Dawn Kopecki, 01/10/05)

- Greg Zerzan will serve as acting assistant Treasury secretary for financial institutions, when Wayne Abernathy leaves at the end of January, said an agency spokeswoman. Zerzan is currently Abernathy's deputy, who joined Treasury in 2003 after serving as the senior counsel for legislation on the House Financial Services Committee. (*American Banker*, Rob Blackwell, 01/12/05)
- The U.S. Treasury has named Fiscal Assistant Secretary Donald Hammond as interim undersecretary for domestic finance, replacing Brian Roseboro, who resigned on December 31. Hammond, a career Treasury official, will serve in the post until the White House names a replacement, said Treasury spokesman Rob Nichols. (*Dow Jones Capital Markets*, Campion Walsh, 01/04/05)
- The Bush administration has named Indiana businessman Allan B. Hubbard as director of the National Economic Council. Hubbard, who succeeds former investment banker Stephen Friedman, will coordinate economic policy among the administration's agencies and departments. (*Wall Street Journal*, Greg Ip, Jackie Calmes and John D. McKinnon, 01/11/05)
- President Bush announced he will nominate U.S. Trade Representative Robert B. Zoellick as the top deputy to incoming Secretary of State Condoleezza Rice. Zoellick would succeed Richard Armitage, who resigned after Secretary of State Colin L. Powell announced he would step down after Rice is confirmed by the Senate. [Zoellick had been mentioned as a possible candidate to replace Franklin D. Raines as chief executive of Fannie Mae.] (*Congressional Quarterly*, 01/07/05)
- The Senate Banking Committee for the 109th Congress will consist of eleven Republican members, including chairman Richard C. Shelby (AL), Robert F. Bennett (UT), Wayne Allard (CO), Michael B. Enzi (WY), Chuck Hagel (NE), Rick Santorum (PA), Jim Bunnign (KY), Michael D. Crapo (ID), John E. Sununu (NH), Elizabeth Dole (NC), and Mel Martinez (FL). The committee's nine Democrat members include ranking member Paul S. Sarbanes (MD), Christopher J. Dodd (CT), Tim Johnson (SD), Jack Reid (RI), Charles E. Schumer (NY), Evan Bayh (IN), Thomas R. Carper (DE), Debbie Stabenow (MI), and Jon Corzine (NJ).
- According to the *Congressional Record*, House speaker J. Dennis Hastert (R-IL) has "undone" a 2001 agreement under which the House Financial Services Committee and Energy and Commerce committees shared jurisdiction over Financial Accounting Standards Board accounting issues. Victory in this Capital Hill turf battle by chairman of the capital-markets subcommittee of the House Financial Services Committee Representative Richard Baker (R-LA), is sending shivers down the spines

of executives at Fannie Mae, said *The Morning Brief*. “Baker’s new role also creates a tougher political landscape for Fannie, which has long used divide-and-conquer tactics to best its foes on the Hill,” said *BusinessWeek*. “With Representative Baker firmly in command of all the issues involved in Fannie’s \$9 billion earnings restatement, the mortgage giant’s hot seat just got hotter.” (*BNA’s Daily Report for Executives*, Rachel McTague, 01/06/05; *The Morning Brief*, Joseph Schuman, 01/14/05)

OMB holds up OFHEO’s corporate governance rule

- The White House budget office is holding up OFHEO’s proposal to require Fannie Mae and Freddie Mac to separate the jobs of chairman and chief executive to insure independent oversight by the GSEs’ boards. Other businesses that combine the two positions oppose OFHEO’s change as an unwelcome precedent. The SEC often requires a separation of the positions in settlements. OFHEO is working with OMB to resolve the differences. (*Wall Street Journal*, John Harwood, 01/14/05)

Berkshire Hathaway is top provider of funds in manufactured housing space

- Following the collapse of the sale and financing of mobile homes in recent years, Berkshire Hathaway, Inc., controlled by billionaire Warren Buffet, is emerging as a top provider of funds for the depressed manufactured housing market. In 2003, Berkshire began filling in the space left by some of the industry’s biggest lenders and investors, such as Fannie Mae and Conseco Inc.’s finance unit, which filed for bankruptcy protection in 2002. The arrival of a conservative lender such as Berkshire with deep pockets brings hope of a sustainable turnaround for the sector. Berkshire has been using its triple-A rating to finance its mobile home operations, raising nearly \$7 billion in debt since September 2003. During the first week of January, the company sold \$3.75 billion in bonds to finance the purchase of a \$4 billion portfolio of manufactured housing loans from J.P. Morgan, who is exiting the manufactured housing market. In addition to financing billions of manufactured housing loans on its balance sheet, Berkshire’s financing units have begun to originate loans under Fannie Mae guidelines for manufactured housing loans for (possible) future sale. (*Dow Jones Newswires*, Christine Richard, 01/12/05)

E-mortgage pioneers claim to save \$800 per loan

- By going paperless, users of the Prime Alliance Web-based offering are saving an average of \$800 a loan. Prime Alliance is comprised of a conglomeration of bankers, technology providers and credit unions that has partnerships with Dexma and Fannie Mae. (*National Mortgage News*, Anthony Garritano, 01/10/05)

Fannie Mae

Fannie Mae circles the wagons

- On January 4, the Fannie Mae Foundation sponsored the biennial swearing-in ceremony for the 43 members of the Congressional Black Caucus (CBC). Fannie Mae board member and Howard University President Patrick Swygert introduced the company's interim CEO Dan Mudd to the CBC. Swygert said, "Today... [Dan Mudd] has begun another critically important challenge, leading Fannie Mae into the future as interim CEO. As a member of Fannie Mae's board of directors, I can tell you that Dan Mudd brings a can-do competence to this assignment. He is enthusiastic and compassionate leader, who will carry on the great work of our dear friend, Frank Raines. Dan served under Frank, and he served wonderfully and loyally, as Fannie Mae's chief operating officer and earned his confidence, trust, and admiration. For those of us who know Frank Raines, that speaks volumes. Dan has been a key part of Fannie Mae's success in building a diverse work force. He will continue the leadership in diversity. Dan also has led the charge in emphasizing the business of Fannie Mae and the mission are one and the same. As Dan puts it, Fannie Mae cannot make its business goals without meeting its mission, and the mission is the very reason we are in business. Please join me now in welcoming a man who is committed to expanding homeownership opportunities for our nation's underserved families and communities."
- Mudd said to the CBC, "Thank you all. Good morning, members of the Congressional Black Caucus. ...I want to congratulate you all as you begin to write the next chapter in the history of the U.S. Congress, and I thank you for the opportunity to join you on a wonderful day. I will tell you that that while much is changing at Fannie Mae, one thing that is not changing is the continuity and the integrity and the conscience that's represented by people like President Swygert. That I promise you will not change."
- "We are gathered here in the pursuit of a mission, and it's the long thought, soul testing, never-ending quest to advance human rights and civil rights and economic rights for all of America's people. We at Fannie Mae cherish the chance to join you today because part of that mission, we believe is the right to equal housing opportunity. This event, as you know, has become a tradition between us. It began 10 years ago, when Fannie Mae was led by Jim Johnson. It grew stronger under Frank Raines. Many in this room knew Frank as a friend or a colleague...Someone who has always been a quiet and thoughtful and passionate defender of this American Dream. So I am humbled to come here today to reaffirm the friendship and the partnership between Fannie Mae and the Congressional Black Caucus. Fannie Mae is determined to keep tearing down the barriers to deliver on the American Dream. And we know now more than ever that we can't deliver on that Dream alone. Certainly, we need to lead, but certainly, we need to listen. We need to join, and we need to

learn to follow, those who believe in the power of this Dream, and that is the people in this room. We need to know who will lead us and teach us, what they know in their hearts and minds and their souls about how best to deliver on those dreams for all Americans. And that means we need to work together with CBC.”

- “So many of you have been good friends to Fannie Mae and our mission. You’ve been friends through thick and thin. We have, indeed, come upon a difficult time for Fannie Mae. I humbly ask you then to have faith in us, because we, like you, know how much remains to be done on the streets where America lives. There is much to be done inside my company. And I humbly ask you to help us and to help me. If there are areas where we are missing, if there are areas where we can do better, we’d like to hear it from our friends and I would be so bold as to say our family first. It is true that Fannie Mae has lent more money to more minorities and more underserved individuals than any single company in history.”
- “However much we do, though, our attitude must be, it is not enough. This is not the time, though, I think to talk about us. It’s time to talk about what we have in common. It’s time to talk about how when Reverb [a singing group that performed at the CBC ceremony] started to sing, they sucked the air out of the room and put it all into our chests and our hearts and made us swell up with pride. ...It’s time to talk about what we have in common, that swelling in our hearts and that swelling in our belief that all Americans have the right to decent housing. We will work with you to make it so. We will work hard inside our company to resolve the serious matters before us, to put our house in order, and to forge a new future. And all the while, you will see Fannie Mae reaching out and listening to the Caucus, to both houses congress, to the administration, and to all who have a stake in housing finance. Over a century of endeavor, you have earned the reputation as the conscience of Congress.”
- “In many ways, I want to tell you today, you are also the conscience of Fannie Mae, keeping us on course to serve those who need serving the most. Let me close by thanking Congressman Elijah Cummings, your outgoing chairman. Anyone who works closely with Elijah Cummings, or sees him guide this Caucus or hears him speak knows that they are in the presence of someone very, very special. Thank you for everything you have done, Congressman Cummings. Let me also extend our congratulations to the new chairman of the Caucus, Representative Mel Watt, of the 12th district of North Carolina. Throughout his career, Representative Watt has been known for his passion for excellence and passion for justice. He has been a forceful advocate for expanding opportunity, a champion for the underserved, and a true friend of housing. Chairman Watt, I look forward to listening and learning from you, and all the members of the Caucus. Thank you, congratulations to all of you, we are grateful for the opportunity to join you on this day. Thank you. Let me introduce Congresswoman Pelosi, ladies and gentlemen, the Leader.”
- Congresswoman Nancy Pelosi (D-CA), said, “Good morning. How are you? It’s a happy day for us, when we can look at this incredible talent gathered here on the stage today, and to say that this is the largest Congressional Black Caucus so far, so

far. ...Thank you, Dan Mudd and Fannie Mae for sponsoring this important occasion, and, yes, I want to acknowledge also the leadership of Franklin Raines. ...Tim Cleyburn and ...others of us on the Appropriations Committee, saw firsthand, I am sure you saw in Ways and Means too, Mr. Chairman, the incredible astuteness, the brilliance of values that Frank brought to the discussion with Congress on the debate on values and priorities when he was head of OMB. I know he did a great job at Fannie Mae, but I want to speak specifically to what we saw firsthand in the Congress. He was a master, he was a master, so Franklin, we miss you here today, but thank you... Mr. President [Swygert], we can call you president of the university, we like having someone that we respect to call Mr. President here in the room with us today. [laughter and applause]... (CSPAN2, 01/04/05, 10:00 AM; *Dow Jones Capital Markets Report*, Dawn Kopecki, 01/04/05)

Uncharted waters fraught with danger for Fannie Mae's board

- Investigations continue on all fronts at Fannie Mae, including special investigations by its regulator, OFHEO, and the SEC; a criminal investigation by the Department of Justice; a special internal investigation led by former Senator Warren B. Rudman for the company's board of directors, and class action lawsuits alleging securities fraud by the company and some of its officers and ex-officers.
- A significant question is the SEC's role at Fannie Mae, which is unclear. While the SEC declines to comment on the specifics of the Commission's role, several analysts predicted that the SEC jurisdiction will complicate matters for Fannie Mae, former CEO Franklin Raines, and former CFO J. Timothy Howard. SEC regulations and the Sarbanes-Oxley Act require top executives of publicly traded companies to certify their companies published financial results. The SEC has been imposing tougher sanctions on individuals in recent years, going after not only companies' executives, but lawyers, directors, and accountants who were either involved in wrongdoing or failed to prevent it. "There's nothing more important from our perspective in what we do than trying to hold accountable individuals," said SEC's enforcement director Stephen Cutler. "We think it's important to punish both individual and corporate wrongdoers. Effective deterrence requires personal accountability."
- In a deal that sent chills through corporate boardrooms, Worldcom shareholders sued the company's outside directors, 10 of whom tentatively agreed to settle by paying \$18 million out of their own pockets. Alan Hevesi, New York's state comptroller and, as trustee of the state's retirement fund the suit's lead plaintiff, reportedly insisted that the directors' personally pay their fines. The WorldCom deal follows a settlement reached in 2004 by former Enron directors, who agreed to personally pay \$1.5 million each to resolve a suit with the Labor Department. Former federal prosecutor John Carroll said the increased focus on individual accountability represents "a philosophical sea change."

- On another front, Nortel Networks recently released its much-delayed audited financial statements for 2001 to 2003 and said that an internal inquiry showed that executives had manipulated the initial results to obtain bonuses. Nortel said that a dozen current executives who played no role in the manipulation would repay \$8.6 million in bonuses voluntarily over three years and will also give up the last two installments of a restricted stock payout dating back to 2003. Nortel's announcement comes at a time when OFHEO is seeking to force the repayment of bonuses for former CEO Franklin Raines and former CFO Timothy Howard. (*Wall Street Journal*, Karea Scannell and Deborah Solomon, 01/07/05; *Wall Street Journal*, Jonathan Weil and Shawn Young, 01/07/05; *New York Times*, Ian Austen, 01/12/05; *BNA's Banking Report*, 01/03/05)

Former Fannie CEO Raines the \$140 million man?
Not bad for six years on the job.

- *Business Week* reports that former Fannie Mae CEO Franklin D. Raines had quite a golden parachute to soften his crash landing in December. According to *Business Week*, "In addition to \$19 million in severance payments, Raines, 55, gets a lifetime salary of \$1.37 million. If he lives until 75, that's \$27.4 million. Add: \$21 million in stock already awarded, \$23.8 million in future stock payouts, a life insurance policy, and an additional \$23.8 million in performance based options. That's on top of more than \$17.5 million paid to Raines since 1999. The grand total is worth \$140 million Not bad for just six years on the job." (*Business Week*, 01/10/05)

A speculative view of Fannie's hedge accounting

- Daniel F. Brice writes on RiskCenter.com, "Fannie is under fire for its creative hedge-accounting methods. It has no place to hide." When Fannie Mae's chairman and CEO Franklin Raines asked SEC's chief accountant Donald Nicolaisen how far off Fannie's books were in relation to FAS 133, Nicolaisen held up a sheet of paper and told Mr. Raines that if it represented the four corners of the rule, "you were not even on the page," according to the *Wall Street Journal*. Brice writes, "That is a priceless quote. But is it right? Without benefit of all the details and a full review of the FAS 133 accounting rules (an ordeal no one should be forced to endure), I venture the following. Of course they were not even "on the page." And both Fannie and KPMG (their external auditor) knew it all along."
- Brice continues, "We all know FAS 133 is ridiculously complex to fathom. We know it was confusing, flawed, and badly written. We all know it has too-strict requirements to get hedge accounting (HA) treatment. We know that some institutions claimed, at least initially, that in many cases it was very hard to determine whether they could legitimately get HA treatment or not. I argue that, in this case, it was not unclear. Banks and others in the mortgage business looked, with great pain, at the FAS 133 rules. Many decided it was quite clear that they could not get hedge

accounting treatment on mortgage hedging. Probably no firm could, due simply to the nature of mortgage hedging and the strict requirements. For them, it was not an iffy or borderline decision. Despite some initial disagreement, most of the rest of the banking and mortgage industry now have come to agree with this view.”

- “So how in the world could Mr. Raines and his internal staff, with straight face, argue that they really believed they could legitimately get HA treatment on mortgage hedging? Answer: They did not believe it. They were nowhere near compliance and they knew it. The only explanation remaining is that Fannie felt politically invincible (at the time, they nearly were). They believed they could get away with it. Their huge bonuses were tied to smooth earnings, which they would be denied without HA treatment. Fannie’s executives were not going to give up those bonuses, no matter what. They figured they could either wriggle by due to their clout and connections (use their implicit immunity to get safe-harbor treatment or whatever), or that they’d each move on to another juicy political post before they get caught.”
- “But, more, by what stretch of the imagination could KPMG have ‘independently’ come to the decision to recommend that Fannie go for HA treatment, when no one else could get it? Answer: They could not. The only explanation can be that they -- like anyone going against this behemoth -- were politically pressured by Fannie. After all, Fannie is a master at political manipulation and pressure, and had an air of immunity about it. They told KPMG what they wanted and -- surprise! -- got it.”
- “Okay, I am speculating. Maybe that’s not the case. Fine. Let’s suppose there were no political pressures or threats. If I were KPMG, I’d be figuring: ‘If I tell Fannie they can’t have HA, they’ll fire us now. That would cripple our business and we’ll get bought out or have to dissolve. If we (KPMG) go along, we have a chance of getting away with it, but even if not, letting Fannie get HA puts off the day of reckoning (in this case for four years), allowing us some breathing room. That’s better than getting fired now and sealing our fate today. So we go along and say HA is okay.’”
- “Either way, no matter what happened, Fannie finally went too far and got caught on something. (Markets don’t tolerate this stuff for long.) That might lead to good changes (i.e., full privatization with no phony privileges). And if that’s what happens, it’s much better than letting Fannie run wild for a few more years and then having us (taxpayers) bail them out on a much larger scale. In other words, if you throw your weight around, don’t expect others to cushion your fall. (*Riskcenter.com*, Daniel F. Brice, 01/04/05)

Fannie Mae postmortems

- In *Newsweek*, Robert Samuelson writes, “In America, we rarely declare ‘victory’ over a problem. Once an issue becomes a target of collective concern, it stays on the political landscape, even if substantial progress occurs. ...At last count about 69

percent of U.S. households owned their homes, up from 55 percent in 1950. ...The remaining obstacles involve poverty more than flaws in the housing market. The housing market serves as a useful background to the controversies surrounding Fannie Mae and Freddie Mac accounting controversy. Samuelson writes, “The temptation is to treat these incidents as further examples of executive bad behavior—while also defending Fannie and Freddie’s critical role for housing. This is exactly the wrong response: it favors a false problem (homeownership) over a real one (a possible failure of Fannie or Freddie).” The GSEs are viewed in the marketplace as quasi-government agencies whose debt enjoys low rates just above Treasuries and a default by either enterprise would be considered a government default. “The result is a heads-I-win-tails-you-lose proposition for taxpayers. If Fannie and Freddie prosper, benefits go to shareholders; if they get in trouble, government would almost certainly rescue them. Congress ought to end this peculiar situation, because a bailout could be massively expensive.”

- “...Congress should rush to end Fannie and Freddie’s special status—and the danger of a bailout. ...Unfortunately, Congress will probably shun anything like this. It might try to toughen regulation of Fannie and Freddie. But this wouldn’t eliminate the danger of a bailout. Blame this obtuseness on the staying power of familiar crusades. Homeownership is a noble cause, and Fannie and Freddie play the theme for all it’s worth. In massive ad campaigns, they portray themselves as the primary engines of rising homeownership. Fannie declares it’s in ‘the American Dream business.’ Well, homeownership isn’t a big problem, and Fannie and Freddie have been minor—not major—forces in past increases. The others include rising incomes; falling interest rates; low-down-payment mortgages (as little as 3 percent) from the Federal Housing Administration; the tax deductibility of mortgage-interest payments; government programs to help first-time buyers. But Congress clings to old mythology. Heeding yesterday’s problem, it may cause tomorrow’s.” (*Newsweek*, Robert Samuelson, 01/10/05)
- Amity Shlaes writes in the *New York Sun*, “Fannie does damage even when it does well. Most parts of the American economy are relatively level playing fields. Everyday business in these fields is so transparent that it makes the Oliver Stones look paranoid. Fannie’s America does, however, feature as much brute political force as the standard anti-corporate flick. This in turn damages the entire economic culture. It is time to end Fannie’s creepy relationship with government. Few projects could do more to sustain the American dream.” (*New York Sun*, Amity Shlaes, 01/04/05)
- Writing in the *New York Times*, Gretchen Morgenson awards the Round Wheel Award—”To Franklin D. Raines, the former chief executive of Fannie Mae... After years of running roughshod over his company’s regulator, [OFHEO], Mr. Raines and his swaggering colleagues learned that what goes around does indeed come around. The regulator accused Fannie Mae of cooking its books. The [SEC] agreed that it had misrepresented its financial statements, and all the lobbyists in the world couldn’t save it from a good, old-fashioned comeuppance. Mr. Raines lost his job but gained a

munificent pension. Who knows? There may even be a hedge fund in his future.”
(*New York Times*, Gretchen Morgenson, 01/02/05)

- Former Congressman Bob Barr (R-GA) writes, “If federal inmate Martha Stewart has been reading the newspapers ...she’s kicking herself; but not for getting caught or for engaging in questionable business practices that brought the feds down on her like a ton of subpoenas. No, she’s kicking herself for thinking too small -- way too small. Next to the likes of just-exited Fannie Mae Chairman and Chief Executive Officer Franklin Raines, Martha Stewart is a dollar-store shoplifter. ... Why is Stewart a convicted federal felon for engaging in a stock transaction that netted less than Raines will receive in a single monthly pension while Raines drives around free as a bird after directly overseeing a massive corporate fraud that reportedly will cause a \$9 billion restatement in the books of the agency he headed?”
- “One answer to these two questions may lie in the fact that Martha Stewart built her corporate empire far from Washington’s gilded hallways. She probably didn’t even know what the FEC stood for ... She focused her efforts elsewhere. Franklin Raines, on the other hand, is as much a Washington insider as ever there was. Ask Raines about the FEC and he’d likely know more about political contributions than any candidate does even though he’s never been one. You can bet he pays much closer attention to who serves on what committees and subcommittees in the U.S. House and Senate than Stewart ever did. That attention to detail, and the fact that the quasi-public agency he headed for five years gives hundreds of thousands of dollars from its political action committee to House and Senate candidates each year may have something to do with the difference in treatment.
- “Perhaps also, sad to say, Stewart was not able to play the race card. Even though her story is as much a rags-to-riches saga as that of Franklin Raines, few if any major political figures came to her defense publicly when the details were made public. On the other hand, stories of Raines’ departure from Fannie Mae under a cloud are characterized not as a possible crime, or even as wrongdoing. His situation is described by friends in high places as a tragedy. He is seen as a victim of external circumstances, which made him a fall guy, not a wrongdoer. For all her PR savvy, Martha never had defenders like that. She paid a heavy price for such oversights.”
(*UPI*, Bob Barr, 01/12/05)

Fannie Mae remains on the editorial boards’ radar screens

- In a January 10 editorial, the *Christian Science Monitor* calls for the privatization of Fannie Mae and Freddie Mac. The *CSM* writes, “Both companies hold an unfair advantage over other lenders in the form of an implicit guarantee in a line of credit from the Treasury Department. That allows them to borrow at cheaper rates than their competitors. They’re also exempt from state and local taxes. But those crutches are no longer needed. Fan and Fred long have expanded beyond their original

mission, set after the Great Depression, which was to help poorer Americans buy homes. ...It's time for both companies to get on a level playing field with the banks as private institutions serving their stockholders alone." (*Christian Science Monitor*, 01/10/05)

- In a January 7 editorial, *The Pantagraph* in Bloomington, IL calls for full review of the Fannie Mae Foundation. *The Pantagraph* writes, "Even if Fannie Mae's accounting problems are straightened out, its integrity could remain in doubt if questionable charitable contributions are not thoroughly investigated." (*The Pantagraph*, 01/03/05)
- Numerous editorial boards decried the largess of retirement packages for former Fannie CEO Franklin Raines and CFO J. Timothy Howard. In a January 3 editorial, *The Washington Post* wrote, "A bit of accountability -- indeed, even a dollop of contrition -- might seem to be in order for Mr. Raines and Fannie Mae's longtime chief financial officer, J. Timothy Howard. ... Messrs. Raines and Howard seem to have developed their own unique notion of accountability, in which being accountable means not having to relinquish a single penny that they might be entitled to under their platinum parachute severance packages." (*Washington Post*, 01/03/05)
- In a January 2 editorial, the *Miami Herald* wrote, "As Washington scandals go, the extravagant retirement package of a Fannie Mae official may not seem like much, but it is symptomatic of a culture that permits the abuse of a public trust for personal gain. Congress and regulatory agencies will have a tough time fixing what is wrong at Fannie Mae, the nation's quasi-public mortgage giant. But they can start by insisting on a revocation of the deal that allows Franklin D. Raines to retire with a monthly pension of more than \$114,000 after he was forced to step down December 22 because of the discovery of huge accounting discrepancies." (*Miami Herald*, 01/02/05)
- *The Kansas City Star* wrote, "If Fannie Mae's board wants to carpet-bomb its executives with money, let the members first fulfill a plan for privatizing the company. The kind of package Raines received is completely unacceptable for a company with a government charter -- which shifts much of the business risk to the Treasury." (*Kansas City Star*, 01/02/05)
- In a January 4 editorial, the *Grand Rapids Press* wrote, "The head of any company that uses accounting gimmicks to vastly inflate profit should get the boot, not a solid gold parachute to cushion his fall. The king's ransom former Fannie Mae chief Franklin Raines is slated to receive for agreeing to "retire" early is an affront to common sense. ... That overly generous deal borders on criminal, which ironically matches up with the allegations of mismanagement that have surfaced against him." (*Grand Rapids Press*, 01/04/05)
- The *Atlanta Journal-Constitution* wrote, "Shareholders of ...Fannie Mae have paid an awful price for a financial performance that the company's directors once judged

“outstanding” but which has proved to be a lie. Almost \$6 billion in stock market value has disappeared since a federal regulator first questioned Fannie Mae’s accounting; the company has now admitted it may have overstated earnings by as much as \$9 billion. For this, shareholders paid millions in salary, bonuses and stock options to Franklin Raines and Timothy Howard. ... If Raines and Howard succeed in collecting yet more money, they will have helped perpetuate the all-too-common practice of paying a king’s ransom to pirates.” (*Atlanta Journal-Constitution*, 01/04/05)

- In a January 2 editorial, *The Advocate* (Baton Rouge, LA) wrote, “If ... Fannie Mae pays a million-dollar-a-year after-tax retirement to its ousted chief executive, in addition to millions in other benefits, the reputation of the company will not be as a facilitator of home ownership in America. Rather, it will be as a titanic boondoggle for the well-connected. ... Raines and his former financial aid want solid-gold parachutes for the wreckage they created. ... This is outrageous, but it is far too typical of how Fannie Mae has operated for a long time: big checks for the politically connected. ... If the Raines deal goes through in anything like its current form, the company and the U.S. government ought to ensure that this is the last Fannie Mae boondoggle.” (*The Advocate*, Baton Rouge, LA, 01/02/05)
- In a January 4 editorial, *The Wall Street Journal* comes to the defense of Franklin Raines, pointing out that the get-rich at Fannie story is “old Washington news.” The *WSJ* writes, “For decades, the shrewdest politicians have understood that after years of penury in government their quickest ticket to the top tax bracket was a job at Fannie or ... Freddie Mac. These ‘government-sponsored enterprises’ had their pick of rising Beltway stars, who clamored to work at a place where taxpayer subsidies guaranteed private profit. Former CEO James Johnson, who helped recruit Mr. Raines to succeed him, parlayed his Fannie windfall to the absolute pinnacle of Beltway society, the chairmanship of the Kennedy Center. Until recently, Messrs. Raines and Johnson were widely rumored to be the leading candidates to be John Kerry’s Treasury Secretary. It’s true that the immediate cause of Mr. Raines’s dismissal includes a regulator’s accusation that, in at least one instance, Fannie execs smoothed its quarterly earnings to meet targets that boosted their own compensation. This could certainly stand some sorting out, as the Justice Department, the SEC and an outside law firm are now doing. We’ll stop defending Mr. Raines if it’s true.”
- “But the big problem here isn’t one more example of runaway “corporate greed” in the person of Mr. Raines, who seems genuinely surprised and hurt by all of this piling on. The problem is the rigged game that the politicians have created to make Fannie and everyone associated with it rich. In the name of ‘affordable housing,’ Congress has long blessed Fan and Fred with an implicit subsidy in the form of a presumed taxpayer bailout guarantee. As study after study has shown, however, the bulk of this subsidy (which allows lower borrowing costs) doesn’t go to reduce mortgage rates or help the poor buy homes. The vast majority of it goes to increase profits that lead to higher salaries for Fannie execs and a higher stock price for its shareholders. A portion of those riches are then lavished back on the Members of Congress in the

form of campaign donations or gifts from the Fannie Mae Foundation to the likes of the Congressional Black Caucus.”

- “All that rhetoric about housing for the poor is little more than political eyewash. When Fannie’s regulator asked the company last year to steer more of its cash toward affordable housing, the company ginned up a lobbying campaign by Members of Congress in opposition. And guess who was one of the leading opponents? None other than Barney Frank, who led 75 other signers in a June 28 letter to the HUD Secretary assailing the proposal. In now denouncing Mr. Raines for his overlarge severance, the Massachusetts Congressman is like the bartender who moonlights as an AA counselor to his customers.”
- “Come to think of it, Mr. Frank and other Fannie enablers on Capitol Hill aren’t any different from the New York Stock Exchange directors who voted to pay Dick Grasso his millions as CEO but then sacked him when the news became embarrassingly public. Focusing on Mr. Raines’s severance has the political benefit of diverting attention from the Members’ own role in creating the rigged system that most of them profit from, one way or another. We suspect that they aren’t angry because Mr. Raines got rich; they’re mad because he got caught.” (*Wall Street Journal*, 01/04/05)

“John Q. public” speaks out on Fannie

- In a Letter to the Editor in the *Los Angeles Times*, Jim Hoover from Huntington Beach, CA, wrote “Former Fannie Mae Chairman and Chief Executive Franklin D. Raines’ and former Chief Financial Officer Timothy Howard’s raid on the coffers of their company, if committed by a two-time felon in the California justice system, would warrant life in prison. Isn’t outrageous remuneration for corporate leaders akin to any form of larceny without use of force, like embezzling money? But Raines and Howard are just symptomatic of what occurs in corporate boardrooms every day. Unfortunately, the rules governing or intentionally not governing executives practically guarantee top executive corruption, including their exploitation of stockholders and hard-working employees. And it is mostly legal. We will only see more of the same.” (*Los Angeles Times*, Jim Hoover, 01/03/05)
- In a Letter to the Editor of the *San Jose Mercury News*, Bill Graham from San Jose wrote, “The [*San Jose Mercury News*] Dec. 28 Op-Ed article ‘The price of character: too high to pay?’ is a sad but accurate evaluation of today’s society. The lack of character is epidemic. Free will, as given by our Creator, is not a license to run amok. Even religious leaders who profess to lead us on the straight and narrow are suspect and guilty. A prime example of domestic lack of character -- extreme greed -- is shown in the former Fannie Mae boss who is getting a \$114,000 monthly pension -- for life. That is not a pension, it is highway robbery. What is wrong with a government that permits such blatant greed? For, of course, corporate regulation is disappearing under this business-friendly Bush administration and the majority in Congress.” (*San Jose Mercury News*, Bill Graham, 01/04/05)

- Former Fannie Mae shareholder William Eleazer wrote in a Letter to the Editor of the *St. Petersburg Times*, “Having sold all my Fannie Mae stock recently at a loss, I read [the *St. Petersburg Times*] editorial with interest. ...[Y]ou suggest a sanction: If the Justice Department finds the books were “cooked” (false bookkeeping, accounting tricks to inflate stock prices and justify stock options and bonuses) any undue compensation should be ‘returned and possible fines levied’ as a warning to other executives who try these tricks as means of self-enrichment. I am appalled that you would suggest only a possible fine and return of “undue compensation” for such flagrant criminal conduct, if proved. Such insubstantial punishment would not be a “warning” but rather an invitation to further attempts at self-enrichment. If by slim chance you “get caught” you just return the pillage. Until greedy CEOs and other corporate officers who commit corporate offenses involving thievery and corruption know they will be held accountable with imprisonment just as it applies to other common criminals, corporate greed and self-enrichment will continue unabated. (*St. Petersburg Times*, William Eleazer, 01/05/05)
- In a Letter to the Editor in the *South Florida Sun-Sentinel*, Morton Zack Margate wrote, “Re the South Florida Sun-Sentinel Business section, Dec. 28, “Ousted execs in line for perks”: Fannie Mae CEO Franklin Raines’ benefits after being ousted are \$114,393 monthly for life; Deferred compensation of \$8.7 million; and lifetime of medical and dental coverage for himself and his wife. Will somebody please tell me where this money will come from? Surely the stockholders would be interested to know. These executives sure make fools out of us ordinary guys. (*South Florida Sun-Sentinel*, Morton Zack Margate, 01/11/05)
- In Letters to the Editor in their hometown newspapers, two former Fannie Mae employees defended the company and their management. In the *Washington Post*, Tamara R. Kalish from South Riding, VA wrote”... [F]ormer chief executive Franklin D. Raines and former chief financial officer J. Timothy Howard are honorable men who relied on varying interpretations of accounting rules. If corporate executives are going to be held accountable for ‘taking liberties’ with the rules, and if their own auditors can’t interpret the rules aptly, why is nobody talking about making the rules less open to interpretation?” In a Letter to the Editor of the *Raleigh News & Observer*, Liz Johnson of Raleigh wrote, “As a former 14-year employee of Fannie Mae, I thought your editorial ‘A giant’s stumble’ was misleading and a little naive. ...[Y]our statement that Fannie Mae might not “have enough money to cover its many obligations” is absurd. My sense is that most of the derivatives held by Fannie Mae are mortgage-related and used to hedge the interest rate risk of its own portfolio -- a prudent and conservative strategy by any financial manager’s standards, and not subject to the risks of investing in stand-alone derivatives.” (*Washington Post*, Tamara R. Kalish, 01/12/05; *News & Observer*, Liz Johnson, 01/03/05)
- In an “open line” segment on CSPAN1, a caller from Penns Grove, New Jersey asked CSPAN’s host, “Can you tell me when [Franklin] Raines will go to jail?” The host responded, “Why do you ask?” The caller said, “Because he has taken under false

pretenses, tens of millions of dollars in manipulated bonuses for him and his top ten or fifteen executives at Fannie Mae and I certainly hope that the Justice Department will prosecute him criminally. (*CSPAN1*, 01/05/04; 8:58:20 AM)

Lehman Brothers' "holiday miracle" for Fannie Mae

- According to analyst Dick Bove with Puck Ziegel & Co, Lehman Brothers pulled off a "holiday miracle" with its private placement of \$5 billion of Fannie Mae preferred stock on December 30. Lehman's efforts appear to be well rewarded. Fannie Mae paid the firm \$75 million in placement agent fees, roughly triple the typical Wall Street fee of 0.50% or \$25 million for a \$5 billion offering. (*Reuters*, Joseph A. Giannone, 01/05/05)

Fannie Mae faces an uncertain future

- Analysts with many Wall Street firms and ratings agencies now acknowledge that Fannie Mae face a future of higher costs and slower revenue growth, as the expenses of ongoing investigations and new regulations impair the company's earnings, ending its 19 year-long history of price appreciation. One concern for Fannie Mae shareholders is the "virtual certainty" of a cut in the company's long-term debt ratings, said Sean Egan, co-founder of Egan-Jones Ratings. "The company is simply not a triple-A company. When Moody's Investors Services and Standard & Poor's wake up to this, the market is going to change Fannie's business model in a minute," Egan said. As a result of the downgrade, he estimates that Fannie would have to pay an additional 60 basis points or about \$548 million extra in interest expense annually. Egan also estimates that Fannie will pay about \$310 million more in dividend expenses each year to pay for OFHEO's demand for additional capital. And, if interest rates rise, Fannie Mae's interest expenses will increase further.
- Friedman Billings Ramsey analyst Paul Miller said, "The [Fannie Mae] stock has gone from a value play based on earnings potential to a slow growth 'financial utility.'" To support its stock price and maintain investor interest, he said Fannie would be smart to boost its dividend payout to 50% of earnings (\$2.80 to \$3.00 a share) from its current 30% (\$2.08 a share), assuming the company's new auditors find no new problems. "But here's the thing: I'm worried about the audit. Given a thorough two years, I'm not sure what they can dig up, and they will have incentive to dig things up," Miller said. If more revelations come out, no matter what the company earns, "You could have a sub-\$50 stock," he added. (*New York Sun*, Roderick Boyd, 01/06/05; *Bloomberg News*, Al Yoon, 01/13/05)

Fannie Mae's possible mortgage sale predicted to impact the subprime market first

- Mortgage Bankers Association's economist Jay Brinkman believes that the subprime market will likely be impacted first, if Fannie Mae elects to sell mortgage assets to raise capital. "In the short run, the move may have more impact on the subprime market than the prime market," said Brinkmann. "We think near term that demand [from other investors] will be sufficient to keep [prime market] prices at current levels." (*Origination News*, Brian Collins, January 2005)

Fannie Mae makes payments on delayed mortgage pool payments and sues servicer

- Fannie Mae said it will make proceeds available in January for 234 loans in 169 mortgage-backed securities that a servicer allegedly collected but failed to pass on to the bondholders. Fannie said the servicer never informed it that borrowers had paid off 234 mortgages in 169 pools. On November 16, Fannie Mae filed a lawsuit against Olympia Mortgage Corp. of Brooklyn, N.Y., and Lieb Pinter, an Olympia principal and managing director, in the U.S. District Court for the Eastern District of New York. In the lawsuit, Fannie asked the court to appoint a receiver for Olympia, which retained at least \$44 million owed to investors from 260 loans. According to the suit, Olympia continued to fund a trust with enough money to cover the monthly payments for the loans, which borrowers had actually refinanced. (*American Banker*, Jody Shenn, 01/11/05; *Reuters*, Julie Haviv, 01/06/05)

Fannie Mae lobbyist seeks election to seat vacated by death of her husband,
Representative Robert Matsui

- Less than two weeks after the death of her husband, Representative Robert Matsui (D-CA) on January 1, Doris Matsui announced she will seek elect to his vacated seat. For eight years, Mrs. Matsui worked as a policy aide in the White House for President Clinton.[The *New York Times* accused Mrs. Matsui of working with fundraiser John Huang to formulate a strategy to solicit contributions from Asian Americans; it was reported that Matsui repeatedly authorized Huang to enter the White House during that period]. Since 1998, she has been a senior advisor and government relations director for the law firm Collier Shannon Scott, where she was a lobbyist for Fannie Mae. (*Sacramento Bee*, David Whitney, 01/12/05)

Freddie Mac

Freddie Mac is on track to post FY2004 results in March

- Freddie Mac said it was on track to report 2004 financial results by March 31, in keeping with promises it made to investors in November. The company will hold a quarterly conference call on January 18 and provide Wall Street an update on progress in its financial accounting and external reporting remediation program and business trends in general. Freddie Mac plans to return to regular quarterly reporting of financial results later this year, with first- and second-quarter results for 2005 due in August, third-quarter results in November and fourth-quarter and full-year 2005 results in January 2006, said Freddie Mac spokesman Michael Cosgrove. (*Reuters*, 01/11/05)

Freddie Mac worries that multifamily originations may have peaked

- In a comment letter to HUD, Freddie Mac raised concerns that multifamily originations may have “peaked,” making it harder for the GSEs to meet its affordable housing goals. Freddie recommends that HUD conduct midyear reviews of MF finance activities and recalibrate the AH goals, if necessary. (*National Mortgage News*, 01/10/05)

Friedman Billings hires Freddie Mac’s traders

- Friedman, Billings, Ramsey Group Inc. (FBR), the Arlington-based investment bank, has hired a team of ten mortgage-backed securities sales and trading professionals from Freddie Mac to create its own institutional MBS trading group. The team will be led by Michael Swell, the former vice president and head of Freddie Mac’s sales and trading group. Robert Cole, the former head trader at Fannie’s group, will head the trading effort of the new unit. The move follows Freddie Mac’s decision in October 2004 to stop market making activities and disband its trading operations. (*Asset Securitization Report*, 01/10/05; *Dow Jones Newswires*, Danielle Reed, 01/06/05; *Financial News Online*, Sarah Butcher, 01/10/05)
- Friedman has also agreed to purchase First NLC Financial Services, a Florida mortgage lender which makes subprime mortgage loans in 28 states and sells loans to investors. FBR plans to pool First NLC loan originations and turn them into asset-backed securities. To help manage the risk of its subprime loans, Friedman plans to purchase private mortgage insurance on a large portion of the portfolio. (*Washington Post*, Terence O’Hara, 01/12/05)

Freddie Mac announces staffing changes

- Freddie Mac has appointed Paul McDermott to its newly created position of vice president, structured and affordable sourcing within its multifamily sourcing division. Effective February 1, McDermott will be responsible for increasing Freddie Mac's purchases of small multifamily loans, portfolios and loans on subsidized affordable apartment properties, as well as for managing Freddie Mac's investments in low-income housing tax credits and commercial mortgage-backed securities. Since April 2002, McDermott has served as Freddie Mac's multifamily's chief credit officer and vice president of risk management and was previously responsible for developing and maintaining processes to ensure the credit quality of Freddie Mac's multifamily mortgage portfolio. (*Reuters*, 01/04/05)
- Freddie Mac has named James P. Witkins as the company's Senior Vice President, Technology effective January 3rd. Most recently, Witkins was managing director for technology and operations at Fleet Boston Financial, loan operations, risk management, capital markets, asset/liability management and treasury. Witkins, 54, will report to Joseph A. Smialowski, executive vice president for Technology and Operations. In this position, Witkins replaces William I. Ledman, who is retiring effective April 1, 2005 from the company after ten years of service. (*PR Newswire*, 01/06/05)

Devon Bank and Freddie Mac announce expanded financing opportunities for Muslim homebuyers

- Chicago-based Devon Bank announced it will begin selling its Islamic home financing products to Freddie Mac, effectively expanding opportunities for Muslims living in Illinois and nine other states to become homeowners while observing traditional Islamic restrictions on paying interest on mortgages and other types of debt. Devon Bank's Islamic housing finance model uses carefully tailored real estate financing documents, in accordance with state and local law, which function similar to a conventional Freddie Mac mortgage. These documents employ the Islamic "murabaha" trade model to avoid religiously objectionable concepts present in traditional mortgage loans documents. "For the past two years Devon Bank's Islamic financing programs have enabled observant Muslims throughout the Chicago area and some other states to acquire homes and businesses in a manner consistent with their faith," said the Bank's Chairman Richard Loundy. "Freddie Mac's agreement to purchase many of our Islamic home financing contracts will enable Devon Bank to assist more observant Muslims everywhere we do business." (*PRNewswire*, 01/10/05)

Freddie Mac and the Freddie Mac Foundation contribute to South Asia tsunami relief

- Freddie Mac said that the company, its foundation and its employees are donating more than \$300,000 to tsunami relief funds. Freddie Mac has donated \$150,000 to the American Red Cross and the Freddie Mac Foundation is contributing \$100,000 to several children's-related charities that are aiding in the South Asia relief effort. The Foundation is also matching donations made by Freddie Mac employees, who have donated about \$60,000. (*Washington Post*, 01/13/05)

Federal Home Loan Banks

Federal Housing Finance Board to conduct special exams of the 12 FHLBs

- Federal Housing Finance Board Chairman Ronald A. Rosenfeld said a special accounting exam of the 12 Federal Home Loan banks is in the offing. "That is something we are considering very carefully," he said. "Our standard of prudence will be every bit as strict" as the standards for the other GSEs and "we will take whatever actions we need to meet that standard." Rosenfeld said the Finance Board would move carefully to ensure it does not overburden the FHLBs, which are busy preparing to register with the SEC by August 29. "It's a function of looking at what needs to be done, what should be done, as well as looking at the current workload that has been thrust upon these banks by virtue of the SEC requirements," he added. Rosenfeld did not provide any other details about when or how such an exam would take place. (*American Banker*, Rob Blackwell, 01/10/05)

FHLB board extensions cancelled by Finance Board

- The Federal Housing Finance Board reversed its decision to extend the appointments of about 30 public-interest directors of the FHLBs, following receipt of a legal opinion from the Justice Department that the extension exceeded Board's authority. In an interview with *American Banker*, Rosenfeld said he wants to change the way the FHLBs' public-interest directors are selected and is committed to fixing the appointment process that is flawed; the importance of good corporate governance has become clear during the past few years, Rosenfeld added. "Some years ago, I think, it would have been perfectly reasonable to appoint Mother Teresa to a board," he said. "I think today that would probably not be a good idea. I think what we need today are people who have the skill and experience that is commensurate with the level of sophistication that is currently in the banking system. That is what we are seeking to accomplish -- to come up with a structure that enables us to achieve that."

- Many have wondered if the Bush administration wants public-interest directors appointed to the boards at all. Rosenfeld disagrees, saying the White House acted appropriately by stepping in to obtain a legal interpretation of the board's authority. "They want me to do the right thing, and the lawyers had a difference of opinion," he added. Nine of the 12 FHLBs have lost their chairman or vice chairman as a result of the reversal, and each of the 12 FHLBs has lost one to three directors.
- Others in the industry wonder when future appointments will be made. "Do they intend to make public-interest director appointments? That is the key question," said Alfred DelliBovi, the president of the FHLB-NY, which lost vice chairman Michael M. Horn. On January 5, David Lindstrom, the president and CEO of Franklin Savings Bank in Pilesgrove, N.J., became the FHLB-New York's vice chairman. Rosenfeld said the issue is one of his top priorities and that the Finance Board would focus on fixing the process first. (*American Banker*, Rob Blackwell, 01/06/05; *American Banker*, Rob Blackwell, 01/10/05)

FHLBs not prepared to fight GSE regulatory reform

- "The Federal Home Loan Banks are spending tremendous amounts of time, money, and energy toward getting ready to go to the SEC," said John von Seggern, president and chief executive officer of the Council of Federal Home Loan Banks (CFHLB). "I think if you talk to most of the management of the Federal Home Loan Banks, they would argue they have a very, very full plate and do not need additional issues to be thrown their way." However, the FHLBs are facing the serious prospect of being included in possible legislative action to revamp the regulatory regime for all of the housing GSEs. In a survey of its members, CFHLB found that they are not prepared to fight expected proposals on Capitol Hill, but have expressed certain principles that they hope a new regulatory system would follow, said von Seggern. CFHLB's members hope that whatever form a possible new regulator takes, it should be independent, while giving the FHLBanks continued ability to serve their member institutions and ongoing access to capital markets. Members also hope that shifting to a new regulatory regime would be as seamless as possible. "Changing the regulatory structure for the Federal Home Loan Bank System will be a disruptive process," von Seggern said. "It just will be. There's no way around it, whether it's good, bad, or indifferent. And at the end of the day if it makes you much better it certainly in the short run will be disruptive. So, let's not do that again." (*BNA's Daily Report for Executives*, Richard Cowden, 01/13/05)

FHLB-Boston announces dividend and election results

- The board of directors for the FHLB-Boston declared a cash dividend with an annual yield of 3.5% on average balances of Class B shares for the fourth quarter of 2004.

- The FHLB-Boston also announced the election results for its board of directors. William P. Morrissey, senior vice president of Central Bank in Chestnut Hill, MA, was re-elected to the board. Morrissey has served on the board from October 1990 to December 1996, and from January 1999 to the present. Stephen Christy, president and chief executive officer of Mascoma Savings Bank, FSB, in Lebanon, NH, ran unopposed. Christy has served on the board of directors since January 1, 2002. Peter F. Crosby, president and chief executive officer of Passumpsic Savings Bank, in St. Johnsbury, Vermont, also ran unopposed for his first term on the board. Morrissey, Christy, and Crosby will serve three-year terms, from January 1, 2005 to December 31, 2008. (*FHLB-Boston Press Release, 12/31/05*)

Farm Credit System / Farmer Mac

Regulatory reform of FCA system “likely” in aftermath of Rabobank/FCSA deal

- As Congress contemplates GSE regulatory reform this year, some question if the new GSE regulator might also oversee the Farm Credit System. After the failed attempt by Farm Credit Services of America (FCSA) to withdraw from the FCS in order to be acquired by Dutch cooperative Rabobank, the FCS regulator is expected to try to restrict its members’ ability to leave, while expanding its powers. *BNA* sources say that these issues, coupled with a tug of war between proponents and foes of new powers for the Farm Credit System, will put farm credit issues more at the forefront of congressional and regulatory action this year than might otherwise be expected.
- A red flag about the FCS’s security was raised last summer, when the Omaha-based FCSA moved to withdraw from the system and become part of Rabobank, raising concerns that private mergers could ultimately disband the FCS. John Blanchfield, Director of the Center for Agricultural and Rural Banking of the ABA, predicts that “mega-mergers” within FCS are inevitable, as institutions “bulk up as much as possible,” to either attract or repel buyers. Blanchfield expects “significant consolidation” in the next year or two particularly in Texas and the Southeast, with the 100 or so existing institutions declining to “maybe 75 or fewer.” Blanchfield said he sees a two-pronged legislative effort ahead. He believes there will be a move to restrict FCS members from voting their shares to sell their institutions. Further, he anticipates that the Farm Credit System will argue that, because Rabobank came so close to “swallowing” a system association, it needs an expanded charter to provide more lending powers. Blanchfield calls this reasoning “reverse logic,” since FCSA “actively went out and sought a buyer.” He notes that, as GSEs, FCS institutions already have advantages over ordinary rural community banks, given their ability to issue Treasury-guaranteed bonds and their numerous tax exemptions on lending. Floyd Stoner, ABA’s executive director for congressional relations and public policy,

added that FCS institutions “are the only retail [GSEs] that compete directly in lending with commercial banks,” and they deserve no new lending authority. Stoner said that Representative Jim Leach (R-IA), who supported GSE reform legislation last year, has indicated he may favor inclusion of FCS institutions under a new GSE regulator. The ABA believes that the new GSE regulator should cover FCS institutions as well, said Blanchfield.

- Issues raised by the proposed FCSA/Rabobank transaction are likely to be the subject of Agriculture Committee hearings this year, said Mark Scanlan, director, office of agriculture & rural policy for the Independent Community Bankers of America. ICBA would like to see more “transparency” in FCA’s regulatory process included in legislation to reform the system, said Scanlon, adding FCA is more a protector than a regulator of the system. A pending regulatory proposal likely to resurface this year would expand the scope of farm credit institutions into nonfarm lending, which ICBA opposes. Instead, community bankers are seeking talks with FCS representatives to arrive at more equitable market access in rural areas, Scanlon said. “We want to try for a win-win,” he said. (*BNA’s Daily Report for Executives*, Marcia Kass, 01/13/05)

FCA regulatory agenda for 2005

- On December 9, the FCA board adopted a proposed rule to strengthen corporate governance of FCS institutions, which goes beyond requirements of the Sarbanes-Oxley Act and seeks to let boards of directors operate more effectively. In mid-January, the proposed rule will go out for a 60-day comment period, which may be extended if response volume is high, said FCA spokesman Carl Clinefelter. The final rule is expected to become effective this fall. In March, FCA expects to issue a final rule to amend regulations on investments in Farmers Notes, which seeks to make credit more available to non-system lenders who make agricultural loans, and to enterprises that sell agricultural supplies, equipment, and other capital goods on credit to farmers and ranchers. In February, a proposed rule on receivership repudiation authorities will go to the board, which responds to a regulatory petition to change the priority of claims from system banks under their joint and several obligations for debt issuances. During the first quarter, FCA also plans to wrap up an evaluation of regulatory burden, and begin a review of FCA expenses, said Clinefelter.
- In April, a notice of proposed rulemaking for a Farmer Mac risk-based capital rule is due, which would change some aspects of the existing capital standards for Farmer Mac and proposes revisions for capital adequacy planning requirements. The date for a final rule is yet to be determined. A proposed rule that would provide an option to borrowers who want their loans syndicated to waive certain borrower rights was proposed in the fourth quarter of 2004 and is tentatively scheduled for final form in the third quarter of 2005. The comment period is still open. Another regulatory proposal scheduled to come before the board in the third quarter concerns the

definition of a farmer, which deals with part-time farmers, said Clinefelter. (*BNA's Daily Report for Executives*, Marcia Kass, 01/13/05)

The Privatized GSE: Sallie Mae

The newly privatized Sallie Mae – a driving force in the marketplace

- In December, Sallie Mae officially cut its ties to the federal government, in a final step completing a process that began almost a decade ago, when Congress passed legislation allowing Sallie Mae to become a private corporation. Created by Congress in 1972 to help the fledgling federal-student-loan program, lawmakers at the time wanted Sallie Mae to create “a secondary market” that would pump more money into the loan program. As a GSE, Sallie Mae was prohibited from making loans to students.
- In the years since the privatization law was enacted, Sallie Mae has become the nation’s top student loan lender, originating more than \$12 billion in loans in 2003. By forging exclusive arrangements with banks and by purchasing nonprofit lenders throughout the country, Sallie Mae has become the driving force in the student loan market. Over the past year, Sallie Mae has been particularly aggressive, acquiring two major lenders in the West--Southwest Student Services Corporation of Arizona and the Student Loan Finance Association. The company’s critics and competitors are now watching with alarm Sallie’s pursuit of the Pennsylvania Higher Education Assistance Agency (PHEAA), the 14th-largest lender in the guaranteed-loan program in 2003. On December 27, PHEAA has turned down Sallie Mae’s offer of \$1 billion; company spokesmen have indicated that Sallie’s management plans to pursue this acquisition through other channels –namely members of the Pennsylvania legislature. In *Washington Research – Washington World* published by Prudential Equity Group, LLC, Charles A. Gabriel, Jr. writes, “[Sallie Mae’s offer] may indeed have put PHEAA in play and set itself up to possibly raise its bid if necessary to land “the big one.” This could unlock not only better access to but probable domination of the rich Pennsylvania college loan market.” As Sallie Mae grows, diminished competition in the loan program will lead to a decline in services and to higher prices for students, with fewer and less-generous discounts on fees and interest rates, warn critics. Sallie Mae officials say their competitors’ fears are overblown and note that their offer would help Pennsylvania students by giving the state \$1 billion that it could use to increase support for its public universities and provide more financial aid. “This proposal, which we carefully crafted, is a win for everyone involved, especially Pennsylvania’s students, colleges, and taxpayers,” said Sallie Mae spokesman Tom Joyce. (*Pittsburg Post-Gazette* (PA), Len Boselovic, 01/03/05; *Pittsburg Post-Gazette* (PA), Stephen Burd, 01/14/05)

- In an analysis of area businesses, the *Washington Post* measured year-over-year increases in local company's market capitalization and found the top performer was Sallie Mae, whose market value grew by \$6.8 billion. (*Washington Post*, Jerry Knight, 01/03/05)

Postal Service

Representative McHugh reintroduces postal reform bill

- On the first day of the 109th Congress, Representative John McHugh (R-NY) reintroduced H.R. 22, the Postal Accountability and Enhancement Act of 2005, with sponsors Tom Davis (R-VA), Government Reform Committee chairman; Henry Waxman (D-CA), ranking minority member; and Representative Danny Davis (D-IL). The legislation, originally crafted last year, is almost identical to the bill that passed the Government Reform Committee by a 40-0 vote in 2004. The bill addresses the Civil Service Retirement System issue and calls for replacing a provision requiring that money owed to the USPS because of an overpayment into the CSRS fund be held in an escrow account. Repeal of this provision would free up \$78 billion over 60 years, letting the USPS pay off debt to the U.S. Treasury, fund its healthcare liabilities and offset rate increases. If that money isn't released, the postal service has said it will seek a double-digit rate increase for the first quarter of 2006. Postal experts warn of increases as high as 15% percent, and even higher for periodicals. The bill also would return responsibility for funding CSRS pension benefits related to the military service of postal retirees -- a \$27 billion obligation -- to the Treasury Department.
- "By putting the House version of the bill out there so early in the session, John McHugh has allowed us to hit the ground running and start talking about this stuff literally from day one," said Neal Denton, executive director of the Alliance of Nonprofit Mailers. Senator Susan Collins (R-ME), chairman of the renamed Homeland Security and Governmental Affairs Committee, is expected to reintroduce her postal bill soon. It is unknown whether hearings will be held on the bill, which is possible because the Senate committee has four new members who might need to be brought up to speed on postal reform issues. The new members -- Pete Domenici (R-NM), John Warner (R-VA), Lincoln Chafee (R-RI), and Tom Coburn (R-OK) -- have experience with postal issues on other committees. Some insiders predict that reform legislation could pass as early as March, while others said May or June. If the postal service files its rate case before legislation is signed into law by President Bush, the USPS can update its revenue requirement. Another big unknown is whether the White House will endorse postal reform legislation, since the administration said the bills in both houses lacked sufficient reform last year. (*DMNews.com*, Melissa Campanelli, 01/10/05)

APWU faces off with the Bush Administration on changes to work-sharing rules

- The American Postal Workers Union and the Bush administration are facing off anew over labor rules in the long-awaited postal reform legislation. In a memo outlining priorities for legislation, Bush administration officials advocate greater flexibility in negotiating work-sharing agreements, which allow the USPS to offer discounts to large mailers for presorting mail and other tasks normally done by postal workers. Union lobbyists oppose such changes. Major changes to work-sharing provisions are unlikely to become a part of the House bill, said Robert Taub, chief of staff for Representative John McHugh (R-NY), who has sponsored postal overhaul legislation in every Congress for nearly a decade. McHugh's reintroduction of the bill is a signal that Congress is ready to act on postal reform, said Taub, but negotiations probably will continue in coming weeks between lawmakers and the administration. (*GovExec.com*, Alyson Klein, 01/10/05)

Miller and Kessler elected to leadership posts of the USPS Board of Governors

- The Governors of the U.S. Postal Service elected James C. Miller III of Virginia to be chairman and Alan C. Kessler of Pennsylvania to be vice chairman for 2005. Miller is a former Director of the OMB and serves as Chairman of The CapAnalysis Group, an economic, financial and regulatory consulting firm associated with the international law firm Howrey Simon Arnold & White. Kessler is a Philadelphia attorney and partner in the firm of Wolf, Block, Schorr and Solis-Cohen, LLP, with substantial experience in the defense of class-action litigation, including securities, antitrust, toxic tort and civil rights cases. (*PRNewswire*, 01/11/05).

Japanese Prime Minister Koizumi is determined to privatize the Japan Post

- On January 4, Japanese Prime Minister Junichiro Koizumi expressed his resolve to begin the privatization process of Japan Post, the governmental postal services and said his Cabinet will submit legislation to the Diet (parliament) session to be convened later in January. Investment bankers have shown keen interest in the fate of the Japan Post, which manages the national mail and express-delivery services and \$3 billion worth of postal savings and postal insurance money. Japan Post is the largest financial institution in the world, and, Kampo, its life insurance division, is by far the largest insurance operation in the world.
- “On the domestic front, the most critical issue for this year is the privatization of the three postal services, even though all political parties have opposed to it,” Koizumi said at his first news conference. On September 10, the Prime Minister's Cabinet approved a privatization plan which would break the post office into four separate businesses that will initially be owned by a government holding company. In Koizumi's holiday statement released New Year's Day, he trumpeted his “trinity

reform” policy--reduction of government subsidies, devolution of tax authority from the state to local governments, and reduction of the state’s tax transfers to local governments. In his statement, Koizumi said that his Cabinet would start privatizing Japan Post in April 2007 as scheduled. “Taking into account the abilities of the private sector, I believe the privatization of postal services is indispensable if we are to boldly push forward the administrative and fiscal reforms, reduce the number of civil servants and leave to the private sector what it can do. As such, I intend for the government as a whole to work for the realization of this reform,” said Koizumi. (*Bureau of National Affairs, Toshio Aritake, 01/05/05*)

TVA

TVA must be leader in environmental quality

- In a January 2 editorial, *the Tennessean* writes, “TVA must be leader on environmental quality. The Tennessee Valley Authority hardly bears all the blame for the air pollution around the Great Smoky Mountains. But TVA, as the largest power producer in the region, does bear most of the responsibility of leadership on air cleanup. Senator Lamar Alexander (R-TN) is prodding TVA to accept that leadership. He recently wrote a letter to TVA directors that focused on the need for the utility to install scrubbers on the three power plants closest to the Great Smoky Mountains. The senator’s letter was sparked by a recent Environmental Protection Agency report that listed Knoxville and Chattanooga as well as Roane, Blunt, Loudon and Anderson counties as being in violation of national standards on particulate matter, or soot. Alexander said that East Tennessee cannot meet national requirements unless TVA installs scrubbers at all units of three plants - John Sevier, Bull Run and Kingston. He acknowledged TVA’s plans to install scrubbers at Bull Run and Kingston by 2010, but the senator specifically called upon the agency to make those plans more definitive by putting the plans into its operating permits and adding the John Sevier plant.”
- “TVA Director Bill Baxter responded that TVA is in the middle of a \$6 billion effort to reduce pollutants, including adding scrubbers. He took issue, however, with some of the Alexander’s analysis. He said that air quality had improved, but that the numbers look worse because the EPA now had stricter standards. Baxter also pointed out that particulate matter is generated by sources other than power plants.”
- “There is no question that the causes for the pollution are multi-faceted. Alexander acknowledged in his letter that cleaner emissions from trucks and automobiles should be part of the solution. The letter also acknowledged TVA’s ongoing effort to clean the air. Still, the senator is right to try to shift TVA into a strong position of leadership on this issue. “TVA’s mission has always gone far beyond power

production. It is the steward of the Tennessee River and its tributaries. It is also a primary supporter of commerce and jobs creation, particularly in East Tennessee - a region that relies heavily on the ability of the Great Smoky Mountains to sustain tourism. Does TVA have a plan for cleaner air? Absolutely. What Alexander is seeking, however, is for that plan to be broadened and to be included in TVA's operating permits. Beginning in May, TVA management will totally change: Instead of being managed by three appointed full-time board members, it will be governed by a nine-member part-time board, which will hire a full-time chief executive officer. Given such a radical change, this is the ideal time for TVA to put its good intentions on the environment into writing." (*The Tennessean*, 01/02/05)

Cleaner energy provided by TVA's wind farms at premium prices

- Eighteen windmills on the South's first commercial wind farm are now producing enough clean power to be seen as more than just an eco-experiment. When the farm opened with three turbines in 2001, it generated a mere 2 megawatts of electricity which would power just 360 homes. In December, 15 larger turbines were added, boosting capacity to 29 megawatts, enough for 3,000 homes. "Magnificent," said Rick Carson, the TVA's renewable operations manager, as he gazed out on the 26 story-tall windmills dotting a two-mile forested ridge atop Buffalo Mountain, 10 miles from downtown Oakridge, TN. Still small in comparison to big wind farms in the Great Plains and Pacific Northwest, TVA's expanded operation is huge for the Southeast, where there is less reliable wind and few sites offering 14 mph breezes needed by turbines to generate power.
- Privately financed by Invenergy LLC of Chicago, the \$30 million expansion of the wind farm is expected to help erase a supply deficit in TVA's Green Power Switch renewable energy program, leaving a surplus that could be sold to other utilities. TVA lured Invenergy into making the investment by offering them a 20 year, \$60 million power purchase. Environmentalists champion TVA's Green Power Switch program, which has 7,156 residential and 339 business customers paying premium prices for renewable energy. (*Associated Press*, Duncan Manfield, 01/07/05)

TVA considers offering long-term contracts to distributors

- Facing the possible flight of power distributors, the TVA is considering offering long-term contracts with lower electric rates. Five small distributors in Kentucky and one in Tennessee have given TVA notice that they plan to leave its system when their contracts expire in the next few years, or at least are keeping open their options for getting power from somebody else. Warren Rural Electric Cooperative Corp. in Kentucky has already signed a contract to start purchasing electricity from East Kentucky Power Cooperative in 2008. Negotiations between TVA and its distributor representatives at the Tennessee Valley Public Power Association (TVPPA) over new contract terms aren't necessarily tied to the threat of departures, but do come as TVA

anticipates the arrival of competition in its seven-state region, where it serves 8.5 million customers.

- Currently, 99 of TVA's 158 distributors have short-term contracts which require a five-year notice to leave the system. TVA would like more utilities sign contracts with terms up to 20 years. TVA executive Kenneth Breeden said he couldn't disclose too much about the talks, but said the agency's goal is to get more predictability for its system and may offer a "price differential" to entice distributors to longer commitments. Breeden hopes new contract terms will be reached by the spring and brought to the TVPPA board for endorsement. Jack Simmons, president and chief executive at TVPPA, said he is concerned that under the new contracts distributors may be charged a random "premium," if they don't sign a long-term contract. "This is not about punishment or reward," Breeden responded. "Anyone who has given notice I would think will look very seriously at these long-term contracts, and some will sign up with TVA." (*Associated Press*, 01/04/05)

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