

The **GSE** REPORT™

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Contents of GSE Report™

Major Events

- [HUD's Assistant Secretary of Housing testifies that Fannie and Freddie are falling short of their core mission \(p. 3\)](#)
- [SEC's top accountant testifies that the SEC staff is "thoroughly" probing Fannie's books \(p. 4\)](#)
- [Senate Banking Committee reviews conflicts of interest in credit rating industry \(p. 6\)](#)
- [Bush administration's FY2006 budget proposal provides roadmap for GSE reform \(p. 9\)](#)

Fannie Mae and Freddie Mac

- [Stay tuned – lawmakers preparing to push GSE reform \(p. 11\)](#)
- [Treasury Secretary Snow meets with White House officials on GSE regulatory reform \(p. 12\)](#)
- [Is Fannie Mae too late to the dance? \(p. 13\)](#)
- [GSE reform legislation could "significantly curtail" the GSEs AU systems \(p. 14\)](#)
- [Financial Services Roundtable applauds push for stronger GSE oversight \(p. 15\)](#)
- [Grassroots coalition of 37 federal, state and local groups tell Congress to pass GSE reform before it's too late \(p. 15\)](#)
- [How do you handle the failure of Fannie or Freddie? \(p. 16\)](#)
- [S&P's DeStafano's comments at AEI forum raises more questions than answers \(p. 17\)](#)
- [Fannie Mae and Freddie Mac: "The implicitly colluding duopoly" \(p. 19\)](#)
- [The debate on cutting the servicing fee continues \(p. 20\)](#)
- [Fannie and Freddie are losing small banks' mortgage business \(p. 21\)](#)
- [E-mortgages on the horizon \(p. 21\)](#)

Fannie Mae

- [The fallout continues, as two more Fannie execs "retire" \(p. 23\)](#)
- [Fannie Mae begins paying benefits to former executives \(p. 23\)](#)
- [Fannie Mae's internal accounting probe may be completed this spring \(p. 24\)](#)
- [Nicholasien's congressional testimony raises more questions about Fannie's application of FAS 91 and FAS 133 \(p. 24\)](#)
- [Fannie Mae's corporate governance rating cut by S&P \(P. 26\)](#)
- [Fannie's former CEO Raines one of the "high flying compensation stars" \(p. 26\)KPMG locks the barn door a little too late \(p. 27\)](#)
- [Fannie Mae finalizes its hiring of Deloitte & Touche \(p. 28\)](#)
- [DC Mayor Williams will try to force Fannie to honor its promise to be an anchor tenant in Waterside Mall \(p. 29\)](#)
- [Citigroup and Capital Research & Management hold 6.3% and 11/1%, respectively of Fannie's common stock \(p. 29\)](#)

- [A look at Fannie's stock chart \(p. 30\)](#)
- [Minority couple sues Fannie, alleging discrimination \(p. 30\)](#)
- [Fannie Mae to save \\$500 per loan? \(p. 30\)](#)
- [Fannie Mae partners with community bank to offer "Korean friendly" loans \(p. 31\)](#)

Freddie Mac

- [Freddie Mac's COO McQuade says GSE reform should reflect their "unique status" in market \(p. 31\)](#)
- [Ralph Boyd elected chairman of the Freddie Mac Foundation \(p. 32\)](#)
- [Freddie Mac promotes John Donoghue as general counsel \(p. 32\)](#)
- [Freddie signs up another outside lobbying firm \(p. 32\)](#)
- [Friends in high places \(p. 32\)](#)
- ["Just the Facts" from Freddie Mac \(p. 33\)](#)
- [Freddie sets multi-family funding record in 2004 \(p. 33\)](#)

Federal Home Loan Banks

- [Council of FHLBs endorses S. 190, providing GSE regulatory reform \(p. 33\)](#)
- [President and CEO of FHLB-Seattle retires \(p. 34\)](#)
- [The Federal Housing Finance Board accepts the FHLB-Chicago's business plan \(p. 34\)](#)
- [FHLB-Atlanta announces appointments of new CFO \(p. 35\)](#)

Farm Credit System/Farmer Mac

- [Federal budget proposal depicts a strong and growing Farm Credit System \(p. 36\)](#)

Postal Service

- [Postal Reform gets early start but momentum is questionable \(p. 38\)](#)
- [Heritage Foundation examines the need for postal reform \(p. 38\)](#)
- [Why this year may be different for postal reform \(p. 39\)](#)
- [Federal budget proposal lacks many of USPS funding requests \(p. 39\)](#)
- [Online banking trends bode ill for USPS' future \(p. 40\)](#)
- [President Reagan stamp unveiled \(p. 40\)](#)

TVA and Rural Electric Co-Ops

- [OMB rates TVA "moderately effective" \(p. 41\)](#)
- [The politicking begins for TVA's new board \(p. 41\)](#)

Major Events

HUD's Assistant Secretary of Housing testifies that
Fannie and Freddie are falling short of their core mission

- At the Senate Banking Committee's hearing on the role of GSEs in the mortgage market on February 10, HUD's Assistant Secretary of Housing and Federal Housing Commissioner for HUD John C. Weicher testified that Fannie Mae and Freddie Mac account for a disproportionately small share of the minority first time home buyer market, raising doubts on whether the GSEs meet their primary mission of expanding home ownership for low income Americans. According to HUD, the housing GSEs accounted for an average 25.9% of loans to first-time minority home buyers from 2001 to 2003, well below the market average of 39.1%. "The GSEs do a rather poor job of serving first time home buyers, particularly minority first time home buyer[s]," said Weicher. Senator Elizabeth Dole (R-NC) commented, "The more I study this issue, the more convinced I am that Fannie and Freddie have consistently fallen short of fulfilling their mission to truly reduce the cost of homeownership for low-income America."
- Weicher also told the committee that HUD has begun an examination of the Fannie Mae Foundation's activities. When asked by Senator Chuck Hagel (R-NE) what HUD has discovered, Weicher said that the review is ongoing and he will report HUD's findings to the panel when it was completed. While Weicher declined to comment on the specifics of the HUD probe, one official said policy-makers have long been concerned about Fannie Mae's use of the nonprofit Foundation to advance its own purposes. The official pointed out that corporations are allowed to provide resources that benefit a charitable arm, but tax laws prohibit corporations from using their charities to the benefit of the company. The Fannie Mae Foundation was set up to also support the U.S. housing market.
- Following Weicher's testimony, a panel of economists consisting of Professor Richard K. Green with George Washington University School of Business, Professor Anthony B. Sanders with the Department of Finance at Ohio State University, Professor Susan M. Wachter with the Wharton School of Business at University of Pennsylvania, and Allen Fishbein, Director of Housing and Credit Policy for Consumer Federation of America testified before the committee. Largely, the economists' testimony questioned the methodology and conclusions of several studies by the Federal Reserve, which concluded that Fannie and Freddie's market activities have a "negligible" impact on market rates. Specifically, one study by Federal Reserve economist Wayne Passmore concluded that the housing GSEs lower rates for home buyers by only 7 basis points. The economists said that often not enough data is available to measure the GSEs' impact on the mortgage market, adding that the absence of data does not mean that Fannie and Freddie have no impact. Sanders estimated that Fannie Mae and Freddie Mac lower borrowing costs by about 28 basis points. Wachter testified that Fannie's and Freddie's impact on homeownership

should not be judged by how much the GSEs lower mortgage rates alone. Technical innovations, such as automated underwriting, developed by Fannie and Freddie in the 1990s are also responsible for boosting ownership, she said. Wachter also countered Weicher's comments, saying that Fannie and Freddie enhance the efficiency of the U.S. mortgage market and provide affordable financing through low downpayment programs and other innovative products. [In the past, Wachter has written several papers on behalf of Freddie Mac.]

- During the hearing, Senate Banking Committee Chairman Richard Shelby (R-AL) said he plans to hold several more hearings on GSE regulatory reform legislation and indicated an interest in scrutinizing the guarantee fees they charge. Shelby also said he plans to focus more on the FHLBs, which are expected to be part of the regulatory overhaul. Shelby said "Several small lenders raised concerns with the committee that the guarantee fees charged small lenders are higher than those charged large lenders." He asked the witnesses, "Do you care to comment on that?" All of the witnesses said that they did not have enough data to respond, because Fannie and Freddie keep most information about their guarantee fees private. Shelby said "My concern, and a lot of people's concern, is that these business practices may be pushing the mortgage industry to an ever more concentrated structure," he said. After the hearing, Shelby told reporters he planned to "explore that [issue] some more."
- Shelby also said he wants to spend more time making an "inquiry" into issues relating to the FHLBs, but he did not elaborate. Senator Paul Sarbanes (D-MD) spent most of his time at the hearing focused on the FHLBs. He repeatedly asked Weicher about whether the FHLBs should have affordable housing goals similar to that of Fannie and Freddie. "Have you had any concerns about the extent of the commitment of the Home Loan banks to affordable housing?" Sarbanes asked. "Have you thought they could do more, or should do more?" Weicher, who is also HUD's designee at the Federal Housing Finance Board, noted that they already pay 10% of their earnings to an affordable housing program [in the form of grants], but he would not say whether anything else is necessary. Sarbanes asked the economists how the FHLBs' program stacked up against what Fannie and Freddie have done. Fishbein responded that more information is needed. "There does not seem to be well-documented data to see who is actually benefiting from these programs," he said. "There really is a black hole with respect to information regarding the program." (*Statement of John C. Weicher, Assistant Secretary of Housing and Federal Housing Commissioner, U.S. Department of Housing and Urban Development, 02/10/05; Reuters, Kristin Roberts, 02/10/05; Bloomberg News, James Tyson, 02/10/05; Dow Jones Capital Markets Report, Dawn Kopecki, 02/10/05; American Banker, Rob Blackwell, 02/11/05; Dow Jones International News, Dawn Kopecki, 02/10/05*)

SEC's top accountant testifies that the SEC staff is "thoroughly" probing Fannie's books
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- At a February 9th hearing of the House Financial Services Subcommittee on GSEs, SEC Chief Accountant Donald Nicolaisen stood by his ruling that Fannie Mae had

violated GAAP and assured lawmakers that the SEC staff is “thoroughly” investigating any evidence of wrong-doing at Fannie Mae. Nicolaisen limited his testimony to public information on the SEC’s investigation of Fannie Mae’s accounting, so as not to compromise the SEC’s ongoing investigation, and emphasized that his views are his own and not those of the SEC.

- When its accounting was criticized by OFHEO in September 2004, Fannie asked the SEC to assess the company’s handling of FAS 133 involving hedging with derivative instruments and FAS 91 regarding the treatment of loan prepayments. “Fannie Mae requested our guidance because in its view, these accounting issues received extraordinary public attention” that created uncertainty in mortgage and capital markets, said Nicolaisen. On December 15, the SEC’s accounting staff announced that some of Fannie’s accounting practices for FAS 133 and FAS 91 didn’t comply with GAAP and called on Fannie to restate its financial reports from 2001 to mid-2004 to eliminate use of hedge accounting and correct for any material errors in accounting for loan prepayments. Nicolaisen said the SEC staff relied solely on information voluntarily supplied by Fannie and OFHEO. Fannie Mae didn’t ask the SEC staff to express any views on whether the information provided was accurate or complete and “we did not do so,” he said. The SEC staff only evaluated whether Fannie properly accounted for hedging transactions and didn’t review its business judgment in utilizing derivatives to hedge its exposure to interest rate risk, said Nicolaisen.
- Fannie Mae’s allies, including ranking minority member Paul Kanjorski (D-PA) and several members of the Congressional Black Caucus and Hispanic Caucus, attempted to cast blame on KPMG, the company’s auditor, and the complexities of the accounting rules for Fannie’s problems. In response to questions about the complexity of FAS 133, Nicolaisen testified that the hedging rules that Fannie Mae violated are “straightforward and clear,” not open to interpretation as the company’s officials had argued. “I think those rules are clear,” he said, adding that other companies using similar rules had applied them correctly. Nicolaisen said, “Fannie Mae internally developed its own methodology to assess whether hedge accounting was appropriate,” adding that this unique strategy was deficient and “did not qualify for hedge accounting.” Additionally, Fannie Mae executives knew that their methods for calculating losses on mortgage prepayments “were not consistent” with FAS 91, he said.
- When asked how long the Fannie restatement might take, Nicolaisen responded, “While I can’t put a precise time period on it, I would imagine we’re talking a number of months, perhaps a year. I would hope it’s not years that we’re talking about.” It will take several months for Fannie Mae to finish a through “scrubbing of the books” before its new auditor, Deloitte & Touche LLP, can begin to re-audit fiscal years 2001 through 2004, he added.
- After the hearing, Representative Chris Shays (R-CT) told reporters that Fannie Mae now has “no leg to stand on. The veneer is off ...and what you see is alarming.”

Shays told *Market News International* that he believed that Fannie Mae's accounting adventures broke the law. "They did crooked things," said Shays. "In my judgment, some should go to jail. He added, "I think Frank Raines perjured himself" in his congressional testimony late last year. "I'm embarrassed that Congress has not stepped forward and dealt with this issue sooner," said Shays. (*Dow Jones Newswires*, Judith Burns, *Dow Jones Newswires*, Dawn Kopecki, 02/09/05; *Reuters*, 02/09/05; *The Main Wire*, Claudia Hirsch, 02/10/05; *Dow Jones Newswires*, Dawn Kopecki, 02/09/05; *Reuters*, 02/09/05; *The Financial Times*, Jenny Wiggins, 02/10/05)

Senate Banking Committee reviews conflicts of interest in credit rating industry
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- At a February 8 hearing on credit-rating agencies, Senate Banking Committee Chairman Richard Shelby (R-AL) said he intends to explore further the possible conflicts of interest in the credit-rating process and lack of competition in the industry. In coming weeks, Shelby said he would like for SEC Chairman William Donaldson to testify before the committee concerning the SEC's role in overseeing the credit-rating agency industry. Committee ranking minority member Senator Paul Sarbanes (D-MD.) said, "I think the SEC needs to move in this area. I think there are some problems, and they need to address them." The SEC might have the authority to regulate these agencies, said Sarbanes, adding he would seek testimony from the Commission on that authority.
- In his opening remarks, Shelby noted that Moody's Investors Services Inc., Standard & Poor's, and Fitch have captured 95% of the credit-rating market. On a case by case basis, the SEC has designated these agencies as "Nationally Recognized Statistical Rating Organizations" (NRSROs), through the no-action letter process. The only other NRSRO is Dominion Bond Rating Service Ltd., a small Canadian firm that received the SEC designation in 2003. Shelby noted that the SEC uses no formal criteria in the designation of an NRSRO. Since 1975, the SEC has required credit-ratings by NRSROs in its net capital rule for broker-dealers as an indicator of a security's liquidity. Investors and the marketplace have come to rely heavily on credit-ratings for determining the creditworthiness of debt securities. NRSRO ratings are also used as benchmarks in legislation, regulatory rulemaking, and in monitoring investment risk by regulated entities.
- Shelby noted several concerns about the credit rating agencies, which remain virtually unregulated although they serve as important gate keepers to the debt market. Specifically, he cited two conflicts of interest in the credit rating industry. First, the rating companies get the bulk of their revenue from the fees that they charge the entities that they are rating. This fee arrangement is similar to the conflicts that the SEC addressed in the research analyst area, Shelby said. The second conflict of interest is the agencies' sale of consultant advisory services to ratings clients, an issue similar to the auditor independence problems that existed prior to the implementation of the Sarbanes-Oxley Act, Shelby suggested. Some have criticized the NRSROs for

not detecting impending corporate disasters at Enron Corp. and WorldCom Inc. Other critics complain that the SEC has restricted competition in the NRSRO market by “unfairly” denying NRSRO status to new rating agencies.

- Kathleen Corbet, president of S&P, testified, “In the Enron case, for example, key Enron personnel have now expressly admitted their role in deliberately misleading S&P Ratings Services and other rating agencies.” Corbet added, “There is no evidence that the issuer-paid model undermines the objectivity of these ratings.” She argued that the SEC should avoid “overly intrusive supervision of NRSRO firms, particularly supervision that may suggest a substantive role for government in either the business operations of credit rating agencies or the ratings process itself.”
- Stephen Joynt, president and CEO of Fitch Ratings, testified that compensation for his firm’s analysts is “focused away from revenue-production activities.” Moody’s President and COO Raymond McDaniel said his firm’s policies forbid any link between revenue and an analyst’s compensation. Commercial considerations are not considered in rating committees, he added. Similarly, Corbet said, S&P analysts are not involved in “commercial or business matters with respect to ratings.”
- Sean J. Egan, managing director and co-founder of Egan-Jones Ratings Co., testified that unlike Moody’s, S&P, and Fitch, his credit rating firm only provides unsolicited ratings based only on public information. “We don’t get paid by issuers,” he said. Egan and James Kaitz, president and chief executive officer of the Association for Financial Professionals, testified that credit-ratings agencies should not have access to nonpublic information about the companies they rate, since it creates opportunities for insider trading abuses. Kaitz testified that the SEC has not only “failed to exercise any meaningful oversight of the recognized agencies,” but also “further empowered [them] when it exempted them from regulation Fair Disclosure,” which provided the agencies access to nonpublic information about the firms they rate.
- Kaitz said that rating agencies’ consulting services provide revenue that has the potential to taint the objectivity of the ratings. McDaniel told the committee that less than 1% of Moody’s business consists of ratings evaluations, which would be considered to be consulting. Similarly, Corbet said the only type of “consulting” S&P does is ratings evaluations, which she said is “truly an extension of the ratings process.”
- The SEC considers whether an agency is “widely accepted,” when determining whether to grant NRSRO status, although other factors are also considered, said Bond Market Association President Micah S. Green. Yasuhiro Harada, executive vice president of Rating and Investment Information Inc., a Japanese rating firm that is seeking NRSRO status, argued that the SEC should relax the “widely accepted” standard so that agencies that specialize in only a single market or industry or geographic sector could receive the designation. Kaitz said, “Only the SEC can remove the artificial barrier to competition it has created.” However, Green suggested, “Much of the value the market assigns to credit ratings is based on

reputation and track record, something new entrants necessarily lack.” This dynamic, “has not created a market failure or a condition in which a segment of issuers goes without service,” Green added. He then cautioned against detailed regulation of rating agency business practices, recommending a “code-of-conduct approach” such as the one being used by the International Organization of Securities Commissioners.

- Witnesses for the credit-rating agencies testified that their firms have made their credit-rating methodologies transparent, publishing them on their Web sites, and making them known to their clients. Since the Enron debacle, they said, their firms have hired more specialists to provide expanded analysis for their clients.
- Senator Jim Bunning (R-KY) asked the panelists to respond in writing to the question of whether any officers, directors, or employees of their agencies have sat on any corporate boards, government boards, or agencies over the past 20 years. Egan volunteered that Moody’s chairman, Clifford Alexander, sat on the board of WorldCom and its nominating committee, and that the prior president of Moody’s sat on the NASD board. [In December 2004, Fannie Mae appointed John K. Wulff to the enterprise’s board of directors; Wulff also serves as a director for Moody’s.]
- After the hearing, Sarbanes told reporters that it would not be very logical to consider the SEC as the creator of NRSROs but as an agency without the authority to regulate, examine, or impose requirements on them. McDaniel, Joynt, and Corbet acknowledged that the SEC inspects their firms as investment advisers. Joynt said, however, that “the content of the rating process itself cannot be regulated by the SEC.” Kaitz told the committee that he finds it “incredible” that SEC officials have said that they do not have authority over the credit-rating agencies. Last June after a Senate hearing on the topic, SEC Director of Market Regulation Annette Nazareth said that because credit-rating agencies receive “not a mention” in the federal securities laws, there are questions regarding the SEC’s authority to regulate in this area. On the one hand, Nazareth said, the SEC may have some flexibility to oversee rating agencies and ensure that they meet defined criteria on an ongoing basis. On the other hand, she said, federal legislation might be needed to empower the Commission to give the agencies a “more rigorous program of oversight.”
- Egan also urged the committee to address the issue of the high credit-ratings assigned to senior unsecured debt of Fannie Mae and Freddie Mac. “From our perspective,” Egan remarked, “neither Fannie Mae nor Freddie Mac are triple-A rated. ...We don’t care what our competitors say.” Egan suggested that pending GSE regulatory reform would affect “new capital not existing capital.” Recalling “the lesson learned from Enron and WorldCom,” he said, “Something has to be done and done quickly.” Egan continued, “Don’t keep up this falsehood that they’re triple-A rated. ...Address it as quickly as you possibly can.”
- Corbet told the committee that S&P had “some degree of confidence” in Fannie Mae and has rated both Fannie Mae and Freddie Mac senior unsecured debt at AA-. McDaniel said that Moody’s sees the GSEs’ relationship to the government as very

significant, in addition to their “strategic role” in the housing market and housing policy. Moody’s has given the GSEs a triple-A (AAA) rating, he said. Senator Hagel (R-NE) asked each executive why their agency had put Fannie Mae on a watch list instead of downgrading them. “A \$9 billion income [re]statement doesn’t trouble you much?” asked Hagel. “Not for the GSEs, given their government-sponsored status,” replied McDaniel.

- Senator John Sununu (R-NH) asked the witnesses if their agencies would change their ratings of Fannie and Freddie if the proposed new regulator were given the power to put either GSE into receivership in the event of an economic crisis. Corbet and Joynt said that they would have to see the legislation in its entirety before responding to Sununu’s question. While “we’ve always stated that any change in the relationship between the GSEs and the government would necessarily be an important factor in our ongoing ratings assessment, we have never said that any specific factor within the legislation would result in an automatic downgrade,” said Corbet. McDaniel said he did not believe the new legislation would have any impact on the credit rating Moody gave Fannie Mae and Freddie Mac. (*Bureau of National Affairs*, Rachel McTague, 02/09/05; *American Banker*, Damian Paletta, 02/09/05; *Reuters*, 02/09/05; *Washington Post*, Alec Klein, 02/08/05; www.moody.com, 02/09/05)

Bush administration’s FY2006 budget proposal provides roadmap for GSE reform
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- In the analytical perspectives section of the federal budget proposal for fiscal year 2006, the Bush administration argues for the need for GSE regulatory reform, given the risks inherent in Fannie Mae, Freddie Mac and the FHLBs. Relative to earlier budgets, the 2006 budget proposal provided a more detailed analysis of the risks of the housing GSEs, noting that Fannie and Freddie may not be fit to handle various risks posed by their businesses. The administration said, “The potential for systemic risk arising from the GSEs’ size and their central role in mortgage markets combined with the difficulty of managing the risks inherent in a large mortgage portfolio raise fundamental questions about the value they add ...relative to the risks their current operations pose.” The budget proposal outlined a litany of problems facing the housing GSEs, including the accounting woes and other operating deficiencies at Fannie Mae, Freddie Mac and within the FHLB System, highlighting the need for meaningful reform of the way the three housing GSEs are regulated.
- According to the budget proposal, “A strengthened regulator would have the in-house expertise to monitor accounting methodology and to detect any problems, as well as the authority and expertise to monitor regulatory standards for the development and implementation of systems and controls.” The budget proposal noted, “A strong regulator would also hold authority to place a failing entity into receivership similar to that held by other financial safety and soundness regulators.” Receivership powers would help prevent dislocation in the financial markets in the event of insolvency and would combat the perception that Fannie Mae and Freddie Mac are backed by the federal government. “By providing clarity to the markets that the GSEs (and their

creditors) are subject to the same business risks as other corporate entities, an even greater level of market discipline might be brought to bear on the GSEs' operations," the budget document said. "In general, this type of market discipline has proven very effective to ensuring that businesses operate in a prudential and safe and sound manner."

- The budget proposal said a new GSE regulator must have authority to approve new activities of the GSEs and to review their ongoing business activities and reject new ones deemed inconsistent with their charters or prudential operations or inconsistent with the public interest. Also, the administration said new regulator must have "unambiguous authority to adjust both risk-based and minimum capital requirements." It also said the HUD should have authority to penalize Fannie Mae and Freddie Mac if they fail to reach the affordable housing goals promulgated by the agency. For the first time in a budget proposal, the administration maintained, "The Treasury Department has discretionary authority to approve or disapprove the issuance of the GSEs' debt" under current law, a position disputed by the GSEs.
- With lawmakers in the House and Senate poised to push legislation to create a single new regulator to oversee Fannie Mae, Freddie Mac and the FHLB System, the Bush budget proposal said the resources of OFHEO and the Federal Housing Finance Board (FHFB) would be shifted to the "new strengthened housing GSE regulator that will be proposed in 2005." The Fiscal Year 2006 federal budget proposal envisions congressional adoption of GSE regulatory reform legislation to restructure the supervisory regime for all of the housing GSEs and to replace the existing regulators with a new entity that operates within the Treasury Department. The proposal includes \$96 million in FY 2006 funding for a new Office of Housing Finance Supervision (OHFS), which would replace the existing OFHEO and the FHFB. The new regulatory agency would be funded through assessments on the housing GSEs. The FY2006 budget proposal provides a 0.8% increase over the combined FY 2005 funding levels of OFHEO and FHFB. (*Budget of the United States Government, Analytical Perspectives, Fiscal Year 2006, Dow Jones Newswires, John Connor, 02/07/05; BNA's Daily Report for Executives, 02/08/05; American Banker, Rob Blackwell, Hannah Bergman, John Reosti, and Shawna Gamache, 02/08/05; Reuters, Kristin Roberts, 02/07/05*)

Fannie Mae and Freddie Mac

Stay tuned-- lawmakers preparing to push GSE reform

- Despite the subdued tone and academic approach of the Senate Banking Committee's hearing on the role of GSEs in the U.S. mortgage market, key lawmakers in the Senate and House are poised to push forward this spring on GSE regulatory reform for Fannie Mae and Freddie Mac. Senate Banking Chairman Richard Shelby told reporters that he's in no rush to introduce a new GSE reform bill and that measured deliberations on its content are still very much underway. He offered no hint at a schedule for unveiling his next proposal. Shelby said his bill will, at a minimum, create a new regulator for Fannie, Freddie and the FHLB that will enjoy strengthened authority over capital ratios and new-product approval and the power to place a failing enterprise into receivership. "That's a floor, not a ceiling," Shelby said. He also indicated that he is studying receivership language included in the GSE reform proposal (S. 190), introduced by Senators Chuck Hagel (R-NE), John Sununu (R-RI) and Elizabeth Dole (R-NC). Shelby said "we'll be working with" Hagel, Senator Paul Sarbanes (D-MD), and others in crafting the bill the committee will eventually consider. Hagel told *Dow Jones Newswires* that Shelby has been "very encouraging and wanted me to reintroduce the bill [S. 190]" and officials at the White House and Treasury have been "very, very supportive." (*Market News International*, Claudia Hirsch, 02/10/05; *Dow Jones Newswires*, Dawn Kopecki, 02/10/05)
- Representative Richard Baker (R-LA), who chairs the subcommittee that oversees Fannie, Freddie and the FHLBs, told reporters he is assembling his most expansive GSE reform bill to date and anticipates delivery by mid-March "at the latest." Baker is drafting legislation, which he intends to present to subcommittee members soon. Baker said he plans to hold a hearing on the legislation, followed by markup in the spring. He said he would put everything on the table and negotiate from there. "This time the environment is different. I think we are going to have all the wheels and spinners previously enumerated plus a few new ones that have not been discussed."
- Baker said the reform legislation will give the new regulator the power to require Fannie and Freddie to curtail their combined \$1.55 trillion loan portfolio. "The legislation will assign to the new regulator the responsibility to examine and report back to us and to take action where appropriate" on the size and composition of the GSEs' loan portfolios, said Baker. His bill, which will provide the new regulator power to review executive pay at the GSEs and sell off assets if an enterprise defaults, is tougher than the legislation that stalled in 2004 after passage by the Senate Banking Committee. Baker said he postponed the introduction of his bill in order to build consensus with the Bush administration over the powers of the new GSE regulator. Baker had a far less sanguine view of the GSEs' approach to current reform efforts, saying Fannie's and Freddie's main priority is "getting out of this congressional session unscathed." Before the year is out, Baker said he expects the House and

Senate to have cleared bills to strengthen GSE oversight, which would prompt the start of House-Senate negotiations to produce a compromise measure which he believes, would meet with presidential approval.

- Congress should create “a strong, independent and world-class regulator” for Fannie and Freddie, said Paul E. Kanjorski (D-PA), ranking minority member on the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. In an interview, Kanjorski said that Baker had not consulted with Democrats on his legislation, but said “it would probably be productive” if the bill was drafted in a bipartisan manner. (*American Banker*, Rob Blackwell, 02/10/05; *Bloomberg News*, James Tyson, Al Yoon, Simon Kennedy, 02/09/05; *The Main Wire*, Claudia Hirsch, 02/10/05; *CQ Today*, Michael R. Crittenden, 02/09/05)
- Former SEC chairman Arthur Levitt, Jr. said, “I think you are going to see Washington in full blossom in terms of political muscle ... You’re going to see Congressman Richard Baker really try to put the screws to Fannie Mae and see to it that they come to call for legislation to put them under a much stricter regulatory regime, making them somewhat less competitive against their banking counterparts.” (*Bloomberg News*, Gina Thompson, 02/09/05)

Treasury Secretary Snow meets with White House officials on GSE regulatory reform

- Treasury Secretary John Snow said he would be meeting with senior White House officials on February 9 to discuss the administration posture on new legislation that would create a “strong regulator” for Fannie Mae and Freddie Mac. White House Chief of Staff Andrew Card; Treasury Secretary John Snow; Greg Mankiw, the chairman of the Council of Economic Advisers; and Allan Hubbard, the head of the National Economic Council, were among those expected to attend this meeting. Federal Reserve Board Chairman Alan Greenspan also was invited, said sources. The participants were to discuss whether to add to the Bush administration’s list of minimum requirements. According to officials familiar with ongoing discussions, the Bush Administration is considering whether to seek limits on the huge assets of Fannie Mae, Freddie Mac and the FHLBs, thereby reshaping the nation’s \$8 trillion housing-finance market. The administration’s discussions on restricting the GSEs’ growth are in the early stage. The administration may shy away from such a move, if strong opposition is voiced in Congress, where many legislators believe that the GSEs are crucial to the health of the housing market. If this proposal meets strong resistance, the administration could seek to rein in the GSEs’ growth through Treasury’s authority to limit their borrowings.
- Snow told reporters that the administration’s support for a strong GSE regulator has only been “underscored” by “recent events,” referring to Fannie and Freddie’s accounting debacles. He reiterated that any legislation that will be acceptable to the administration must deal with three broad GSE issues: capital standards, new lines of business and receivership. “The critical issue here is a regulator capable of dealing

with fundamental issues of the soundness and safety of the mortgage markets and of the systemic risks that the GSEs, being as large as they are, could pose to the financial system as a whole,” said Snow. (*Market News International*, John Shaw, 02/09/05; *Reuters*, 02/09/05; *Wall Street Journal*, James R. Hagerty, 02/07/05; *American Banker*, Rob Blackwell, 02/09/05)

Is Fannie Mae too late to the dance?

- Sources say that Fannie Mae has told lawmakers it will stop fighting key proposals to strengthen oversight of the housing GSEs and Freddie Mac could do the same. However, such offers may be arriving a little too late with the White House holding a high-level meeting [February 9] in part to discuss GSE legislation, the sources said.
- Fannie is now lobbying Capitol Hill for a GSE regulatory reform bill, containing some provisions it opposed last year. According to sources, Fannie has said it could now accept the bill offered by Senate Banking Committee Chairman Richard Shelby in March, without the changes to receivership language that Fannie had insisted on during a committee vote. Fannie now appears to be willing to accept language that would let a proposed new regulator put the GSEs into receivership if they encountered a severe financial crisis. According to sources, Fannie also would be willing to accept a regulator with power over minimum capital requirements and more limited oversight over new activities. While Freddie Mac’s position is still largely uncertain, some sources said the company is also very close to embracing the original Shelby bill. While this represents significant movement for the GSEs, observers said the Bush administration would probably not see it as sufficient regulatory reform.
- If Fannie and Freddie embraced the receivership provision, a major roadblock to GSE regulatory reform would be removed. Last year, Fannie and Freddie had opposed the provision; fearing credit rating agencies would lower their debt ratings because they would no longer perceive the GSEs as backed by the government. That argument had lost steam as officials from the major agencies have either said the provision would not be a problem or downplayed the question. Sources suggested Fannie and Freddie have been convinced that that they could afford to give ground on the issue, because the provision probably would not affect their debt ratings.
- Any Fannie offer is liable to be met with skepticism by the Bush administration and its allies, and it would not remove many other roadblocks for enactment, said sources. Agreeing to the language in the Shelby bill could just be posturing from the two GSEs, said many insiders.
- In surveying the GSE regulatory reform landscape, *The Wall Street Journal* notes, “One of the more interesting developments of the new season ...has been the

transformation of the once legendarily bellicose Fannie Mae into an apparent pussycat in the wake of an adverse ruling on its accounting by the chief accountant at the [SEC] and executive housecleaning.” Meanwhile, the *WSJ* writes, “Freddie Mac also has undergone a personality change, with its new chairman and chief executive officer, Richard Syron, sounding for all the world like a Fannie-style political tough guy of old, in contrast to the bean counter demeanor associated with Freddie during Leland Brendsel’s long run at the helm of the firm.” (*American Banker*, Rob Blackwell, 02/09/05; Dow Jones Newswires, John Connor, 02/03/05)

GSE regulatory reform legislation could “significantly curtail” the GSEs AU systems

- A provision tucked in the Hagel-Dole-Sununu GSE regulatory reform legislation (S. 190) could significantly curtail Fannie Mae’s and Freddie Mac’s automated loan approval systems. The GSEs are already lobbying hard against several provisions in the legislation that would place new restrictions on their activities, including their automated approval systems used by lenders to screen the creditworthiness of mortgage customers. Mortgage Banker’s Association’s lobbyist Steve O’Connor said, “It’s intended to give the regulator more guidance on how to define what’s a permissible secondary market activity and what’s not permissible under their charter acts,” said Steve O’Connor. “The boundary between the primary and secondary market has been the MBA’s number one issue with the GSEs for several years. The GSEs were chartered to provide a liquid secondary market.” MBA’s top lobbyist Kurt Pfoth added, “The legislation draws a needed bright line between primary and secondary markets, which will empower the regulator to keep Fannie and Freddie focused on their mission.”
- S. 190 gives the new GSE regulator the power to define the boundary between secondary market activities allowed by their charters and primary market activities, which deal directly with consumers and are not allowed. In recent years, Fannie and Freddie have been accused of using new technology to increasingly blur the lines between the two markets and gradually creeping into primary market functions. Last year, well over 50% of the residential mortgage loans in the U.S. were screened by the GSEs, when Freddie Mac’s Loan Prospector reviewed about 5.2 million loans and approximately 8.1 million mortgage applications were screened by Fannie’s Desktop Underwriter last year, according to companies. S. 190 would relegate the GSEs to dealing with mortgage loans only after they have been closed and would expressly prohibit the GSEs from underwriting a loan “directly or indirectly.” Anne Canfield, executive director of the Consumer Mortgage Coalition, said “The provision gives authority to the regulator to review if Fannie and Freddie have moved beyond their secondary market function into the primary market. Fannie and Freddie are supposed to be limited to the secondary market. They’ve used their automated underwriting systems to encroach on the primary market.” (*Dow Jones Newswire*, Dawn Kopecki, 02/02/05; *National Mortgage News*, 01/31/05)

Financial Services Roundtable applauds push for stronger GSE oversight

- The Financial Services Roundtable, a 99-member group of insurers, banks and brokerages including The Charles Schwab Corp., JPMorganChase & Co. and Fidelity Investments, applauded Senators Chuck Hagel (R-NE), John Sununu (R-NH) and Elizabeth Dole (R-NC) for introducing S. 190 to improve oversight of GSEs. “This bill is an excellent proposal that would strengthen the entire housing finance system,” said John Dalton, former Secretary of the Navy and President of the Housing Policy Council for The Financial Services Roundtable. “The need for a strong regulator to ensure the safety and soundness of the GSEs is imperative to enhance the opportunities for homeownership in this country.” Dalton continued, “We hope members of the Senate will study this thoughtful legislation. ...It is a strong foundation for the action on this issue that Chairman Shelby has announced as a priority for 2005. We support the Committee’s efforts and hope they will proceed expeditiously” Dalton added, “We are very optimistic about getting a bill this year.” (*Bureau of National Affairs*, Richard Cowden, 02/03/05; *Financial Services Press Release*, 01/27/05; *MarketWatch.com*, Robert Schroeder, 02/02/05)

Grassroots coalition of 37 federal state and local groups tell Congress
to pass GSE regulatory reform before it’s too late

- A grassroots coalition of 37 federal, state, and local groups representing millions of Americans warned Congress that if they don’t act now to pass GSE regulatory reforms, it may soon be too late. In a joint statement to lawmakers organized by the National Taxpayers Union, the group said “The past year has offered story after story of financial mismanagement and accounting scandals at the two government- backed lending giants. Of even greater concern to taxpayers, however, is the potential cost if either of these entities faces bankruptcy or default.” The group’s concern is reflected in the breadth of the coalition which included national organizations, such as Competitive Enterprise Institute, Consumer Alert, and Council for Citizens Against Government Waste, as well as citizen, consumer, and policy groups from 19 states. Recognizing that that tighter government oversight of Fannie Mae and Freddie Mac “would be a good start,” the group said “The best answer to ending the threat to taxpayers is complete privatization of these two entities.” Noting the problems of the saving and loan crisis in the 1980’s that many members of Congress “chose to simply ignore the situation,” the coalition letter concluded, “The history books will record that their lack of leadership ...ended up costing Americans hundreds of billions of dollars. ...We urge the 109th Congress to act decisively to avert another financial disaster...” (*U.S. Newswire*, 02/10/05)

How do you handle the failure of Fannie or Freddie?

- At a February 3 AEI forum, legal and economic experts debated the policy options available for dealing with an insolvent housing GSE. Participants on the panel included Robert Eisenbeis, W. Scott Frame and Larry Wall, economists from the Federal Reserve Bank of Atlanta; associate professor Richard S. Carnell from Fordham University School of Law; and S&P's managing director of financial institutions Michael DeStefano.
- Unlike the regulators of other GSEs such as the Farm Credit System or Farmer Mac, OFHEO does not have receivership authority should either Fannie Mae or Freddie Mac encounter serious financial trouble, said Carnell. "The lack of this mechanism [receivership] is the single most serious weakness in U.S. financial institution law," he said. Instead, OFHEO has the authority to place either of the GSEs in conservatorship, which is an inadequate response to the potential problem, said Carnell. Receivership power includes the ability to liquidate a company's assets and pay its creditors, while conservatorship doesn't provide such extensive control over the GSE's assets.
- Carnell said that the question of receivership authority was the reason why the Senate failed to enact GSE regulatory reform in 2004. When the committee passed a provision diluting the receivership feature in the bill, the Bush administration pulled its support for the measure. The legislation originally proposed by Senator Richard Shelby (R-Ala.) met all the criteria Carnell believes are necessary to address the event of an insolvent GSE. The bill would have provided for prompt judicial hearings; would have spelled out priorities among creditors; and authorized establishment of a bridge institution to manage the GSE's operations, said Carnell.
- Eisenbeis agreed that OFHEO's existing procedures to handle an insolvent housing GSE are insufficient. In a study titled "Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises," Eisenbeis, Frame and Wall note that receivership has become a well-understood process for dealing with insolvent banks. Adapting receivership authority to the case of large institutions, such as Fannie and Freddie, should involve strengthened procedures for forcing troubled banks into early resolution. "There is a tendency for regulators in general, and governments for that matter, when faced with a problem of dealing with one of these failures ...to engage in some sort of forbearance rather than attempting to deal with problem promptly," said Eisenbeis. "This has been true with banks in the past. ...It was clearly the case with thrifts in the [savings and loan] debacle. And it's also held for housing enterprises and GSEs in general." A more responsive regulatory system would use market value trigger mechanisms to compel an institution to take prompt corrective action before it becomes dangerously undercapitalized, he said. Another vital component of a system to resolve the problems of a failing GSE would be to set clear priorities for claims on the institution's assets, said Eisenbeis. "Uncertainty in the priority of claims is the enemy of market discipline," he added. With OFHEO lacking full authority to resolve a default, such power falls to Congress, which reinforces the market

perception of implied government support for Fannie and Freddie, said the Atlanta Fed report. “The current setup appears designed to more create the substantial spillover effects and force Congress to mitigate the problems by providing creditors of a failed housing enterprise with a bailout,” the report concluded.

- Peter Wallison, an AEI resident fellow, said that Fannie and Freddie have resisted the receivership features of the GSE regulatory reform bill introduced last year, and act as if they believe “the markets will be spooked by receivership powers.” However, past experience would argue against this assumption, said Wallison, noting that the Farm Credit Association has receivership power over its member banks and yet their debt tends to trade in the same range as that of Fannie Mae and Freddie Mac. “While Fannie and Freddie have chosen to fight on this ground, that does not mean they have correctly assessed whether a receivership provision would adversely affect them.” He said. “It is all guesswork at this point.” If Congress approves a GSE regulatory restructuring package that includes receivership authority for Fannie’s and Freddie’s regulator, the new power may not make a significant difference and at worst could be counterproductive. “It may only signal to the capital markets that Fannie and Freddie are more likely than ever to be bailed out,” said Wallison. (*Bureau of National Affairs*, Richard Cowden, 02/07/05; *Bloomberg News*, James Tyson, 02/03/05; *Bloomberg News*, James Tyson, 02/05/05)

S&P’s DeStefano’s comments at AEI forum raises more questions than answers
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- In a question and answer session, S&P’s managing director of financial institutions Michael DeStefano faced pointed questions from the audience about his agency’s rating of Fannie Mae. *Dow Jones Newswires* reporter Dawn Kopecki said “I have a question for Michael [DeStefano] that might kind of put you on the spot. I’m sorry. Last year--you seem to have switched your opinion on whether receivership would affect the GSEs’ credit rating; is that correct? DeStefano responded, “Yes and no,” as the audience laughed. An unidentified panelist asked, “Senator Kerry, where are you?” Wallison responded, “Reporting for duty, captain,” as the audience laughed.
- DeStefano said, “First of all, it doesn’t put us on the spot, and I’m glad that somebody in the capital markets has a memory longer than... thirty days... And our reaction to the legislation last year which was, you know, it over--and really fed in part into our decision to consider these, you know, as three, was all sorts of things that were both in the legislation and that were being said around the framework of the legislation. And we perceived that receivership could have, we thought at the time, you know, a meaningfully inhibiting effect upon Congress’ ongoing oversight role, which we’ve repeatedly said is really important to our view of the creditworthiness of the securities. And, however, having now said that we’re, you know, talking about Category-3, strong governmental interest, the receivership, you know, plays less of a role in our overall thinking.”

- DeStefano continued, “And then we also think that when you step back and you look at the dynamic of the whole process that, you know, Congress is not saying to bond holders you’re going to get a regulator, and we’re walking and don’t expect any-- because, you know, there’s lots of that preserves the role of Congress. And so our sense is that, you know, in the final analysis, you know, insofar as it’s appropriate, there will be, you know, congressional input into any ultimate resolution of a GSE. And I think it’s--in the Fed paper you talk about, you know, even in your view of the receivership, it wouldn’t extinguish the charter. That could only be done by Congress. [Asked of Eisenbeis] Was that in your paper?” Eisenbeis responds, “Right. Mm hmm.” DeStefano continues, “So, you know, I think even in terms of existing legislation, there is, you know, building in a role for Congress. So, you know, so I think that in our analytics, we’re at the different places now than we were last year.”
- Kopecki follows up by asking, “You’re saying that you think that whatever bill passes that there will be some sort of congressional review a la the Bennett Amendment?” DeStefano responds, “No, because we don’t even know what the proposed legislation is, you know. We don’t know what the proposed legislation is, but if it—” Kopecki interjects ...”In the Senate, it’s the Shelby Bill without the congressional review.” DeStefano responds, “Without tagging on a congressional review, in our view, unless there’s something ultimate to lead us to believe that there would no role for Congress, we would assume that there would be a role for Congress.
- Kopecki then asks, “Even though the White House has said they would veto that?” DeStefano responds, “Yeah. No, I’m not saying that they would have to be the mechanism. Let’s say you had the Shelby Bill pass. Okay? And the Shelby Bill says you can have receivership, dah, dah, dah, dah. The Shelby Bill doesn’t say that there’s no role for Congress; that Congress can’t have a debate; that Congress cannot intervene. You know, the Farm Credit System is subject to receivership. And as we all know, both part of the Farm Credit--I’ll get the--okay--both part of the Farm Credit System was liquidated, and we had a recapitalization. Now I’m--shaking--we’ve always considered the receivership in the Farm Credit and the FO2B context sort of [inaudible] light. You know, that you can reorganize the system and cut out pieces of it but that you weren’t going to close down the whole system by a receivership...”
- Kopecki said, “My follow-up question is dealing with analysts and Fannie and Freddie. When Enron stock dropped from \$60 a share to \$10 a share, analysts continued to have strong buy ratings on the stock, and it seems like the same thing is happening with Fannie; and the same thing with the debt. And you in particular last year, when you came out saying that the receivership provision would cause you to downgrade their debt, I’m hearing--I’m only asking because I’m hearing increasing rumblings from the Hill and from staff at other agencies that Congress is really ticked specifically at S&P for doing that. And the belief is that Fannie Mae put you up to it, to kind of lobby them. So I have to ask did Fannie at any point, or Freddie, indicate to you that they would like ...that information to get out there in the press?”

- DeStefano responds, “Oh, gosh. How does one begin to respond to that? One, we never said that receivership would lead to a downgrade, but that receivership is something that we would look at, just as we would look at anything else of a nature that could change the relationship between the GSEs and Congress. Okay. And... Kopecki interjects, “But you said it would cause them to lose their triple-A status.” DeStefano responds, “Mm hmm.” Kopecki said, “I can get the quotes.” DeStefano responds, “I’d like to see the quotes because we never said that. I never said that. And in the nature of things, we would never say that unless we were taking a rating action along that line. So that’s not the case. And whether we are a registered lobbyist for Fannie Mae and Freddie Mac I think the answer to that is no.”
- Kopecki follows-up, saying “But did they at any time indicate that they’d like to get that information out in the press, or out in the public somehow?” DeStefano responds, “I think I know what you’re asking, and it would be really tough for me to answer, you know, in a way that would—I’d have to answer, you know, was this their initiative? No. Do they have independent grounds other than rating considerations to care about receivership is something you would have to ask them.” (*Unedited Transcript of “Receivership Powers: What Are They and Should Fannie and Freddie’s Regulator Have Them?”*, www.aei.org, 02/03/05)
- As a result of DeStefano’s comments at the AEI forum, Merrill Lynch’s agency debt analyst Rajiv Setia said that Fannie Mae and Freddie Mac bonds may be less volatile after DeStefano suggested that adding a receivership provision to legislation designed to strengthen oversight of the companies wouldn’t cause S&P to cut their credit ratings. DeStefano’s comments were a turn from last year when his company said installing receivership power at the regulator may signal a decline in Congressional support for Fannie Mae and Freddie Mac, said Setia. Any sign that the companies’ AAA credit ratings won’t be affected also improves chances for the bill’s passage this year, he added. Since S&P may have “reconsidered its stance” on receivership, “the potential for inordinate spread volatility has been greatly lowered,” said Setia in an interview with *Bloomberg News*. DeStefano’s comments also set the stage for legislation to be passed “smoothly” this year, he added. (*Bloomberg News*, 02/09/05)
- [While Wall Street may have read positive signals in DeStefano’s comments on receivership powers for the GSE regulator, others suggest that his comments raise even more questions about the independence of the ratings agencies from corporate pressure and the thoroughness of the agencies’ analysis in rating corporate debt.]

Fannie Mae and Freddie Mac: “The implicitly colluding duopoly”
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- In a speech at the National Economists Club, Former FHLB-Chicago President and CEO Alex J. Pollock said that while Fannie Mae and Freddie Mac have served a useful purpose in shifting housing finance risk from households to the capital markets, they have become so powerful that may present another kind of risk to the

taxpayer. Pollock, now a resident fellow at the American Enterprise Institute, said Fannie Mae and Freddie Mac account for \$4 trillion in total assets, plus off-balance-sheet guarantees of mortgage-backed securities. “Almost everybody who has ever studied this concludes that they are an implicitly colluding duopoly,” said Pollock. The eventual solution to the problem raised by the concentration of power in the hands of the two GSEs is privatization. In the near term, Pollock said lawmakers should encourage the FHLBs to compete with Fannie Mae and Freddie Mac in the securitization of mortgage-backed securities. Unless Fannie and Freddie are privatized, “the only possible competitors to Fannie Mae and Freddie Mac are the Federal Home Loan Banks,” he said.

- Today, Fannie Mae and Freddie Mac hold such dominating positions in the market, they may have too much power in setting the fees they earn as credit risk insurance, said Pollock. The size of the fees Fannie and Freddie earn for this service have grown out of proportion to the actual risk they bear, he added, with today’s charges at levels like that of “airline travel insurance and similar scams.” Pollock said, “And the reason that those relationships are where they are is because they’ve got market power.”
- The ironic risk of passing GSE regulatory reform this year is that its passage could actually reinforce the market perception of the closeness between the GSEs and the government, thereby defeating the purpose of imposing more controls on Fannie and Freddie, said Pollock. On the other hand, he said, such a new public policy could offer “a chance to think about a new housing finance paradigm. This one has lasted 25 years. That’s a pretty good run. How about a new housing finance paradigm built on the model of competitive markets instead of on the model of creating a duopoly?” (*BNA’s Banking Report*, Richard Cowden, 02/07/05)

The debate on the cutting the servicing fee continues

- In an interview with *Bloomberg News*, Mark Hanson, a vice president in mortgage funding for Freddie Mac, said “We’re supportive of housing. To determine if it’s good [to cut the servicing fee to 0.125 points from .25 points] for borrowers, we need to know whether the capital markets will pay the same or lower price” for bonds backed by loans with the lower servicing fee. “We’re getting mixed reviews from investors and lenders.” By reducing the servicing fee, a lender could offer a lower rate to the consumer and reduce the likelihood the loan would be refinanced, he said, which would “buoy” the value of the security by the decreased chances of prepayment. However, investors are concerned that the lenders with “less skin in the game” would be more apt to encourage refinancing, boost prepayments, and hurt the value of mortgage securities. And, some investors say the reduced servicing fee “can only be a negative because it gives the servicer a greater opportunity to solicit refinancing because it’s less of a consequence to their balance sheet,” he said. (*Bloomberg News*, Al Yoon, 02/03/05)

Fannie and Freddie are losing small banks' mortgage business

- According to a recent survey conducted by America's Community Bankers, community banks have been selling more of their mortgages to wholesalers, such as Washington Mutual Inc., and fewer to Fannie Mae and Freddie Mac. During the first nine months of 2004, the community banks had sold 35% of their mortgage originations to wholesalers and conduits, up from 22% in the year-earlier survey. During this period, the banks sold 8% of their loan originations to Fannie Mae and 10% to Freddie Mac, down from 16% to each the in 2003. The most active acquirer was Washington Mutual, which captured 16% of community banks' business. (*American Banker*, Laura Thompson Osuri, 02/09/05)

E-mortgages on the horizon

- Lenders who want to develop a paperless mortgage must adhere to common technology standards developed by the Mortgage Industry Standards Maintenance Organization (MISMO standards). Richard Jones, chief information officer for Countrywide Financial said, "We must have standards that govern the rules of engagement and how information is passed from company to company and back to the borrower." Ed Albrigo, a vice president at Freddie, called the MISMO standards "a key priority for us." According to a recent Mortgage Bankers Association study released in October, e-mortgages using the MISMO standards generates \$249 savings for each a loan, 75% of which inures to the lender. Only 40% of the lenders surveyed said they use the standards, while 40% to 50% said they expected to start using them in the near future.
- Albrigo said that using MISMO's Smart [Securable, Manageable, Archivable, Retrieval, and Transferable] format for electronic promissory notes is "a great place to start," when a lender is ready to automate. Unlike paper documents that are scanned into a computer system, Smart documents make it easy to separate certain data from the rest of the document to be fed into automated decision-making engines. Jim Witkins, Freddie's chief information officer, said using the Smart format is "not rocket science," and that the technology can be easily adopted by large and small banks.
- While lenders are starting to recognize the importance of e-loans, they've yet to develop end-to-end systems that reduce costs, said Mark Lefanowicz, president and COO of E-Loan, Inc. While lenders have been quick to implement automated underwriting tools, they've yet to start thinking about technology solution as wholes rather than parts, resulting to ineffective use of technology, said Lefanowicz. Since only a handful of counties accept electronic signatures, one of the biggest obstacles to creating an end-to-end electronic mortgage platform is automating the closing process. Lefanowicz said pressure should be exerted on counties to allow electronic closing. "It's going to take a political initiative on a national basis," he said.

“Everybody has to work together to put pressure on Congress to get these individual counties to adopt the technology.”

- Lefanowicz said Stewart Title Guarantee Corp. of Houston and First American Corp. of Dallas have set good examples in electronic closing while other title companies “are not doing as good a job because ultimately they are going to lose revenue.”
- Mortgage technology was initially slow to evolve because changes must be accepted on the front end where loans are made to consumers, as well as on the back end where they are sold in the capital markets, Lefanowicz said. “It’s the only industry I know of in which something has to be sold twice.” Lenders have created their own barriers to innovation by not participating, he added. He cited the lack of involvement in the electronic mortgage registry, particularly in home-equity lending. “Being a barrier or a nonadapter hurts all of us,” he said.
- Lefanowicz said his company receives over 90% of its applications, 2,400 a day, over the Internet. When asked if technology could eventually replace people altogether in the mortgage underwriting process, he said, “It would be very difficult.” But, he conceded that car loans may one day be processed entirely electronically. In January, Lefanowicz said E-Loan began offering car loans through the online auctioneer eBay Inc. and announced that it had entered into a marketing agreement with auto information site, Edmunds.com. (*American Banker*, Isabelle, Lindenmayer, 02/01/05; *American Banker*, Isabelle, Lindenmayer, 02/03/05)

Fannie Mae

The fallout continues, as two more Fannie execs “retire”

- Fannie Mae’s Executive Vice President Louis Hoyes and Senior Vice President Jayne Shontell retired, the seventh and eighth employees to leave or be reassigned after the company reported accounting violations. The “planned retirements” of Hoyes, 56, who was in charge of the GSE’s single-family mortgage business and Shontell, 51, who ran investor relations, were not related to the investigations of Fannie’s accounting, said company spokesperson Janis Smith.
- According to the company’s SEC filing, Hoyes left the company with \$311,070 of stock options and deferred compensation of \$3.3 million, of which he took \$3.2 million in a lump sum and deferred the rest. Upon his retirement, options to purchase another 99,741 shares were cancelled. Hoyes and his spouse will also receive a pension of \$133,320 a year for life.
- Thomas Lund, a senior vice president of Fannie Mae’s credit guaranty business, will be interim head of the company’s single-family mortgage business, according to the company. Mary Lou Christy, a vice president of investor relations, will be interim head of investor relations, the company said. (*American Banker*, Hannah Bergman, 2/1/05)

Fannie Mae begins paying benefits to former executives

- In a January 31 letter, OFHEO gave Fannie Mae permission to begin releasing pension and deferred-compensation payments to former CEO Franklin Raines and former CFO J. Timothy Howard, who stepped down in December. OFHEO said the initial pension and deferred compensation payments “would not be affected” by the agency’s ongoing review. The regulator specifically gave Fannie Mae permission to make deferred payments related to a long-term incentive plan linked to financial results now subject to correction. However, these payments do not extend to stock options, 2004 bonuses, or other incentive payouts, said OFHEO associate director Patrick J. Lawler. Fannie Mae made the payments “pursuant to our review and in consultation with the Justice Department,” said OFHEO spokeswoman Corinne Russell. “These payments do not affect our ability to seek restitution at a later point in the examination,” she said.
- According to Fannie Mae’s SEC filing, Raines and Howard are entitled to monthly pensions of \$114,393 and \$36,071, respectively for the rest of their lives and their surviving spouses. Raines was owed \$8.7 million of deferred compensation and Howard was owed \$4 million, Fannie Mae reported, which will be paid in installments over a period of years.

- A Wayne County, MI pension fund has asked a federal court to temporarily block certain payments to Raines and Howard, arguing that their departures should have been characterized as terminations for cause. Fannie Mae cited OFHEO's January 31 letter in papers arguing that the court should not prevent it from "honoring contractual obligations" and that the former executives would be entitled to the same pension benefits even if their departures were treated as firings. In a court filing, lawyers for the former executives said the payments shareholders have sought to block are not tied to earnings the company has agreed to restate, but rather to an earnings measurement devised by Fannie Mae called "core business earnings." (*Washington Post*, David Hilzenrath, 02/09/05)

Fannie Mae's internal accounting probe may be completed this spring

- Former Senator Warren B. Rudman said he hopes to wrap up his investigation of accounting problems at Fannie Mae some time this spring--possibly by May. In late September, the company's board hired Rudman to investigate OFHEO's charges that executives manipulated accounting rules to manage the company's earnings to meet Wall Street's expectations. "We're aiming for sometime this spring," he told *Dow Jones Newswires*, but warned that the timeframe could slip as his investigative team from the law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP digs deeper into Fannie's accounting. "It tends to be a moving target as you come across more information, more documents, there's more work," said Rudman. "It's much more important to the board to get it right. This is highly complex. It's got a lot of facets to it, very complex accounting issues, very complex internal control issues. There are a million documents to look at. We're making good progress." Rudman confirmed that he recently met with OFHEO, the SEC, Justice Department and Public Company Accounting Oversight Board to update them on his progress. Rudman said he updates the regulators and law enforcement officials by phone every week and in person every few weeks. (*Dow Jones Newswires*, Dawn Kopecki, 02/02/05; *Bloomberg News*, James Tyson, 01/31/05)

Nicholasien's congressional testimony raises more questions about Fannie's application of FAS 91 and FAS 133

- After hearing Nicolaisen's testimony before the House Services subcommittee, Paul Mampilly concludes that Fannie's "FAS 91 problem was likely underestimated." On *Capuchinomics.com*, Mampilly continues, "A single line from Nicolaisen's testimony regarding the time -- one year -- it might take to completely re-work Fannie Mae's accounting led to a familiar rally in the compan[y's] shares. [Important Disclosure: (Mampilly is) short shares of Fannie Mae.] ...The buyers of that rally however missed the new and potentially exciting implications of Nicolaisen's testimony. The *Wall Street Journal* in "SEC's Top Accountant Says Fannie Should Have Known Better" quotes Nicolaisen as saying that 'Fannie executives knew their methods for

calculating losses on mortgage prepayments “was not consistent with” accounting standard FAS 91.’ Contrary to FAS 91, Fannie recognized adjustments to its mortgage portfolio only if the adjustments ‘exceeded a self-defined materiality limit, referred to as a “precision threshold.”’ The ‘precision threshold’ was likely just a euphemism for management manipulation of accounts. [Fannie Mae’s] management decided, on some ad-hoc basis, when to write down the value of its mortgage portfolio, when to reserve against it or to deem it uncollectible.”

- “As of June 2004 (2Q) [Fannie’s] mortgage holdings were \$891.2 bill. Credit losses for the same period were \$16.6 million or a loss ratio of 0.30%. The commentary accompanying these figures said, ‘credit-related losses were significantly lower than expected ...driven by a continuation of very low average losses per case on foreclosed properties.’ However, in the same announcement, ex-CFO Timothy Howard in explaining declining earnings growth blames ‘the recording of \$278.2 million in other-than-temporary impairment on debt securities, including manufactured housing securities, virtually all of which related to the implementation of a new estimation process for the recognition of impairment as defined by our regulator.’ Is the magnitude of this ‘other-than-temporary’ charge provide an indication of what lies ahead?”
- “[Fannie Mae] estimated its FAS 91 adjustment for September 2004 (3Q) at \$26 mill. However, the release warns that ‘if it is determined that [Fannie’s] current accounting under FAS 91 was not in compliance with GAAP, the company would have to determine the effect on each prior reporting period and restate prior periods, as necessary. The impact of such a restatement could be material to GAAP and core business results ...and would vary from period to period based on the composition of the company’s mortgage assets and fluctuations in interest rates, volatility, and projected prepayment speeds that existed at the time.’ The accumulation of these observations suggest a significantly larger FAS 91 adjustment is in [Fannie’s] future.”
- With regard to FAS 133, Mampilly points out that Nicolaisen testified before Congress that derivative accounting standards relevant to Fannie Mae are “straight forward and clear” and “not overly complex” and that “those large financial institutions who engage in derivative transactions are familiar with those rules.” Mampilly writes, “These assertions fly in the face of ex-CEO Franklin Raines’ testimony to the same committee that ‘these accounting standards are highly complex and require determinations over which experts often disagree.’”
- “A FAS 133 case study on FAS133.com entitled *FNM: Using Shadow Processing to Preview FAS 133 Hurdles* (April 3, 2000) details [Fannie’s] attempts to get ready for the new accounting standard through the experience of Kimberly Rawls (of FNM’s financial standards department). The case study suggests that any misunderstanding of FAS 133 accounting at [Fannie] is likely to have been deliberate. In the case study, Rawls is quoted as saying, “[W]e will develop alternative strategies when necessary to deal with any type of earnings volatility and equity volatility that we know that we will experience, given that a large proportion of our derivatives will be

considered cash flow hedges.” The case study states, “Senior management remained very focused throughout the various ED stages. ‘In fact,’ says Ms. Rawls, ‘Our CFO and President met with the FASB on several occasions to discuss various issues, including the combination of derivatives and in particular, the combination of basis swaps with other swaps.’ [The case study continues,] “Hence, when the final statement was issued in June 1998, [Fannie Mae] was in the unusual position of being intimately familiar with many of its concepts. In contrast, in most MNCs, only the accounting department was somewhat familiar with the impending standards.”

- Mampilly concludes, “While CEO Raines was not at [Fannie Mae] yet in 1998, CFO Howard was almost certainly a party to these preparations. This case study raises more questions on [Fannie’s] books and the benign interpretations of its troubles by market participants.” [James A. Johnson served as chairman and chief executive officer of Fannie Mae from February 1991 through December 1998.] (*Capuchinomics.com*. Paul Mampilly, 02/11/05)

Fannie Mae’s corporate governance rating cut by S&P

- Standard & Poor’s cut Fannie Mae’s corporate governance score to CGS-7 from GS-9, because of the company’s accounting errors, late regulatory filings and concerns about its board’s ability to provide oversight. S&P’s maximum score is CGS-10. The change doesn’t affect Fannie Mae’s credit rating of AAA, said the rating agency. “The SEC’s determination suggests governance shortcomings with regard to the quality of public disclosure and the ability of the Audit Committee to monitor adequately the company’s accounting,” said S&P analyst Dan Konigsburg. S&P also cited Fannie Mae’s inability to file a third- quarter earnings report with the SEC, and “sharpened concerns” over how Fannie Mae’s board has monitored relations with OFHEO. The new rating still reflects strong governance practices and policies, said S&P. The credit agency anticipates that relations with OFHEO may get better and financial disclosure will likely improve once the company restates its earnings.
- Corporate governance scores, which are solicited by companies, are “distinct” from “governance assessments” that are conducted as part of credit reviews, said S&P. In January 2003, Fannie Mae was the first company to obtain S&P’s corporate governance rating, which CEO Franklin Raines said was an affirmation of the company’s “best in class” practices. In December, Raines was ousted after the SEC agreed with OFHEO that Fannie Mae broke accounting rules. (*Bloomberg News*, Al Yoon, 02/02/05)

Fannie Mae’s former CEO Raines one of the “high flying compensation stars”

- When the New York Stock Exchange put together its \$187.5 million compensation package for its former chairman Richard Grasso, the NYSE pay committee

benchmarked Grasso’s pay against comparable corporate executives. The 2002-2003 comparable group included “high flying compensation stars” such as Fannie Mae’s [former] chairman and CEO Franklin D. Raines. The following table summarizes, in dollars rounded in thousands, Raines’ compensation for his service as CEO at Fannie Mae from fiscal years 2000 to 2003, as disclosed in Fannie Mae’s proxy statements. Raines’ compensation consisted of salary, bonuses, options and restricted stock and long-term incentive plan payouts (LTIP).

<u>Year</u>	<u>Salary</u>	<u>Bonus</u>	<u>Options/ Restricted Stock (1)</u>	<u>LTIP</u>	<u>Total Compensation</u>
2003	992,000	4,180,000	3,007,000	11,621,000	19,800,000
2002	992,000	3,300,000	6,680,000	7,234,000	18,206,000
2001	992,000	3,125,000	7,946,000	6,803,000	18,866,000
2000	992,000	2,481,000	5,829,000	4,589,000	13,891,000

(1) Options and restricted stock valued using the Black-Scholes model, as disclosed in proxy filing
Source: “Executive Compensation at Fannie Mae,” by Lucian Bebchuk and Jesse Fried, January 2005

- In a case study examining Fannie Mae’s executive compensation, Lucian Bebchuk, professor of law at Harvard Law School and Jesse Fried, professor of law at University of California at Berkeley, point out that more than 50% of Raines’ reported pay came from annual bonus and LTIP payouts. The authors note that while they do not know if Raines or former CFO J. Timothy Howard were in any way influenced by the company’s compensation incentives to inflate earnings, “there is a growing body of evidence, however, that in the aggregate the structure of pay affects the incentive to inflate earnings.” The authors conclude, “While large pay packages might be acceptable when it serves the goal of providing incentives to enhance long-term shareholder value, it is unacceptable when it produces perverse incentives to overstate earnings and artificially boost short-term stock returns.” (*Dow Jones Newswires*, Jed Horowitz, 02/02/05; *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, Lucian Bebchuk, Professor of Law, Economics and Finance Harvard Law School, and Jesse Fried, Professor of Law, University of California at Berkeley, January 2005)

KPMG locks the barn door a little too late
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- In the *International Herald Tribune*, Jim Peterson expresses skepticism about the effectiveness of Section 404 of the Sarbanes Oxley Act, requiring management and auditors to report on the condition and “effective operation” of corporate controls, in light of KPMG’s recent actions at Fannie Mae. On December 28, Fannie Mae

disclosed in an SEC filing that KPMG had told the company, “There existed strong indicators of material weaknesses in internal control over financial reporting.” A week earlier [December 21], Fannie had announced that its board had fired KPMG. Peterson notes, “While the linkage of KPMG’s firing and its subsequent issuance of controls advice is difficult to determine, the timing is critical. To paraphrase the burning question about Richard Nixon in the last phase of his doomed presidency, ‘What did KPMG know, and when did they know it?’”

- In September, OFHEO had criticized Fannie Mae’s accounting policies and practices, management integrity and internal control effectiveness. KPMG’s client relationship with Fannie had been “at peril” since at least November, when it held up the filing of company’s third-quarter financial results pending approval by the SEC’s accountants. Instead, the SEC concluded on December 15 that Fannie Mae’s accounting for loans and financial derivatives had violated accounting rules, leading to an announcement of a [minimum] \$9 billion downward restatement of its earnings for fiscal years 2000-2004. Peterson asks, “How much virtue can there be, or effectiveness either, in a December whistle-blowing when regulators and the politicians had already been on the scene for three months?”
- Peterson continues, “So now, the pain of Raines falls mainly on the plain: the investors who have seen the value of their stock slide. After Fannie Mae skidded from \$81 to \$63 last autumn, how pleased should investors have been to learn only in December that the company’s auditors had concerns about the materially weak nature of its controls? Throughout the autumn, Fannie Mae defended itself, with the concurrence of KPMG. But at the end, KPMG was isolated on the wrong side of the SEC and without the support of Raines, now stripped of the Washington protection accumulated as a high official in the Clinton administration.”
- “Open for question, then, is whether KPMG’s attitude reflected inspired revelation or the extrinsic event that the critics finally got the upper hand. You have to pity its strategic bind and the abuse it caught from both ends. In betting on the survival of Raines, the accountants backed a losing horse. Yet by December, when Fannie Mae revealed that KPMG had distanced itself from the now-discredited Raines-era controls, the accounting firm’s withdrawal of its endorsement could not bring it redemption because it was already off the job. Under those conditions, KPMG’s parting shot leaves the lingering question for those expecting Section 404 to be effective: why did the message not reach the investing public sooner? The model for the future is not encouraging.” (*International Herald Tribune*, Jim Peterson, 01/29/05)

Fannie Mae finalizes its hiring of Deloitte & Touche
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- On January 28, Deloitte & Touche officially became Fannie Mae’s new independent auditor, replacing the company’s longtime auditor KPMG, who was dismissed in December. 2004. (*Dow Jones Newswires*, Paulette Chu, 02/03/05)

DC Mayor Williams will try to force Fannie Mae to honor its promise
to be an anchor tenant in Waterside Mall

- D.C. Mayor Anthony A. Williams threatened to use “any resource at our disposal” to force Fannie Mae to make good on its promise to develop an office complex at the Waterside Mall in Southwest Washington. “Frankly, I’m really perturbed, really exasperated. I’m really angered ...by their decision. And I told Fannie Mae directly that I’m reconsidering my tack,” said Williams at his weekly news conference. “We should reserve any resource at our disposal to get them to reconsider their decision,” Williams said. “If you can’t live up to your commitment to move to Southwest, everything is back on the table.”
- One D.C. Council member has suggested that the city consider suing Fannie Mae for as much as \$200 million. Recently, Williams, City Administrator Robert C. Bobb, and council members Jack Evans and Sharon Ambrose confronted three members of Fannie Mae’s board at a meeting in the mayor’s office. While Williams declined to say precisely what the city’s options are, he said he wouldn’t rule out a lawsuit or legislation to force Fannie Mae to compensate the city for lost development opportunities. Evans said a lawsuit is the city’s best option, even though Fannie Mae officials never signed a binding contract to build a 2-million-square-foot office complex at an estimated cost of \$500 million to \$700 million. “Legally, the District could sue Fannie Mae for lost opportunity costs, which I estimate are in the ballpark of \$200 million,” said Evans, the chairman of the council’s Finance Committee. “Fannie Mae owes us an obligation to complete the project in Southwest. They can’t just walk away. They made an oral commitment. ...I’m not saying it will stand up in court. But I’m saying we can try.” (*Washington Post*, Lori Montgomery, Dana Hedgpeth, and David Hilzenrath, 02/10/05)

Citigroup and Capital Research & Management hold 6.3% and 11.1%, respectively
of Fannie’s common stock

- According to a recent SEC filing, Citigroup holds a 6.3% stake in Fannie Mae. Citigroup reported that it held 61 common million shares of Fannie Mae as of December 31, 2004. Citigroup’s ownership was reported in a “passive” filing with the SEC, in which the investor does not have to provide details about the dates that shares were acquired or sold, or the cost of the transactions. (*Reuters*, 02/11/05)
- Capital Research & Management Co. reported to the SEC its ownership of 107 million shares of Fannie Mae on December 31, 2004, representing an 11.1% stake in the GSE’s common stock. The stake, which consisted of 95.7 million shares beneficially owned, made the Los Angeles investment advisor Fannie Mae’s largest institutional shareholder, according to Thomson Financial. (*Dow Jones Newswires*, Shira Ovide, 02/11/05)

A look at Fannie's stock chart

- Bernie Schaeffer writes on *SchaffersResearch.com*, “Since the start of the year, [Fannie Mae] ...has slid lower by more than 11 percent. One interesting tidbit is the contrast between the heavy stock volume that coincided with the equity's September low and the current light stock volume, which I see as a concern, since it indicates a 'slow bleed' rather than a 'V-bottom' environment. Light put volume is additionally problematic, as it indicates that those with long big put open interest are in no hurry to liquidate on stock weakness as they might have been in the past. Not only does this eliminate a source of short covering from those short these puts, but it also adds pressure for them to add to their short-stock hedges. This does not preclude the cavalry from rescuing FNM yet another time, but I'd say the chances of a major (and scary) break of support are much higher now than they've ever been.”
(*SchaffersResearch.com*. Bernie Schaeffer, 02/10/05)

Minority couple sues Fannie, alleging discrimination

- A black couple, who allege that their mortgage-backed offer for a house was rejected for a lower cash bid by a white man, has filed a federal lawsuit against Fannie Mae, accusing the company of racial discrimination. Ray and Dorothy Scaife's lawsuit alleges that Fannie Mae refused to sell the house to the couple because of their race and that its preference for cash sales over conventional forms of financing is a discriminatory practice. The parties agree that the issue is Fannie Mae's purported practice of preferring a cash offer over one contingent on financing, when purchase offers are comparable. Aladean DeRose, a deputy Fort Wayne city attorney who represents the Scaifes, said Fannie's policy runs contrary to the stated purpose of increasing home ownership among low-income people, especially minorities. “If that's truly a policy of Fannie Mae, then it needs to be changed,” DeRose said. Fannie Mae's attorneys have filed motions to dismiss the case on procedural matters, arguing that the lawsuit fails to state a valid claim because there was no “intentional discrimination” against the Scaifes. (*Associated Press*, 02/06/05)

Fannie Mae to save \$500 per loan?

- *National Mortgage News* reports that Fannie Mae unveiled a plan to streamline the mortgage loan process and cut the cost of origination by \$500 a loan using new technology which pushes its “more robust” Desktop Underwriter to the point of sale as an ordering platform. *NMN* writes, “...[M]ortgage technology vendors are very upset that this is an invasion of their space and yet another way for Fannie Mae to ensure that more loans are funneled through them. Adding further fuel to this fire is the proposed GSE bill (S. 190) that will ban or limit Fannie and Freddie's use of their

AU systems if they “directly or indirectly” infringe on primary market activity.”
(*National Mortgage News*, Anthony Garritano, 02/07/05)

Fannie Mae partners with community bank to offer “Koran friendly” loans

- Devon Bank, a \$260 million community bank in Chicago, is working with Fannie Mae on developing home mortgages for Muslims who obey to the teachings of the Koran, forbidding interest payments. Devon Banks buys properties on behalf of its Islamic customers and then sells the homes to these customers at a price which includes projected interest payments. The Islamic customer repays the Bank for the home on an installment plan. Almost half the value of Devon’s mortgages is from Islamic financing. In January, Fannie Mae agreed to buy Devon’s Islamic home loan products. The Bank is also offers Koran-friendly financing for commercial real estate, business equipment, and letters of credit. Other banks offering Islamic financing services include the University Bancorp Inc. in Ann Arbor, MI, and HSBC USA Inc. in New York. (*Business Week*, Janet Ginsburg, 02/14/05 online 2-14)

Freddie Mac

Freddie Mac’s COO McQuade says GSE reform should reflect their “unique status” in market

- In a February 9 speech, Freddie Mac’s president and chief operating officer said, “...[W]e believe that any [GSE regulatory reform] legislation should enhance the confidence of domestic and global financial markets in the GSEs. It ought to strengthen our regulator and promote our housing mission. And it should maintain our ability to innovate and serve emerging markets. ...The structure of the regulator is important. Wherever it is located, it must provide strong, independent oversight and be committed to housing. Strength and independence are key attributes to maintaining the confidence of the capital markets.”
- “As for capital, no one disputes the need to ensure safety and soundness. But it’s very important that capital requirements be tied to risk, as the regulatory community is increasingly seeking to do with our global financial service counterparts through Basel II. Requiring us to hold capital beyond the risk of our business simply limits our ability to execute our housing mission.”
- “...Ultimately, we believe that any sound reform ought to reflect the unique status and role in the housing markets of the GSEs. We have special and growing mission obligations and special privileges to help us achieve them. It’s the mix of those obligations and privileges that makes housing finance in the U.S. work, and the

markets understand this. The key for us is that we continue to have access to these markets the way that we do now.”

- “So these are three of the important elements to us: a strong regulator that values housing; capital requirements tied to risk; and provisions that maintain our GSE status and role. We welcome reform and intend to work constructively for it.” (*Prepared remarks of Eugene McQuade at the Credit Suisse First Boston Financial Services Conference, 02/09/05*)

Ralph Boyd elected chairman of the Freddie Mac Foundation

- The Freddie Mac Foundation’s directors elected Ralph F. Boyd, Jr. to be chairman of the board. Boyd also serves as the company’s executive vice president of Community Relations, responsible for all philanthropic efforts, including corporate giving and employee volunteerism. Boyd replaces Freddie Mac Chairman and CEO Richard F. Syron, who remains on the Foundation board. Syron resigned as the board’s chairman to focus more attention on key legislative and business issues facing the Freddie Mac. (*PR Newswire, 02/07/05*)

Freddie Mac promotes Joan Donoghue as general counsel

- Freddie Mac has promoted Joan Donoghue to senior vice president and general counsel. Donoghue replaces Ralph Boyd, who is succeeding CEO Richard Syron as chairman of the Freddie Mac Foundation. Donoghue previously served as senior vice president and principal deputy general counsel since April 2004. (*Dow Jones Newswire, John Connor, 02/07/05*)

Freddie signs up another outside lobbying firm

- Freddie Mac, which recently hired former DaimlerChrysler lobbyist Timothy McBride to head its in-house government-relations shop, has also hired the outside lobbying firm of Royer & Brooks, formerly known as Royer & Babyak. (*The Hill, 02/08/05*)

Friends in high places

- Anita McBride has replaced Andi Ball as chief of staff for First Lady Laura Bush. She is married to Tim McBride, who served as the personal assistant to former President George H. W. Bush and now is Freddie Mac’s chief lobbyist. (*Washington Post, Ann Gerhart, Roxanne Roberts, and Judith Weinraub, 02/04/05*)

“Just the Facts” from Freddie Mac

- In its newest institutional advertising brochure, Freddie Mac notes that it is “A Recognized Leader.” The company writes, “Freddie Mac is recognized for our leadership in business, an employer and a partner with the community. Freddie Mac is ranked as a Fortune 100 company. *Working Mother* magazine ranks us as one of the Best Places for Women to Work. The *Washington* magazine says we’re one of the best places to work in the metropolitan Washington, D.C. area. Our employee and supplier diversity programs rate highly among *Computerworld*, *Latina Style*, and *Diversity, Inc.*” (*Just the Facts*, Freddie Mac, February 2005)

Freddie sets multi-family funding record in 2004

- Freddie Mac closed \$23.8 billion in new multifamily business transactions in 2004, a record for the company. The company’s multifamily originations included approximately \$2 billion in targeted affordable housing products, financing apartments that receive some form of government subsidy, up from \$776 million in 2003. Freddie Mac’s multifamily transactions financed approximately 450,000 apartment homes affordable to families earning low or moderate incomes. (*Freddie Mac Press Release*, 02/09/05)

Federal Home Loan Banks

Council of FHLBs endorses S. 190, providing GSE regulatory reform

- The Council of Federal Home Loan Banks voted unanimously to endorse S. 190, a bill introduced by Senators Chuck Hagel (NE), John Sununu (R-NH), and Elizabeth Dole (R-NC) to consolidate and strengthen oversight of Fannie Mae, Freddie Mac, and the banks themselves. The Council’s vote was the first time the 12 FHLBs had officially taken a stance on GSE regulatory reform legislation, which would combine oversight of Fannie, Freddie, and the FHLBs into a new regulatory agency. John von Seggern, the president of the Council, said the bill would not impede the FHLBs’ cooperative mission to provide liquidity to members to make mortgage and other loans. S. 190 “allows the Federal Home Loan Bank System to continue what it’s best at,” said von Seggern. “This is a process that, if Congress continues down this path, we want to take part in.” (*American Banker*, Hannah Bergman and Damian Paletta, 02/07/05)

President and CEO of FHLB-Seattle retires

- Effective March 15, Former Seattle Mayor Norm Rice will retire as president and chief executive of the FHLB-Seattle, two months after the Bank entered into a supervisory regulatory agreement with the Federal Housing Finance Board. The decision by Rice, 61, the Bank's CEO for six years, was "mutually agreed to" with the board and was neither required by regulators nor the result of a recently started independent review of bank operations, said David A. Bley, the bank's executive vice president. "There was no one thing causing this to occur ...the time was right for Norm to move on and for the board to determine the future direction of the company," he added. Bley is leading the internal management committee that will manage the bank until an interim chief executive is selected. The Bank's board has formed a committee to find a new CEO and plans to hire an outside search firm, said Bley.
- During the first quarter of 2005, the Bank began a new policy of paying dividends based on the previous quarter's earnings, subject to limitations. For the first quarter of 2005, the FHLB-Seattle has declared a Class B(1) stock dividend at the annualized rate of 1.63%. The dividend is much lower than the 4% dividend paid in the first and second quarter of 2004 and the third quarter dividend rate of 3.5%. No dividend was paid in the fourth quarter of 2004. (*Seattle Times*, Melissa Allison, 02/02/05; *Associated Press*, 02/02/05; *BusinessWire*, 01/31/05; *American Banker*, Hannah Bergman, 02/01/05)

The Federal Housing Finance Board accepts the FHLB-Chicago's business plan

- The Federal Housing Finance Board has approved the FHLB-Chicago's three-year business and capital management plan, fulfilling a key requirement of the Bank's Written Agreement with the regulator announced last summer. The plan is designed to ensure the Bank continues serving the housing finance needs of its member financial institutions by allowing for the on-going growth of its advances business and the development and evolution of the Mortgage Partnership Finance® Program, while also addressing the regulatory issues raised by the Finance Board. "We are pleased to have completed the development of this plan, which represents another milestone in the overall process of enhancing our business and risk management capabilities undertaken in recent months," said J. Mikesell Thomas, President and CEO of the FHLB-Chicago.
- According to the plan, the Bank will begin to substantially reduce the amount of excess, or "voluntary," stock owned by its member financial institutions, measured as a percentage of regulatory capital. As of December 31, 2004, about 58% of its stock was held by members voluntarily. The Plan calls for that percentage to be gradually reduced to 43% or less by the end of 2007. The Bank will also delay the implementation of a new capital structure until December 31, 2006, or until a time

mutually agreed upon with the Finance Board. The Bank will reevaluate the structure of the Bank's capital plan and may propose amendments for approval by the Finance Board based on the review. The Bank will also explore alternative methods of capitalizing and funding MPF assets including techniques to liquefy program assets, creating additional capacity for the Bank and other FHLBs.

- The Bank will adopt a new dividend policy providing for a maximum payout ratio in a given quarter not to exceed 90% of Adjusted Core Net Income (ACNI) for that quarter. ACNI is the Bank's GAAP net income less gains or losses arising from significant non-recurring events. While the Written Agreement remains in effect, annualized quarterly dividends greater than 5.5% will require the Finance Board's approval.
- As the capital restructuring occurs under the plan, management expects that the Bank's total MPF assets will remain relatively flat or decline gradually, consistent with recent trends. Paydowns of existing MPF assets will create capacity for the Bank to serve the needs of participating members. Management also expects that the restatement of the Bank's prior period financial statements will be completed shortly. (*FHLB-Chicago Press Release, 02/10/05*)

FHLB-Atlanta announces appointments of new CFO
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- The FHLB-Atlanta has hired Ernest (Lee) Puschaver as its chief financial officer to strengthen the risk management and prepare the Bank for registration with the SEC. Puschaver will oversee the financial risk measurement and modeling, accounting services, risk assessment and control, and derivatives and investment operations departments for the Bank. Puschaver, the former director of finance and chief operating officer for FleetBoston Financial Corp., succeeds Gary Glass who retired in November 2004, following a career of 30 years with the Bank, including 11 years as its CFO.
- The FHLB-Atlanta also announced it has promoted W. Wesley McMullan to executive vice president and director of the financial management division and hired Praveen Jha to serve as senior vice president and director of member sales and trading. (*Reuters, 02/02/05; American Banker, Dean Anason, 02/02/05*)

Farm Credit System / Farmer Mac

Federal budget proposal depicts a strong and growing Farm Credit System

- According to the analytical perspectives section of federal budget proposal for fiscal year 2006, the financial condition of the FCS banks and associations continued a 15-year trend of improving financial health and performance in 2004. On September 30, 2004, the System's capital totaled \$18.0 billion. In addition, the Farm Credit System Insurance Corporation holds \$2.1 billion of restricted capital for FCS members. The System's loan volume has increased to \$94.9 billion in September 2004. Over the 2001-2003 period, the System's assets growth has averaged 7.4%. The rate of capital accumulation for the System has been greater, resulting in total capital (including restricted capital) equaling 16.2% of total assets at year-end 2003, compared to 15.3% at year-end 2000. Nonperforming loans decreased significantly to 0.88% of total loans in September 2004, versus 1.38% in September 2003. Competitive pressures, higher balances of lower yielding investments, and a low interest rate environment reduced FCS's year-to-date net interest margin to 2.52% for September 2004 from 2.62% percent in 2003. The current interest rate environment and strong competition in the lending markets are likely to continue placing pressure on the System's net interest margin. Consolidation continues to affect the structure of the FCS, reducing the number of banks from 9 in January 1995 to 5 in September 2004, and the number of associations from 232 to 97 over the corresponding period.
- According to the budget proposal, "The FCSIC ensures the timely payment of principal and interest on FCS obligations. FCSIC manages the Insurance Fund which supplements the System's capital and supports the joint and several liability of the System banks. On September 30, 2004 the Insurance Fund's net assets totaled \$1.9 billion... [T]he Insurance Fund was at 2.01% of adjusted insured debt obligations of the System banks, slightly above the statutory minimum of 2%."
- "...Each of the System institutions is rated under the FCA Financial Institution Rating System (FIRS) for capital, asset quality, management, earnings, liquidity, and sensitivity. ...In September 2004, all 102 banks and associations had ratings of 1 or 2, and no institution was under an enforcement action."
- "Over the past 12 months, the System's loans outstanding have grown by \$3.6 billion, or 3.9 percent, while over the past five years they have grown \$25.2 billion, or 36.2 percent. The volume of lending secured by farmland increased 51.5 percent, while farm-operating loans have increased 34.7 percent since 1999. Agricultural producers represented the largest borrower group, with \$76.9 billion including loans to rural homeowners and leases, or 81.1 percent of the dollar amount of loans outstanding. International loans (export financing) represent 3.0 percent of the System's loan portfolio. Loans to young, beginning, and small farmers and ranchers represented 12.9, 18.7, and 31.8 percent, respectively, of the total dollar volume outstanding in

2003, which is slightly higher than in 2002. These percentages cannot be summed given significant overlap in these categories. Providing credit and related services to young, beginning, and small farmers and ranchers is a legislated mandate and a high priority for the System.”

- “The System, while continuing to record strong earnings and capital growth, remains exposed to a variety of risks, including concentration risk, possible changes to government programs, the volatility of agricultural exports and commodity prices, animal and plant diseases, and concerns about future off-farm employment prospects, given the trends in job outsourcing and global competition.”
- “Farmer Mac was established in 1987 to facilitate a secondary market for farm real estate and rural housing loans. Since the Agricultural Credit Act of 1987, there have been several amendments to Farmer Mac’s chartering statute. ...[T]he Farm Credit System Reform Act of 1996 ...transformed Farmer Mac from a guarantor of securities backed by loan pools into a direct purchaser of mortgages, enabling it to form pools to securitize. The 1996 Act increased Farmer Mac’s ability to provide liquidity to agricultural mortgage lenders. Since the passage of the 1996 Act, Farmer Mac’s program activities and business have increased significantly.”
- “Farmer Mac continues to meet core capital and regulatory risk-based capital requirements. Farmer Mac’s total program activity (loans purchased and guaranteed, and AgVantage bonds purchased) as of September 30, 2004, totaled \$5.5 billion. That volume represents 1.8% reduction from program activity at September 30, 2003. Of total program activity, \$2.2 billion were on-balance sheet loans and agricultural mortgage-backed securities and \$3.3 billion were off-balance sheet obligations. Total assets were \$3.8 billion at the close of the calendar third quarter, with non-program investments accounting for \$1.4 billion of those assets. Farmer Mac’s net income to common stockholders for the first three quarters of 2004 was \$18.4 million, a decrease of \$1.74 million, or 8.7% from the same period in 2003.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006, pages 99-98*)

Postal Service

Postal Reform gets early start but momentum is questionable

- After a decade of congressional attempts to reform the USPS, key lawmakers and stakeholders hope that the reintroduction of last year's reform packages that nearly made it to the floors of the House and Senate will mean that legislation reforming the beleaguered Postal Service will actually come to fruition. However, with the USPS expected to announce higher profits and the GSE's apparent backing away from the threat of "double digit" rate increases, it is possible that some of the momentum gained last year on postal reform may dissipate this year. The mailing industry may be willing to accept a smaller rate increase rather than face uncertainties and the unintended consequences with a wholesale change of postal policy. Gene Del Polito, president of the Association for Postal Commerce, said he is unsure of whether a postal reform package will get approved by Congress this year. "The scenario changes weekly," Del Polito said. "There's a tremendous force to say, 'Let's go with what we got.'" (*Bureau of National Affairs*, Derrick Cain, 02/03/05)

Heritage Foundation examines the need for postal reform

- James L. Gattuso, research fellow with the Heritage Foundation, notes that as Americans turn to email and other forms of electronic communication to send messages and make payments, the number of first-class letters has dropped over 5% with priority and express mail plummeting some 25% since 2001, threatening the long-term viability of the U.S. postal service. As a result, the USPS has warned that postal rates will increase in 2005, with first-class stamp costs rising to \$0.41 or even \$0.43 cents. In the long run, Gattuso said, rate increases will only make the problem worse, driving even more mail to the Internet.
- In January, Representative John McHugh (R-NY) introduced H.R. 22, the "Postal Accountability and Enhancement Act." Essentially the same as bills that were approved in House and Senate committees in 2004, H.R. 22 would grant USPS some flexibility and increase regulatory oversight, but does not include many of the recommendations of the presidential commission. Moreover, the legislation would transfer billions in postal retirement costs to the U.S. Treasury.
- Gattuso writes, "More comprehensive reform of the postal service is needed [than that contemplated by H.R. 22]. The 2003 presidential commission's recommendations provide a good guide for doing this. Its suggestion that a base-closure style commission for identifying which facilities should be closed is especially promising. Increased flexibility for postal management would also be helpful, but should be paired with other reforms. Unlike other businesses, USPS enjoys special privileges stemming from its governmental status, including a

monopoly on the delivery of letter mail and exemption from taxes and many regulations. As long as these privileges exist, strict oversight and regulation of its activities is necessary. Congress should act to allow USPS to be run more efficiently, while ensuring oversight of its activities by a strong independent regulator. At the same time, USPS' special privileges should be re-evaluated, and the organization required to operate on the same terms as private firms." (*Heritage Foundation Regulation in Brief No. 11*, James L. Gattuso, 02/08/05)

Why this year may be different for postal reform

- In a recent Op-Ed, Robert McLean, Executive Director of the Mailers Council, writes, "There are several reasons why [postal reform] may pass. First, within 48 hours of the November 3 election, Treasury Department officials, speaking on behalf of the White House, notified many mailers to say that postal reform remained a high priority. Second, the members of Congress who will consider postal reform bills at the committee level have made reform their single biggest priority. Third, the USPS is going to file a rate case this year that has the potential to devastate many categories of mail unless Congress quickly passes reform legislation. The bottom-line result [of a big rate hike] is inescapable: mail volume will drop. This year may be the last opportunity for reform before the much-predicted postal crisis occurs." (*PostalWatch.com*, 02/07/05)

Federal budget proposal lacks many of USPS funding requests

- The Bush Administration's budget proposal for fiscal year 2006 includes only one of the funding requests submitted by the U.S. Postal Service last year. In September, the Board of Governors of the USPS approved a budget request which included \$227 million for emergency preparedness funding; \$108.5 million for free mail for the blind; and \$29 million as part of the Revenue Forgone Reform Act of 1993, representing the 13th of 42 payments on more than \$1.2 billion owed to the USPS. This request was submitted to the OMB. In December, OMB submitted a final request to the White House, which included only \$61.7 million for free mail for the blind. This single funding request was included in Bush's budget recommendation, which has been sent to Congress. "It's an annual process that begins now, and we'll have discussions with the House and the Senate appropriations committees and see where it goes," said Mitch King, manager, government relations for the USPS.
- In the federal budget proposal, the Bush administration addressed the need for postal reform and the resolution of the Civil Service Retirement System funding. According to the budget proposal, the administration plans to use "the pension savings provided to the postal service by the Postal Civil Service Retirement System Funding Reform Act of 2003 that would otherwise be held in escrow in 2006 and beyond, to put the postal service on a path that fully funds its substantial retiree health benefits liabilities." The budget proposal also said the administration continues to support the

“enactment of comprehensive postal reform legislation that is consistent with the report of the President’s Commission on the United States Postal Service.”

According to the budget proposal, the administration “believes that the postal service should continue providing affordable and reliable universal service, while limiting exposure to taxpayers and operating appropriately in the competitive marketplace.” (*DMNews.com*, Melissa Campanelli, 02/08/05)

Online banking trends bode ill for USPS’ future

- According to a survey by the Pew Internet and American Life Project, nearly half of all adult Internet users in the United States now manage their bank accounts online, making banking the fastest-growing online activity. Approximately 44% of Internet users bank online in the U.S., up from 30%. The nonprofit group said banking has grown faster than any other online activity since it began measuring Internet use in March 2000. [The USPS has attributed the continuing decline in first class mail volumes to email use and automated bill paying systems and Internet banking. This survey portends that declining first class mail volumes will likely continue.] (*Reuters*, 02/09/05)

President Reagan stamp unveiled

- The Postal Service’s new stamp commemorating President Ronald Reagan was unveiled February 10 at a ceremony at the Ronald Reagan Presidential Library and Museum with First Lady Nancy Reagan in attendance. James Miller, chairman of the Postal Service board of governors, said the stamp illustrates Reagan’s famous smile, tilt of head and twinkling blue eyes in a way that captures the “warmth, personality and humanity of Ronald Reagan.” (*Associated Press*, 02/10/05)

TVA

OMB rates TVA “moderately effective”

- The U.S. federal budget proposal for 2006 rates TVA Power as “moderately effective.” A decade ago TVA’s nuclear power plants posed serious technical and safety problems, the agency has overcome these problems and today its nuclear power plants set industry standards, notes OMB. Today, TVA has a high level of debt compared to many of its competitors in the electricity industry. Moreover, the agency lacks a strategic plan, making it difficult to assess TVA’s plans to spend funds on additional power plants and transmission lines, said OMB. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006, page 80*)
- As the White House pushes the agency to do more to trim its “excessive” borrowing, the TVA’s pace of debt reduction is slowing, according to the 2006 federal budget proposal. TVA projects it will reduce its total financial obligations by \$150 million and cut its statutory debt by \$10 million during the next fiscal year. Without a rate increase, TVA projects it will pay down its debt in fiscal 2006 by less than half as much as it did in 2005, well below the rate needed to reach the goals outlined in the agency’s strategic plan adopted just over a year ago. “In my view, the debt reduction numbers that TVA is offering in these budget documents for next year are wholly inadequate,” said TVA Director Bill Baxter. “We need to be doing more to reduce our debt to ensure we are competitive in the future.” (*Chattanooga Times Free Press, Dave Flessner, 02/10/05*)
- The Bush administration’s budget proposal suggests reforms to the TVA. Among the administration’s proposals are giving the Federal Energy Regulatory Commission (FERC), which oversees public utilities, jurisdiction over TVA’s transmission system; forcing the Authority to count more transactions toward its \$30 billion debt ceiling; and requiring TVA to register its debt securities with the SEC to force greater transparency in its operations. TVA spokesman John Moulton said the Authority would support FERC oversight of “certain areas.” Moulton said the TVA already uses “accepted accounting practices when counting its debt,” and opposes additional SEC requirements because they would be costly and take longer. (*Associated Press, Hilary Roxe, 02/07/05*)

The politicking begins for TVA’s new board

- Saying Memphis deserves greater representation at TVA, city leaders launched a campaign to have the Memphis Light, Gas and Water (MLGW) Division’s chairman, L.R. Jalenak, appointed to the Authority’s soon-to-be-expanded board. Jalenak, 74, has been a member of its board since 1993. Although MLGW is by far TVA’s largest

customer, local leaders say the city often gets overlooked by the utility. (*The Commercial Appeal*, Tom Charlier, 01/27/05)

- The TVA's biggest customers want President Bush and Congress to rename TVA Chairman Glenn McCullough of Mississippi to the Authority's new and expanded board when his term expires May 18. The Tennessee Valley Public Power Association (TVPPA), the trade group for TVA's 158 distributors, endorsed keeping McCullough on the board when it becomes a nine-member, part-time entity later this year. TVPPA is also urging lawmakers to name one of the group's former leaders, retired Middle Tennessee Electric Co-op President Jim Baker, from Murfreesboro, TN, to the board. Other distributors, officials and lawmakers have suggested other candidates, including former Tennessee Deputy Governor Justin Wilson, retired Alabama Congressman Ronnie Flippo, and Chattanooga attorney J. Wayne Cropp.
- Jack Simmons, the executive director for TVPPA, said McCullough has worked well with TVA customers and would make a good chairman of the new board along with Baker as one of the new directors. "Both men are well known to the membership of TVPPA and, we believe, meet the qualifications for members of the TVA board that are spelled out in the authorizing legislation," Simmons said in a letter to Senate Majority Leader Bill Frist (R-TN) and other regional lawmakers.
- The idea of reappointing McCullough, the former mayor of Tupelo, MS, doesn't sit well with Senator Trent Lott (R-MS). "I'd rather that he not stay on the board," said Lott, who pushed President Bush to name McCullough chairman in 2001. Lott has since expressed disappointment with him. "I wouldn't object to it as sort of a transitional phase," Lott said. "I'd prefer to go to an all-new board and CEO." Lott said he doesn't believe the current TVA board has done enough to address TVA's staggering \$25 billion debt, nor enough toward completing the unfinished Bellefonte nuclear power plant in Alabama. Lott said he expects to get together with Senator Thad Cochran (R-MS) and Representative Roger Wicker (R-MS) to offer several names for the president to consider. In an e-mail statement, Cochran expressed strong support for McCullough, saying "I think Glenn is especially well qualified because of the experience he has had in helping manage the authority and his personal qualities of honesty and intelligence."
- McCullough said he is not campaigning for an appointment to the new board but has indicated to distributors he would be willing to serve. "If the White House contacts me, I certainly support President Bush and would give any offer serious consideration," said McCullough. "I'm going to keep my options open."
- Senators Bill Frist (R-TN) and Lamar Alexander (R-TN) are not commenting about whom they intend to recommend. "It would be premature to discuss candidates at this time, but both Senator Frist and Senator Alexander have said in the past that they want to find the most qualified people to serve on the new TVA board," said Nick Smith, a Frist spokesman. White House spokesman Taylor Gross said President Bush will listen to recommendations and advice from members of Congress, "but

ultimately, the president is going to look for the best person to do the job.”
(*Chattanooga Times Free Press*, Andy Sher and Dave Flesner, 02/07/05; *Associated Press*, 02/07/05; *Commercial Appeal*, Tom Charlier, 02/27/05)

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