

# The **GSE** REPORT™

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## ***Major Events***

Freddie Mac's expensive turnaround – and uncertain future
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- In its 2004 Annual Report and June 14<sup>th</sup> Proxy Statement, Freddie Mac describes the company's efforts to rebuild its management team and its accounting systems and internal controls, in the face of a 21% increase in salary and benefit costs and additional reserves for anticipated costs related to settlements of lawsuits stemming from its accounting problems. The company also reiterated the uncertainties of GSE regulatory reform legislation, which may alter Freddie's business model and have a material adverse effect on Freddie Mac's future earnings, stock price and shareholder returns.
- Struggling to emerge from its accounting scandal over the past two years, Freddie Mac paid hefty cash bonuses in 2004 to recruit and keep top talent, including \$2 million signing bonuses to COO Eugene McQuade and top investment strategist Patricia Cook. In addition, the company gave CFO Martin Baumann a \$300,000 retention bonus in 2004, which was in addition to his \$200,000 signing bonus in 2003. In total, the company spent \$758 million on compensation and benefits in 2004, up 21% from \$624 million the previous year. Freddie's compensation expenses increased, in part, due to its larger workforce with 800 employees being hired during 2004. In 2004, the company also paid an additional \$50 million "employee incentive pay" in 2004 and \$18 million of severance pay related to the closing of its securities trading subsidiary.
- Freddie Mac's CEO Richard Syron was the company's highest paid employee in 2004, receiving \$8.9 million in salary, bonuses, restricted stock and other compensation and \$4.4 million in stock options for total compensation of \$13.3 million. COO McQuade, who joined the company in September, received \$9.3 million in salary, bonuses, restricted stock and other compensation (which included a \$2 million signing bonus). Freddie Mac spokeswoman Shawn Flaherty said the 2004 compensation levels reflect the board's mandate to Syron to clean up the GSE's accounting problems and build a team of experienced executives, while meeting goals. "Syron wanted his pay to reflect the company's goal of increasing homeownership for America's families," Flaherty said. "And those goals are all measurable. Service to our mission and service to our shareholders are not mutually exclusive ideas, but instead we see them as mutually reinforcing." She added that Syron wanted to move away from compensation being tied to earnings per share.
- Freddie Mac's expenses related to its accounting debacle skyrocketed in 2004. Freddie Mac spent \$588 million on professional services in 2004, an 89% increase from the \$311 million the company spent on such services in 2003. The company also paid \$16.8 million in legal fees for all current and former employees and board members who are being sued or have been called to provide testimony in legal actions

stemming from its financial restatement. Freddie Mac said it is “probable” that the company will have to pay out large legal claims stemming from shareholder lawsuits and various law enforcement actions stemming from the GSE’s financial restatement. “Freddie Mac believes that a loss in connection with the proceedings arising from the restatement is probable,” said the company in its 2004 annual report. While Freddie estimated that its potential losses would range between \$75 million and \$100 million for legal settlements, the GSE cautioned that the final costs could be lower than or exceed its projections. “It is not possible for the company to reasonably estimate the upper end of the range of any additional losses that might result from the adverse resolution of any of these legal proceedings, or their potential effect on the company’s financial condition or results of operations,” said Freddie.

- In its annual report to shareholders, Freddie Mac said that the company continues to have problems with its financial controls, which may not be fixed until 2006. The company said it is continuing to test its controls and is working to address remaining problems. Freddie Mac said it ended 2004 with “material weaknesses” in various financial and internal controls within financial operations, information technology controls and the management risk and control self-assessment process. The company also called its integration of operations and finance a material weakness. “For this weakness, we will apply risk reduction techniques in 2005, but do not expect to remediate fully until 2006,” said Freddie Mac. The company said its goals to produce future financial disclosures could be hurt if additional problems are encountered during testing of its internal controls. “There are continued risks to our financial reporting timeline as we strive to fully remediate the remaining material weaknesses and enhance our internal control environment,” said Freddie Mac. Freddie Mac chairman and CEO Richard Syron added, “While much remains to be done, Freddie Mac made significant strides last year in putting our house in order,”
- In its information statement, Freddie Mac said the company faces “an uncertain regulatory environment” in light of GSE regulatory reform legislation now being discussed by lawmakers in Congress. The company wrote, “We currently generate a significant portion of our net income through our portfolio investment activities. Legislative provisions now under consideration could give our regulator substantial authority to regulate the amount and composition of our portfolio investments and would enable the regulator to require substantial reductions in those investments. Freddie Mac continued, “Additional provisions under consideration would increase the regulator’s authority to require us to maintain higher capital standards and to approve new programs and business activities, and would modify our affordable housing goals and require that a specified percentage of our profits be placed in a fund to support affordable housing. The company said it is “possible that the enactment of legislative provisions that go beyond the key elements identified above could further erode or eliminate the special abilities and responsibilities set forth in our charter that make it possible for us to pursue our mission effectively.”
- In the company’s annual report, Syron said: “The genius of the GSE business model established by Congress is that it employs private capital to achieve a public mission.

In the political environment of the past year, the full meaning of this point has often been obscured. So it is one I have made clearly and vigorously as part of the legislative process.” Freddie Mac said it believes that “appropriate regulatory oversight legislation would strengthen market confidence and promote our mission.” (*Dow Jones Newswires*, Dawn Kopecki, 06/14/05; *Washington Post*, Terence O’Hara, 06/15/05; *Dow Jones Chinese Financial Wire*, 06/14/05; *Dow Jones Capital Markets Report*, John Connor, 06/14/05; *Associated Press*, 06/14/05; *Reuters*, Kristin Roberts, 06/14/05; *Dow Jones International News*, John Connor, 06/14/05)

“Fannie Mae’s condition warrants significant supervisory concern” says OFHEO

- OFHEO said that Fannie Mae and Freddie Mac made progress in 2004 toward correcting their accounting problems, but continue to be a cause for concern for the agency. Last year, Fannie Mae and Freddie Mac increased their mortgage portfolios by less than 1%, the lowest rate of growth in more than a decade. In its annual report to Congress, OFHEO detailed the GSEs’ progress in revamping their internal controls, accounting systems and overall financial condition, but provided little new information on its ongoing investigation of Fannie’s and Freddie’s accounting practices.
- After previously criticizing Fannie Mae’s accounting, controls over financial reporting and corporate governance, OFHEO expanded its criticism to the company’s management of credit and liquidity risks. While OFHEO said Fannie’s management of credit and liquidity risks was generally “satisfactory,” the regulator pointed out several soft spots, including a few “of greater significance” on the credit risk side such as methodologies the company uses for its loan-loss reserve, the testing of some of its credit risk models, its protections against fraud, and its processes for policy reviews. “Management in both the single-family and multifamily lines of business and internal audit need to strengthen their oversight functions” on credit risk, OFHEO said. OFHEO said it can’t yet assess whether Fannie Mae has improved its internal audit and financial reporting controls. “The interim and new management team has begun to implement a program to correct these deficiencies, but it is too early to determine the effectiveness of their management or program,” said the agency. Fannie Mae’s risk management for transactions, accounting and financial statement records of the controller’s department is “weak but improving,” said OFHEO. While some of regulator’s concerns about segregation of duties and accounting problems have been corrected or nearly corrected, “implementation of new systems for financial records and other areas will require several years to address,” said the agency. “The full picture of the quality of operations risk management will not be known until the Board’s consultants and the external auditor complete their analyses and OFHEO completes its ongoing examination,” said the agency. While the company is “on track” to achieve its 30% capital surplus by September 30, 2005, OFHEO concludes that Fannie Mae’s “condition warrants significant supervisory concern.”

- While Freddie Mac’s condition is improving, the company continues to “warrant supervisory concern” for OFHEO. The regulator gave Freddie Mac generally better scores for managing its risks, but cited its “long-standing finding” about Freddie’s inability to aggregate management of counterparty risks. The agency also warned that the company has relaxed “certain underwriting standards . . .to increase market share and achieve affordable-housing goals,” citing Freddie’s purchases of loans not tested by its automated underwriting system and of no-documentation loans. “Although the enterprise reported 2004 financial results on March 31, 2005, it does not have current financial statements in circulation, and does not expect to be a timely filer of 2005 information until the first quarter of 2006,” said the agency. “The significant and pervasive nature of weaknesses in accounting operations, along with substantial manual controls needed to prepare reliable financial information, adversely affected Freddie Mac’s ability to release timely quarterly financial information.” While Freddie Mac is addressing weaknesses in controls and accounting, the company’s efforts are not complete, said OFHEO. (*Reuters*, 06/15/05; *Bloomberg News*, Al Yoon, 06/15/05; *Associated Press*, Marcy Gordon, 06/15/05; *American Banker*, Jody Shenn, 06/16/05; *Dow Jones Newswires*, Dawn Kopecki, 06/15/05; *The Main Wire*, 06/16/05)

Federal Reserve Chairman Greenspan expresses concern that use of riskier mortgages is pushing up home prices to “unsustainable levels” in some markets

- In testimony before the Congressional Joint Economic Committee, Federal Reserve Chairman Alan Greenspan said that the growth of riskier mortgage products that allow people buy homes that they otherwise could not afford could add pressures to the market. “The apparent froth in housing markets may have spilled over into mortgage markets,” Greenspan told the panel. “The key dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern.” [According to LoanPerformance, 25% of the mortgage loans originated in 2005 have been interest-only loans, up from under 5% two years ago.] While he said it was unlikely that there was a nationwide housing “bubble,” Greenspan repeated that home prices in some areas were at “unsustainable levels.” He added that home prices in some areas may fall when the market cools as interest rates rise, but that probably would not do serious harm to the U.S. economy. (*Washington Post*, Nell Henderson and Kirstin Downey, 06/10/05; *American Banker*, Damian Paletta, 06/10/05; *BussinessWeek Online*, 06/16/05)
- Fannie Mae appears to share some of Greenspan’s concern about riskier mortgages – specifically adjustable loans with negative amortization. Jef Kinney, Fannie’s vice president for business and product development in single-family, said his company is worried that consumers are taking riskier loans on the assumption that home prices will keep rising. Fannie’s leadership role in the housing markets means it does not want to enable such risk taking, he said, even though it causes his company to lose market share to private-label securitizers. Kinney added that Fannie buys some

option ARMs already, but has no plans to make them a standard product. In contrast, Freddie has signaled a bigger appetite for neg-am adjustable rate mortgages, while Fannie continues to urge caution. Freddie recently announced plans to buy option ARMs in bulk from a larger group of lenders than it does now and will offer it as a standard product in 2006. (*American Banker*, Jody Shenn, 06/06/05)

- According to *Business Week*, there's evidence that homebuyers and their lenders are "climbing out on a limb." According to a National Association of Realtors' survey released in November, 15% of those polled were able to get a mortgage with no money down compared to 18% in early 2003 and virtually none in the late 1990s. This trend could leave many homeowners "under water" if home prices take even a small dip. Lenders are also extending more loans to borrowers, who have had credit problems in the past. According to the Mortgage Bankers Association, the share of subprime loans rose to 28% in the second half of 2004, a jump from less than 5% in 1994. (*BusinessWeek Online*, 06/16/05)

## ***Fannie Mae and Freddie Mac***

Senator Shelby opposes profit-based AH fund in GSE regulatory reform bill

H.R. 1461 stalls in the House, as GOP leaders refuse floor time for the bill

- Senate Banking Committee Chairman Richard Shelby (R-AL) will block legislative efforts to create an affordable housing fund from the GSEs' profits, since such a fund would provide "perverse economic incentives" for the companies to grow larger and accept more risk. Committee spokesman Andrew Gray said, "Shelby believes that there are better mechanisms to refocus [Fannie and Freddie] on affordable housing without providing economic incentives." Shelby's position puts him at odds with Senate Democrats, led by Senator Jack Reed (D-RI), who sponsored a similar affordable housing proposal last year. Reed, who plans to introduce a revised affordable housing proposal when the committee takes up the GSE regulatory reform legislation next month, said he would be "hard pressed" to support a bill that did not include more funds for low-income housing. Details of Reed's measure still need to be worked out, including the form of the fund distribution, as either direct investments or through grants, and the oversight of the fund distribution. "The [GSE] regulator is going to be capable of making sure, on a fair basis, these funds go to serve the goal of affordable housing," said Reed. "The key to this is effective oversight." Reed also rejected arguments that his provision would create a political "slush fund" for the GSEs, noting that a similar requirement for the FHLBs has worked well. "This is not some wild, untried, untested proposal," said Reed. "This has been the books for several years and many call it the crown jewel of the [FHLB] System."
- The proposed AH set-aside program was not expected to be a source of contention in the Senate, because the Banking Committee had approved Reed's program last year as part of an effort to strengthen the regulation of Fannie Mae and Freddie Mac. But that legislation never made it to the Senate floor. Gray said that the committee's adoption of Reed's proposal last year was "not intended as an endorsement of the substance" of the provision. "The reason we adopted the Reed amendment last year was to demonstrate that even with an expansive new affordable housing program, we still could not attract enough Democratic support to move the bill through the Senate. It was not intended as an endorsement of the substance," Gray said.
- Earlier this year, the Mortgage Bankers Association recommended to the House and Senate banking committees that the GSEs' contributions to an AH fund be tied to a percentage of their outstanding debt, which would act as a [modest] restraint to portfolio growth. "It creates a different set of incentives, and it is one that may be gaining new currency," said MBA's lobbyist Kurt Pfothenauer.

- Slowly and deliberately, Shelby is working on GSE regulatory reform legislation, which he expects introduce in the Senate Banking Committee in July. “We’re working on putting together a strong legislative package,” said Gray. “We’re still making final determinations as to where we’ll come down in certain areas.” The hot-button issue of portfolio limits - whether Congress should merely grant the regulator the authority to curb the size of the companies’ retained mortgage investments or require the watchdog to impose limits - is an issue yet to be nailed down, said Gray. “The chairman believes that the new regulator should have the authority to address concerns with the size and content of the GSEs’ portfolio holdings. How that is ultimately crafted as language remains to be seen,” he added. (*Washington Post*, Annys Shin, 06/17/05; *Dow Jones Newswires*, Dawn Kopecki, 06/16/05; *National Mortgage News Online*, 05/17/05; *The Main Wire*, Claudia Hirsch, 06/13/05; *American Banker*, Rob Blackwell, 06/17/05)

#### H.R. 1461 stalls in the House, as GOP leaders refuse floor time for the bill

- H.R. 1461’s provision requiring that 5% of Fannie Mae’s and Freddie Mac’s profits be set aside in the Affordable Housing Fund (AHF) has sparked a fight among Republicans in the House and stalled floor action on the bill, following a meeting with White House staff and protests from their own party members. Administration officials and a number of House Republicans fear that the AHF would give Fannie Mae and Freddie Mac political insurance in Congress, which the GSEs would use to build and expand its political support on Capital Hill and nationally in local communities. [The National Association of Local Housing Finance Agencies, the U.S. Conference of Mayors, the National Association of Counties, and the National Low Income Housing Coalition lobbied for the inclusion of the AHF provision in H.R. 1461.] Since it is a profit-based fund, lawmakers and administration officials also worry that the fund would give the GSEs incentives to expand their investment portfolios and increase their risk profile. Members of the conservative Republican Study Committee have circulated a letter asking the House leadership not to consider H.R. 1461 on the House floor if it contains the affordable housing set-aside. So far, they have gathered more than 30 signatures, according to a spokesman for Representative Mike Pence (R-IN.), who chairs the committee of more than 100 conservative party loyalists. The group believes that the AH measure sets a dangerous precedent by taxing private companies to accomplish a public policy goal. According to Representative Barney Frank (D-MA), Representative Bob Ney (R-OH) has been working hard to defeat Republican efforts to strip the AHF from the legislation. “Ney is trying to keep it in the bill,” said Frank. While “there is a major struggle now among Republicans,” he predicted that efforts to remove the provision would fail.
- The White House jumped into the fray, criticizing H.R. 1461 for lacking several “key elements of necessary reform and meeting with the staff of House Speaker J. Dennis Hastert (R-IL) to “provide its views” on the bill and to urge the speaker to keep the legislation in its current form from getting a full vote in the House. In an interview

with *Dow Jones Newswires*, White House spokesman Trent Duffy said, “The administration’s principles on GSE reform are very clear and were presented to committee members and to the speaker. Those views were made public, they were made clear to the committee, they were made clear to the leadership.”

- While the timing on floor action in the House appears to have slipped, Peggy Peterson, a House Financial Services Committee spokeswoman, said concerns over the AH set-aside aren’t likely to derail the bill. “We’ve had great support from the House leadership. This bill is headed in the right direction ...and the normal course of the legislative process is playing out,” she said. Several House Republican legislative aides told *Dow Jones International News* that Republican leaders have removed H.R. 1461 from the floor schedule for the time being, and it isn’t likely to be considered “any time soon.” One House GOP leadership aide said the bill has been temporarily derailed while lawmakers renegotiate the affordable housing fund issue. “Once a specific issue is ironed out that’s acceptable to the (GOP) conference on the housing trust fund provision, we’ll be able to move forward,” he added. Some GSE allies say privately that they fear that H.R. 1461 has lost momentum because of tension between the administration and Congress.
- Several congressional aides and industry lobbyists say the uproar over the AH provision has Fannie Mae, Freddie Mac, and their allies at the National Association of Realtors and other industry groups frantically lobbying the House Rules Committee, which can amend bills before they go to the floor for debate. According to these sources, the GSEs and their allies are seeking to change the Affordable Housing Fund measure, currently set up as a grant program giving the companies little say over how the money is spent, into a direct investment program in which the companies retain more control. While a direct-investment structure could endanger the bill’s fragile Democratic support and won’t win support from conservatives, it might avoid another problem percolating in the House where CBO is in the process of assessing the legislation’s impact on the federal budget. In a June 8th letter to CBO Director Douglas Holtz-Eakin, Representatives Michael G. Oxley (R-OH) and Barney Frank (D-MA) argued that CBO shouldn’t account for the AH fund as government money, saying “such a determination would be inconsistent” with the treatment of a similar AH program within the FHLB system. Moreover, they argue, the federal government would not take possession of nor control the affordable housing funds. While the funds are similar in design to that of the FHLB system, the AHF created by H.R. 1461 provides far more government oversight and legal restrictions on how the funds are used, which could result in CBO assigning a budget score to the GSE regulatory reform legislation. If this occurs, the fate of H.R. 1461 would be further complicated by the House budget and appropriations committees gaining jurisdiction over the bill. (*Washington Post*, Annys Shin, 06/17/05; *Dow Jones Newswires*, Dawn Kopecki, 06/16/05; *Dow Jones International News*, Dawn Kopecki, 06/10/05; *The Bond Buyer*, Matthew Vadum, 05/31/05; *BNA’s Daily Report for Executives*, R. Christian Bruce, 06/13/05; *American Banker*, Rob Blackwell, 06/10/05; *UPI*, 06/15/05; *Wall Street Journal*, John D. McKinnon and Dawn Kopecki, 06/15/05)

The editorial boards at the *Wall Street Journal* and *New York Times* speak out on the proposed AH set-aside in H.R. 1461

- In a June 14<sup>th</sup> editorial, the *Wall Street Journal* wrote, “For the list of worst Congressional legislation ever, we have a new candidate: last month’s debacle in the House Financial Services Committee on Fannie Mae and Freddie Mac. In the name of reforming these [...GSEs], the Members voted to make them even more financially dangerous, while grabbing a chunk of their profits for political payola to boot. Chairman Mike Oxley and friends voted to create a new ‘affordable housing fund’ to the tune of \$600 million or more a year. Already facing deserved criticism for being under-capitalized, Fannie and Freddie would have to dole out 5% of their after-tax income each year to an assortment of ‘non-profit and for-profit housing organizations, government agencies and lenders.’ This means passing out \$3 billion and potentially much more over five years to anyone in the housing industry who is politically well connected -- say, anyone with a pal on the Financial Services Committee.”
- “It’s no surprise that Democrats favor this kind of income redistribution to Acorn and other liberal interest groups, but the key to its passage was Republicans. California’s Gary Miller (a homebuilder by trade) and Ohio’s Bob Ney led a bloc of eight or so GOP Members who told Mr. Oxley they’d defeat the entire Fannie reform package if the affordable housing subsidy wasn’t included. They in turn were doing the bidding of the National Association of Home Builders, which wants more taxpayer largesse for what is already the most government-favored industry in the U.S. economy. A few Republicans offered an amendment to kill what they’re aptly calling a ‘slush fund.’ But they were crushed, 53-17, and even lost 20-17 among Members of their own party.”
- “All of this is much worse than just another political honey pot, as bad as that is. Its supporters understand that siphoning profits from Fannie and Freddie will make it even harder to impose sensible, free-market reforms on the companies -- such as raising their capital levels or reducing their portfolio of mortgage-backed securities (MBSs). Both the Federal Reserve and Treasury say the latter two reforms are needed to reduce the risk to taxpayers -- and the systemic risk to the broader financial system -- in case the companies run into trouble. The ‘slush fund’ diversion lets opponents of reform claim that the companies need the larger (and riskier) MBS portfolios and lower capital levels to make more money. Voila, reform becomes harder to pass, and the homebuilders cut themselves in on more of the subsidy action. As Lily Tomlin once said, no matter how cynical you get, you can’t keep up.”
- “...The reform effort now moves to the Senate, where we can hope Banking Chairman Richard Shelby won’t waltz like Mr. Oxley. Let’s also hope House Republican leaders wake up to the game Mr. Oxley is asking them to endorse. In return for creating a new subsidy for liberal activists, the GOP majority will get the blame for failing to reform a pair of scandal-plagued companies supported by

taxpayers. What a deal. Barney Frank couldn't have written a better bill for Democrats if he were Financial Services Chairman -- which, come to think of it, he is in everything but title. The crafty liberal would love to set a precedent that 5% of corporate profits can be confiscated for his favorite social causes. At least the White House has noted its displeasure at the Oxley bill, which should signal to GOP leaders that they need to rewrite it in the House Rules Committee, or simply deny it a vote on the House floor. The homebuilders and Realtors will squawk that this is "anti-housing," as if we aren't in the middle of a great housing boom. A Home Builder press release only yesterday began, "With Housing Market Exploding ... Homeownership rates are at a record 69%, with low-income buyers increasingly able to tap no-down payment, or interest-only repayment, loans."

- "The economic risk in real estate today is that many people are buying homes they won't be able to finance if mortgage rates rise. This is also one of the dangers of putting so much housing risk in two giant companies, Fannie Mae and Freddie Mac, and it is why the political grown-ups need to defeat Mr. Oxley's Potemkin reform." (*Wall Street Journal*, 06/14/05)
- In sharp contrast to the *Wall Street Journal's* view of H.R. 1461, *The New York Times* sees the A.H. provision as a welcome answer to the "affordable housing crisis." In a June 16<sup>th</sup> editorial, the *Times* wrote, "Congress is waking up at last to the fact that millions of poor families are no longer able to buy or even rent decent homes. In the House, bipartisan support is coalescing around a proposal that would create an affordable-housing fund by setting aside a small portion of profits from Fannie Mae and Freddie Mac. ... [T]he basic idea -- to put money earned on housing right back into the same area -- makes perfect sense. ... The money would be used to increase home ownership and create more decent rental housing. ... [M]oney to house the poor, and to promote home ownership in depressed areas, has to come from somewhere. Since the private sector seems unable to address the crying need for decent and affordable housing, Congress needs to step in." (*New York Times*, 06/16/05)

<p>Republican Policy Committee report urges Congress to limit the GSEs' portfolios</p>
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- Pointing to Federal Reserve Chairman Alan Greenspan's warnings that the GSEs' large investment holdings pose a systemic risk to the economy, the Senate Republican Policy Committee (RPC) urged Congress to limit the size of Fannie Mae's and Freddie Mac's portfolios, concluding in a policy paper, "No reform package would be complete -- or worthy of passage -- without such a limit." The RPC said the GSEs' \$1.5 trillion investment portfolios serve "no credible purpose" and should be limited by Congress to a "a level consistent with prompt securitization" of the mortgages purchased from loan originators, but did not specify whether a GSE regulatory reform bill should set specific limits or direct the GSEs' regulator to set them. "By capping the portfolios, Congress would be limiting the ability of the GSEs to exploit their taxpayer subsidy to profit on the spread between their debt and mortgage yields," said

the RPC. “Portfolio limits would do nothing to compromise Fannie and Freddie’s ability to purchase mortgages, or provide liquidity to the secondary mortgage market... [I]t is important to recognize that even if Congress were to eliminate this source of subsidies, the GSEs would remain very profitable entities.”  
(*CongressDaily/A.M.*, Molly M. Peterson, 06/08/05; *Reuters*, 06/07/05; *The White House Bulletin*, 06/08/05)

Treasury Secretary Snow wants brighter line for GSEs
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- In a June 1<sup>st</sup> letter to Senator Chuck Hagel, Treasury Secretary John Snow said that there should be a clear line between primary and secondary mortgage market activities in GSE regulatory reform legislation. Snow said that Fannie Mae and Freddie Mac should not be allowed to engage in activities that do not serve their mission, and that Congress should “provide clear direction to the new GSE regulator on the boundaries of the GSEs’ mission.” Without clear direction from Congress, the new regulator may have a hard time delineating between permissible and prohibited activities, said Snow. (*American Banker*, Rob Blackwell, 06/13/05; *Dow Jones Newswires*, Dawn Kopecki, 06/09/05)

Will H.R. 1461’s provision to increase conforming loan limits in high cost markets exacerbate the real estate bubble?
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- Robert Reich, former Secretary of Labor in the Clinton administration, said, “Congress, in its infinite pre-midterm election wisdom, is moving to increase the size of mortgages backed by Fannie Mae and Freddie Mac, which will mean more money for home loans and more air in the [real estate] bubble.” (*Marketplace*, 06/01/05)
- *Congressional Quarterly Weekly* columnist John Cranford agrees with Reich, writing that the increase in conforming loan limits “would not only give Fannie and Freddie a competitive advantage against other lenders, but it also might further stimulate the already hyperactive housing market.” This provision might let Fannie and Freddie get “even fatter than they are now when Congress is trying to encourage competition and rein in their growth.” The proposed change will do nothing to put a lid on home prices, when in fact “it’s likely to turn up the heat” and “add to the housing froth.” (*Congressional Quarterly Weekly*, John Cranford, 05/28/05)
- In a June 14<sup>th</sup> editorial, the *Wall Street Journal* wrote, ““The Oxley bill is worse than current law... It raises the dollar limit on mortgages that Fan and Fred can purchase -- to about \$540,000 from \$359,650 -- thus elbowing out non-subsidized private companies from even more business. Fannie has a statutory obligation to promote affordable housing, but how many poor people do you know with \$500,000 mortgages?” (*Wall Street Journal*, 06/15/05)

- The Council for Citizens Against Government Waste said, “One of [H.R.1461’s] most alarming deficiencies is a provision to create a new affordable housing fund using 5 percent of the GSEs’ after-tax income. The fund is a tax on home ownership that will be passed through to consumers and inflate the cost of buying a home. (*PR Newswires U.S.*, 06/15/05)

H.R. 1461: A world class failure
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- In an American Enterprise Institute’s white paper, AEI Fellow Peter J. Wallison and Thomas H. Stanton, a Fellow for John Hopkins University’s Center for the Study of American Government, conclude that H.R. 1461 is a complete failure, because it fails either to improve on current law, or to address the critical issues of financial and systemic risk that have been identified by Chairman Greenspan and the Bush administration. While the bill fails to significantly improve upon the regulatory authority of OFHEO, it dramatically increases the opportunities for Fannie Mae and Freddie Mac to exploit their subsidies in order to expand into other areas of residential finance. While H.R. 1461 makes modest improvements in OFHEO’s current regulatory structure, the legislation still does not provide new GSE regulator the level of authorities provided to federal bank regulators. In fact, the deficiencies of H.R. 1461 so far outweigh its modest regulatory improvements that the U.S. taxpayers generally would be better off with the current law governing GSE regulation. Wallison and Stanton conclude, “[U]nless there is a reasonable chance that the bill can be strengthened on the House floor, in the Senate, or in conference, [H.R. 1461] does not deserve to proceed further in the legislative process.” Wallison and Stanton point to the five major weaknesses in H.R. 1461 to support their conclusion:
  - **One year gap in regulatory oversight.** “[H.R. 1461] limits OFHEO’s activities immediately after enactment to winding up its operations, but does not authorize the new [GSE] regulator to begin operations for a year. In the meantime, the GSEs (including the Federal Home Loan Banks) are free from safety-and-soundness oversight, and their expansion into new lines of business would not be controlled. Then, when the new regulator begins operations, it is prohibited from reviewing the activities in which Fannie and Freddie are already engaged. The result is a hiatus in which Fannie and Freddie have a free pass to enter any field that might arguably be related to their mission, with little authority in the new regulator to question its legitimacy under the law. This provision alone should be of concern to the many housing-related industries that might find themselves competing with Fannie and Freddie one year after the enactment of a law that contains the elements of this bill.”
  - **Expansion of the GSEs’ mission.** “It creates, as a ‘principal duty’ of the regulator, an obligation to ensure that that the operations and activities of each GSE will foster...national housing finance markets that minimize the cost of housing finance... The effect of this provision, which will be read in its

broadest sense by the GSEs in the future, is to make the regulator—which was supposed to restrain the power of the enterprises [and ensure the GSEs’ safety and soundness]—into their government cheerleader and supporter. This language will inevitably affect the way the regulator interprets the rest of the bill, giving the GSEs an argument for expanding their activities into new sectors of the housing finance market where, arguably, they might be able to reduce the costs faced by homebuyers. When combined with the vague language of the GSEs’ charters, this regulatory direction may compel the new regulator to approve activities—such as title insurance, appraisal and perhaps even real estate brokerage—that compete with other services in the housing industry. If the use of the GSEs’ subsidy will ‘minimize the cost of housing finance’ the regulator may be obligated to approve these new services.” Clearly, Congress has already forgotten the lessons “learned” during the thrift failure of the 1980s, when the Federal Home Loan Bank Board, which was bound by a statutory mandate to promote the savings and loan industry, failed to effectively regulate the savings and loan institutions and protect the American taxpayers. Wallison and Staunton argue that if the GSE regulator attempts to place restrictions on the GSEs with regard to approval of new products or activities that Fannie and Freddie will go to either the courts or Congress to challenge the regulator’s action, arguing that such product or service would help minimize the cost of housing finance.

- **Standards for approval of new products and activities.** The authors argue that H.R.1461 “puts on a show” of putting in place tougher procedures for the regulator to approve new GSE products and services. The bill grandfathers the GSEs’ automated underwriting system in existence on the date of enactment and the GSEs counseling and education activities for the public, as well as all GSE activities through 2006, which were not subject to review by the regulator. As worded, the bill creates the inference that GSE “products” and “business operations” are not new programs subject to regulatory review. Moreover, “the bill expressly prohibits aggrieved parties from bringing private rights of action to enforce the prior approval provisions of the bill and ...precludes the regulator from enforcing orders to seek GSE compliance with these provisions.” If the new GSE regulator views his principal duty to minimize the cost of housing finance, the regulator is likely to view this section of the bill as authorizing the expansion of new GSE products and activities into new areas. Under that interpretation of the bill, the GSEs would, for example, be able to add to their automated underwriting systems new components, such as automated valuation models to substitute for many appraisals and their own self-insurance to substitute for title insurance.
- **Increase in conforming loan limits in high cost markets.** “... [The] bill would allow the GSEs to serve high cost areas and finance mortgages up to \$540,000 in size. This would greatly expand the GSEs’ market share to parts of the market that clearly do not deserve government subsidies beyond the generous tax preferences already available [for homeowners]. If there is any

justification for the existence of the GSEs, it might be the use of their subsidies to assist low cost or affordable housing. The bill makes a flawed attempt to do this, ...but its increase in the ceiling on mortgage size detracts from this mission and marks it as another effort at welfare for the upper middle class rather than a genuine attempt to increase funds for low income housing. To qualify for a \$540,000 mortgage, a homeowner probably needs to earn at least \$150,000-\$200,000 annually.”

Since term “high cost area” is ambiguous in the bill, the regulator will be under pressure to adopt a narrow definition of the term to census tracts or even number blocks of houses. Such an interpretation of the bill could result in every upper middle class neighborhood in the U.S. be deemed “high cost” and a proper area for the GSEs to fund mortgages up to the new high-cost limit. [By expanding the GSEs’ conforming loan size in high cost markets, Fannie Mae and Freddie Mac have the potential to access another 25% of the home loan market, by some estimates, in addition to the companies’ current market share of 47%.]

- **Five percent affordable housing set-aside.** “One of the worst features of H.R. 1461 requires the GSEs to create affordable housing funds with 5% of their profits in each year. This will amount over time to billions of dollars for each GSE. While low income housing groups welcome this support, there is a darker side. The bill allows the GSEs to control these funds, enabling them to further increase their political power by allocating billions of dollars to their supporters in the mortgage market and away from those with whom they have policy or other disagreements. Undoubtedly, much of the largess will flow to the congressional districts represented on the financial services committee. ...Most importantly, the bill does not prohibit the GSEs from discriminating against potential recipients when they distribute their affordable housing funding. Given the track record of the GSEs in retaliating on political grounds against those who oppose them, this is an important omission.”

Since the wording of the affordable housing language is broad, the authors argue that the GSEs can use this broad language—for example their authority to guarantee tax-exempt and taxable bonds of housing finance agencies—to justify their expansion into other comparable areas, such as guaranteeing bonds that states and localities issue for purposes such as community development. They conclude, “Again, especially but not solely because of the duty under the bill to encourage expansion of the GSEs, the regulator is likely to approve these new activities and thereby allow the GSEs to become major participants in the financial guaranty business.”

- Taken together, the five structural flaws in H.R. 1461 far outweigh the few significant positive provisions of the bill. The authors argue, “This is the time to enact statutory improvements in GSE supervision that are needed to address the conspicuous failings of Fannie Mae and Freddie Mac and the risks that they pose to the larger financial

system. H.R. 1461 would improve current law in some places. Unfortunately, when taken as a complete package, the bill fails either to improve on current law, or to address the critical issues of financial and systemic risk..." (*H.R. 1461: A GSE "Reform" That Is Worse than Current Law*, American Enterprise Institute, Peter J. Wallison and Thomas H. Stanton, 06/17/05)

Freddie Mac's founding CEO reminds us:  
Freddie Mac was meant to "succeed and die young"

- In a June 13th letter to the editor of the *Wall Street Journal*, Freddie Mac's founding CEO Thomas R. Bomar wrote, "I became Freddie Mac's first CEO in September 1970. It was my charge to create a market for trading conventional home mortgages. The objective was to stabilize and reduce the cost of housing credit. At its first meeting, the board informed me that Freddie Mac's purpose was to create the secondary mortgage market as established by Congress and, when this was accomplished, to put the corporation out of business as a government-sponsored entity. We never imagined that the GSEs would assume their massive and potentially economic disrupting size, and engage in activities never contemplated by Congress."
- "In 1973, I was appointed by the president and confirmed by the Senate to be chairman of the [FHLB] Board and chairman of Freddie Mac. The understanding continued that Freddie Mac was to be effective for its congressionally authorized purpose and then disengage as a federally supported entity. This purpose being clearly understood, Freddie Mac was never allowed to build up any sizable staff. Rather, its owners, at that time the [FHLBs], carefully controlled its operations. Freddie Mac was intended from its inception to be a transitional vehicle carrying out activities that the private market could not perform at the time without government assistance. It never built up a large mortgage portfolio during its first years as it is not necessary to carry a large mortgage portfolio to generate a secondary trading market. Accumulating a large mortgage portfolio would have been inconsistent with the intent for which Freddie Mac was created. How times have changed!" (*Wall Street Journal*, Thomas R. Bomar, 06/13/05)

House Appropriations subcommittee approves OFHEO's \$60 million budget request for  
2006

- The House Appropriations subcommittee approved OFHEO's \$60 million budget request to fund the regulatory oversight of Fannie Mae and Freddie Mac in fiscal 2006. "We gave [OFHEO] exactly what they asked for, which is what we do every year," said John Scofield, spokesman for the House Appropriations Committee. The Senate Appropriations Committee, chaired by Fannie and Freddie ally Senator Christopher Bond (R-MO), hasn't taken action yet this year on OFHEO's budget. (*Dow Jones Chinese Financial Wire*, Dawn Kopecki, 06/13/05)

### Senate Banking Committee votes approves Bush administration's nominees

- On June 9, the Senate Banking Committee approved the nomination of Ben S. Bernanke to be chairman of the president's Council of Economic Advisers, by a vote of 11 to 1. The key vote was cast by Senator Jim Bunning (R-KY). By a voice vote, the committee also approved the nomination of Brian Montgomery to be HUD's assistant housing secretary. (*Bureau of National Affairs*, 06/10/05)

### Former OFHEO director Armando Falcon joins Canonbury Group

- Armando Falcon, Jr., former director of OFHEO, has become a principal in the London-based Canonbury Group and will be establishing the firm's Washington office. The Canonbury Group provides financial market expertise to professional investors and senior business managers about the policy and political risks that can move market prices and influence performance. "Armando Falcon will be immensely valuable in helping investors and business managers better understand many of the important risks they face," at Fannie, Freddie and the U.S. housing market, said Philippa Malmgrem, founder of the Canonbury Group and a former special assistant to the president in the White House, where she was responsible for financial market issues for President George W. Bush. (*Dow Jones Newswires*, John Connor, 06/14/05; *Wall Street Journal*, 06/15/05)

### The GSE gravy train running dry on K Street?

- *Roll Call* writes, "...Fannie Mae [and] ...Freddie Mac have deployed over the last decade one of the most extensive, and expensive, lobbying teams ever assembled. The goal: to block Congressional attempts to tighten their regulatory reins. In some cases, to hear some lobbyists tell it, the companies have kept lobbyists on retainer simply so they could not be hired to work against them. Over the last six years, the companies combined have hired a breathtaking 86 lobbying firms and spent nearly \$124 million on lobbying, according to the Center for Public Integrity. But recently, the companies have been humbled by twin accounting scandals. Now, they are facing the prospect of legislation that would loosen their grip on the mortgage market. And as both face pressure to pare back their lobbying operations, this gravy train is beginning to dry." (*Roll Call*, Tory Newmyer, 06/16/05)

### The ultimate fall back for derivatives market — a rich Uncle Sam

- A fixed income strategist of a big bank that sells derivatives to Fannie and Freddie said to John Dizard with *Financial Times*, "If we are short vega (volatility) to the GSEs, then we buy it back from the hedge funds. It all comes down to the volatility of forward rates. When you get bull flattenings (of the yield curve, such as the one

going on now) then forward rates are more volatile than short rates.’ In other words, writes Dizard, “We are not worried, because we can lay risks off on the hedge funds. But what if they are not there, or are not there in the same size?”

- “‘That is what Greenspan is worried about,’ says the strategist. ‘He is very sensitive to what happened to portfolio insurance in 1987 [an equity derivatives strategy that caused the severity of the 1987 stock market crash]. If the GSEs were forced to delta hedge [rapidly lay off rate risks to other market participants] and the liquidity was not there [not enough speculator/hedge fund money], you could have a gap movement [a discontinuous market, with an extremely sudden price change].’ [Dizard concludes,] In that case, unhedgeable paper losses on their portfolio could leave the GSEs with a large hole in their balance sheet. Also, with an inverted curve, they could, at the margin, be paying more than they would be receiving. [Fannie and Freddie] wouldn’t fail - they have a rich uncle - but the follow-on costs to the housing market, the economy, and the other parts of the financial markets would be severe.” (*Financial Times*, John Dizard, 06/06/05)

Fannie and Freddie cut derivatives more than 30% in 2004
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- According to OFHEO’s annual report for 2004, the notational amount of derivatives at Fannie Mae dropped by 33% to \$722.9 billion last year, while Freddie Mac’s fell by 30.2% to \$756.8 billion, as both companies have purchased floating-rate mortgages and slowed the growth of their investment portfolios. (*Bloomberg News*, 06/15/05)

## ***Fannie Mae***

### Fannie Mae seeks new employment contract for its newly appointed CEO

- Fannie Mae's board has asked its compensation committee to propose a new employment agreement and compensation arrangements for Daniel H. Mudd, the GSE's newly appointed president and chief executive. Provisions for the new agreement will be subject to the review and approval by the director of OFHEO. (*Dow Jones International News*, Bhattiprolu Murti, 06/07/05)

### Fannie Mae asks court to dismiss shareholder lawsuit, claiming the company's accounting errors were not the result of fraud

- Fannie Mae has asked a federal court in the District of Columbia to dismiss the shareholder suit filed against it, asserting that the company's accounting errors in its financial statements for fiscal years 2001 through 2004 were not the result of fraud. Fannie argued that it is one of the most heavily regulated companies in the U.S. with oversight conducted by OFHEO, HUD, the Department of the Treasury and the GAO. Given the complexity of the accounting rules in dispute, Fannie Mae said it regularly sought guidance from its external auditors, KPMG, who approved the company's policy for derivative accounting and provided it with clean audit opinions throughout the 2001-2004 period. "Simply put, Fannie Mae's accounting and implementation of [the rules] was open and transparent to its auditors and regulator - facts wholly inconsistent with fraud," the company argued.
- The proposed class action led by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio is "largely copied" from the OFHEO report and contains "over 140 pages of verbatim reprints of Fannie Mae's public disclosure" intermixed with conclusory allegations, said Fannie Mae. The company argues that the plaintiffs failed to provide sufficient detail regarding how any of the quoted disclosures were false and misleading, which is required under the antifraud provisions of federal securities laws. Mere allegation of errors in the application of generally accepted accounting principles are insufficient to support a claim for securities fraud, the company maintains. While the plaintiffs also accuse Fannie Mae of lacking sufficient internal controls to prevent the mistakes, Fannie contends that these allegations also do not show that the errors were fraudulent. At best, the shareholders are alleging mismanagement, the company argued. (*Securities Litigation & Regulation Reporter*, 06/03/05)

Fannie Mae Foundation chooses Democratic leader in Missouri state house to attend affordable housing program at Harvard University

- The Fannie Mae Foundation has selected Representative Jeff Harris (D-Columbia, MO), who serves as the Democratic leader in the Missouri House, as a fellow in its program for government officials. The Foundation's fellows, who are chosen based on the individual's accomplishments in the field of affordable housing, attend a three-week course at Harvard in Cambridge, MA, designed to enhance leadership skills and develop new management techniques. Other participants include state legislators from Illinois, Maryland and Arizona as well as officials from across the U.S. The program runs from June 12 through July 1. (*Columbia Daily Tribune*, 06/08/05)

## ***Freddie Mac***

### Freddie Mac's former CEO Brendsel settles his lawsuit against OFHEO

- Freddie Mac's former CEO Leland C. Brendsel has agreed to settle his Washington, D.C., federal court dispute with OFHEO over \$54 million of his compensation package. Brendsel and Freddie Mac's regulator have signed a stipulation agreeing to resolve litigation initiated by the former executive. In March 2004, Brendsel sued OFHEO and former director, Armando Falcon Jr. in the U.S. District Court for the District of Columbia, accusing the defendants of improperly withholding his compensation, and requested a preliminary injunction to prevent OFHEO from directing the Freddie Mac to freeze the funds. U.S. District Judge Richard J. Leon granted Brendsel's motion for a preliminary injunction in August 2004, issuing an order preventing OFHEO from enforcing its asset freeze directive. OFHEO and Falcon appealed to the U.S. Court of Appeals for the District of Columbia Circuit. Freddie Mac later paid Brendsel, who moved for summary judgment March 31 in the District Court, arguing that Leon's previous order resolved all of the case issues.
- Under the terms of the recent stipulation, OFHEO consents to having the preliminary injunction converted into a permanent injunction barring the agency from withholding Brendsel's pay under the employment agreement and to having judgment entered in Brendsel's favor. OFHEO has also withdrawn its appeal. The District Court has not yet approved the agreement. (*Corporate Officers and Directors Liability Reporter*, 06/02/05)

### In 2004, Freddie's mortgage holdings shifted "dramatically" to non-traditional products

- On December 31, 2004, Freddie Mac said that its holdings of non-agency MBSs, totaled \$127.5 billion, representing 27% of its \$664.47 billion retained portfolio, compared to \$114.77 billion or 18% of its portfolio at the end of 2003. "This growth is a result of the strong supply of non-agency mortgage-related securities, particularly floating-rate products, combined with the fact that investment opportunities in fixed-rate products have not been as attractive to us," said Freddie in its annual report. During the year, the spreads Freddie could earn on fixed-rate mortgages narrowed amid increased competition, rising rates and stubbornly high housing prices, driving consumers to turn to non-traditional products to make their housing purchases more affordable. The increase in Freddie's adjustable-rate mortgage holdings has implications for the company's earnings, because its spreads on ARMs are generally less than those on its existing holdings of fixed-rate mortgages. The company's heavier reliance on ARMs also decreases the company's exposure to interest rate risk, reducing its reliance on interest-rate derivatives to manage this risk.

- While Freddie doesn't say how much of its non-agency holdings are bonds backed by ARMs, Jim Vogel, executive vice president at FTN Financial Capital Markets, says the market assumes that almost all of them are, since the company is restricted to buying loans of no more than \$359,650, and most fixed-rate mortgage originations now exceed this limit. The bulk of Freddie's non-agency holdings are bonds secured by single-family mortgages, which totaled \$123.41 billion, or 19% of the retained portfolio, at the end of 2004, compared with \$72.16 billion, or 11% of the portfolio, at the end of 2003. Freddie Mac's holdings of its own MBS fell to 55% of the company's retained portfolio at the end of 2004 from 61% at the end of 2003, while its holding of Fannie Mae MBS fell to 9% from 12%.
- In 2004, Freddie's investments in non-agency commercial mortgage-backed securities rose slightly to \$41.18 billion, or 6% of the portfolio, from \$33.06 billion, or 5% of the portfolio in 2003, while its holdings of non-agency mortgage revenue bonds remained steady at 2% of the portfolio. The percentage of whole, or unsecuritized, mortgage loans in the portfolio was unchanged at 9%. (*Dow Jones Newswires*, Allison Bisbey Colter, 06/14/05)

Personnel changes at Freddie Mac
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- Freddie Mac Senior Vice President and Treasurer Jerome Lienhard has resigned and accepted a position from MBNA Corp. Lienhard, 48, who ran debt funding and investor relations for Freddie Mac, will be a senior executive vice president and treasurer at MBNA, said Freddie Mac spokesman Michael Cosgrove. The GSE hasn't announced plans to replace Lienhard. (*Bloomberg News*, Al Yoon, 06/09/05)
- David H. Stevens, who was in charge of Freddie Mac's national lending division, has resigned and joined Wells Fargo Home Mortgage as head of the correspondent division. (*National Mortgage News*, 06/06/05)
- To replace Stevens, Freddie Mac has named Paul Mullings, JP Morgan Chase's mortgage finance manager, as a senior vice president of its Single Family Mortgage Sourcing, responsible for managing and building relationships with the company's 2,000 lender customers. Mullings, who joins the company on July 11, will report to Freddie Mac President and COO Eugene McQuade. Prior to joining Chase Home Finance in 1997, Mullings was president and CEO of Mortgage Electronic Registration Systems, Inc. (MERS). He led MERS during its launch and successful capitalization, and was instrumental in the development of the first set of industry standards for electronic mortgages. (*Reuters*, 06/15/05; *PR Newswire*, 06/15/05)

#### Freddie Mac extends forbearance for returning military

- Freddie Mac is requiring its 2,300 mortgage servicers to extend a 90-day forbearance to borrowers recently released from active military service to help them avoid foreclosure. Freddie mandated that lenders not initiate or resume foreclosure for at least 90 days from the date the borrower is released from active duty with the U.S. armed forces. According to the company, the 90-day forbearance period goes beyond what is required under a law to protect servicemen and women from creditors while on active duty. “This change gives lenders more time to work with servicemen and women and explore all relief options available,” said Ingrid Beckles, Freddie Mac’s vice president of default asset management. (*Reuters*, 06/13/05)

#### Freddie Mac expands its acceptance of employer housing aid

- Beginning June 10, Freddie Mac is extending to all of its mortgage products the benefits of using employer financial assistance as a source of funds. Previously these benefits could only be used with Freddie’s affordable mortgage products. Under Freddie Mac’s new Employer Assisted Homeownership Benefits policy, borrowers can take advantage of a wide variety of different types of financial benefits employers may offer, including grants, unsecured loans or secured secondary financing to supplement their downpayment, closing costs, financing costs, or pre-pays and escrows. (*PR Newswire*, 06/10/05)

## ***Federal Home Loan Banks***

FHLB-Topeka will file late with the SEC

- *The American Banker* reports that the FHLB-Topeka expects to miss a June 30 deadline for registering with the SEC and several sources said the FHLB-Pittsburgh will likely miss it as well. Andrew Jetter, the president of the FHLB-Topeka, said he does not expect the Bank to make the June 30 cutoff for an initial filing of its Form 10 financial statement. In an interview with *American Banker*, Jetter said the Bank must first complete a restatement of its 2001, 2002, and 2003 financial statements because of accounting mistakes it discovered this year. He anticipates that the Bank will ask the Finance Board for a filing extension in the next two weeks. “We are getting to the point with the restatement that it’s very clear that the date is unrealistic for us” to meet the SEC deadline, he said. “From our perspective, we have in good faith done everything that we could and diligently worked through the issues that we have.” Jetter expects the Bank to register by the end of August. As a result of the restatement, the FHLB-Topeka expects its 2001 earnings to drop by 9%, to \$80.2 million, but that the effect on its 2002 and 2003 earnings will not be material. The Bank cannot release 2004 earnings until it resolves the past accounting.
- Apparently, the FHLB-Pittsburg faces similar problems with its historical accounting statements. On March 31, the Banks’ Office of Finance said it was reviewing the impact of “corrections for certain errors” in 2002 and 2003. Since the FHLB-Pittsburgh earned only \$28 million in 2003, even a small correction would have a material impact in percentage terms. The Bank’s lack of an audited opinion for 2004 has led many to conclude that the Bank either will not make the filing deadline or could choose to file a “quiet Form 10,” which is one that does not provide an auditor’s opinion. According to a Bank spokeswoman, the FHLB-Pittsburg still has time to get such an opinion and hopes it can file on time. “This is our priority,” she said. “We are committed to this registration process.”
- Sources have told *The American Banker* that some of the other 10 FHLBs may also have trouble making the deadline. Since the June 30 deadline was set by the Federal Housing Finance Board and not the SEC, the consequences of missing the filing date remain an open question. The SEC has told several FHLBs that the June 30 date was not its timetable and that it didn’t plan to force the FHLBs to comply with it. Several sources said the SEC is conducting an extremely rigorous review of the FHLBs’ accounting, making the process complicated as the Banks vet transactions with internal and external auditors, lawyers, and the SEC. The Finance Board’s deadline for filing of Form 10 with the SEC was June 30 with the FHLBs expected to be fully compliant on August 29. The regulator is not saying what will happen if a Bank does not complete its initial filing, which a Finance Board spokeswoman said “at that point in time we will deal with it.” (*American Banker*, Rob Blackwell, 06/13/05)

Michael Roster joins the board of directors of the FHLB-San Francisco

- THE FHLB-San Francisco's board of directors has picked Michael Roster to serve as director representing the state of California. Roster, executive vice president and general counsel of Golden West Financial Corporation and World Savings Bank FSB, based in Oakland, California, will hold the position until December 31, 2005. (*Mortgage Banking*, 05/01/05)

FHLBs' staffing announcements

- The FHLB-Indianapolis has named Douglas J. Iverson as senior vice president of the Mortgage Purchase Program. In a unanimous vote, the Board promoted Iverson from Vice President and Manager of the MPP to head the new MPP Division, reporting directly to the Bank's president and CEO Martin L. Heger. (*PrimeZone Media Network*, 06/10/05)
- The FHLB-San Francisco has promoted Suzanne Titus-Johnson to senior vice president and general counsel for the Bank. The board has also promoted Kevin Gong to senior vice president and chief corporate securities counsel and Jeannette Paul as vice president of accounting policy. (*Mortgage Banker*, 05/01/05)

## ***Ginnie Mae***

### GNMA issuance in steep decline in 2005

- *National Mortgage News* reports that 2005 is shaping up to one of the worst in five years for Ginnie Mae's single family program. "It's undeniable that we're off quite a bit this year," said acting GNMA president Michael Frenz, saying his agency has been losing business in the subprime market and, to a lesser extent, the interest-only and payment option loans. According to *NMN*, subprime production is "on track" to account for 20.3% of all loans funded this year versus 3.5% for Ginnie Mae. A decade ago, GNMA reported a production market share of 11.1%, while subprime lenders accounting for 5.5% of the market. (*National Mortgage News*, Paul Muolo, 06/13/05)
- In July, Ginnie Mae expects to boost its securitization of hybrid adjustable-rate mortgages, now that FHA lenders are originating a competitive 5/1 hybrid product. (*National Mortgage News*, 06/13/05)

### Ginnie Mae issues final rule allowing the issuance MBS in \$1,000 denominations

- Ginnie Mae has issued a final rule, which reduces the minimum face amount of Ginnie securities from \$25,000 to \$1,000 denominations beginning in July. (*Asset Securitization Report*, 06/13/05)

## *Postal Service*

Postal reform tango
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- Expectations are “high” that the Senate Committee on Homeland Security and Government Affairs will vote to recommend the Senate’s postal reform bill before the July 4 recess, said Bob McLean, executive director of the Mailers Council. While some predict that the Senate committee could vote to recommend its version of the reform bill as soon as June 22, a spokeswoman for Senator Susan Collins (R-ME), who chairs the committee, said that date was being discussed but was by no means set in stone. Mailers expect a near-unanimous vote in the committee in favor of the bill, said Ben Cooper, executive vice president of Printing Industries of America. “The bill is supported by everyone,” he said. “It’s hard to come up with any opponents.” Strong congressional support is one reason mailers are so optimistic that reform finally will pass in 2005 after numerous delays. Reform is particularly important this year because it could affect the upcoming 5.4% postal rate increase, which mailers anticipate, will be implemented in January 2006. It is also possible that the House of Representatives’ postal reform bill, which has passed out of its committee, could get a vote from the full House in late June or in July. If a reform bill passes Congress and is signed by Bush by early November, the Postal Service could cut the rate increase in half or push it back a few months, Cerasale said. Every month that the Postal Service’s rate increase is delayed saves mailers \$250 million nationwide.
- Nevertheless, obstacles remain. Before either the Senate or House bill goes to a full floor vote, disagreements with the Bush administration need to be settled, Cerasale said. The White House remains unmoved on its stance that the USPS should pay for pension credit given to retired postal employees for military service. Sponsors of the reform bills in Congress oppose the president on this issue, and mailers note that all other federal agencies use tax money to pay for military-service pension credits. Persuading the Bush administration to change its position will be difficult, Cerasale said. Another disagreement lies with the escrow account that the USPS is required by Congress to create by the end of September 2006, using money it saved from its overpayments into the Civil Service Retirement System. The White House wants to use the escrow money to fund future employee benefits in advance. “We are optimistic,” Cerasale said. “We still have a big job ahead of us. We must try and see what can be worked out with the administration on the money issues.”
- Finally, there are signs of opposition to the reform bills from organizations such as Americans for Tax Reform, which hold some influence with lawmakers and the administration, Cooper said. The bills have bipartisan support, but most of it comes from Democrats, he said. That may lead the majority Republican leadership to wonder why they should support a “Democratic” bill. Though the Bush administration has given no sign of budging, McLean said mailers and management groups are lobbying the White House hard as well. Grassroots lobbying has been the

key to bringing postal reform to the forefront of the congressional agenda, he said. Congress has put postal reform on the back burner many times in past years. This year, mailers as well as management and employee organizations -- such as the National Association of Postmasters of the United States and the National Association of Letter Carriers -- made reform their top lobbying priority. "You have to have awareness before you build momentum," McLean said. "You have to have momentum before you have a vote." (*DMNews.com*, Scott Hovanyetz, 06/10/05)

H.R. 22: Another bailout of the USPS without enough reform  
to make it a good deal for the American taxpayers

- In memo to members of the Republican Study Committee, Representatives Mike Pence (R-IN), Jeb Hensarling (R-TX), and Jeff Flake (R-AZ) wrote, "The number one problem facing the Postal Service (USPS) is a complete inability to control costs. H.R. 22 contains none of the main collective bargaining proposals offered by the President's Commission to reduce USPS' long-term unfunded pension and healthcare liabilities or to bring USPS salaries in line with the private sector. H.R. 22 contains none of the reforms offered by the Commission to establish a BRAC-style process to consolidate and shut down facilities that lose money. H.R. 22 includes a cap on postage rate increases that will not work. In its present form, H.R. 22 constitutes yet another bailout of the Postal Service without enough reform to represent a good deal for American taxpayers." (*PostalWatch.com*, 06/15/05)
- Pence and Hensarling are still waiting for a response from House Speaker Dennis Hastert (R-IL) and Majority Leader Tom DeLay (R-TX) on a letter they sent in May, criticizing H.R. 22 for worsening the deficit. The letter, which urged leaders to delay a floor vote until those issues are resolved, echoed the Bush administration's concerns about shifting payment for the agency's military pensions to the Treasury and giving the Postal Service access to money slated for an escrow account. In their letter, Pence and Hensarling reminded the House leaders that CBO estimated the cost of H.R. 22 to be at least \$5.9 billion over the next five years and might call for an additional \$1.6 billion in funds -- money not provided for in the budget resolution. Pence and Hensarling argued that H.R. 22 does not do enough to cut down on the agency's expenses." (*PostalWatch.com*, 06/14/05)

Formidable hurdles remain for postal reform

- *Roll Call* reports that although postal reform legislation has bipartisan support and basically no opposition within mailing industries, H.R. 22 is ready for the floor, but isn't moving forward with the speed lobbyists had expected, according to a "handful of K Streeters." According to these sources, the hurdles to postal reform are formidable. The White House and conservative lawmakers, who want a reform bill that costs taxpayers less, have two major budgetary sticking points with the bill,

concerning who should pay for the pensions of retired postal workers who were also military employees and whether the USPS should have access funds it overpaid into its pension fund. One GOP Congressional aide said, “You have a bad bill currently that costs too much and doesn’t have enough reforms on the labor side. This is a Republican majority, and I think a lot of our members are skeptical as to why our Government Reform committee produced this bill.” Supporters of H.R. 22 said that passing it is urgent to save the taxpayers’ money. (*Roll Call*, 06/15/05)

APWU keeping close eye on H.R. 22 provision, allowing labor unions  
a seat on the Postal Service Board of Governors

- In a June 15<sup>th</sup> *American Postal Workers Union (APWU) Update*, APWU President William Burrus said, “The coalition of those favoring passage of reform appears to be holding, although conservatives have recently advocated the removal of a provision that would allow labor unions to select a representative to serve on the Postal Service Board of Governors. The House Government Reform Committee Chairman Tom Davis (R-VA) has reiterated support for the provision and says he intends to leave it in the legislation, despite the criticism. The APWU expects that the final bill reforming the Postal Service will include a provision for a labor representative on the Board of Governors and we expect it to be included, as well as other provisions for which we have fought so hard. Removing the provision at this late date would be a breach of the trust built up over months of painstaking negotiations. We have refrained from placing our friends in Congress in the difficult position of opposing legislation that is supported by others in the postal community. This issue may fracture that wall of solidarity.” (*American Postal Workers Union Update*, William Burrus, 06/15/05)
- According to *Congress Daily*, “House Government Reform Chairman Tom Davis (R-VA) plans to leave in a provision allowing labor unions to appoint a representative to the Postal Service’s Board of Governors as part of sweeping postal overhaul legislation, despite criticism from some Republican lawmakers and conservative groups. GOP opposition to the provision could delay a floor vote on the measure, particularly since the White House also opposes some provisions of H.R. 22. Instead of changing the bill, which is backed by a broad but fragile coalition of stakeholders, Davis plans to continue talking to conservative House members to garner support before the measure goes to floor, likely later in [June or July].” (*Congress Daily*, Alyson Klein, 06/13/05)

National Taxpayers Union voices opposition to H.R. 22

- In a June 8th letter addressed to House Speaker Dennis Hastert, Paul J. Gessing, National Taxpayers Union Director of Government Affairs, stated, “On behalf of the 350,000 members of the National Taxpayers Union (NTU), I write in opposition to H.R. 22. Although NTU has long called for postal reform, it is impossible for taxpayers to support this poor substitute for reform because it further expands the

monopoly powers granted to the United States Postal Service (USPS) and does nothing to bring needed market discipline to the agency. H.R. 22 will cost American taxpayers some \$27 billion over the next few decades in pension benefits for prior military service, despite the fact that these costs are owed by USPS. H.R. 22 would reduce the independence of the Postal Board of Governors by guaranteeing a seat on the Board for organized labor. Since the Board is meant to be an independent oversight body, free of outside influence, giving labor unions that have a direct stake in preserving the status quo certainly is not a wise 'reform.' NTU is eager to work with you in truly reforming America's mail system. Unfortunately, in its current form, H.R. 22 is not a means to that end and is therefore unacceptable." (*National Taxpayers Union Press Release*, 6/14/2005)

Will the postal reform legislation handicap the USPS?

- In a recent white paper for the EMA Foundation for Paper-Based Communications, former Kappel Commission executive director Murray Comarow said, "Legislation is pending to 'reform' (note the quotation marks) the Postal Service. I believe that, on balance, both the Senate and the House bills will seriously handicap that agency in providing universal service at affordable prices. Nine million jobs depend on the Postal Service, directly or indirectly. Before some version of those bills becomes law, the Congress, as well as stakeholders, should review the organizing principles upon which postal reform should be based. The public interest needs members of Congress today who will say, 'Where are the organizing principles that provide the practical and intellectual foundations for this legislation?' Stakeholders who support S. 662 and H.R. 22 should ponder the same question. I would ask them, 'Are you sure that supporting this legislation only to get relief on escrow and military pensions won't cost you dearly?'" (*PostalWatch.com*, 06/17/05)

USPS files errata with the Postal Rate Commission to reflect a 150% increase in the Postal Service's after rates net income in test year 2006

- According to the *Association for Postal Commerce*, "The Postal Service's financial situation is better than its original estimates when it filed the rate case in early April and much better than when it filed its operating budget last year. Postal Service Witness Maura Robinson has filed an errata to her R2005-1 testimony to indicate that the Postal Service now projects its after-rates net income in the test year (2006) to be \$281 million, up [150%] from the original projection of \$112 million. Further, Robinson's errata filing says net income in fiscal year 2005 will be \$1.68 billion, up from the \$1.64 billion projected in the rate request. The Postal Service has adjusted its investment income and interest expenses in the errata filing. The USPS made the adjustments to the 2006 and 2005 revenue figures because it made some incorrect assumptions on interest rates, which led to lower original estimates on investment income and interest expense. In other rate case news, PMG Jack Potter is scheduled

to testify at the Postal Rate Commission (PRC) in hearings on R2005-1 on June 27.”  
(*Association for Postal Commerce*, 06/17/05)

- The *Association for Postal Commerce* is also reporting, “Because of the radical improvement in USPS finances, postal management had asked the Governors for permission to pull the 2005 postal rate case, but several members of the Board objected. Ostensibly, one of the reasons for saying “No” was concern over the possible passage of postal reform legislation.” (*Association for Postal Commerce*, 06/17/05)

## **TVA**

### President Bush appoints interim chairman of TVA board

- President Bush has appointed Bill Baxter to serve as interim chairman of the TVA, following the retirement of TVA chairman Glenn McCullough on May 18th. With McCullough’s departure, the two remaining TVA board members are Baxter, a Bush appointee, and Skila Harris, a Clinton appointee. The TVA board will be expanded to seven members this year. Baxter said he hopes those new members will be in place by October 1<sup>st</sup>, when TVA’s new fiscal year begins.
- In the interim, Baxter said he hopes to “keep the momentum going” on the TVA board. In the near future, Baxter and Harris will be considering a \$524 million rate increase to offset TVA’s higher fuel prices. The rate hike represents a 7.52% increase in wholesale power rates to TVA distributors, the first increase since 2003. TVA estimates that the increase would raise the average residential bill \$3.50 to \$6.50 per month, starting October 1<sup>st</sup> when the hike goes into effect. On July 22, the TVA board will receive a formal briefing from the agency’s managers on the rate increase and will then vote on raising electric rates, as part of its approval of the 2006 annual budget.

### Tilting at windmills?

- Wind power advocates say the “flailing at windmills” by Senator Lamar Alexander (R-TN) is unlikely to be successful. “He might not accomplish much of anything except making some noise on the Senate floor. Wind energy is a very popular item with Republicans and Democrats,” said Jaime Steve, the legislative director of the American Wind Energy Association. Stephen Smith, executive director of the Southern Alliance for Clean Energy, said many environmentalists were surprised by the vehemence of his attack, partly because as chairman of the Senate’s Energy Subcommittee, Alexander has been a vocal proponent of clean air. “A leading

senator ... in a key committee assignment launches a factually inaccurate ... attack on wind power right at the beginning of a national energy debate, and people are just caught off guard,” Smith said.

- Earlier this year, Alexander introduced a massive energy bill, backing clean-coal technologies, solar power and other forms of green power, but leaving out wind-power producers. Alexander criticized the cost of wind energy, saying the federal tax credit for generating it could cost about \$3 billion, accounting for more than 27% of the \$11 billion the Senate has discussed for energy tax incentives. He said these large, industrial windmills mar scenic vistas and produce power only about 40% of the time, making the power source too unreliable. “At a time when America needs large amounts of low-cost, reliable power, wind produces puny amounts of high-cost, unreliable power,” said Alexander.
- The TVA operates Tennessee’s only wind-power project along a two-mile stretch of Buffalo Mountain, west of Knoxville, whose 18 turbines generate 29 megawatts of power to support 3,000 homes. After Alexander asked TVA for a two-year moratorium on new wind farms, the agency said it has no plans to build more. However, Smith said the eastern third of Tennessee offers pockets of potential, and other groups are gathering data for “a handful” of possible projects.
- Critics charge there is a personal component to Alexander’s opposition to wind projects. Alexander, who has a home near the Great Smokey Mountains, has expressed concerns about more windmills being built along the Tennessee mountain ridges. “We see this as a continuation of the not-in-my-back-yard philosophy,” Steve said.
- While Alexander said he plans to offer his proposal as an amendment to the Senate’s sweeping energy bill, not everyone agrees with Alexander’s opposition to windmills. Some influential Republicans have historically backed wind-power incentives, including chairman of the Senate Finance Committee Chuck Grassley (R-IA), who helped create the tax credit for windmills in 1992. (*Associated Press*, Hilary Roxe, 06/13/05; *Tennessean*, Mike Madden, 06/18/05)

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