

The GSE REPORT™

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Major Events

Senate Banking Committee passes rigorous GSE regulatory reform bill on party-line vote

- The Senate Banking Committee approved legislation establishing a rigorous new regulatory regime for Fannie Mae, Freddie Mac, and the FHLB System on a party-line vote of 11-9. The legislation creates a new regulator for Fannie Mae, Freddie Mac and the FHLB system, which is given broad authority and direction to reduce their investment portfolios and restrict the types of assets held in portfolio. The bill directs the GSE regulator to establish criteria regarding the assets a GSE can hold and to consider GSEs' safety and soundness as well as the "systemic risk" posed by the size and composition of those investments. The agency would also have a free hand to raise capital requirements as needed; to restrain the GSEs' ability to expand into other lines of business; and establishes, according to one regulator, a "bullet-proof receivership mechanism" in the event of a GSE failure. According to most proponents of GSE regulatory reform, S. 190, as passed by the Senate Banking Committee, is considered to be significantly stronger than a companion bill passed by the House Financial Services Committee by an overwhelming bipartisan vote of 65-5 in May.
- Partisan differences remain over provisions in the House bill to set aside 5% of the GSEs' profits in an affordable housing fund and to increase the conforming loan limits in high cost markets; and a provision in the Senate bill to restrict the size of Fannie Mae's and Freddie Mac's investment portfolios. During markup, Senator Jack Reed (D-RI) introduced an amendment for an affordable housing fund, as a part of minority leader Paul Sarbanes' (D-MD) substitute. Reed's proposal provided for fund contributions equal to 4.2 basis points for each dollar of unpaid principal balance of new purchases by Fannie and Freddie and allocated 25% of the AH fund proceeds to pay Treasury's interest obligations on REFCorp bonds. Reed also incorporated provisions to address the Republicans' concerns that the affordable housing fund would be used as a "slush fund" for liberal housing advocacy groups. Despite such changes, the committee Republicans voted down the Sarbanes substitute on an 11-9 vote.
- Acknowledging that the affordable housing fund should not be a difficult issue to resolve, Senator Chuck Schumer (D-NY) said, "I think we're willing to work on the housing part. I think there is agreement on that, but the portfolio limits area very large sticking point for me and I think for just about every one of us on this [Democratic] side." Schumer pointed out that the bill's portfolio restrictions would result in shifting about \$760 billion in housing assets from Fannie and Freddie to other private financial institutions. By moving these assets and the risk they encompass out of the GSEs, the bill would simply move them into the portfolios of large institutions that "lack Fannie and Freddie's housing focus," he said. "And so

what we've done is, we haven't reduced the risk, but we've reduced the commitment to housing." Senator Jon Corzine (D-NJ) pointed out that foreigners fund a large percentage of GSE debt. "I'm not certain that they would fund that money in other institutions that might be the substitute" for the GSEs, Corzine said. Sarbanes said, "You are venturing into very uncharted and potentially dangerous waters [with S. 190]. We have to be very careful, in my opinion, not to do anything that may put this housing system at risk."

- The only amendment passed by the committee was a provision introduced by Senator Rick Santorum (R-PA) to make changes in the statutory language in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, that established Fannie and Freddie's annual affordable housing goals. The provision would establish new reporting requirements designed to ensure that Fannie Mae and Freddie Mac are servicing underserved markets, by requiring the companies to publicly disclose the same mortgage data under the Home Mortgage Disclosure Act that insured depository institutions must release.
- Despite the partisan split, most lawmakers on the panel said they don't believe that the Democrats and Republicans are that far apart in reaching consensus on the broader bill. Shelby said lawmakers will work over the August recess to try to bridge the gap, with hopes of scheduling a vote on the Senate floor in September or October. "We have not come to closure with the Democrats yet, but we will continue to talk," said Shelby. He acknowledged that Republicans will probably have to make some concessions on affordable housing and "maybe some in portfolios" to attract Democratic support in the full Senate. "I believe there is room to talk," said Shelby. "We're a lot closer than a lot of people think on this whole bill," he added. But, Shelby cautioned that he doesn't "want a bill that isn't a strong bill" and would not move legislation to the Senate floor unless he thinks it will force Fannie and Freddie to become smaller. Shelby did not specify whether the accord must be crafted ahead of a full-Senate vote or, later in conference with House lawmakers.
- Senator Christopher Dodd, (D-CT), said, "We're not that far apart...we're heading in the right direction." Dodd added that he hoped the committee staffs could work together over the upcoming recess "to see if we can't come up with a proposal we can all embrace before the Senate in early September or October." Acknowledging that his party has not threatened a filibuster of the bill, Dodd told reporters, "The word 'filibuster' is nowhere near the horizon." Responding to Dodd's comments, Shelby said, "We're probably 90% there." Looking beyond the Senate floor vote, Senator Robert Bennett (R-UT) said, "I agree that we're close. I agree that this is enormously important. I share the sense that we're not quite there." Bennett then addressed Shelby, saying "I've decided to support your measure to get the bill moving forward because the fact is we're going to ultimately resolve these issues in conference." While some were optimistic about the ability to strike a deal and keep legislative momentum going, the ranking minority member of on the panel, Senator Paul Sarbanes (D-MD), called the investment portfolio issue "very complicated and difficult." Although Shelby had long sought bipartisan support for GSE regulatory

reform legislation, he finally released his bill in order to hold debate and a markup before Congress' August break. Shelby stated he was more interested in having a "strong" bill, than one that simply had bipartisan support.

- Minority leader Senator Harry Reid (D-NV) said, "The legislation from the Senate Banking Committee, passed on a party-line vote by the Republican majority, includes measures that would cripple the ability of Fannie Mae and Freddie Mac to carry out their mission of expanding homeownership. While I favor improving oversight by our federal housing regulators to ensure safety and soundness, we cannot pass legislation that could limit Americans from owning homes and potentially harm our economy in the process."
- Following the committee's vote, Treasury Secretary John Snow praised the panel for reporting out S. 190. "The Committee's action represents an important milestone toward creating a regulator with powers and authorities commensurate with that of other large, complex financial institutions," said Snow. "The legislation also creates significantly enhanced market discipline and capital requirements for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The legislation strikes a proper and prudent balance in ensuring that the activities undertaken by these entities do not engender systemic risk while providing broad access to housing finance."
- Freddie Mac spokeswoman Sharon McHale said the Senate measure was taking the wrong approach in limiting the assets the GSEs can hold. "We think it's very unfortunate that the bill [S. 190] goes so far beyond regulatory reform and jeopardizes the nation's housing finance system," said McHale. The portfolio provision would "essentially shut down a major business line for Freddie Mac by limiting us to mortgage securitization, jeopardizing investment from around the world," she added. McHale also voiced concerns about the regulator's enhanced authority over capital ratios and new products.
- Fannie Mae spokesman Charles V. Greener said, "We are hopeful that a bipartisan consensus will emerge that gives the new regulator full authority to oversee our portfolio operations to ensure that they are conducted in a safe and sound manner." Portfolio limits are acceptable "in response to a clearly identified and quantifiable safety and soundness risk, taking into account the enterprise's obligation to provide liquidity to the markets and achieve our affordable housing mission," Greener added.
- Reaction was generally positive from bank trade organizations to the committee's passage of S. 190. Floyd Stoner, the American Bankers Association's executive director for congressional relations and public policy, issued a statement saying, "These government sponsored enterprises are vital to banks of all sizes in meeting our nation's housing and community development needs. It is essential that the enterprises be governed by a responsible, independent and respected regulator." Diane Casey-Landry, president and chief executive officer of America's Community Bankers, said in that Shelby's bill "contains effective procedures for focusing Fannie Mae and Freddie Mac on their secondary market activities and approving new

products and programs consistent with their mission.” Casey-Landry added that ACB would urge Senate Majority Leader Bill Frist (R-TN.) to move S. 190 to a vote on the Senate floor. Michael Petrie, chairman of the Mortgage Bankers Association, wrote in a letter to Shelby, “Your legislation represents a clear understanding of the need to improve oversight of the GSEs relative to safety and soundness, systemic risk, and to ensure that Fannie Mae and Freddie Mac do not deviate from their Congressionally-chartered purposes.” Prior to the committee markup, the Housing Policy Council of the Financial Services Roundtable wrote a letter to the members of the Banking Committee, urging them to approve the Chairman’s mark and to oppose any amendments which would weaken the bill’s strong oversight authority of the new GSE regulator.

- While bankers’ reactions were generally positive to the Senate Banking Committee’s actions, many Wall Street analysts now say that the chances are “slim” that Congress will pass GSE regulatory reform legislation this year. After the panel’s partisan vote, analysts escalated their warnings. In a research note, Eric Wasserstrom, an analyst with UBS Securities LLC analyst, wrote, “The lack of consensus on the portfolio limits and the broad disparities between the House and Senate bills make the passage of [legislation] unlikely this year.” FTN Financial Markets’ equity research manager Jim Vogel said, “Oddly enough, I think there’s a sense that today [the Committee’s action] is sort of a step backward.” Some lobbyists disagree, saying there was a chance for action because the areas of disagreement are so few. “There’s agreement on many more issues than there is disagreement,” said Howard Glaser, a mortgage industry consultant and former senior housing official in the Clinton administration. Where there is disagreement, it remains wide, Glaser acknowledged.
- While GSE regulatory reform faces an uncertain future in both chambers of Congress, it is the first time in more than five years of debate on such legislation has made it this far, with a Senate vote coming as early as September. Sheila Bair, a former Treasury official and now a professor at the University of Massachusetts Amherst, believes that the prospects for a stronger GSE regulatory reform bill are better because Shelby did not compromise in committee. “What he is doing is brilliant, strategically,” Bair said. “The forces who are opposing real reform will not relent. To give in now would not have been good strategy, because he would have to give again on the floor, because that is the way the opposition works.” (*Dow Jones Newswires*, Dawn Kopecki, 07/28/05; *American Banker*, Damian Paletta, 07/29/05; *Washington Post*, Annys Shin, 07/29/05; *Bureau of National Affairs*, Richard Cowden, 07/29/05; *Dow Jones Newswires*, Dawn Kopecki, 07/29/05; *Reuters*, 07/28/05; *The Main Wire*, Claudia Hirsch, 07/28/05; *Reuters News*, Kristin Roberts, 07/28/05; *Dow Jones Capital Markets*, John Connor, 07/27/05; *CQ Today*, 07/28/05; *UPI*, 07/28/05; *Dow Jones Capital Markets*, John Connor, 07/28/05; *The Main Wire*, Claudia Hirsch, 07/29/05; *Associated Press*, 07/28/05; *The Main Wire*, Claudia Hirsch, 07/24/05; *Housing Policy Council Press Release*, 07/28/05)

Federal Reserve Chairman Alan Greenspan tells Congress that *no* legislation
is better than passage of H.R. 1461

- In testimony before both the House Financial Services Committee and the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan said that the current version of a House bill to reform the regulation of GSEs is worse than no reform at all, because H.R. 1461 fails to restrict Fannie and Freddie's investment portfolios. Greenspan told the House Financial Services Committee, "I do not think [H.R. 1461] appropriately removes what is a very significant threat to the long term health of the U.S. financial system." Greenspan reiterated the Fed's position that Freddie and Fannie do little to lower mortgage costs to consumers, are leveraged at hazardous levels, and are dangerously undercapitalized. "The concern that I have is that over the longer run ...we will all be at risk if, indeed, there is a systemic problem," he said. H.R. 1461 "did not address the problems that I thought were stamped with respect to the GSEs. We would probably be better off with no bill than a bill of that nature," Greenspan said.
- When asked if the risks posed by the GSEs could be mitigated by raising the amount of capital the companies hold, Greenspan responded, "Unquestionably if their risk-based capital were raised to the level of where commercial banks are, that would assuage a good deal of the problem. It would still leave the issue, however, of the ability on the part of these institutions to raise any amount of capital at low interest rates irrespective of the status of these institutions." Without restricting the companies' portfolios, Fannie and Freddie will still be able to expand those holdings at low cost by cashing in on Wall Street's view that the GSEs are backed by the government, said Greenspan.
- Greenspan reiterated the Fed's position that the GSEs' combined \$1.5 trillion mortgage portfolios drive up the companies' profits and expose taxpayers to significant risk, but do not drive down mortgage costs for consumers. "The motive for accumulating portfolios is solely, essentially in all respects, profit making," he told the Senate panel. "I have no objection to that. Indeed they are profit-making organizations. They are chartered as such and their shareholders could very well, presumably, sue if they did not pursue those goals. But that is not adding liquidity to the housing market nor, in our judgment, is it assisting the market generally," said Greenspan. "And in addition, because it is a highly leveraged operation and because it requires sophisticated hedging of interest rate risk, it is imparting a significant risk to the American financial system."
- Greenspan refuted arguments that the push to restrict the GSEs' operations is motivated solely by large competitors, looking to increase their share of the mortgage market. Senator Robert Bennett (R-UT), whose son is deputy director of Fannie Mae's Utah partnership office, said "The small banks, the mortgage brokers, the home builders, the Realtors are all saying: Don't mess the portfolios or the GSEs. ...They've indicated that they believe if Fannie Mae and Freddie Mac are constrained in their portfolios, that the price will go up, and they will be forced to deal with other

institutions.” Greenspan responded that the GSEs’ allies, including the National Association of Realtors, National Association of Home Builders, Independent Community Bankers of America, were “mistaken” in that belief and “will find that they are at significant risk” if a problem at Fannie or Freddie disrupts the broader housing finance system. “The nature of the argument misses the really fundamental point, which is that we are creating a potential very serious systemic risk. And to have arguments that are going on about whose market share or whose potential profits will change in somewhat different ways, I think is missing the much larger point,” he added.

- Greenspan compared the differences between the Bush administration’s proposal to curb the GSEs’ portfolios and H.R. 1461’s provision, allowing the new GSE regulator to curtail the companies’ on-balance-sheet holdings only if those assets threaten the financial stability of Fannie or Freddie, but not the broader U.S. financial system. “We’re not raising questions with respect to the portfolios as a risk to the GSEs. On the contrary, it’s expanding their profitability in everything else that goes with it,” he said. Rather, the GSEs’ portfolio holdings pose a far greater risk to the overall financial system than mortgages owned by U.S. banks largely because Fannie and Freddie have significantly lower reserves than commercial banks, he said. “It’s a different order of magnitude largely because, one, the size of the leverage, and two, the extent to which the financial markets grant the GSEs effective U.S. Treasury status with respect to their bond issuance when they do not do that for commercial banks,” he said. Critics of portfolio limits “extraordinarily exaggerate” the practical affects of cutting the companies’ assets, he added. “There are changes. I don’t want to deny that there will be changes. But I think people extraordinarily exaggerate what the implications are,” said Greenspan.
- Greenspan also said that Fannie Mae and Freddie Mac’s ability to weather multi-billion accounting errors is directly attributed to their status as GSEs. “How is it possible to have these huge accounting losses and serious questions about what the earnings of these institutions are and have virtually no effect on the rates at which they can sell debentures?” he asked. “And the reason, essentially, is that the financial state of Fannie and Freddie has got almost nothing to do to what the interest rate is on their debentures or their ability to actually sell them,” because of their status as a government-sponsored entity. (*Dow Jones Newswires*, Dawn Kopecki, 07/22/05; *Reuters*, Kristin Roberts, 07/21/05; *Dow Jones Capital Markets Report*, Elizabeth Price, 07/20/05)

Fannie Mae and Freddie Mac

Efforts to craft a compromise over the affordable housing fund are on the front burner in the House of Representatives

- House lawmakers were unable to reach a compromise in a closed-door meeting on July 19th, regarding the affordable housing fund provision in H.R. 1461, according to lawmakers exiting the meeting. House Majority Leader Tom DeLay (R-TX) met with House Financial Services Chairman Michael Oxley (R-OH) and several members of the committee to see if common ground could be found on the affordable housing provision. According to the *National Mortgage News*, “One source said negotiations are ‘very fluid.’” DeLay’s spokesman Ben Porrit, said, “The majority leader is working through issues on the bill and hopes to bring it to the floor as soon as possible.” While no decisions were made at the meeting, Oxley said he’s hoping to float a new proposal during the August recess. “We had a real good discussion,” said Representative Tom Feeney (R-FL), as he left the meeting. Feeney, who has helped organize opposition of the provision among conservative Republicans, said he believed the attendees “understand how this money could be used for advocacy groups.” Representative Jeb Hensarling (R-TX), said they had a “good, healthy discussion. We’ll have to see what comes out of it.” Representatives Richard Baker (R-OH), Paul Gillmor (R-OH) and Ed Royce (R-CA) also attended the meeting, but declined to comment as they left DeLay’s office. Several congressional aides said that the conservative Republican Study Committee has rejected Oxley’s offer to scale back the size of the affordable housing fund and to devote 25% of the money to pay down the REFCO bonds, among other things.
- H.R. 1461, which overwhelmingly passed the House Financial Services Committee 65-5 in May, also has become bogged down by a few controversial provisions and procedural snafus. House Judiciary Chairman F. James Sensenbrenner (R-WI) has received permission from House officials to assert jurisdiction over H.R. 1461, pushing back the possibility of action on the House floor until late September at the earliest. The Judiciary Committee will review parts of the bill which fall under its jurisdiction, including provisions related to criminal penalties and receivership authority. Representative Barney Frank (D-MA), ranking member on the Financial Services Committee, said he fears the Judiciary Committee’s review will only help opponents derail the bill. “My concern is [the delay] will be used for inappropriate purposes,” Frank said. (*Dow Jones Newswires*, Dawn Kopecki, 07/20/05; *National Mortgage News*, 07/21/05; *Washington Post*, Annys Shin, 07/19/05)

The *Wall Street Journal* applauds Chairman Shelby's
leadership on GSE regulatory reform

- In a July 27 editorial, the *Wall Street Journal* wrote, “The doughty band of Fannie Mae and Freddie Mac reformers isn’t beaten yet. Senate Banking Committee Chairman Richard Shelby plans to mark up a bill this week to protect taxpayers against the risky business of these ‘government-sponsored enterprises,’ and the question is whether he can coax enough skittish Republicans to pass it. The Alabama Senator’s proposal is a quantum improvement over the non-reform that passed the House Financial Services Committee earlier this year. In particular, it would force Fan and Fred to reduce their portfolios of mortgage-backed securities, a source of great profit for the companies but also of significant taxpayer risk. The House bill punted on this point, and without it any reform isn’t worth much.”
- “Just as encouraging is what the Shelby bill deletes from Congressman Mike Oxley’s House embarrassment: It doesn’t raise the conforming loan limit in high-cost housing areas, an increase that would allow Fan and Fred to use their taxpayer subsidy to grow even more market share. And it doesn’t include an ‘affordable housing fund’ that Mr. Oxley created as a sop to the homebuilder lobby and to Barney Frank of Massachusetts; this is little more than a Congressional tax on Fannie profits to dole out to favored interest groups. Federal Reserve Chairman Alan Greenspan said last week that ‘no bill’ would be better than Mr. Oxley’s folly.”
- “The Senate expectation is that most or all Banking Committee Democrats will oppose the Shelby bill, since they view Fan and Fred as Congressional business subsidiaries -- guaranteed sources of political cash and high-paid patronage jobs. This means Mr. Shelby will need the votes of all Republicans, and his Committee does include such reform stalwarts as Elizabeth Dole (N.C.) and John Sununu (N.H.). The question marks are Utah’s Robert Bennett, whose son Rob works in Fannie’s Utah partnership office; Rick Santorum, who wants homebuilder buddies as he faces a tough re-election fight in Pennsylvania next year; and Kentucky’s Jim Bunning, who’s always hard to predict. One concern is that these three might simply fail to appear at the hearing, and thus the bill might not have enough votes to emerge from Committee. Let’s hope they show up and help their Chairman, not to mention taxpayers who are on the hook if the two scandal-plagued companies get into more trouble.” (*Wall Street Journal*, 07/27/05)

Editorial boards for the *Baltimore Sun* and *Seattle Times* support H.R.1461’s AH fund

- In a July 25th editorial, the *Seattle Times* writes, “Delays in a congressional vote on tighter federal oversight of mortgage-lending giants Fannie Mae and Freddie Mac should not result in legislative death by review. ...The problem is that in Congress, the longer a bill languishes, the dimmer its prospects. It would be a missed opportunity if Congress fails to tighten the reins on Fannie Mae and Freddie Mac. The legislation’s main intent, creating an independent regulator for the two mortgage

giants following last year's accounting scandals, is critical. The financial upheaval cost taxpayers tens of millions of dollars and warranted an investigation by the Justice Department. Clearly, there is a need for closer regulatory scrutiny of the two banks."

- "Another appealing part of the legislation would require Fannie Mae and Freddie Mac to set aside 5 percent of their after-tax profits for an affordable-housing fund. The fund would pay for the preservation, rehabilitation and construction of low-income housing. Estimates of how much the fund could eventually raise range from \$400 million to \$1 billion annually. That would be the most substantial investment in affordable housing the federal government has undertaken in a long, long time."
- "To Representative F. James Sensenbrenner Jr. (R-WI), chairman of the Judiciary Committee: Pore over the bill if you must, right down to the last comma. But in the end, agree that Congress has found the best solution to reining in Fannie Mae and Freddie Mac without disrupting the lending institutions' core mission to broaden opportunity for home ownership. The same applies to the low-income housing set-aside. Fannie Mae's and Freddie Mac's loss of some freedom would become the public's gain." (*Seattle Times*, 07/25/05)
- In a July 28th editorial, the *Baltimore Sun* also voices support for the provision for an affordable housing fund in H.R. 1461. The *Sun* writes, "Tucked within a wide-ranging piece of legislation aimed at reforming and strengthening regulatory oversight of government-sponsored housing finance agencies Fannie Mae and Freddie Mac is a timely and welcome requirement that would force the two mortgage giants to set aside 5 percent of their after-tax profits for affordable housing. ...It could pump as much as \$3 billion over the next five years into the production, preservation and rehabilitation of affordable rental housing and toward assisting first-time homebuyers. Some Republican lawmakers opposed to the set-aside dismiss it as a 'slush fund' for the housing industry."
- "...The fund would favor projects that benefit families with very low incomes and would pay for the building or rehabilitating of about 4,000 housing units a year. It would help poor and working-class people who have seen decent and affordable housing move increasingly beyond their reach. Given the increasing rates of homelessness in this country and that about a third of Americans are spending 30 percent or more of their income on housing, the housing fund would be a good step toward meeting the needs of people with severe housing cost burdens. The private housing market clearly is not meeting this need. The fund would not require annual appropriations from the federal government, nor would it burden taxpayers. The Bush administration, which touts its efforts to expand homeownership, should be backing the measure. Instead, it seems swayed by arguments that the housing fund distracts from the legislation's larger reform goals. But there is no reason why the legislation cannot both reform and assist." (*The Baltimore Sun*, 07/28/05)

Restricting Fannie and Freddie's portfolios could lead to
"unintended -- and very dangerous -- consequences"

- In a July 26th editorial in the *Washington Times*, former Reagan budget director and Freddie Mac consultant James C. Miller, III wrote, "Conservatives and others have expressed outrage over the recent Supreme Court ruling giving government power to take private property from one owner and give it to another to promote economic development. Right now Congress is considering doing something similar, and there's hardly a peep of protest. In the name of enhancing stability in financial markets, Congress might 'downsize' two major private companies and transfer stockholder value to someone else. The companies are Fannie Mae and Freddie Mac, financial institutions created by Congress to support home mortgage lending. Contrary to popular belief, neither is a government agency. Both are federally chartered private companies -- profit making, owned by stockholders and publicly traded. The two companies have been extremely successful in both their public and private goals, having lowered mortgage costs by billions of dollars each year and built mortgage investment portfolios totaling some \$1.5 trillion."
- "Their critics argue that, because the companies are so large, any problems they encounter could endanger the broader financial system. But there is no evidence the two companies are uniquely prone to failure. Mortgages are extremely safe investments, and Fannie and Freddie employ extensive and sophisticated hedging to reduce interest rate risk to a minimum. ...Forcing financially sound companies to divest the bulk of their assets would be unprecedented. If this were proposed for any other company, conservatives would argue it would amount to confiscating stockholders' property on a flimsy pretext. But Fannie and Freddie are unpopular with many conservatives because of their special charters and the benefits they receive. Ironically, some conservatives object to another proposal -- requiring Fannie and Freddie to pay 5 percent of their profits into an affordable housing fund -- as a government-mandated transfer of stockholder wealth. Yet the amount taken by the tax would be minuscule compared to the wealth that would be taken under the portfolio proposal."
- "Conservatives should be alarmed at the precedent this proposal would set. Once government grants itself this power, why couldn't it eventually be applied to other companies and industries? For example, many banks and other financial companies operate under federal and state charters. Banks receive subsidies in the form of federal deposit insurance -- taxpayer support that makes deposits a cheap source of funding -- and access to low-cost funds from the Federal Reserve. Large banks receive preferential treatment in capital markets, because investors believe they too are too big to fail. Large banks also pose at least as much risk as Fannie or Freddie. If government can force Fannie and Freddie to sell most of their assets, what's to keep government from later doing the same to Citigroup or Bank of America?"
- Moreover, if government can force the sale of assets because the owner used a subsidy to acquire them -- which seems to be an implicit justification for doing this to

Fannie and Freddie -- no one's property is safe. Subsidies are widespread and used by almost everyone. Homeowners get them through tax deductions for mortgage interest and local real estate taxes. Virtually all businesses benefit from a direct or indirect subsidy. Once government uses a new power, it always seeks to use it again more broadly. Fannie and Freddie could be the first targets of this power, but they would not be the last. Given Fannie and Freddie's size and their key role in our system of housing finance, concerns about the potential risks of their mortgage investments are not out of place. But the best way to address the issue is to ensure they operate safely and soundly and cover their risks through adequate hedges and capital. This is far better than taking wealth from stockholders under a misguided theory that the companies are simply too successful and too big. A precedent of this sort could lead to unintended -- and very dangerous -- consequences." (*Washington Times*, James C. Miller, III, 07/26/05)

Fannie Mae now holds an "unsustainable \$731 billion *non-mission* supportive portfolio"

- Until recently, it was almost unthinkable for anyone on Wall Street to question the wisdom of buying and holding shares of Fannie Mae and Freddie Mac. But as the GSE regulatory reform debate continues in Congress, some Wall Street analysts have begun to look closely at Fannie Mae and Freddie Mac's balance sheet and business model in the context of Congressional reform – and come to surprising conclusions. Banc of America Securities' equity analyst Robert Lacoursiere recently recommended a "Sell" rating for Fannie Mae in BofA's first-ever report on the company. Assuming that regulators will require Fannie and Freddie gradually to reduce their portfolios to a level consistent with their congressionally mandated "mission" of helping to ensure a steady flow of funds into the mortgage market. Lacoursiere estimates Fannie's portfolio is nearly five times as large as it needs to be to accomplish that. In his report, Lacoursiere concluded that Fannie now holds an "unsustainable \$731 billion non-mission supportive portfolio." He predicts that both Fannie and Freddie will be reducing their portfolios at a 3.5% quarterly rate, and will be decreasing their combined portfolios to \$1.05 trillion by the end of next year from \$1.52 at the end of the first quarter. Lacoursiere also initiated a "Neutral" rating for Freddie Mac.
- Morgan Stanley analyst Kenneth Posner predicts that regulators will raise the minimum capital requirement for Fannie Mae and Freddie Mac to 4% or 5% of their mortgage portfolios from the 2.5%, putting their capital requirements in line with those for commercial banks. If the GSE regulator also will take steps to reduce risk-taking at Fannie and Freddie by limiting their reliance on short-term borrowings, the new regulatory regime probably will leave the companies with "little opportunity to grow," said Posner.
- Regardless of what actions Congress takes regarding GSE regulatory reform, Fannie and Freddie's glory days could be behind them, as the GSEs' borrowing-cost advantage over other financial concerns has narrowed and growth prospects in the

mortgage market for the foreseeable future appear to be outside the companies' purview in subprime and nonconforming mortgage markets. (*Asset Securitization Report*, Karen Sibayan, 07/25/05; *Wall Street Journal*, James R. Hagerty, 07/20/05)

Federal Reserve Governor Gramlich says restrictions on GSE portfolios won't have "huge impact" on the structure of the mortgage market

- In a speech before a business group in Honolulu, Federal Reserve Board governor Edward Gramlich downplayed the impact of a provision that the Senate is currently mulling to place new limits on the size of portfolios of Fannie Mae and Freddie Mac. "However this plays out, it won't have a huge impact on the structure of the mortgage markets," he said, adding that there will be "minimal effect" on the overall housing market. (*Dow Jones Newswires*, Michael S. Derby, 07/27/05)

Fannie Mae issues economic study of the benefits and risks of bank investments in GSE and mortgage-backed securities

- A July 2005 study, conducted by Noel Fahey, Director of Regulatory Policy for Fannie Mae, analyzes the differing investors' demands for GSE debt securities and mortgage backed securities and assesses the degree of systemic threat posed by GSEs debt securities. Specifically, the study addresses the question: Do the GSEs support the mortgage market through holding loans or MBS in portfolio or just through guaranteeing MBS held by others. Fahey concludes that at least one major set of investors—U.S. agricultural and community banks—exhibits a pronounced preference for GSE debt over MBS. He also asserts that the same investment behavior pattern "is likely to be true of other investors, including many foreign investors."
- "The large amount of GSE debt securities held by banks has raised the question whether such investments pose a systemic risk to the banking industry," writes Fahey in this study. He concludes that investment patterns of bank holdings do not constitute a systemic threat for two reasons. First, large banks, which hold most of the banking industry's assets and thereby "harbor" the biggest potential for system risk, have a small portion of their balance sheet invested in Fannie Mae debt. Specifically, "megabanks" with assets in excess of \$50 billion hold just 6.8% of their capital in Fannie Mae debt. Further, the ten largest banks have on average only 1.2% of their capital invested in Fannie Mae debt. Secondly, banks with relative large investments in Fannie Mae debt tend to be smaller and comprise a small percentage of the (bank) industry's assets. Fahey's study finds that 466 banks or 5.2% of the industry which have over 100% of their capital invested in Fannie Mae debt hold only 2% of the industry's assets. Further, approximately 97% of the banks with 100% of their capital invested in Fannie Mae debt have less than \$1 billion of assets each. Fahey concludes that banks holding 86.1% of the industry's assets hold less than 25% of their capital in Fannie Mae debt. He concludes, "[B]anks that might pose a systemic threat don't hold much Fannie Mae debt; [while] banks that hold relatively

large amounts of Fannie Mae debt don't pose a systemic threat.” (*A Study of the Benefits and Risks of Bank Investments in GSE and Mortgage-backed Securities*, Noel Fahey, July 2005)

Congress must act now to provide a receivership mechanism for Fannie and Freddie

- In an August 2005 white paper titled “Handling the Failure of a Government-Sponsored Enterprise, Fordham University’s associate professor of law Richard Scott Carnell examines the five GSEs and explains how their government sponsorship impairs market discipline, enriches shareholders, and promotes artificial growth and risk taking. Carnell argues that through a timely adoption of workable receivership mechanisms, Congress could avoid using public money or credit to rescue an insolvent GSE’s creditors. Using bank solvency law as a model, Carnell examines the GSE insolvency regimes and concludes that the regimes for Fannie and Freddie have grave deficiencies and the regimes for the FHLBs, Farm Credit System and Farmer Mac need improvement. Carnell then outlines how a troubled GSE could be organized and analyzes recent congressional reform proposals. Based upon this analysis, Carnell concludes that Congress should act now to provide a receivership mechanism for Fannie and Freddie and broaden the authority of receivers for the Farm Credit System and Farmer Mac. This white paper is available on Fordham University’s website: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=745486. (*Washington Law Review*, Vol. 80, “Handling the Failure of a Government-Sponsored Enterprise,” Richard Scott Carnell, August 2005)

OFHEO finalizes rule on mortgage fraud

- OFHEO has finalized its rule on a mandatory mortgage-fraud reporting routine for Fannie Mae and Freddie Mac, which differs little from its proposed rule announced in February that was criticized by the GSEs and lender trade groups. The final rule requires Fannie Mae and Freddie Mac to report fraud or “possible” fraud “promptly,” but not more than ten days after becoming aware of it, rather than in a four-day timeframe as originally proposed. The regulator requires immediate notification in cases in which a fraud could have a “significant effect” on Fannie’s or Freddie’s safety and soundness. The rule also establishes requirements for fraud-related internal controls, procedures, and training at Fannie and Freddie. It will take effect 30 days from the date of publication in the Federal Register (*American Banker*, Jody Shenn, 07/26/05; *Bureau of National Affairs*, 07/26/05; *OFHEO Press Release*, 07/25/05))

The latest word on Congressional and Bush administration announcements

- House Speaker J. Dennis Hastert (R-IL) recently told a group of supporters that he plans to run again and serve as speaker for the remainder of President Bush's second term. Hastert's announcement postpones a likely brutal succession fight that would be a distraction from next year's midterm elections and could adversely impact Bush's domestic agenda. According to an attendee, Hastert told an audience of about 80 at the Chicago Club that he will run again "at the urging of his constituents and the president." The audience responded with a standing ovation, said the attendee. Representative Deborah Pryce (R-OH), chairman of the House Republican Conference and member of the House Financial Services Committee, told party colleagues in a June 21st letter that she will also run for a third term as chair of the Conference in November 2006. (*Washington Post*, Mike Allen, 07/24/05)
- In a voice vote, the Senate Banking Committee confirmed six nominees for key financial services posts, including John Dugan, as comptroller of the currency; John Reich as the Office of Thrift Supervision director; Representative Christopher Cox as the SEC chairman; Martin Gruenberg as the FDIC vice chairman; and Roel C. Campos and Annette L. Nazareth as SEC commissioners. On July 30, the Senate approved Cox as chairman of the SEC, and Campos and Nazareth to fill the two Democratic positions on the Commission. (*American Banker*, Rob Blackwell, 07/29/05; *Bureau of National Affairs*, 07/29/05; *Associated Press*, Liz Sidoti, 07/30/05)
- President Bush intends to nominate Emil W. Henry, Jr. to be assistant secretary of Treasury for financial institutions, serving as the point person for GSEs. Henry currently is a senior partner with Gleacher Partners, an investment banking and management asset firm and previously worked in Morgan Stanley's merchant banking division. The White House has also nominated Michele Davis for a post at the State Department. Davis is Fannie's senior vice president for regulatory policy. (*Dow Jones International*, Henry J. Pulizzi, 07/28/05; *Reuters News*, 07/28/05; *American Banker*, Jody Shenn, 07/26/05)

Agency debt could be the big loser in China revaluation

- With Fannie Mae and Freddie Mac being primary beneficiaries of currency controls in China over the past couple of years, no one has more to lose than Fannie Mae and Freddie Mac with the country's revaluation of the yuan. With the supply of agency debt steadily declining as a result of Fannie Mae's and Freddie Mac's pared mortgage holdings, Asian investors have become a bigger presence in a shrinking agency market. "Over the past year-and-a-half to two years, both the proportion and dollar value of agencies held by Asian investors really grew," said David Boberski, head of interest-rate strategy at Bear Stearns. "And China has been an important component of this demand." Boberski believes that China's move to revalue the yuan by 2% and

allow it to float in a tight band against a basket of currencies, while relatively modest, is still significant. “It’s clearly a move to lessen the need for intervention in the currency market, and that means substantially less to be invested in dollar-denominated bonds,” he said. Even participants who downplay the significance of China’s move think any fall-off will hit the agency market hardest.

- Timothy Rowe, a senior portfolio manager at Smith Breeden, agrees that the revaluation is much more negative for agencies than it is for either Treasuries or mortgage bonds. “Over the past several months, agency valuations have gotten pushed to pretty expensive levels, and foreign buying has been the driver,” Rowe said. While mortgages have also become somewhat expensive, foreign buying hasn’t been quite as important a factor in that market, he added. Moreover, Rowe believes that foreign central banks are likely to continue diversifying their dollar-denominated holdings into mortgages, even if their appetite for U.S. assets declines. (*Dow Jones Newswires*, Allison Bisbey Colter, 07/21/05)

Federal Reserve Alan Greenspan again warns Congress that the “boom” in housing prices could reverse itself in certain regional markets
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- In recent Congressional testimony, Federal Reserve Chairman Alan Greenspan again warned that the “boom” in housing prices could reverse itself in certain geographical areas. “We certainly cannot rule out declines in home prices, especially in some local markets,” said Greenspan, adding there are “signs of froth in some local markets where home prices seem to have risen to unsustainable levels.” He concluded, however, that the impact on the broader economy would probably be small. In fact, several Federal Reserve district banks reported that a few hot markets appear to be cooling. “Residential real estate activity remained robust overall but showed a few signs of cooling in some districts,” said the Federal Reserve’s Beige Book. According to Federal Reserve Bank of Boston, home price appreciation has moved from “hot” to “normal” in Massachusetts, while housing inventories in New England have become “somewhat less tight.” According to the Beige Book, “In the Richmond, Atlanta and San Francisco districts housing activity remained strong but eased in a few markets that had been especially hot markets -- Washington, D.C., several Florida markets and parts of southern California.” The Federal Reserve Bank of New York reported that the condominium market in Manhattan is “less frenzied” than in the spring and that “housing inflation” has slowed in New Jersey. (*CNN/Money*, Aaron Smith, 07/20/05; *Reuters*, 07/22/05; *National Mortgage News*, 07/30/05)
- At a recent Rotary Club economics conference in Concord, CA, Freddie Mac president Eugene McQuade voiced his concerns about real estate values in “white hot” markets such as the Bay Area. While nationwide, the country is not perched on a bubble, he said, the landscape is more ominous in places with white-hot realty markets such as the Bay Area. “Let’s face it, the big run-ups on both coasts and in places like Las Vegas are not sustainable. Nor should they be,” McQuade said. Borrowers who have adjustable-rate or interest-only mortgages could see their

budgets stretched as interest rates rise, while those who bought second homes in hopes of a quick profit could face bankruptcy as the equity in their investment properties evaporates in an atmosphere of flat prices, he said. Early evidence suggests that the housing market has begun to slow with fewer homes being sold to the highest bidder in a single day, said McQuade. “Clearly, home prices will adjust downward in the next year or two. I expect they will be flat for two or three years rather than drop sharply.” (*Contra Costa Times*, George Avalos, 07/30/05)

Fannie Mae

Internal probe of Fannie Mae’s books should be completed later this fall

- In an interview with the *Wall Street Journal*, former Senator Warren B. Rudman said he hopes that his outside investigation of Fannie Mae’s books will be completed later this fall. Fannie Mae hired Rudman and his team of lawyers from the Washington law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP to investigate OFHEO’s allegations of widespread accounting improprieties at the company. Warren told the *WSJ* that there is no way that their report will be completed in September, as many in Washington have speculated. “I would hope this year, but it’s certainly not going to be in September,” said Rudman. “It’s highly complex, huge numbers of documents, a lot of people to be interviewed and re-interviewed.... Barring unforeseen circumstances, later this fall.” He said his team continues to meet regularly with OFHEO, the U.S. Attorney’s Office, the SEC, and the Public Accounting Oversight Board to apprise them of their findings. Rudman said that his investigation is not specifically looking at Fannie Mae’s lobbying tactics or its nonprofit foundation, which have been the subject of criticism in recent years. “We’re tangentially only looking at the Fannie Mae Foundation,” said Rudman. “We’re not focusing on lobbying; there was nothing in the OFHEO report about that. To the extent these issues deal with things like governance, we will look at that. Compensation, how that’s established. All those things are interrelated.” (*Dow Jones Newswires*, Dawn Kopecki, 07/26/05)

Fannie Mae’s portfolio shrinks for 8th month to lowest level since 2002

- Fannie Mae’s mortgage portfolio shrank for an eighth month in June to the lowest level in three years. The company’s investments contracted by \$19.9 billion to \$808.2 billion, a 25.3% decline on an annual basis. Fannie Mae’s portfolio is down from \$904.6 billion at December 31, 2004, as the company conserves cash to build a 30% capital surplus required by its federal regulator by September 30, 2005. According to a May 19th statement by OFHEO, Fannie Mae was “on target” to meet the capital surplus by its September deadline. The company sold \$10.4 billion from

its portfolio in June, bringing year-to-date sales to \$50.5 billion, and entered into contracts to sell \$2.3 billion in mortgages during June, compared with \$8.1 billion in May. Fannie Mae's overall amount of mortgage debt that it owns or guarantees grew at a 0.2% annual rate last month to \$2.293 trillion. The company's duration gap was zero months in June, versus -1 month in April and May. (*The Main Wire*, 07/28/05; *American Banker*, Jody Shenn, 07/29/05; *Bloomberg News*, Al Yoon, 07/28/05)

Fannie Mae announces its third quarter dividends

- Fannie Mae's board of directors declared a third quarter dividend on the company's common stock of \$0.26 per share, unchanged from the second quarter. Fannie Mae also declared dividends on the company's preferred stock in accordance with the terms of the preferred stock (*Fannie Mae Press Release*, 07/19/05)

Fannie Mae participated in \$11.8 billion of multifamily financing in first half of 2005

- Fannie Mae said it participated in \$11.8 billion of multifamily financing during the first six months of 2005, 11% more than in 2003. [The company did not break out comparable number for the corresponding period in 2004]. More than 92% of the multifamily units financed by Fannie Mae were for affordable to families with income at or below their communities' median, said a company spokesman. The percentage reserved for families with low or very low income rose 6% to about 60%, while the percentage in underserved areas rose 17% to about 62%. (*American Banker*, Jody Shenn, 07/26/05)

Fannie Mae announces management appointments

- Fannie Mae announced the appointment of Thomas Lund as Executive Vice President of its Single-Family Mortgage Business, Kenneth Bacon as EVP of Housing and Community Development, and Richard Lawch as Senior Vice President of Multifamily Mortgage Business. All three executives have been serving in these roles on an interim basis since December 2004. (*M2 EquityBites*, 07/21/05)

AFL-CIO partners with Fannie Mae to make housing "more available and affordable"

- The AFL-CIO has launched a \$750 million community investment plan funded by pension funds to spur economic development, create union jobs and make housing more available and affordable in Chicago, IL. While Boston, Los Angeles, Philadelphia, San Francisco and Washington, D.C., were also considered, Stephen Coyle, chief executive officer of the AFL-CIO Housing Investment Trust, said that Chicago was chosen because of its large union population and its history of being a

good place to make union investments. “We probably will - over time - do the same kind of structural investment program in other cities,” said Coyle. The five-year investment program targets the needs of working families, by providing \$250 million each to support homeownership, rental housing and neighborhood revitalization or mixed-use projects. Through a partnership with the AFL-CIO HIT HOME program, Countrywide Home Loans Inc. and Fannie Mae will provide single-family loans for the families of union workers, including approximately 30,000 municipal government employees. (*Associated Press*, 07/23/05)

Freddie Mac

Freddie Mac’s portfolio shrinks in June for the first month in five

- Freddie Mac said its mortgage portfolio shrank in June for the first month in five, as falling interest rates boosted the company’s loan prepayments. The company’s mortgage holdings shrank by \$3.1 billion or 5.6% in June to \$665 billion, said Freddie Mac’s spokesman Michael Cosgrove, a spokesman for the McLean, Virginia-based company. Moreover, Freddie Mac’s holdings of its own mortgage securities fell by \$10.6 billion in June, as falling interest rates boosted early repayments by \$16.1 billion, the fastest monthly rate this year. Sales of securities from Freddie Mac’s portfolio also rose to the fastest pace this year, at \$10 billion. “Neither market conditions nor forward commitments in June show any promise of reversing the long-term decline” in the portfolio of its own securities, said Jim Vogel, an analyst for FTN Financial in Memphis, Tennessee. In recent months, Freddie Mac has augmented its portfolio through purchases of [private label] non-agency securities, committing to buy \$15.9 billion in mortgages in June, compared with \$15.8 billion in May. On June 30th, Freddie Mac held \$213 billion in non-agency securities, more than 3.4% a month earlier and 21% on December 31, 2004. Freddie Mac also reported that its duration gap remained at zero months in June, unchanged from May. (*Bloomberg News*, Al Yoon, 07/25/05; *Reuters News*, 07/25/05; *American Banker*, Jody Shenn, 07/25/05)

Freddie Mac serves as chair of the host city committee for the National Urban League’s annual conference

- As chair of the host city committee, Freddie Mac has rolled out the welcome mat for its long time partner, the National Urban League and the 15,000 members who will be attending the League’s conference from July 27–31 in Washington, DC. Highlights of the League’s conference include an interactive exhibit hall with five “specialty zones” [including one on homeownership], and numerous educational and networking opportunities such as a gala, luncheons, seminars and concerts. “I want to

congratulate the Urban League on its significant accomplishments over the past 95 years. The Urban League has become part of the fabric of communities across America, building a long tradition of empowering communities and changing lives. At Freddie Mac, we share this commitment to strengthening communities and people,” said Ralph F. Boyd, Jr., executive vice president for Community Relations, Freddie Mac and host city committee chair for the National Urban League Conference. (*Freddie Mac Press Release, 07/28/05*)

Freddie Mac ranks #5 in the lobbying expenditures in 2004

- According to *PoliticalMoneyLine.com*, Freddie Mac ranked fifth in aggregate lobbying expenditures, spending \$15.4 during 2004. Companies, trade associations and other interest groups spent a record \$2.14 billion to lobby Congress and the federal government in 2004, according to the *PoliticalMoneyLine* analysis. (*Bloomberg News, 07/18/05*)

Freddie Mac creates new position for vice president of external risk management

- Freddie Mac named former Wells Fargo Home Mortgage executive Michael E. Wade to the new position of vice president for External Operational Risk Management, responsible for ensuring the high quality of the company’s single family operations. Wade’s duties will include analyzing Freddie Mac’s Seller/Servicers’ underwriting processes, managing on-site quality control and operational audits, and developing and implementing quality control and operational policies and procedures. Wade will report to Janet Eakes, senior vice president of Single Family Operations. Previously, Wade was Wells Fargo Home Mortgage’s senior vice president of Credit Policy and Strategy. (*Freddie Mac Press Release, July 26, 2005; Reuters, 06/26/05*)

Freddie Mac joins the “red hot” IO loan market, tripling its IO pool volume

- According to a research note published by *Greenwich Capital*, Freddie Mac created \$9.2 billion in interest-only ARM pools in the second quarter, tripling its volume on the product from the first quarter. Greenwich analyst Michael Corsi credited Freddie Mac’s “initial interest” product for the surge in IO activity. (*National Mortgage News, 07/25/05*)

Freddie Mac crosses the \$5 billion threshold in low income housing tax credit investments

- Freddie Mac announced that its portfolio of Low-Income Housing Tax Credit (LIHTC) investments now exceeds \$5 billion, making the company one of the largest

corporate investors in tax credit housing development. Since making its first LIHTC investment in 1988, Freddie Mac's LIHTC portfolio grew to \$500 million in 1996 to over \$5 billion in 2005, through 225 separate limited partnership investment funds covering over 3,900 housing developments and producing more than 290,000 affordable homes. (*Freddie Mac Press Release, 07/28/05*)

Asian buyers out in force, buying 50% of Freddie Mac's latest REMIC sale

- Asian investors purchased 50% of Freddie Mac's recent \$1.25 billion 10-year REMIC, while Japanese investors bought another 10%, representing the highest level of participation ever registered out of the region for a reference security, said Jonathan Prince, vice president of mortgage investor relations at the company. Domestic investors comprised 40% of the deal, he said. With \$1.6 billion of orders, Freddie Mac's sale was 30% oversubscribed, Prince added. (*Reuters, Julie Haviv, 07/19/05*)

Freddie Mac adds the 5/1 hybrid ARM to their Home Possible program

- Freddie Mac has added a 5/1 hybrid ARM to Home Possible, its low-down payment mortgage product line for low- and moderate-income borrowers. Freddie also announced that it has lowered the mortgage insurance coverage levels required on Home Possible loans, making them more affordable. Effective September 18th, the company will modify its policy on credit scores, allowing LP to process applications where only one of the borrower has a "useable" credit score. "This new feature in Loan Prospector will assist sellers in meeting the needs of borrowers who have little or no credit established," said Freddie Mac. (*National Mortgage News Online, 07/30/05*)

Federal Home Loan Banks

FHLB-Seattle hires OTS Deputy Director Riccobono as the Bank's COO

- The FHLB-Seattle has hired OTS deputy director Richard Riccobono as the Bank's executive vice president and chief operating officer. Riccobono will join the FHLB-Seattle on August 10, where he will report to the Bank's president James E. Gilleran, former the Director of OTS. Gilleran said his former deputy director at OTS has "extensive banking knowledge, management talents and experience with the Federal Home Loan Bank System."
- According to his employment agreement, the FHLB-Seattle is paying Gilleran an annual salary of \$525,000 and bonuses of up to 60% of his salary. Under the Bank's long-term compensation plan, Gilleran can more than double his base pay through additional bonus awards of up to 45% of Gilleran's salary based on three-year performance targets. The FHLB-Seattle has not yet released Riccobono's employment agreement.
- The FHLB-Seattle also announced other senior management changes to better align the Bank's operations and establish a more comprehensive organizational structure. Mark Szczepaniak will become the chief financial officer for the Bank, after serving as its controller since October 2004. Prior to joining the FHLB-Seattle, Szczepaniak was a senior vice president and the corporate controller at the FHLB-Chicago. Steve Horton, who has served as the FHLB-Seattle's interim CFO since October 2004, will now become the Bank's chief risk officer. David Bley will again oversee the FHLB-Seattle's product marketing and business development operations as its executive vice president and director of sales, marketing, and business development. Before being named COO in February 2005, Bley was director of products and services; previously, Bley headed up the Bank's Corporate and Community Affairs division. (*Dow Jones Newswires*, Dawn Kopecki, 07/20/05; *Business Wire*, 07/20/05)

FHLB-Cincinnati hires lobbyist with links to Ohio GOP chairman

- While Ohio GOP Chairman Bob Bennett served as the chairman of FHLB-Cincinnati, the Bank gave an \$80,000 "lobbying contract" to a firm headed by ex-GOP executive, director/consultant Tom Whatman. According to *Hotline*, "Whatman once 'retained' Bennett at Strategic Public Partners, a firm Whatman operates, and has described Bennett as a 'mentor.'" FHLB-Ohio president David Hehman said that Bennett "recused himself from the [board's] vote" to hire Whatman, but declined to say "whether he introduced [Whatman] to the Bank or pushed for hiring his lobbying firm." Bennett said, "Believe it or not, I don't believe I ever mentioned Tom Whatman's name to anybody. His name came up in Washington, I believe, and I was asked about it. David Hehman asked me, maybe, he asked if I knew Tom. I

introduced him to Tom. It was not my suggestion.” (*Hotline*, 07/22/05; *Toledo Blade*, James Drew, 07/20/05)

Mortgage Partnership Finance Program fundings plunge in the second quarter

- During the second quarter, the FHLBs funded only \$1.9 billion in originations under the Mortgage Partnership Finance (MPF) program, down from \$7.6 billion in the same quarter of 2004, according to the FHLB-Chicago. Bank officials attribute the decline in funding to increased demand in the market for adjustable-rate mortgages and interest-only loans. The MPF program provides a secondary market solely for standard fixed-rate mortgages. (*FHLB-Chicago Press Release*, 07/25/05)

Federal Housing Finance Board sponsoring a seminar on how the FHLBs can support small businesses in rural communities

- On September 27th, the Federal Housing Finance Board is sponsoring a seminar on ways the FHLBs can increase their support for small businesses in rural and agricultural communities, under provisions of the Gramm-Leach-Bliley Act of 1999 which authorize the FHLBs to accept small-business and small agricultural loans as collateral for advances. The seminar will focus on how the FHLBs “can better utilize this [collateral] authority to meet the community financial institutions’ liquidity needs.” Senator Chuck Hagel (R-NE) will be the luncheon keynote speaker. A FHFBB spokesman told *National Mortgage News*, “The Finance Board would like the banks to do more of this lending.” (*Federal Housing Board Press Release*, 07/21/05; *National Mortgage News Online*, 07/22/05)

Farm Credit System / Farmer Mac

Farm Credit Administration director Flory addresses value of FCA’s GSE status

- In a conference on the changing landscape of Farm Credit, FCA director Douglas L. Flory addressed the value of the agency’s GSE status. Specifically, Flory said that the agency’s GSE status lowers FCA’s cost of funding by about 80 basis points which is worth about \$800 million a year. Moreover, its GSE status provides FCA continual access to capital markets, allowing maximum flexibility to match funds and a providing a wider diversity of eligible investors. FCA also has the ability to attract Central Bank investors, willing to give the System exceptional pricing. Lastly, the FCA is exempt from SEC registration. Flory believes that the three key issues for FCA’s future is preserving the agency’s GSE status, building upon the System’s

cooperative principles, and striving for diversity. (*Talking Points for Panel on the Changing Landscape of Farm Credit*, the Honorable Douglas L. Flory, 07/19/05)

Expanding the reach of FCS lending?

- According to *Farm Credit Watch*, the FCA issued a “highly contradictory philosophy statement” on June 16 reflecting the regulator’s desire to greatly expand the reach of FCS lending. While the statement carefully adheres to the FCS’s statutory mandate that the FCS “offer high quality, reasonably priced credit and related services to farmers, ranchers, their cooperatives, rural residents, and other entities upon which farming operations are dependent,” the contradiction arises because the statement goes beyond current law to state that the FCA intends to ensure “an adequate and flexible flow of money into rural areas” by enhancing “the ability of System institutions to better meet the needs of agriculture and rural America.” The statement goes on to say that “we will work to eliminate unnecessary regulations that impair the ability of the System to accomplish its mission to serve agriculture and rural America.” Bert Ely writes, “The FCA, of course, ignores the fact that thousands of tax-paying banks already provide rural America with ample, reasonably priced credit. More importantly, this statement signals that the FCS regulator is prepared to do everything it can to help the FCS achieve its long-term objective of lending to anyone anywhere for any purpose.” (*Farm Credit Watch*, Bert Ely, July 2005)

Farm Credit System’s lending edge

- In the July issue of *Farm Credit Watch*, Bert Ely writes, “The FCS can be much more aggressive in lowering rates it charges on its real-estate loans than on its non-real-estate lending because its real-estate lending profits are exempt from all income taxes. Although some FCS associations are more aggressive than others in minimizing their tax bills, the average FCS tax advantage on real-estate lending, as *FCW* reported last month, is about 115 basis points. This figure represents a pure 86 basis-point edge from the real-estate lending tax exemption the FCS enjoys plus a 31 basis-point advantage arising from the ability of FCS associations to concentrate profits in their real-estate lending subsidiary. In a May 19 speech, [Federal Reserve] Chairman Alan Greenspan stated that Fed staff has estimated that ‘private investors have granted [Fannie and Freddie] a market subsidy in the form of lower borrowing rates. . . at 40 basis points in recent years.’ Since all GSE debt yields are close, it is reasonable to assume that the FCS has a 40-basis-point funding-cost advantage over banks, after taking into account banks’ substantial deposit-gathering costs. Therefore, it is fair to conclude that FCS associations, on average, enjoy a 155 basis point advantage on real-estate-secured lending. On non-real estate lending the cost advantage is about 70 basis points -- the 40-basis-point funding-cost advantage plus the 31-basis-point tax advantage mentioned above. (*Farm Credit Watch*, Bert Ely, July 2005)

Christmas in July

- Bert Ely writes in *Farm Credit Watch*, “The FCA has just authorized the five FCS banks to boost their investment-to-loan ratio to 35% from 30%. On March 31, 2005, this ratio equaled 27.0%, up from 21.0% at the end of 2002. According to the FCA, the investment-percentage increase ‘is designed to help ensure that FCS banks have adequate liquidity if a market disruption or other extraordinary situation occurs.’ In fact, as a GSE, FCS access to the capital markets, reinforced by the 1987 bailout, is nearly as good as the U.S. Treasury. What the FCA really has done is increase the ability of the FCS to capture even more profits by arbitraging its GSE status. Assuming an arbitrage profit of 30-40 basis points per investment dollar, the six-percentage-point increase in the banks’ investment-to-loan ratio since 2002 has boosted the banks’ annual profits by \$15-\$20 million, which they pass, tax-free, to their member associations. Watch for the banks’ loan-to-investment ratio to climb higher as the banks increasingly arbitrage their GSE status. (*Farm Credit Watch*, Bert Ely, July 2005)

USDA study finds that young farmers more likely to be served by FCS than banks

- According to an economic study published by the USDA’s Farm Service Agency, today’s young and beginning farmers are increasingly likely to receive financing for their farms and ranches from the Farm Credit System (FCS) instead of from commercial banks. The study confirmed that, in contrast to some earlier surveys, young and beginning farmers are more likely to receive loans from Farm Credit institutions. According to the study, young farmers were 1.45 times more likely to be new FCS borrowers than new bank borrowers during the years covered by the survey, 2001 and 2002. Published in *Agricultural Finance Review*, the study, “Competition in Farm Credit Markets,” further confirmed that FCS also is continuing to fulfill its mission to serve agriculture by providing credit to these farmers and ranchers that produce the majority of crops and livestock in the United States. Family farmers and ranchers, including young and beginners, and especially those farmers and ranchers whose rural communities are underserved by commercial banks, were the groups most likely to borrow needed funds from the FCS, the study showed. (*U.S. Newswire*, 07/26/05)

Export-Import Bank approves insurance policy for CoBank, ACB

- The board of directors of the Export- Import Bank of the United States approved an insurance policy for CoBank, ACB for up to \$180 million in Letters of Credit to support U.S. exports to Iraq. The insurance will be used to support trade financing from CoBank, ACB, a member of Farm Credit System. Under this policy, Ex-Im Bank will support Letters of Credit issued by the Trade Bank of Iraq in favor of U.S.

exporters including Telwar International, Inc. of Brentwood, Tennessee to purchase bulk agricultural commodities. (*PRNewswire*, 07/21/05)

Last FCS Bailout Bonds finally paid off!

- On June 10, the FCS repaid \$325 million of 15-year bonds, the last bailout bond issued by FCS in 1987 when the System went bankrupt, as a result of reckless FCS lending in the 1970s and early 1980s. As a result of the insolvency, FCS issued \$1.261 billion of Treasury-guaranteed bonds were issued against a \$4 billion line-of-credit Congress authorized, which the System repaid over a 17 year period. (*Farm Credit Watch*, Bert Ely, July 2005)

The Privatized GSE -- Sallie Mae

Sallie Mae is chartering a bank to originate private student loans and market college plans

- Sallie Mae announced that it has applied for an industrial loan charter for a bank in Utah, which the company will use to originate private student loans and market college savings plans. The company said it plans to inject \$100 million of capital into the Sallie Mae Bank and grow its asset base to \$1.2 billion by the third year of operation. Sallie Mae has hired Mark B. Howard, the former chief financial officer of Volkswagen Bank, to head the Salt Lake City-based bank. Sallie Mae spokesman Tom Joyce said Sallie Mae is creating the bank to provide “more control and flexibility” over its loan portfolio and to jump into the rapidly growing market for college savings plans. This move brings Sallie Mae in direct competition with its lending partners, a step many banks have feared for years.
- On June 30, Sallie Mae had \$116.5 billion of student loans, 88% of which are funded by the federal government and the balance originated by bank partners. Joyce said Sallie would retain some of its bank partner relationships, but would terminate others. “There are places where we partner with banks at the desire of the school client,” he said, “[so] we will continue to work with some strategic lending partners going forward.” The move should have little direct effect on Sallie’s partnerships with JPMorgan Chase & Co., Citigroup, and Bank of America Corp, which originate the government-funded loans. However, Sallie Mae’s loan partners may perceive the company’s entrance into the direct lending as an incursion into their market. Seth Faler, senior analyst with Bankstock.com, said, “Banks are more interested in working with non-competitors [than direct competitors].”
- Bert Ely, an Alexandria, VA bank consultant, said Sallie Mae’s desire to open a bank may have motivated the company to accelerate its privatization plan. Applying for a

bank charter has probably “long been in the game plan,” said Ely. Owning a bank offers Sallie Mae a number of advantages, including cheaper funding, better cross-marketing, and easier payments processing, Ely added. (*American Banker*, Isabelle Lindenmayer and Jody Shenn, 07/29/05)

Postal Service

The House of Representatives overwhelmingly passes the Postal Accountability and Enhancement Act by a vote of 410-20

- For the first time in 35 years, the House of Representatives has passed comprehensive legislation overhauling the U.S. Postal Service. The House’s overwhelming bipartisan vote of 410 to 20 for H.R. 22 followed three hours of floor debate and the defeat of four amendments. Sponsored by Representative John M. McHugh (R-NY) and committee chairman Tom Davis (R-VA), H.R. 22 creates a modern system of rate regulation; establishes fair competition rules and a powerful new regulator; addresses the Postal Service’s universal service obligation and the scope of the mail monopoly; institutes improvements to the collective bargaining process; and mandates transparency in the Postal Service’s finances, costs, and operations. In addition, the bill positions the Postal Service to operate in a more business-like manner, no longer operating under a break-even mandate. While the measure maintains the requirement for six-day-a-week mail delivery, it gives the USPS more flexibility in some operations and in setting rates. The House bill also addresses the Civil Service Retirement System, calling for the elimination of the escrow requirement established by the Postal Civil Service Retirement System Funding Reform Act of 2003 and the return of the responsibility for funding \$27 billion of CSRS pension benefits related to military service of postal retirees to the Treasury Department. According to McHugh’s press release about the House’s passage of H.R. 22, “The legislation also substantially reduces the need for the across-the-board increase in postal rates, which the Postal Service had anticipated taking effect in January 2006.”
- On July 27, the Bush administration published an Administration Policy on H.R. 22, stating, “The Administration looks forward to the passage of postal reform legislation that the President can sign reflecting his five reform principles and to working with Congress to address these issues. However, the bill ultimately presented to the President must not contain provisions that would have an adverse impact on the Federal budget, either by releasing funds from escrow without devoting them to pre-fund liabilities or by transferring the military service obligation from USPS to taxpayers. Should the final bill have such an adverse impact on the Federal budget, the President’s senior advisers would recommend that he veto the bill.” According to sources, the White House is offering a possible compromise that could break a stalemate over making postal reform legislation budget neutral. According to lobbyists close to negotiations, the White House proposes that the Postal Service’s

\$27 billion in payments to date for military pensions could be used to finance the agency's retiree health benefits. The USPS would be required to make the military pension payments in the future. The White House also has suggested allowing the Postal Service to borrow at least \$2 billion in each of the next two years, instead of giving the USPS access to the escrow account funds, as provided in both the House and Senate bills, according to the lobbyists. The agency's borrowed funds could be used to help hold down postal rates in the short term, while ensuring the legislation does not contribute to the federal deficit, lobbyists added. If a compromise is reached, the new language will likely be added to postal reform legislation considered by the Senate or in conference committee because of the "delicate politics" behind the legislation. (*DMNews.com*, Melissa Campanelli, 07/27/05; *Press Release from Representative John M. McHugh*, 07/26/05; *Associated Press*, 07/27/05; *Statement of Administration Policy for H.R. 22*, Executive Office of the President, 07/26/05; *CongressDaily*, Alyson Klein, 07/26/05)

OCA and Postal Service reach agreement

- The Office of the Consumer Advocate (OCA) has notified the Postal Rate Commission (PRC) that it will not be filing a direct case in the proceeding for Docket R2005-1 for a 5.4% across-the-board rate increase. The USPS and OCA engaged in negotiations to speed up the proceeding and entered into an agreement. In return for OCA refraining from filing a direct evidentiary case, the USPS has made two commitments. The USPS has agreed to establish a working group, to include OCA, to investigate the possibility of a non-denominated stamp that, once purchased, would be valid in the future for first-ounce, single-piece, First-Class Mail postage, regardless of the then-current rate. The USPS also has agreed to post on its website nationwide service performance data for certain products on a quarterly basis. The USPS will also post a notice at its post offices, advising customers that performance data are available at its website. (*Alliance for Non-profit Mailers*, 07/20/05)

Across-the-board postal rate increase should be rejected!

- In recent testimony, former PRC staffer Bob Mitchell said, "This case [R.2005-1] is no different from any other omnibus postal ratemaking case and, accordingly, it should be considered under conventional Commission rules pursuant to the Postal Reorganization. Its across-the-board character should be rejected." According to Mitchell, the rates being proposed build on the rates of Docket No. R2001-1, which were pursuant to a non-unanimous settlement agreement, and therefore on the now-out-of-date costs of FY 2000. According to Mitchell, no improvements in the efficiency of the rate structure are being proposed, despite substantial investment since 1999 by the USPS and mailers in "product redesign" initiatives. Despite the Postmaster General's statement that a more traditional case will come "on the heels" of this one, no one really knows how long any rates recommended will remain in effect. Funding issues central to the legislation being considered [H.R. 22 and S. 662] make such uncertainty unavoidable. Moreover, the same postal reform

legislation that may change the way the Postal Service is regulated, may also lead to structures such as price caps. If price caps were to be based on the rates recommended in this case, instead of on the rates emanating from a more traditional next case, the tie to FY 2000 costs (which were not the result of full Commission deliberation, due to the settlement) could lie behind the rates for some time. Under these circumstances, it seems unwise as well as unfair to proceed in a way that virtually neglects all current cost relationships and builds without review on rates built on now-badly-out-of-date costs, argues Mitchell. (*Alliance for Non-profit Mailers*, 07/20/05)

TVA

TVA board approves 7.5% rate increase

- The Tennessee Valley Authority's board of directors approved a 7.5% across-the-board electric rate increase effective October 1st, which will raise about \$524 million a year. TVA said this rate increase, which was necessary due to the rising cost of fuel and purchased power from other utilities, will affect the 62 industries served directly by TVA and about 8.5 million consumers in Tennessee and parts of Mississippi, Alabama, Kentucky, Georgia, North Carolina and Virginia. The new rate increase will raise its average residential customer's monthly electricity bills between \$3.50 and \$6.50.
- TVA's board of directors also approved the utility's \$8.7 billion budget, which included a \$340 million debt repayment, approximately \$200 million for clean air improvements, and about \$1.1 billion in capital projects primarily for the restart of a Brown Ferry Nuclear Plant reactor in Alabama in 2007. The board also decided to begin writing off a \$3.9 billion investment in the unfinished Bellefonte nuclear plant in Alabama, which has been mothballed since 1988. TVA's chief financial officer Michael Rescoe said that TVA will begin depreciating most of the utility's investment in Brown Ferry over the next ten years to "satisfy" regulators. TVA has not given up on the 1,500 acre Bellefonte site as a viable location for a power plant, possibly a next-generation nuclear plant. (*Associated Press*, Mack Spencer, 07/23/05; *Associated Press*, 07/22/05)

North Carolina Attorney General announces plans to sue TVA to force the utility to clean up its emissions

- N.C. Attorney General Roy Cooper said he plans to sue the Tennessee Valley Authority within 30 days to force the utility to clean up emissions from its coal-fired power plants. TVA plants' emissions are contributing to air pollution in Western

North Carolina, harming human health and plants and obscuring views, said Cooper. The Clean Smokestacks Act of 2002 forced utilities to curb harmful emissions and it's time for TVA to act, Cooper added. TVA said it has spent \$4 billion to reduce emissions [and plans to spend an additional \$2 billion for this purpose], but refuses to spell out specifically what sorts of reductions it plans to achieve, he said. "They won't agree to any type of legal document that guarantees reductions," said Cooper. "It's important for us to see the fine print. If they are willing to do these things, they should be willing to put it in writing." In November, Cooper sent a letter to TVA, the U.S. Environmental Protection Agency and environmental administrators in three states notifying them of North Carolina's intention to file a federal lawsuit. (*Ashville Citizens Times*, Clark Morrison, 07/26/05)

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