

The **GSE** REPORT™

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Major Events

Federal Reserve Chairman Greenspan urges lawmakers to limit the size of Fannie and Freddie's portfolios
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- In testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan strongly advocated placing a ceiling on the size of Fannie Mae's and Freddie Mac's asset portfolios and warned that unchecked growth by the GSEs creates systemic risks to the U.S. financial system. Greenspan further told lawmakers, "World class regulation, by itself, may not be sufficient and, indeed, might even worsen the potential for systemic risk," if investors believe that strengthened regulatory oversight increases the likelihood of a government bailout of the GSEs. And if Congress fails to strengthen the oversight of Fannie Mae and Freddie Mac, Greenspan said the "possibility of insolvency and crisis rises," which is "the heart of the dilemma in designing regulation for GSEs." He added, "We at the Federal Reserve believe this dilemma would be resolved by placing limits on the GSEs' portfolios of assets. Almost all of the concerns associated with systemic risks flow from the size of the balance sheets of the GSEs, not from the purchase of loans from home-mortgage originators and the subsequent securitization of these mortgages."
- Greenspan said the Fed worries the most about the "growth and magnitude" of the GSEs' combined \$1.5 trillion mortgage portfolios, which concentrate interest rate risk and prepayment risk, "[making] our financial system dependent on their ability to manage these risks." He added, "Without restrictions on the size of GSE balance sheets, we put at risk our ability to preserve safe and sound financial markets in the United States, a key ingredient of support for homeownership." The primary systemic problem embodied by the GSEs is that they have grown to such unforeseen size, said Greenspan. He told lawmakers, "We do perceive that if the expansion should continue along the lines it's been growing--and we see no reason that that [it] is going to stop ..., something will go wrong..., and since we are sufficiently on the safe side of the systemic risk horizon..., we have time [now] to make the adjustments in a manner which does not disrupt the economy or the financial system."
- While Fannie Mae and Freddie Mac have slowed their portfolio growth in recent months as a result of accounting scandals at both companies, Greenspan said it is likely that they will resume rapid expansions once they believe their current troubles are behind them. "Without changes in legislation, Fannie and Freddie will, at some point, again feel free to multiply profitably through the issuance of subsidized debt," he said. "To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventative actions are required sooner rather than later."

- In answer to lawmakers' questions about the systemic risk posed by the GSEs, Greenspan said the concern was not so much that the companies would fail, but that measures required to resolve the problems of a GSE would disrupt the financial system itself. "We have to distinguish between the safety and soundness of the individual institution and the potential risk that may occur even though it remains safe and sound," said Greenspan. "In other words, there are innumerable types of problems that can arise where an institution gets into some trouble, creates secondary effects in the marketplace as a consequence of that, manages to right itself so it remains secure because of perhaps its capital, but has left significant disruptions in the overall marketplace, which fester in a manner which creates enormous systemic problems."
- Greenspan attributed the rapid expansion in the GSEs' portfolios, which grew tenfold from \$132 billion in 1990 to \$1.38 trillion in 2003, to the companies' drive for profits in recent years. He said the GSEs' implicit federal backing allows them to borrow at subsidized rates, squeeze out would-be competitors by paying slightly higher prices to lenders and maximize profits. "This edge has enabled Fannie and Freddie to gain gradually but inexorably an ever larger share of the home mortgage market [which grew from 5.6% of the single-family market in 1990 to 23% in 2003]. Investors have provided Fannie and Freddie with a powerful vehicle for pursuing profits through the rapid growth of their balance sheets, and the resultant scale has given them an advantage that their potential private-sector competitors cannot meet," he said. As a result, the GSEs' annual return on equity often exceeds 25%, far in excess of the industry average of 15% among other large private competitors, said Greenspan. "Virtually none of the GSE excess return reflects higher yields on assets; it is almost wholly attributable to subsidized borrowing costs," he added.
- The bulk of the GSEs' portfolio growth over the past decade has stemmed from the companies' acquisition of their own mortgage-backed securities, which the Fed believes serves no public purpose beyond increasing shareholders' profits, said Greenspan. By holding mortgages and MBS on their balance sheets, the GSEs increase their exposure to interest rate and prepayment risk and, in turn, increase their use of derivatives to hedge against those hazards. "Limiting the systemic risks associated with GSEs would require that their portfolio holdings be significantly smaller," he said, adding that there is little evidence that portfolio limits on the GSEs would directly impact consumers.
- In a recent study, the Federal Reserve found "no link" between the size of the GSEs' portfolios and mortgage rates and "no evidence" that it would be more difficult for consumers to obtain fixed-rate mortgages if the GSEs were forced to reduce the size of their portfolios, said Greenspan, and added that portfolio limits would have a "modest effect" on financial markets. "The past year provides yet more evidence, with GSE portfolios not growing and mortgage spreads, as well as the spread between yield on GSE debentures and Treasury securities, declining further," he said. "Indeed, while GSE stock prices have fallen substantially and turmoil has continued at the GSEs, mortgage markets have functioned well." Greenspan told lawmakers,

“As far as we can tell, GSE mortgage securitization, in contrast to the GSE’s portfolio holdings, is the key ingredient to maintaining and enhancing the benefits of the GSEs to homebuyers and secondary mortgage markets,” he said.

- Greenspan told lawmakers, “Limitations on portfolio holdings imposed gradually over several years would leave the GSEs with ample liquidity, frees the GSEs of the difficulties of hedging large-scale interest rate risk, and would focus the GSEs almost exclusively on the purchase and securitization of mortgages, including mortgages for affordable housing.”
- Greenspan underscored the importance of creating a GSE regulator “on par with banking regulators” with the authority to set minimum capital standards and to unwind the GSEs’ operations should any of them fail. He said Congress needs to clarify the circumstances under which a GSE can become insolvent as well as the resulting process to pay off creditors and shareholders. “This process must be unambiguous before it is needed,” he said. “Current law, which contemplates conservatorship and not receivership for a troubled GSE, requires the federal government to maintain GSEs as ongoing enterprises, but other than a symbolic line of credit at the U.S. Treasury, provides no means of financing to do so. Left unresolved, such uncertainties could threaten the stability of the financial markets.” In response to a question from Senator Richard Shelby (R-AL) about the need for receivership powers, Greenspan said, “It’s essential that the receiver have the capacity to essentially stabilize the situation [of a failing GSE], which means that they need to have the ability essentially to control the finances of the situation. And that means that under statute, you have to have a specific statement as to when a regulator does put an [enterprise] in receivership. In other words, having receivership language which is not mandatory is essentially not receivership language.”
- Senator Jack Reed (D-RI) noted that some large commercial banks hold assets in the range of \$1 trillion, but the Federal Reserve has not advocated limiting the size of their loan portfolios. Greenspan drew a distinction between investors’ perception of the GSEs and the major commercial banks. Since the market regards the likelihood that the government would allow either Fannie or Freddie to fail to be so remote, the GSEs’ debt trades at rates that are nearly the same as Treasury instruments--a level of implied subsidy. Greenspan said this implied subsidy gives the GSEs a significant price advantage over comparable private issuances. “We have concluded that the reason why the markets probably presume this is that they assume that while Fannie and Freddie will be bailed out in the event that they run in to trouble, other banking institutions may be considered too large to liquidate quickly, but not too large to liquidate and indeed to create a significant amount of haircuts on the holders of debt,” Greenspan said. “That’s the conclusion of the marketplace.”
- Greenspan also underlined critical differences between the risks borne by commercial banks and the GSEs. Banks tend to take credit risk, against which they hold capital, Greenspan said. The GSEs deal primarily in mortgage-backed securities, which represent low credit risk, but by holding large amounts of mortgage-related assets in

their portfolios, they take on significant interest rate risks that fluctuate as rates change and as borrowers liquidate loans. To mitigate their interest rate risks, Fannie and Freddie engage in sophisticated “dynamic hedging” strategies through the use of derivatives, he said. These procedures “are very complex and sometimes go astray,” said Greenspan.

- Despite calls during the hearing for bipartisanship and for workable solutions rather than ideological posturing, the discussion occasionally took on political overtones. Senator Charles Schumer (D-NY) praised Fannie Mae and Freddie Mac, saying the GSEs have been an integral part of a strong U.S. housing market. While acknowledging that both companies have had accounting problems and establishing a new regulator to supervise the GSEs may be appropriate, Schumer said, “I think something else is in the air here. I think there are a whole lot of people who want to take advantage of [Fannie Mae’s and Freddie Mac’s] auditing problems ...to take the whole thing down. To greatly reduce the amount of debt Fannie and Freddie hold is a huge and dramatic change that could change our housing markets, increase the cost of housing, maybe deal with the housing bubble in ways that we don’t know.” Schumer said he saw in the GSE regulatory reform initiative an analogy to the Bush administration’s recent attempt to restructure Social Security. “Social Security has a problem and there are ideologues who want to undo it. Fannie and Freddie have a problem. Instead of fixing the problem, ideologues want to take advantage of that and they’ve been chafing at the bit for a long time to undo Fannie and Freddie.” Schumer argued that some of the changes being suggested for GSE regulatory reform were too radical and could hurt borrowers. He urged lawmakers “Don’t undo Fannie and Freddie.” Aside from Schumer’s comments, criticism of Greenspan’s testimony was muted from other Democrats at the hearing.
- A number of committee members appeared to be hesitant to set statutory limits on the GSE portfolios, with some saying they preferred to give a proposed new regulator power over the GSEs’ mortgage portfolios. “One of the greatest risks to Fannie and Freddie is the interest rate risk due to their substantial holdings of their own mortgage backed securities,” said Senator Elizabeth Dole (R NC) “A possible solution to this dilemma would be to give the regulator the ability to determine the proper level of holdings if it becomes a risk to safety and soundness.” Senator Jon Corzine (D NJ) said that while Greenspan was right to raise questions about the size of the mortgage portfolios, he cautioned that the Fed chairman’s recommendation might go too far. “There are dangers in all of these various propositions. ...Maybe there is some middle ground here.”
- In response to Bunning’s question about the effect of the GSEs divesting their portfolios on the marketplace, Greenspan responded “We obviously have given very considerable thought to that question ...and it’s a complex issue -- the way that liquidation would occur over a period of time is not necessarily by selling mortgages, but just allowing them to liquidate. ... [T]he average maturity of a mortgage, mortgage-backed security or set of mortgages, is only about four years. ...So you could very readily get the actual amount of portfolio outstanding going down even as

a GSE continues to make new purchases because the amortization is so high. So that there is no market disruption in that context.”

- Responding question from Senator John Sununu (R-NH) about how to set distinct limits on the GSEs’ portfolios, Greenspan said, “I think the ideal thing ...would be to have the Congress give general guidelines with respect to the nature of the constraints [on the GSEs’ portfolios] in the aggregate, because remember, it’s the aggregate which creates the systemic problem. And instead of leaving systemic decisions to a regulator, which should not be done, you create a framework which enables them to make judgments. Exactly how the legislation is written, I think, has got to be up to the Congress.” Senator Jack Reed (D-RI) argued that leaving such a critical decision about portfolio restraints in the hands of lawmakers was a mistake. “I think the idea that Congress will reach a less political judgment than a regulator is questionable,” he said. Greenspan replied that an alternative would be for Congress to outline for a regulator what steps it should take to shrink the portfolio. “It is up to the Congress to stipulate, if not the exact ratio, at least the principles that the regulator must apply in order to come to a conclusion about the portfolio,” he said.
- In his opening statement, Senator Jim Bunning (R-KY) cautioned fellow lawmakers, “To those outside this committee who do not want a bill, I say be careful what you wish for.” (*Federal News Service*, Transcript of the Hearing of the Senate Banking Committee, Witness Alan Greenspan, Chairman of the Federal Reserve, 04/06/05; *American Banker*, Rob Blackwell, 04/07/05; *Reuters*, 04/06/05; *New York Times*, Stephen Labaton, 04/07/05; *USA Today*, Sue Kirchhoff, 04/07/05; *Investor’s Business Daily*, Sean Higgins, 04/07/05; *Bureau of National Affairs*, Richard Cowden, 04/07/05; *Dow Jones Newswires*, Dawn Kopecki, 04/06/05)

Treasury Secretary Snow urges Congress to provide the new GSE regulator the authority to set limits on the size of Fannie and Freddie’s portfolios
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- In testimony before the Senate Banking Committee, Treasury Secretary John Snow repeated his view that limits should be placed on the size of the GSEs’ mortgage portfolios, but did not ask Congress to set a specific statutory limit on those portfolios. Instead, Snow suggested that a new, more-powerful regulatory agency for Fannie Mae and Freddie Mac could determine the kind of limits to impose on the GSEs’ portfolios. Many viewed Snow’s testimony as a reflection of the Bush administration’s willingness to be flexible on legislation to strengthen the regulation of Fannie Mae and Freddie Mac, which improves chances that such a bill will be passed this year.
- Snow told lawmakers “I would not [limit the GSEs’ portfolios] through an absolute limit on the size of the portfolio. [Instead,] I would give the regulator a directive that the GSEs only hold so much as is necessary to carry out their mission with an appropriate level of safety.” He added that Congress could provide “policy guidance to the new regulator that says, ‘You have some discretion here but you should use that

discretion to limit those portfolios” to the level necessary to ensure smooth functioning of the mortgage-backed securities market, which funds home mortgages. Senate Banking Committee Chairman Richard Shelby (R-AL) supported Snow’s suggestion of granting the GSEs’ new regulator discretion over the size of the mortgage portfolios.

- Asked by the panel how he would envision paring back the level of the GSE holdings, Snow said, “I trust we’re going to have a regulator that is very sensitive to that issue, who understands these markets, and who in making whatever determination is made would bring a highly sophisticated, market-oriented point of view to that, which will probably mean some gradual sell-off over time of a portion of that portfolio that isn’t necessary to carry on the major purpose. These are big and liquid markets, and over some time--five years or so, I would think there could be, without disruption, an effective sell-off.” Both Snow and HUD Secretary Alphonso Jackson told the lawmakers that they were confident the market would not be hurt if Fannie Mae and Freddie Mac were forced to limit their portfolios. “We believe that our capital markets could adjust to a significant reduction in the presence of the GSEs as mortgage investors,” Snow said.
- Snow and Jackson said the Bush administration also supports a new regulator with power over minimum and risk-based capital, and the ability to approve all new activities. The officials also favor giving the regulator the authority to put a GSE into receivership, in the event of insolvency, without seeking prior approval from Congress.
- Jackson also informed the panel that his agency had recently discovered charter violations at Fannie Mae. In formal letters, HUD has directed Fannie Mae to suspend its international consulting and real estate management services programs which are prohibited by their charter. Last May, Fannie Mae’s international operations gained notice, when *Reuters News Service* reported that the Egyptian Finance Minister Medhat Hassanein announced plans for a joint venture company between Fannie Mae, the World Bank’s International Finance Corp., and Egypt’s National Investment Bank to “securitize home loans and help spur on the nascent Egyptian mortgage market.” HUD has sent Fannie Mae a letter suspending it from providing international consulting services without first obtaining written approval from the agency. HUD has also ordered Fannie Mae to shut down a real-estate management service it offered lenders. On behalf of investors, Fannie would sell unwanted properties that were acquired after borrowers defaulted on a loan for a fee. Fannie also offered its management service to outside parties on foreclosed properties that were not in any way financed by loans purchased or guaranteed by Fannie.
- Snow encountered resistance from Democrats and several tough questions from Republicans on the issue of restricting GSEs’ portfolios. Senators Paul Sarbanes (D-MD) and Charles Schumer (D-NY) asked why the Bush administration was so worried about the size of Fannie Mae’s and Freddie’s Mac’s mortgage portfolios, but voiced no concerns about other large financial institutions, such as Citigroup, which

are often said to be “too big to fail.” Snow responded that the GSEs are different from large commercial banks, given their government status and are treated differently in the marketplace. “The marketplace itself is providing a degree of discipline that we don’t see with respect to the GSEs,” said Snow.

- Senator Jon Corzine (D-NJ) expressed concerns about the adverse effects that instituting strict limits on the GSEs’ portfolios could have on the housing market. Corzine said, “Before we start tinkering around with this in a gross fashion, I think we need to be careful. I think we ought to be focused on risk-based capital.”
- Senator Robert Bennett (R-UT) also questioned how the markets might react if a new regulator suddenly limited Fannie’s portfolio. “What are they going to do if the regulator decides \$100 billion is the right number?” Bennett asked. He also asked Snow, if he could live with a decision from a new regulator that the mortgage portfolios do not pose a significant risk. “You are leaving the door open that a regulator, after considering everything, comes to the conclusion that this situation is benign and we will allow it to continue,” Bennett said. (*BNA’s Daily Alert*, Richard Cowden, 04/08/05; *Washington Post*, Kathleen Day, 04/08/05; *American Banker*, Rob Blackwell, 04/08/05; *Wall Street Journal*, James R. Hagerty and Dawn Kopecki, 04/08/05; *The Main Wire*, Claudia Hirsch, 04/07/05; *Dow Jones Newswires*, Dawn Kopecki, 04/08/05)

Falsified signatures aided Fannie Mae’s executive bonuses, says OFHEO Director Falcon

- Fannie Mae employees falsified signatures on accounting transactions that helped the company meet its earnings targets for 1998, a “manipulation” which triggered multimillion-dollar bonuses for top executives, said OFHEO Director Armando Falcon, Jr. These entries were related to the transfer of \$200 million in expenses from 1998 to later periods, which increased Fannie Mae’s 1998 earnings per share and triggered the release of a \$27.1 million bonus pool for senior executives. In 1998, Fannie Mae paid \$1.932 million to chairman and chief executive James A. Johnson; \$1.11 million to Franklin D. Raines, chairman-designate; \$1.108 million to Chief Operating Officer Lawrence M. Small; \$779,625 to Vice Chairman Jamie S. Gorelick; \$493,750 to Chief Financial Officer J. Timothy Howard; and \$493,750 to Robert J. Levin, an executive vice president. Falcon declined to say if there was any indication of criminal activity related to the accounting improprieties which triggered the 1998 bonus payment.
- During his congressional testimony before the House Financial Service subcommittee and in comments to reporters afterward, Falcon drew for the first time a link between the falsified signatures, disclosed by OFHEO last month, and the accounting manipulations that led to payment of 1998 bonuses, disclosed by the agency last fall. Falcon told lawmakers that a Fannie Mae employee has told investigators that financial records from 1999 to 2002, which bore his name and signature, were not prepared by him. “We have identified several problems involving procedures for

preparing, reviewing, authorizing and recording” the company’s accounting, said Falcon, whose agency is sharing all information from its probe with the SEC and the Department of Justice. OFHEO has ordered Fannie Mae to determine whose signatures were falsified, why, and whether any executives who received bonuses as a result of the transactions knew about them or the circumstances leading up to them, said Falcon. He did not disclose the names of the employees interviewed, the names used in the falsified signatures or who might have signed the names. “We’re looking into who did it and how far up it went,” said Falcon.

- OFHEO has also obtained testimony from an employee in Fannie Mae’s controller’s division indicating the employee would change the books when asked, even though he often did not understand the purpose of the changes, said Falcon. The agency is investigating the extent and circumstances of those changes, he added. OFHEO has found numerous instances, spanning several years, where managers directed low-level employees to modify database entries, which Falcon characterized as a “pervasive” practice. “As with previous accounting problems we have uncovered, they reflect Fannie Mae’s tendency toward overly aggressive interpretation of [generally accepted accounting principles], or in certain instances - when compliance with GAAP would negatively affect the company - a willful disregard of accounting rules,” Falcon said. “They also reflect situations where Fannie Mae’s accounting policies actually do comply with GAAP, but enterprise personnel have failed to follow those policies.”
- “There were almost no controls [in Fannie Mae’s accounting] in some instances,” Falcon said. As an example, he pointed to one employee being allowed to make a change in an accounting formula on a spreadsheet which resulted in the improper reporting of \$1 billion. With proper controls, Falcon noted, a single employee should not have been able to make changes without several layers of verification. One lapse in Fannie Mae’s internal controls and systems dates back 21 years, said Falcon, with most of the problems occurring within the last four years. “There was a breakdown in the integrity in the process by which financial statements were produced,” Falcon said. “The fact that Fannie Mae operated a faulty and inaccurate system for more than two decades revealed serious system weaknesses.” When asked by Representative Paul Kanjorski (D-PA) why OFHEO had not detected these errors sooner, Falcon said he consistently told Congress that OFHEO did not have adequate resources and staff necessary to examine companies the size of Fannie Mae and Freddie Mac. In response to questions, Falcon said that OFHEO is examining if his agency or Congress have been misled by Fannie Mae’s executives. His agency is also looking closely into the role that Fannie Mae employees played in the promulgation and implementation of accounting policies.
- In his testimony, Falcon said Fannie Mae also violated GAAP rules when it pursued a policy of holding mortgage-backed securities for a month before deciding whether to sell them or hold them in the company’s own investment portfolio. Under FAS 115, the company is required to make the classification at the time of the acquisition rather than at the end of the month, he said. Internally, Fannie Mae referred to this practice

as “keep the best, sell the rest.” Falcon told lawmakers, “This practice appears to stand in stark contrast to the company’s denials of engaging in ‘cherry picking’ when the matter was reviewed by a 2003 Task Force on Mortgage-Backed Securities Disclosure,” comprised of officials from OFHEO, the SEC and the Treasury Department.

- Falcon testified that Fannie Mae probably will not report its finances for years, and may not be current in its reporting for a number of years after that. “The model might be to look at the Freddie Mac situation. There it did take a couple of years for the company to produce financial statements and it will take it a couple of years beyond that to get timely,” said Falcon, in response to questions from the panel.
- “We expect additional accounting issues to surface,” Falcon told lawmakers as OFHEO’s investigation of Fannie’s accounting progresses. Noting that his agency’s scope of examination had “proceeded well beyond our expectations,” Falcon noted that his agency will need more money from Congress this year to continue its examination of Fannie Mae. Falcon also pointed out to lawmakers that his agency had levied the \$5 million special assessment against Fannie Mae, which the company has paid, pursuant to a law passed by Congress last year. However, OMB cited a “technical deficiency” in OFHEO’s governing statute that precludes it from spending the special assessment. Falcon told lawmakers that his agency needs approval from Congress to expend these funds.
- On the eve of his appearance before the House subcommittee, Falcon submitted his letter of resignation as OFHEO director to President Bush, effective May 20 “absent extraordinary circumstances.” Falcon’s five-year term as Director had ended in October 2004, but had agreed to remain with the agency while the Bush administration located his replacement. In his letter, Falcon wrote he was comfortable leaving OFHEO “now that the most critical and pressing issues have been addressed” at Fannie Mae and Freddie Mac. He added, “The agency has successfully dealt with serious problems at two of the largest financial institutions in the world. We did so in a manner that avoided disruption in our financial system, while allowing both companies to continue fulfilling their vital public mission.” Falcon is stepping down as OFEHO Director to pursue other career opportunities. Deputy Director Stephen Blumenthal will serve as Acting Director of the agency until the White House appoints a permanent replacement. House Financial Services Chairman Michael G. Oxley (R-OH) said, “OFHEO Director Armando Falcon has done a commendable job under difficult circumstances.” He added, “Stephen Blumenthal ...is knowledgeable, effective, and capable. He has the ability to lead OFHEO as we in Congress continue our efforts to build a new regulator to oversee the GSEs.” During Falcon’s appearance before the subcommittee, many lawmakers commended Falcon for his service as OFHEO director and wished him success in his new career endeavors. (*The Washington Post*, Kathleen Day and Terence O’Hara, 04/07/05; *Wall Street Journal*, James R. Hagerty and Gregory Zuckerman, 04/07/05; *American Banker*, Michele Heller, 04/07/05; *Dow Jones Newswire*, Dawn Kopecki, 04/06/05; *Bureau of National Affairs*, Karen L. Werner, 04/07/05; *Reuters*, 04/06/05;

Dow Jones-Chinese Financial Wire, Dawn Kopecki, 04/06/05; *Bloomberg News*, James Tyson, 04/06/05; *OsterDowJones Commodity Wire*, Dawn Kopecki, 04/06/05; *US Fed News*, 04/05/06)

JUST HOW MUCH CAPITAL WILL FANNIE HAVE AFTER ITS RESTATEMENT?

OFHEO Director Falcon confirms big capital hit “possible” from Fannie’s trust acting

OFHEO does not release capital information for Fannie Mae for 4th quarter

Moody downgrades Fannie Mae’s financial strength rating

- While there’s no disputing that Fannie Mae will have to recognize huge losses that were previously kept out of earnings, there are indications that the company’s bookkeeping was so poorly done that it could end up having to bring huge amounts of assets onto its balance sheet as part of its financial restatements. Any large-scale transfer of assets onto its balance sheet would be a nightmare for Fannie, because it could be extremely expensive to carry out, take many months to execute and, in a worst-case scenario, leave the GSE severely undercapitalized, writes Peter Eavis in *TheStreet.com*. As OFHEO negotiates with Fannie Mae its capital classifications and Moody’s downgrades the company’s financial strength, the prevailing question is just how much capital will Fannie Mae have after it completes its restatement? No one knows. (*TheStreet.com*, Peter Eavis, 04/06/05)

OFHEO Director Falcon confirms big capital hit “possible” from Fannie’s trust acting

- After his appearance before the House subcommittee, OFHEO director Armando Falcon, Jr. confirmed to reporters that Fannie Mae’s capital position could be significantly affected by problems in the way it accounted for its off-balance sheet assets. “It’s a very complex issue and there’s much more work that needs to be done on it,” Falcon. When asked if the issue could have a significant impact on Fannie’s regulatory capital, Falcon said, “possibly.” He wouldn’t speculate on the potential size of the problem.
- At issue is how Fannie Mae has accounted for trusts that it used to sell mortgage-backed securities. Under FAS 140, Fannie has treated these trusts as special purpose entities (“QSPEs”) which kept the trusts’ assets and liabilities off its balance sheet. Keeping Fannie’s QSPEs off its balance sheet is crucial to Fannie’s business model, because the level of assets on its balance sheet determines how much capital it must hold. By law, Fannie has to hold capital equal to only 0.45% of the MBSs that it guarantees but doesn’t own - those that aren’t on its balance sheet, while it must hold of 2.5% capital for MBS and other assets it books on its balance sheet. According to analysts and close to the “U.S. probe” of Fannie Mae’s accounting, the company could be forced to find as much as \$30 million in capital, if regulators find that

Fannie wrongly kept \$1.42 trillion of mortgages off its balance sheet. “That’s the worst case scenario,” said one source close to the investigation.

- Under FAS 140, the central question is whether Fannie Mae severed control over the assets it placed in trust, said New York University accounting professor Paul Brown. Fannie Mae’s guarantee that payment would be made to debt holders on the loans in the trusts may show that the company did not sever control and rid itself of risk associated with the assets, he said. “I cannot imagine why they would set up trusts in such a way that some would qualify [for off-balance sheet treatment] and some would not,” Brown said. According to New York University accounting professor Stephen Ryan, a key question under FAS 140 could be: Who is the “transferor” of the loans to the trusts? “If there’s not sale accounting, then the loans will go back on the books of the transferor,” said Ryan. “If the transferor is Fannie, they go on Fannie’s books. If the transferor in a securitization is a bank, then they go back on the bank’s books. FAS 140’s criteria are legal control and effective control. The only question is whether the effective-control hurdle is met. I think that one could interpret that either way.” Determining who the transferor is may not be clear cut. Under contracts with the lenders, Fannie Mae takes legal title of the loans from the banks and agrees to place the loans in the trusts. Fannie argues that it has “no real control” over the assets as it moves them into the trusts; therefore, Fannie believes it isn’t the transferor and that, for accounting purposes, the mortgage lenders are the transferors.
- In his April 6th column in *The Street.com*, Peter Eavis identifies three potential problems Fannie may have in qualifying its QSPEs for off-balance sheet treatment. Eavis writes, “The first big problem is that Fannie appears to continue to have too much control over the loans in the QSPEs, which are supposed to be almost totally independent of Fannie. In the disclosures for its MBS entities, Fannie says that it has the ‘right and the option, without obligation and in its discretion, to withdraw’ certain delinquent loans from the pools of MBSs. But FAS 140 says that a company that runs a QSPE can’t have ad hoc discretion over what assets go in and out of the trust. Any additions or removals have to happen according to preset ‘automatic’ guidelines.” Second, Eavis points out that Fannie may not have made its off-balance-sheet entities sufficiently “remote.” He writes, “FAS 140 suggests strict guidelines for this. Companies transferring assets to the QSPEs are supposed to execute a legally clear-cut sale of the assets, but since Fannie doesn’t typically book gains on the assets it transfers, the legal requirements may not have been fulfilled.” Eavis speculates that Fannie may also have failed to properly document the assets held in off-balance-sheet trusts. He writes, “That could mean that the yield on Fannie’s MBS may not exactly match the underlying loans that are supposed to be in the MBS, since Fannie may have failed to classify which loans go with which securities.”
- While it is unclear how many of Fannie’s QSE assets will be ordered onto the balance sheet by regulators, if only 20% of these assets were placed on the balance sheet, Fannie would need \$6 billion in capital. Since OFHEO has almost no flexibility under the law over Fannie and Freddie’s minimum and critical capital requirements, a

substantial increase in Fannie's balance sheet would automatically raise both capital ratios. If this occurs, OFHEO's options are limited, points out Eavis. If Fannie Mae's QSPE accounting isn't correct, theoretically the company could transfer the assets onto the balance sheet and immediately reissue them, using the proper accounting. Eavis writes that this wouldn't be an easy thing to do, since investors would probably demand a fee for participating in an exchange offer and documentation may be too "slipshod" to execute an organized re-issue. If that's the case, OFHEO would be best advised to demand Fannie book the assets onto its balance sheet until an orderly solution can be found, said Eavis. OFHEO would then have to demand sharply higher capital, which could result in Fannie Mae being classified as "severely undercapitalized" and put the company on extremely shaky footing, he said. "While this may seem outlandish, it's hard to think of any other alternatives," Eavis concludes.

- On September 30 [the last quarter for which data are available], Fannie Mae was required to hold a minimum of \$31.8 billion in capital against \$904.5 billion in assets. On that date, the company held an adjusted \$28.9 billion in "core capital" and was nearly \$3 billion short of its minimum requirements, according to OFHEO. The agency said Fannie's critical capital level, which is the threshold that triggers conservatorship provisions under Fannie's governing law, was \$16.3 billion.
- While Fannie Mae supporters continue to argue that the GSE is being unfairly targeted, even some Fannie Mae critics find it hard to envision OFHEO taking a severe line on the QSPEs, given the scale of the issue. "One Fannie [critic] says [Fannie Mae's] best defense may be that the size of the issue means 'Fannie is like the guy with a bomb strapped to his chest. The situation has to be treated delicately,'" writes Stephen Schurr in *The Financial Times* [London, England]. (*Dow Jones Newswires*, Dawn Kopecki and Siobhan Hughes, 04/06/05; *TheStreet.com*, Peter Eavis, 04/06/05; *Reuters*, Kristin Roberts, 04/06/05; *Dow Jones News Service*, Dawn Kopecki, 03/28/05; *The Wall Street Journal*, Jonathan Weil, Dawn Kopecki, and James R. Hagerty, 04/04/05)

OFHEO does not release capital information for Fannie Mae for 4th quarter

- Due to its ongoing review of Fannie Mae's accounting records and internal controls, OFHEO concluded that it does not have the information it needs to release its capital classification for the fourth quarter of 2004. According to a Fannie Mae statement, "OFHEO will not be releasing the capital classification at this time as Fannie Mae continues to provide OFHEO with information related to the company's accounting and controls that may affect its capital classification." OFHEO spokeswoman Stefanie Mullin said, "OFHEO will make its determination [of the company's capital classification] when the agency has received and analyzed all relevant information from Fannie Mae."
- In response to questions during House Financial Services subcommittee hearing, Falcon said that Fannie Mae needed more time to respond to the results of his

agency's analysis of the GSE's capital. "We're continuing to have discussions with Fannie Mae about their proposed classification," he told lawmakers. Fannie has 30 days from OFHEO's notice to comment on their proposed classification, he said. "When they give us their comments, we will take them into consideration and then determine the appropriate classification." Falcon declined to say what classification his agency had assigned to Fannie for the fourth quarter of 2004.

- Falcon said Fannie Mae's most recent classification as "significantly undercapitalized" for the third quarter of 2004 triggers statutory provisions which provides OFHEO broad discretion over the company's operations, including the ability to limit its assets and even place the GSE into conservatorship if necessary. In the latter instance, OFHEO would appoint an outside conservator to run the Fannie Mae and liquidate its assets, if necessary. "We do have the authority (right now) and the statute gives us broad discretion on when to decide to put them into conservatorship," Falcon said to reporters. "If we thought that their financial health was in jeopardy such that we needed to place them into conservatorship, we would do so without hesitation. [But], we have not found that it's necessary to date." (*Dow Jones Newswires*, Dawn Kopecki, 03/28/05; *Dow Jones Newswires*, Dawn Kopecki and Siobhan Hughes, 04/06/05)

Moody's downgrades Fannie Mae's financial strength rating

- On the day that OFHEO announced it would not be releasing the company's capital classification, *Moody's Investors Service* cut its ratings for Fannie Mae's financial strength from A- to a B-plus with a stable outlook. Moody's downgrade of the GSE's financial strength is based upon the perception of whether the company may need future financial help from shareholders or possibly the federal government. Specifically, Moody's noted that OFHEO's ongoing investigation of Fannie Mae may result in the recognition of additional losses, which will adversely impact the company's regulatory capital in the short term. In a statement, Moody's said, "More importantly, the identification of additional accounting and internal control issues, along with the continuing regulatory and related investigations, may be suggestive of larger governance and control problems [at Fannie Mae.]. These governance and control challenges, as well as uncertainty regarding capital levels prompted Moody's to place the GSE's BFSR under review for downgrade in 2004. Moody's believes that Fannie Mae is actively working towards resolving all issues related to the accounting investigation, but in the rating agency's opinion complete remediation will take time, and likely not occur until 2006." Moody upheld its AAA rating for its senior unsecured debt, backed by a stable outlook and affirmed its rating for Fannie Mae's short-term debt at Prime-1. (*Moody's Press Release*, 03/28/05; *BNA's Daily Report for Executives*, 03/30/05)

Representative Baker introduces the Federal Housing Finance Reform Act of 2005
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- On April 5, Financial Services Capital Markets Subcommittee Chairman Richard Baker (R-LA) introduced The Federal Housing Finance Reform Act of 2005, to

create a Federal Housing Finance Agency (FHFA) to oversee Fannie Mae, Freddie Mac and the FHLBs. Within one year of enactment of the legislation, the agency would assume authority for the enterprises from OFHEO and the Federal Housing Finance Board with the rules and orders of the existing regulators remaining in effect and enforceable, until determined otherwise. Under this bill, the FHFA would be headed by a Director, appointed by the President and confirmed by the Senate for a 5-year term with Deputy Directors for the Divisions of Enterprise Regulation, Federal Home Loan Bank Regulation, and Housing. The Housing Finance Oversight Board would advise the Agency on overall strategies and policies, but would have no executive authority. The Board would be comprised of the Secretaries of the Treasury and HUD; two members, appointed by the President and confirmed by the Senate; and the Director, serving as Chairperson. The FHFA would annually assess the regulated entities for its reasonable costs and expenses with no Congressional appropriations approval required.

- Under the bill, the FHFA would have broader authority to oversee the business of Fannie Mae and Freddie Mac than OFHEO. It could set capital standards for the GSEs and could limit and withhold executive compensation. The FHFA could pre-review new programs¹ being undertaken by the GSEs and could reject new activities² if they are not in the public interest. The regulator could set and enforce affordable housing goals for Fannie Mae and Freddie Mac and would annually set the set conforming loan limits, based upon the agency's annual housing price index. The bill would also give the FHFA the authority to limit the growth of the Fannie Mae's and Freddie Mac's loan portfolios, which currently total about \$1.6 trillion.³ The bill requires FHFA to report to Congress on the enterprises' holdings; the risk implication of their holdings; an analysis of the portfolio holdings for safety and soundness purposes; an assessment of whether portfolio holdings fulfill the housing mission of the enterprises; and an analysis of systemic risk implications from the portfolio holdings and whether they should be reduced over time. The bill also establishes criteria for the composition, operation, and compensation of the enterprises' board of directors and requires the GSEs to comply with several provisions of the Sarbanes-Oxley Act regardless of their registration status with the SEC.
- Reforms of the FHLB system include decreasing the size of the FHLB boards of directors from 14 to 13 with at least two members serving as public interest directors. The terms of the directors would be extended from three years to four years and the current cap on directors' compensation would be lifted. A new Federal Home Loan Bank Finance Corporation would be established as a jointly-owned subsidiary of the FHLBs to issue and service their consolidated debt obligations. The bill would also allow government insured depository institutions with assets less than \$1 billion [an

¹ Editor's note: Program is defined to mean mortgage program.

² Editor's note: Activity is defined more broadly than program.

³ Editor's note: The Baker Oxley bill gives the FHFA *some* authority to limit the GSEs' portfolios. The bill does not appear, however, to give the FHFA authority to limit the size of the portfolios if there are concerns about systemic risk. Rather, the bill permits the Director to order the GSE to dispose any individual asset, instead of giving the FHFA express authority to limit the overall size of the portfolios.

increase from the current \$500 million asset limit] to use FHLB advances for lending to community development activities and to use such secured loans as collateral for advances generally.

- House Financial Services Chairman Michael Oxley (R-OH) praised Baker's bill as "strong and reasonable," which provides a solid foundation for building the new agency "from the ground up." Oxley said, "It is time for Congress to act. We've had accounting problem after accounting problem, regulatory issue after regulatory issue with the GSEs. All parties must realize that this situation just cannot continue as it is. The current agency has done a commendable job with its limited and inadequate powers." Oxley is an original cosponsor of the bill.
- Baker said that he rejected stronger draft legislation submitted by the Federal Reserve, which called for curbing the mortgage portfolios to \$200 billion over five years. Instead, Baker opted to provide the regulator the power to set the GSEs' portfolio limits⁴ and report to Congress its assessments of the GSEs' portfolios. In a statement, Baker said, "I am growing toward the conclusion that how we address the size of Fannie and Freddie's portfolios lies at the heart of our efforts to reduce risks and improve their housing mission performance, and I believe [the] provisions [in the bill] represent a good starting point for discussion about the best approach to take." Baker said he decided against setting hard limits on the size of the GSEs' portfolio to allow for flexibility depending on economic conditions. Instead, the new regulator would have the authority to take whatever actions it feels are warranted to set appropriate portfolio levels for the firms. The bill does not alter the \$2.25 billion lines of credit that Fannie Mae and Freddie Mac have with the Treasury Department.
- Baker said that he hopes to hold a hearing on the bill very soon and hoped for a subcommittee vote on it in May. He indicated that he does not expect the Bush administration or Federal Reserve to either strongly endorse or oppose the bill. "I'm not expecting an endorsement, but I'm not expecting much criticism," said Baker. "Before [passing GSE regulatory reform] was politically impossible. Now it's politically tough. I'll take politically tough over impossible any day," said Representative Christopher Shays, (R-CT), a co-sponsor of the Baker bill.
- Barney Frank, the minority leader of the House Financial Services Committee, said the Baker bill would provide the GSE regulator too much power to reduce the size of the GSEs' portfolios. Frank said he wants to "toughen the criteria" by which the regulator could mandate "severe reductions" in portfolio assets or other activities.
- Mortgage bankers and home builders are expected to fight Congressional efforts to restrict Fannie Mae's and Freddie Mac's portfolios, arguing that any retreat by the GSEs from the mortgage finance market would hurt home buyers by curtailing the amount of funds available for mortgages, making them more expensive. Both the National Association of Home Builders and the National Association of Realtors said

⁴ *Ibid.*

they would oppose any legislation that would “reduce the capacity” of Fannie and Freddie.

- Industry lobbyists speculated that Baker omitted statutory limits on GSEs’ portfolios in the bill, in part, to curry support from Oxley, who co-sponsored the bill. “Because it’s an Oxley-Baker bill, it’s a safe assumption that it’s a compromise and one that probably reflects some political realities,” said one industry lobbyist.
- Commenting on the Baker bill in a research note, Medley Global Advisors analyst Josh Rosner called FHFA’s outside directors “informers,” adding that the agency’s board structure appears to enhance the GSEs’ political influence over the new regulator. He said that the only job of the outside directors appears to be to “apprise legislators about what the regulator is doing. If this is actually in the bill, we believe it would strongly argue that the GSEs’ ties to the government are being significantly enhanced instead of weakened.”
- In *Prudential Equity Group’s Washington Research Washington World*, Charles A. Gabriel, Jr. writes, “[W]e view the surprisingly constructive first move on GSE legislation—coming from Baker, arguably the Hill’s most knowledgeable member on GSE matters and the two companies’ chief Hill critic after nearly a decade of service as chairman of the House Capital Markets subcommittee—as bolstering the conviction behind our two-in-three odds of investor-friendly reform legislation being adopted during the 109th Congress.” (*Financial Services Committee Press Release*, 04/05/05; *Bureau of National Affairs*, Karen L. Werner, 04/06/05; *Congressional Quarterly Today*, Michael R. Crittenden, 04/06/05; *American Banker*, Rob Blackwell, 04/06/05; *Washington Post*, Terence O’Hara and Kathleen Day, 04/06/05; *Dow Jones Newswires*, Dawn Kopecki, 04/06/05; *National Mortgage News*, 04/07/05; *Prudential Equity Group’s Washington Research Washington World*, Charles A. Gabriel, Jr., 04/05/05; *Dow Jones Newswire*, Dawn Kopecki, 04/05/05)

Triage Report: Freddie Mac a “work-in-progress,” as profits fall more than 40% in 2004

- Whipsawed by fluctuations in interest rates, Freddie Mac’s net income dropped \$2.8 billion or 41% in 2004 to \$2.83 billion or \$3.78 per share. The company said that the decline in its net income was attributable to losses on derivative contracts used to hedge interest rates, caused primarily by a \$4.5 billion loss from reclassifying derivatives. Earnings were also impacted by a decline in interest income, which fell to 4% to \$9.1 billion, and ballooning administrative expenses, which increased 33% to \$1.6 billion. Freddie Mac’s loan portfolio, which totaled \$655 billion at year end, grew 1.3% percent in 2004, the slowest pace in the past five years. The company’s capital totaled \$34.9 billion at year end, exceeding its 30% surplus capital target set by OFHEO by more than \$3.5 billion. Freddie Mac estimated the fair value of its net assets at \$30.8 billion on December 31, 2004, up 13% from \$27.3 billion the prior year. Many investors consider fair value a better measure of the company’s health,

because its earnings are affected by volatility in its derivatives book due to interest rate fluctuations.

- With the company's issuance of its 2004 results, Freddie Mac is bringing its financial reporting current two years after an accounting scandal caused a massive review of its finances and ouster of top management. Freddie Mac plans to begin reporting quarterly results in August, when it expects to report its first and second quarter results for 2005; third quarter results by mid-November; and fourth quarter and full year data in January 2006. The company plans to begin filing with the SEC in the second quarter of 2006. Freddie Mac isn't expected to provide non-GAAP measure of earnings until it reports its 2005 results next year. According to the company's chairman and CEO Richard F. Syron, Freddie Mac's overhaul of its internal controls and accounting systems will not be complete until the end of the year. "We still have a lot of work to do," Syron said to analysts on a conference call, discussing the company's fiscal year 2004 results. "We looked at 2004 as what you might call a triage year," he said. "We have filled a lot of the holes," he said. "We are not finished yet, and we are making substantial progress in getting the ship moving in the right direction." Syron added, "We are extremely well capitalized for the assets we hold. Our capital strength has allowed us to increase our common stock dividend." While well positioned for future growth, Syron noted that the company must refrain from "dramatic action" until Freddie Mac is once again fully current on its quarterly financial reporting. "We know that over the longer run, we do need to manage our capital more efficiently, that is to get it back to our shareholders," said Syron. In 2005, management expects Freddie Mac to report net interest income materially below that reported 2004, primarily due to compression in net interest margins on its existing portfolio and lower nominal margins on floating-rate mortgage-related security purchases. Management anticipates the decline to be offset significantly by narrower non-interest losses in 2005, assuming current forward rates are realized.
- While Freddie Mac is looking for opportunities to restart retained portfolio growth, unattractive debt-to-mortgage spreads are holding back the GSE's expansion, said Jerome Lienhard, who oversees the company's debt, equity, and mortgage securities funding. "... [W]e have ample excess capital to grow the retained portfolio meaningfully," said Lienhard, adding [but] "we don't expect at this time to see meaningful growth in our retained portfolio growth." He said that the company is not conducting an outright liquidation of MBS from its portfolio, but is "selling through restructuring" using REMICs.
- On March 31, OFHEO declared that Freddie Mac was "adequately capitalized" in the fourth quarter of 2004, based upon the company's 2004 financial results. OFHEO said the company's minimum capital requirement was 24.13 billion as of December 31; Freddie Mac's core capital exceeded that minimum requirement by \$10.77 billion.
- Edwin Groshans, who follows Freddie and Fannie for the Fox-Pitt, Kelton Inc., said the company's 2004 results were encouraging on two fronts: Freddie's capital

position was more than ample, and its market share grew. Fannie Mae, which has always had a larger market share than Freddie, could lose more market share this year. “It represents a real opportunity for Freddie,” said Groshans. During 2004, Freddie Mac’s market share in the mortgage securitization market increased from 37% in 2003 to 43%, relative to Fannie Mae.

- Other analysts said that Freddie’s numbers are so “murky” that it is hard to tell anything about the company’s performance. Jonathan Gray, a Sanford C. Bernstein & Co. analyst, said FASB rules have made it very difficult to understand what is going on at the GSE. “The Freddie Mac numbers unfortunately require a lot of work to gain any kind of insight into what actually happened,” Gray said. “We have FASB to thank for this.” An industry analyst, who described Freddie Mac’s results as “ugly,” said “It’ll be interesting to see whether the market, as it has in the past, looks past GAAP results and follows the company’s lead in accepting the fair-value statements.”
- Josh Rosner, a financial institutions analyst at Medley Global Advisors, said Freddie’s 2004 financial results should “highlight the need for strong safety and soundness oversight and reemphasize the fact that past transgressions may have been supported by a lack of full transparency.” Rosner hopes that the company’s 2004 financials may add “strong support for those who argue that the GSEs’ safety and soundness regulator needs far more powers and authorities than it has had historically.”
- In *Business Week*’s S&P Stock Picks and Pans, analysts Jason Seo and Mark Hebeke write “Freddie Mac released its much-anticipated 2004 earnings per share of \$3.78, well below our estimate mainly due to \$4.5 billion in derivative losses. We are encouraged by core business strength and market share gains relative to Fannie Mae, but we are concerned about Freddie’s ability to manage its derivatives going forward. While we believe Freddie has most of its accounting issues under control, we are still uneasy about what we see as a difficult political environment. ...Our 12-month target price remains \$57.” The analysts reiterated their sell recommendation for Freddie Mac.
- During the investors conference call, Syron stated that Freddie Mac “is committed” to working with Congress on GSE regulatory reform legislation. Syron told analysts that there is no consensus as yet on whether or how to legislate limits on Freddie’s and Fannie’s mortgage portfolio growth. “Legislative or regulatory limitations on our ability to conduct these activities, through restrictions on portfolio size, debt issuance or otherwise, could require us to significantly alter our current business activities and could adversely affect our future profitability,” said Freddie Mac. (*American Banker*, Rob Blackwell, 04/01/05; *Washington Post*, Terence O’Hara, 04/01/05; *Financial Times*, Stephen Schurr, 03/31/05; *Wall Street Journal*, James R. Hagerty, 03/31/05; *Market News International*, Claudia Hirsch, 03/28/05; *Market News International*, Claudia Hirsch, 03/31/05; *Bloomberg News*, Al Yoon and James Tyson, 03/31/05;

Associated Press, 03/31/05; Reuters, Kristin Roberts, 03/31/05; Business Week, Jason Seo and Mark Hebeka, 03/31/05; Reuters News, 03/31/05)

Fannie Mae and Freddie Mac

Senator Shelby: “We’re on the road to action” for GSE regulatory reform

- When asked about the timetable for creating GSE regulatory reform legislation, Senate Banking Committee Chairman Richard Shelby (R-AL) told reporters, “We’re on the road to action. “We have four more hearings that I know of, and then we’re going to move towards the legislative proposals. We’re going to try to put it together, and I think the time is right now. The GSEs need a world-class regulator.”
- While Shelby favors reducing the size of Fannie Mae and Freddie Mac, he believes that it is unlikely that Congress would legislate specific caps. Instead, he believes that Congress must empower any new GSE regulator to set and impose portfolio limits if it deems a reduction is necessary. Shelby said “The regulator ought to have the power to do that or not do it, not the Congress. I believe that if you have a regulator that knows what’s going on at the GSEs, they will know what’s in the portfolios, they will know what the risk is and then they can deal with the risk capital.” And should the GSE regulator have the power to cap? Shelby responded, “Absolutely. I think it’s essential, among other things. I’ve said many times that I don’t know of a financial institution that has been well capitalized, well managed and well regulated that’s ever gotten into financial trouble, so if you go by those three measures alone, you’ll have a sound financial institution.” Shelby added that he wants to see the GSEs’ portfolios reduced. “All of us know that’s where the [systemic] risk is,” he said. (*Bloomberg News, Bill Arthur, 04/07/05; Main Wire, Claudia Hirsch, 04/07/05*)

GSE regulatory reform bill may be voted out of
House Financial Services Committee by Memorial Day

- Chairman of the House Financial Services Committee Michael Oxley (R-OH) said that a vote on GSE regulatory reform legislation is “feasible, maybe before the Memorial Day recess” beginning May 30. Oxley has backed a bill introduced by Representative Richard Baker (R-LA) that would create a regulator with power to constrain Fannie Mae and Freddie Mac by limiting growth in their combined \$1.53 trillion loan portfolios. “My sense is right now it’s not as problematic as it once was, so the lifting is little bit lighter than last time,” said Oxley. He added that he is “leery” of adding language to a bill that caps the portfolios at a specific dollar amount. “If you put it into law, it really reduces the flexibility of the regulator,” Oxley said. “If you believe as I do that you will create this world-class regulator,

you've got to trust the regulator to make these kinds of decisions.” (*Bloomberg News*, James Tyson, 04/06/05)

Representative Frank says limiting the GSEs' portfolios will “shrink substantially” lending for affordable housing

- Representative Barney Frank (D-MA), the House Financial Services' minority leader, voiced reservations about the Baker bill, saying reductions in Fannie Mae's and Freddie Mac' portfolios would undermine their ability to meet their federal mission to promote homeownership. “The affordable housing that is done by Fannie Mae and Freddie Mac is a percentage of their overall activity,” said Frank. “You cannot shrink their overall activity without also shrinking substantially what they do in affordable housing.” When asked if the “worst [news] is out” for Fannie and Freddie,” Frank responded, “That's what I'm told by the SEC and by the regulators. When asked about bill introduced by Representative Baker (R-LA), Frank noted that Representatives Oxley (R-OH) and Baker (R-LA) didn't consult Frank and other Democrats when drawing up their bill. “It wasn't done in any bipartisan way,” he said. Frank voiced concerns about provisions in the bill which stop Fannie Mae and Freddie Mac from getting involved in new housing productions, even if there were no safety and soundness issues. “On our side, we want to fully empower the regulator to protect against safety and soundness problems. But we don't want to see housing interfered with,” said Frank. (*Bloomberg News*, James Tyson, 04/06/05; *Bloomberg In Focus*, 04/06/05, 12:02:07 PM)

Senator Corzine opposes limiting Fannie Mae's and Freddie Mac's portfolios

- In an interview with Bloomberg News, Senator Jon Corzine (D-NJ) said, “Almost everyone agrees that [Fannie Mae and Freddie Mac] should carry larger capital. But I think hard caps are not a good idea. I sort of disagree with the view that there's no market discipline on these two institutions, also. Last time I checked, their spreads fluctuated quite a bit over a period of time, depending on how people assess the risk.”
- On balancing regulation of the GSEs and protection of the mortgage market, Corzine said, “That's the absolute essence of the debate we're having in the banking committee and ultimately in the broader Congress. We need to make sure we have a competent, world-class regulator who is informed about risk-management techniques and is willing to have adjustments in the risk-based capital rules that reflect changing conditions in the underlying institutions.”
- “There is no question that we have the largest percentage of home ownership in the world. It has grown dramatically as a function of these two institutions. It's grown dramatically as they build up their portfolio as well including, while not meeting the objectives we'd like to see, among minority homeownership and low and moderate income. We want to continue that process. That's one of the things that makes our

country unique. People have a stake-holding in it by owning their own home.”
(*Bloomberg News*, Brian Sullivan and Rachael Katz, 04/07/05)

Fannie Mae and Freddie Mac noticeably quiet on issue of limiting the GSEs' portfolios

- Both Fannie Mae and Freddie Mac have been unusually quiet in public about Greenspan's proposal to restrict the GSEs' portfolios. Sources have said that Fannie has been silent even in private, because of its recent accounting scandal and resulting fallout. While Freddie Mac is said to vehemently oppose statutory portfolio limits, some sources said it could be willing to accept a regulator with power over GSE portfolios, depending on how that authority is structured. (*American Banker*, Rob Blackwell, 03/31/05)

Editorial pages support downsizing Fannie and Freddie

- In an April 8 editorial, the *Christian Science Monitor* writes, “If the government-sponsored mortgage giants known as Fannie Mae and Freddie Mac knew what was good for them, they'd accept proposals to create a more muscular regulator over them and reduce their supersized \$1.5 trillion portfolios. Those proposals were laid out in a bill introduced ...by Rep. Richard Baker (R), chairman of the House financial services subcommittee on capital markets. His measure rightly reflects a growing, post-Enron alarm in Congress over the risks a potential collapse of these two beasts poses to the nation's economy. Yet officials at Freddie Mac have already signaled opposition to these reforms - which are endorsed by lead Bush administration officials - saying they would “adversely affect our future profitability.”
- “...Fannie and Freddie have expanded beyond their original government charter of providing affordable housing to low-income Americans - so much so, they now control half of the \$7.6 trillion US mortgage market. Their portfolios grew some tenfold between 1990 and 2003. Critics contend they've used those portfolios simply to generate profits for their stockholders, not to further their charter. If they failed, taxpayers could be forced to pay off the mortgage duo's debts because of their quasi-governmental status, which includes a nominal line of credit with the Treasury Department that allows them to undercut the banks by borrowing at below-market rates.”
- “Fan and Fred's intense lobbying, together with a currently weak regulator, has let them balloon in size for years. But both were recently red-faced by nothing less than multibillion-dollar scandals that used accounting tricks to smooth earnings. For Fannie, that meant being forced to restate an estimated \$11 billion in earnings going back to 2001. In 2003, Freddie was forced to reduce its earnings by \$5 billion - proof positive a new regulator with enhanced oversight powers is in order.”

- “Although the [Baker] bill falls short by not calling for an end to the line of credit with Treasury, the measure deserves broad support for being the most comprehensive effort to date to rein in these outsized companies.” (*Christian Science Monitor*, 04/08/05)
- In an April 8 editorial, *The Financial Times* writes, “Fannie Mae and Freddie Mac are rogue elephants. It is time Congress did something to stop their rampage. The [GSEs] have exploited the general assumption that they enjoy a de facto government guarantee to trample all over genuine private sector competitors. In the process they have grown so large as to pose a systemic risk to the US financial system and to US public finances. This growth must be permanently halted and ultimately reversed. Richard Shelby, the Republican chairman of the Senate banking committee, deserves full support in his bid to tame them.”
- “...The basic idea should be to return both entities slowly over time to their original roles as intermediaries responsible for repackaging home loans and selling them on. They may serve a useful purpose ensuring liquidity, but there is no justification for government-sponsored institutions acting as big long-term investors. If Fannie Mae and Freddie Mac did not exist, there would be no need to invent them. Denmark and Germany have thriving secondary markets for long-term fixed rate home loans without quasi-government intermediaries. There, the private sector repackages loans, provides credit enhancement and standardizes loan data by agreement. Mortgage spreads are just as tight. When the UK investigated housing finance last year, it concluded there was no need for a British Fannie Mae or Freddie Mac.”
- “[But] Fannie Mae and Freddie Mac do exist. Scrapping them would be complex and unnecessarily disruptive. But downsizing them is essential. Whatever the risks of disturbing the housing market at a sensitive juncture, the risks of inaction are bigger.” (*Financial Times*, 04/08/05)

<p>Will literal application of GSE regulatory reform principals reduce the GSEs to nothing more than regulated public utilities?</p>
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- In the *Washington Post*, Steven Pearlstein writes, “Hallelujah! The Fannie/Freddie wars are [nearly] over.” Pearlstein notes that many of the old issues on GSE regulatory reform have been resolved and a consensus on reform is growing around goals of expanding home ownership; providing liquidity to the secondary market; and assuring the safety and soundness of the enterprises. He cautions, “But too literal an application of such principles could reduce Fan and Fred to nothing more than regulated public utilities -- companies that attract investors by paying predictable dividends and grow only as fast as the mortgage market. Under a public utility model, the companies would have little incentive to continue providing the kind of innovative new products and services that have attracted hundreds of billions of foreign capital to the United States while making the housing market the envy of the world. From a parochial point of view, this cramped model for Fan and Fred would

also be a blow to the Washington-area economy, where the companies have been a reliable source of job and income growth and anchors for a fast-growing financial-services sector. And no doubt it would force the directors of Fannie and Freddie to seriously consider asking permission to take the companies private -- which, of course, is what critics have wanted all along." (*Washington Post*, Steven Pearlstein, 04/08/05)

Bright-line proposal stirs debate in GSE regulatory reform

- The debate on GSE regulatory reform is focusing on a proposal to limit explicitly Fannie Mae's and Freddie Mac's business to secondary markets. The proposal, dubbed the "bright-line" test, is part of a GSE regulatory reform bill sponsored by Banking Securities and Investment Subcommittee Chairman Chuck Hagel (R-NE), which would require the regulator to define a boundary between the primary and secondary mortgage markets. The Mortgage Bankers Association and other supporters of the test contend it would enable the regulator to keep Fannie Mae and Freddie Mac, which are not allowed to originate loans or participate in any other primary mortgage activities, focused on their mission.
- However, critics argue that the provision would preclude many GSE activities and products that increase access to mortgage credit, lower homeownership costs and foster innovations in financing. "For example, the 'bright-line' provision would undermine state-of-the-art mortgage underwriting technology that has contributed significantly to the vibrancy, competitiveness and risk management that are vital to the contemporary housing finance system," said a group of six trade associations in a letter to Senate Banking Chairman Richard Shelby (R-AL) and ranking member Paul Sarbanes (D-MD). The groups said the provision also "would curtail the development of market-driven mortgage products and programs that meet lender and homebuyer needs." The Independent Community Bankers of America, National Alliance of Independent Mortgage Bankers, National Association of Home Builders, National Association of Realtors, and National Community Reinvestment Coalition signed the letter.
- Senator Elizabeth Dole (R-NC), a co-sponsor of Hagel's bill, said that the bright-line language is not intended to prohibit access to GSEs' automated underwriting systems. Speaking at a Senate Banking Committee hearing on GSE regulations, Dole said the provision aims to ensure competition between the GSEs' automated underwriting systems and private systems. "Unfortunately, Fannie and Freddie have used their market dominance to suppress competition with private systems," she said.
- During the panel's hearings, Hagel asked administration officials whether a new GSE regulator should have the authority to delineate between primary market and secondary market activities. Federal Reserve Chairman Greenspan said the Fed is familiar with the issue, but had not examined it in "sufficient detail to [provide] usable insight." At a later hearing, Treasury Secretary Snow said that he was not sure

whether drawing a bright line between primary and secondary mortgage activities would have a direct impact on the GSEs' safety and soundness. "That's one of those things you would want to understand the full implications of before you put it into law," Snow said. "My knowledge on it isn't sufficiently advanced so I could give you a clear-cut answer on it." Snow, Greenspan and HUD Secretary Jackson agreed to take a closer look at the issue and weigh in with Hagel at a later date. (*CongressDaily AM*, Molly M. Peterson, 04/08/05; *National Mortgage News Online*, 04/01/05)

The National Association of Hispanic Real Estate Professionals warns that GSE regulatory reform will severely limit capital for AH mortgages

- The National Association of Hispanic Real Estate Professionals (NAHREP), a non-profit trade association with 14,000 members in 48 states, warned that proposed GSE regulatory reform legislation would severely limit capital for affordable mortgages and cut off education programs that prepare Hispanic families to become homeowners. According to the trade group, proposed changes to GSE regulation would actually increase barriers to buying a home at a time when the Hispanic rate lags behind the national average by more than 20%. "We support the call for a strong, credible regulator that will restore market confidence in the Government-Sponsored Enterprises (GSE), however, we caution against any proposals that go beyond these core goals and dramatically alter Fannie Mae and Freddie Mac's ability to support the growing minority housing markets," said NAHREP Chairman and Cofounder Gary Acosta. The group also voiced concerns that the "Bright Line" proposal is an unnecessary provision that would bar GSEs from the very activities that increase access to mortgage credit and reduce barriers to home ownership. (*Business Wire*, 04/04/05)

As 'bright line' debate heats up, Fannie secretly tests new tech system

- Fannie Mae is testing a new technology system called "Closing Collaboration Tools, a system that will increase Fannie's participation in lending from the point-of-sale forward, even if the loan is sold to Freddie Mac. The system may prove controversial because it puts Fannie Mae into the transaction well before the loan reaches the secondary market.
- Reportedly, the project will combine a data quality service, a document exchange process and an E-Sign Service. The program, which is being pilot-tested now, is designed to increase automation into the closing process. Detailed information about this project is hard to come by because Fannie has been asking its partners to sign non-disclosure agreements.

- The data quality service and the document exchange will operate in tandem, according to sources. The idea is that Fannie will provide a secure collaborative workspace by providing communication channel between originators and settlement service companies. As the data moves through this space, Fannie's servers will review it in order to provide a validation service at key points from origination through post-closing.
- The GSEs have already begun talking to other technology providers about integrating their systems by using an Application Programmer Interface Fannie is providing. Fannie officials are reportedly interested in working Fiserv, and have been discussing how the new tool would interface with GATORS.4.0, a closing system developed by Fiserv.
- The way Fannie moves the data could also be controversial. Sources said that Fannie plans to flow all of the data from the LOS and closing systems with which it has interfaces by using infrastructure provided by Realec. Given the hush-hush nature of the project, there has been no public discussion of how prices will be determined. Realec is likely to charge for the use of its system, and any fees levied against lenders or closing companies could find their way back onto the borrower's tax. This could conflict with Fannie's declared mission to lower the cost of homeownership in America.
- Finally, a Fannie spokesperson said that this project is "just one aspect" of the company's effort to revamp its technology. One implication of the project is that Fannie has chosen to integrate its new tools with loan origination and closing systems, instead of finding some other way to work directly with its lender sources. (*Inside Mortgage Technology*, 2/05)

OFHEO announces final corporate governance rule for Fannie Mae and Freddie Mac
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- On April 4, OFHEO announced the publication of a final rule governing the code of conduct, operations and compensation for management and for board members of Fannie Mae and Freddie Mac. "This regulation is part of our continuing effort to ensure that Fannie Mae and Freddie Mac are held to the highest standards of business conduct and corporate governance," said OFHEO Director Armando Falcon, Jr.
- Under the new rule, OFHEO will require compensation for the GSEs' executives, directors and employees to be "reasonable and appropriate." Compensation must be based on factors such as risk management, compliance with the law and operational stability, in addition to earnings. The rule also requires reimbursement by a senior official if an accounting restatement is required under certain circumstances.
- The rule limits directors to ten years of service and/or 72 years of age. Board members must attend at least eight meetings a year and at least one meeting each

quarter. The rule also expands the duties of the board to include an annual review of its legal and regulatory obligations.

- Fannie Mae and Freddie Mac are now required to maintain a code of conduct, which is reviewed by the board every three years, at a minimum. The GSEs' must now require that their CEO and CFO certify the company's financial disclosures. OFHEO now requires the GSEs to develop a risk management and compliance program, which reports directly to the CEO and provides reports to the board of directors. Fannie Mae and Freddie Mac are also now required to meet Sarbanes Oxley standards, even if they deregister or have not registered with the SEC. (*OFHEO Press Release*, 04/04/05)

<p>Bush Administration taps Ben Bernanke as chairman of the Council of Economic Advisors</p>
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- President George W. Bush has chosen Federal Reserve Board member Ben Bernanke to be the next chairman of his Council of Economic Advisors (CEA). The White House said Bush would nominate Bernanke to be a member of the CEA, and upon his confirmation by the Senate, would designate him as the chairman. Bernanke would succeed Harvey Rosen, who has served as interim chairman since the departure of N. Gregory Mankiw earlier this year. Bernanke is considered one of the leading candidates to succeed Federal Reserve Chairman Alan Greenspan, when he steps down from the Fed January 31. Before joining the Federal Reserve's board, Bernanke was a professor of economics and public affairs at Princeton University for 20 years; he previously taught at Stanford University, New York University and Massachusetts Institute of Technology.
- Fed spokeswoman Michelle Smith said that Bernanke plans to remain at the Fed until he was confirmed by the Senate, but "he is recusing himself from monetary policy matters." Smith also said Bernanke would not attend any further meetings of the Federal Open Market Committee. (*Associated Press*, 04/01/05)

Fannie Mae

Speculation continues over Fannie's new CEO

- In spite of strong denials from his spokesperson, the financial media continues to speculate about the prospect of William McDonough being named as Fannie Mae's new chief executive officer. Amy Borrus writes in *Business Week*, "Has William McDonough's ardor for bean-counting waned? Two years ago, when the former banker became chairman of the newly created Public Company Accounting Oversight Board, he crowed to reporters: "I adore accounting theory." But after getting the auditing industry's new regulator up and running, the former New York Federal Reserve president is in the running to be Fannie Mae's next CEO, Washington insiders say. Gossip about his itchy feet has circulated for months at the SEC which must approve a successor. One source says McDonough, 70, is bored at PCAOB, and notes he's no longer seen as a successor to the Fed's Alan Greenspan. A PCAOB spokeswoman says McDonough isn't talking to Fannie Mae. Steering Fannie through three ongoing federal probes and a push by Congress for tougher oversight would be a challenge, but lucrative: Former Fannie CEO Franklin Raines' pay averaged more than \$2 million, vs. McDonough's \$595,000 annual salary. Also said to be Fannie candidates: William Shea, former CEO of insurer Conseco, and former Senator Phil Gramm (R-TX)." (*Business Week*, Amy Borrus, 04/04/05)

Frank Raines, Fannie Mae's former CEO, is removed from Darden Ethics Institute

- Fannie Mae's former chairman and CEO Franklin D. Raines has been removed as co-chairman of the Institute for Corporate Ethics at the University of Virginia's Darden School of Business, a prominent corporate governance and ethics group he helped create in 2004. An Institute spokesman said that Raines could no longer be on its advisory board because he is no longer a CEO of a company that is a member of the Business Roundtable. The Institute's bylaws require that "academics and Business Roundtable CEOs" comprise the council.
- Raines and Pfizer's CEO Henry A. McKinnell persuaded the Business Roundtable to set up the Institute in January 2004 to promote corporate ethics programs, after the Enron and Worldcom scandals. At a ceremony announcing the Institute's formation, Raines said, "Our overall goal is to help restore the trust of the American people and American investors in business corporations." (*Washington Post*, Terence O'Hara, 03/31/05; *Bloomberg News*, James Tyson, 03/30/05)

Fannie Mae, rated the best corporate citizen in 2004, falls off the list in 2005

- In 2004, the *Business Ethics Magazine* named Fannie Mae #1 on its survey of “100 Best Corporate Citizens.” In 2005, however, Fannie Mae was one of ten companies removed from the list for “financial and social reasons.” The “100 Best Corporate Citizens” is based upon an analysis of companies in the Russell 1000 Index, which “perform to higher standard, serving a variety of stakeholders with excellence and integrity.” (*PR Newswire*, 04/07/05; *Wall Street Journal*, 04/08/05)

Do corporate foundation gifts to affiliated board members compromise directors’ independence?

- In a recent study of annual reports from the 20 largest U.S. corporate foundations, the *Chicago Tribune* concluded that foundation money has poured into organizations affiliated with their companies’ board members, which can compromise directors’ independence. In aggregate, the 20 largest corporate foundations gave nearly \$25 million to non-profit groups for which one or more directors was an employee, trustee or held another leadership position. The Fannie Mae Foundation ranked number three in the *Tribune’s* study, which donated \$1.24 million or 2.7% of total donations to groups affiliated with members of its board of directors according to its latest tax return. “I think it’s terrible,” said Paul Lapidés, a board member and director of the Corporate Governance Center at Kennesaw State University. “It’s hard to be independent and receive big contributions. This coziness and interference with a person’s ability to be independent or independent-minded is certainly affected by some of those large numbers.” (*Chicago Tribune*, Andrew Countryman, 03/27/05)

Fannie Mae leads the pack in lobbying expenditures for the 108th Congress

- According to a study by the Annenberg Public Policy Center at the University of Pennsylvania, spending for print and television advertisements on legislative issues totaled more than \$404 million during the 108th Congress. The study concluded that 1% of the organizations accounted for 57% of dollars spent in 2003 and 2004. Fannie Mae was the top spender, which accounted for \$87.2 million or more than 22% percent of the total expenditures. (*Roll Call*, Emily Pierce, Kate Ackley and Amy Keller, 04/01/05)

Wall Street rumblings

- Appearing on *CNBC’s Strategy Session*, Michael Farrell, chairman and CEO of Annaly Mortgage Management said “We’re actually excited about [a tougher GSE regulator] in our company. We think it is an opportunity. We have always seen Freddie and Fannie as actually friendly competitors in that vein. They are huge

companies, \$1.5 trillion balance sheets each. Just to put in that perspective for viewers, that is the entire capitalization of the Nikkei. So they are too big to fail. Alan Greenspan knows that. Congress knows that. They are working on the problem. I think Freddie Mac is ahead of it. They have been moving back towards their congressional charter. The markets have accepted that, and the bonds, but they are going to punish the equity because the growth is uncertain. Fannie Mae still has a little bit of work to do I would say here.” (*CNBC’s Strategy Session*, 04/07/05)

Deeds speak louder than words?

- According to a recent report by the *National Mortgage News*, Fannie Mae wants to become a company “where its deeds speak much louder than its words,” said Fannie Mae senior vice president and chief acquisition officer Thomas Lund. It wants to be a company that thinks less about its own needs and more of what its partners needs are, he added. (*National Mortgage News*, 03/28/05)

Fannie Mae releases new and revised appraisal forms

- After a period of testing and revisions, Fannie Mae has released a series of 11 new or revised appraisal report forms, including the final revisions to the 1004 Report or Uniform Residential Appraisal Report (URAR). Fannie Mae now has one form for reporting appraisals for each property and inspection type for both the Desktop Underwriter and manually processed mortgages. “As a result, lender and appraisers are now able to determine which report form should be used based upon the type of property and property inspection required,” said the company. (*PR Newswire U.S.*, 03/28/05; *National Mortgage News*, 04/04/05)

Freddie Mac

Freddie Mac to hold annual stockholder meeting on July 15

- Freddie Mac's board of directors has set July 15 as the date for the company's next annual shareholders meeting for holders of common stock as of May 27. At this meeting, which convenes at 9:00 A.M. eastern standard time at Freddie Mac's corporate headquarters, shareholders will elect 13 members to the company's board. Freddie Mac's board consists of 13 shareholder-elected directors and five additional directors appointed by the President of the United States. In 2004, the president did not name appointments to Freddie Mac's board and has not named any appointees for this year, according to the White House. Freddie Mac will disclose the slate of directors that shareholders will vote upon in a proxy statement to be issued in June. (*Reuters*, 04/05/05; *Associated Press*, 04/05/05)

Shareholders permitted to file amicus filing in government's appeal over Brendsel's \$54 million in compensation

- Over objection by former Freddie Mac CEO Leland C. Brendsel, a D.C. appellate court is permitting two of the company's shareholders to submit amicus filings in the government's appeal over \$54 million of Brendsel's compensation. Under the terms of the recent per curiam order handed down by the U.S. Court of Appeals for the District of Columbia Circuit, shareholders Maureen Henry and E.L. Greenfield can participate in the appeal filed by OFHEO on Freddie Mac's behalf. In this appeal, OFHEO and its director, Armando Falcon Jr., contest an order enjoining the agency from directing Freddie Mac to freeze Brendsel's compensation. (*Corporate Officers and Directors Liability Report*, 03/21/05)

Freddie Mac launches Reference REMICs

- Freddie Mac is introducing a new mortgage securitization program to vie for capital from a broader investor base, called reference "REMIC" securities. These securities, which will be secured by mortgage loans and securities in Freddie Mac's multibillion-dollar retained or investment portfolio, will become benchmarks for the structured sector of the \$5.5 trillion U.S. mortgage-backed securities market, said Mark Hanson, Freddie Mac's vice president of mortgage funding. "It's an ever growing attempt to attract more capital in housing," Hanson said. "What we are trying with this program is create much greater transparency and liquidity around these securities." He added, "There's a lot demand for U.S. mortgage products right now. The demand overseas is particularly interested in large, liquid, straight-forward products."

- In the early 1980s, REMICs, or Real Estate Mortgage Investment Conduits, were developed to appeal to more investors by offering greater cash flow certainties and less prepayment risks. While REMICs address prepayment issues, they are not as liquid as “pass-through” mortgage securities guaranteed by Freddie Mac, Fannie Mae and Ginnie Mae, since traditional REMIC classes tend to be small and quoted in wide bid/ask spreads in the secondary market. Freddie Mac hopes that its reference REMIC product could fill the gaps of traditional REMICs. In April, Freddie Mac’s first Reference REMIC will total at least \$2 billion; the company will continue the series with a quarterly scheduling of offerings with each tranche totaling at least \$1 billion. In 2005, the company plans to offer up to two of these single-class reference REMICs each quarter, starting in the second quarter, said Hanson. Freddie Mac will offer its Reference REMICs through Wall Street dealers and will pay them to create a liquid secondary market for them, he added. “We will be reinvigorate the REMIC market we think by providing more transparency and liquidity.” The securities will be issued through a multi-tiered syndicate of dealers and daily closing prices will be posted by lead managers Thomson TradeWeb and Bloomberg Terminal. (*Reuters*, Richard Leong, 03/30/05; *National Mortgage News*, Ted Cornwell, 04/04/05)

Amcore Bank first to partner with Freddie Mac by offering Home Possible Mortgages®
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- Amcore Bank is the first financial institution to partner with Freddie Mac in offering the Home Possible Mortgages to borrowers at or below 100% median income or living in underserved areas. “Home Possible represents one of our most significant new efforts to foster homeownership among moderate-income families in the past 10 years,” said David Stevens, Freddie Mac’s senior vice president of single family sourcing. “We applaud AMCORE Bank for becoming one of the first to make Home Possible available to hard working families in their markets.” Borrowers can take advantage of different Home Possible mortgages to finance one-to-four family properties, including manufactured homes. Amcore Bank is wholly-owned subsidiary of AMCORE Financial, Inc., headquartered in Northern Illinois with banking assets of \$4.9 billion and 72 banking locations in Illinois, Wisconsin and Iowa. (*AMCORE Financial Press Release*, 04/05/05)

Federal Home Loan Banks

FHLB-Chicago announces financial results for 2004

- In 2004, the FHLB-Chicago earned \$365 million in net income for fiscal year, resulting in a 7.7% return on equity for the period. Earnings were down 16% from earnings in 2003, largely due to the increase in restated 2003 net income resulting from recent accounting changes. The Bank's profitability and the effects of prior period accounting changes will allow the FHLB-Chicago to contribute more than \$47.5 million in 2005 to address the housing needs of low-income families through the Affordable Housing Program. The FHLB-Chicago's president and CEO J. Mikesell Thomas said, "The Bank remains in a very strong financial position. Our retained earnings grew 26% in 2004 to \$489 million at year end. We finished the year with a capital ratio of 5.59%, well above our statutory minimum of 4% and our current regulatory minimum of 5.1%." On December 31, 2004, the Bank had total assets of \$85.7 billion, advances outstanding of \$24.0 billion and \$47.1 billion in Mortgage Partnership Finance Program Assets outstanding. (*FHLB-Chicago Press Release, 03/31/05*)
- During 2004, 147 new financial institutions joined the FHLB-Chicago's MPF Program, bringing the total number of participants to 885. More than 80% of the program's members are community financial institutions with assets less than \$567 million. Approximately 12% of its members are mid-sized institutions with assets of \$567 million to \$5 billion and 5% are large institutions with assets exceeding \$5 billion. During 2004, the Bank's MPF assets outstanding increased 0.7% to \$87.3 billion, while the volume of MPF assets funded during the year declined 74.4% to \$18.4 billion. (*FHLB-Chicago Press Release, 03/31/05*)

FHLB-Seattle announces unaudited net income of \$82.7 billion in FY2004, a 42% decline from FY2003

- The FHLB-Seattle GSE reported unaudited earnings of \$82.7 billion, a 42% drop from its 2003 net income. As of December 31, 2004, the FHLB-Seattle held total capital of over \$2 billion for a capital-to-assets ratio of 4.5%, well above their 4.15% regulatory capital requirement. The Bank has submitted to the Federal Housing Finance Board a three year business and capital management plan, calling for the adoption of strict risk management controls and procedures; the termination of its mortgage purchase program; a 25% reduction in staffing as part of an organization restructuring; and strengthening of the Bank's management, through the hiring of a new president and CEO and further changes a the Bank's senior management level. The Bank warned that it "anticipates minimal to no dividends for its members" over the next few years and "may report net loss for some financial reporting periods."

- *National Mortgage News* reported that the FHLB-Seattle had a \$260 million “unrealized loss” on its balance sheet at year-end, representing approximately 13% of the Bank’s capital. A FHLB-Seattle spokesman cautioned that the unrealized losses are a “snapshot at a point in time,” reflecting a mismatch between the Bank’s assets and liabilities, which could shrink or grow in size over time. (*FHLB-Seattle Press Release*, 04/05/05; *National Mortgage News*, 04/07/05)

FHLB-Topeka restates its 2001 earnings
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- The FHLB-Topeka has restated its 2001 earnings, lowering them nearly 9%, to \$80.2 million, because of accounting problems. The Bank identified the error through an independent review of accounting for derivatives and hedges for 2001 through 2003. While the review is ongoing, the Bank said it does not expect to restate financial results for 2002 or 2003. (*American Banker*, Michele Heller, 04/04/05)

Problems with FHLBs accounting delays financial results for the FHLB System

- New accounting and audit problems at three of the 12 regional FHLBs have delayed the publication of the System’s full third-quarter and year-end 2004 financial statements. The Office of Finance, which issues debt on behalf of the FHLBs, said it won’t be able to issue audited combined results until there is “resolution of certain accounting matters at the FHLB-Pittsburgh and FHLB-Topeka, and of a matter under review at the FHLB-Seattle by its board of directors.” Office of Finance spokesman Michael Ciota said the Pittsburg and Topeka Banks’ accounting issues are primarily related to the way they applied FAS 133, governing derivatives transactions and hedging activities. The Office estimated that correcting the errors at Pittsburgh and Topeka would reduce the System’s combined 2004 earnings by \$5 million. Ciota described the problem in the FHLB-Seattle as “non-financial.” While the outstanding issues aren’t expected to have a material impact on the FHLB System at this time, the Office of Finance said that “could change upon closer inspection.”
- According to Office of Finance’s preliminary results for 2004, the FHLB System’s advances grew 13.1% to \$581 billion; net income increased 9.1% to \$1.879 billion; and capital grew 7.1% to \$41.8 billion; and total assets rose 12.4% to \$925 billion at yearend. The Office attributed the System’s rise in net income to higher interest income on advances and investments as a result of increased advance volume and slightly higher yields. (*Dow Jones Newswires*, Dawn Kopecki, 04/01/05; *American Banker*, Michele Heller, 04/04/05)

FHLB-Dallas, FHLB Cincinnati, and FHLB-San Francisco announce board changes

- The FHLB-Dallas announced the election of Chesley N. Brooks, Jr. as chairman of the board of directors; March E. Ceverha as acting Vice Chair and James H. Clayton as a new director. Brooks, who succeeds Fred Miller Jr. as chairman, is chairman and CEO of Omnibank, headquartered in Houston, TX. Ceverha, who succeeds Patricia Brister as vice chairman, is founder and current president of Trinity Commons, a not-for-profit enterprise which is coordinating the construction of Trinity River Project in Dallas, TX. Clayton is the chairman and chief executive of Planters Bank and Trust in Indianola. (*PRNewswire*, 03/29/05)
- The FHLB-Cincinnati announced the election of Charles J. Kock as chairman of the board and Carl F. Wick as vice chair. Kock is chairman of Charter One Bank in Cleveland, OH; vice chairman of Citizens Financial Group; and a board member of The Royal Bank of Scotland. Wick is the principal/owner of Wick and Associates Business Consulting and is retired from NCR Corporation. (*PrimeZone Media Network*, 03/31/05)
- The FHLB-San Francisco announced the election of Michael Roster to its board of directors. Roster is Executive Vice President and General Counsel of World Savings Bank, FSB, as well as Golden West Financial Corporation, World Savings' \$110 billion holding company that operates in 38 states. (*FHLB-San Francisco Press Release*, 04/05/05)

FHLB-San Francisco announces staff changes

- Effective April 1, the FHLB-San Francisco has promoted Suzanne Titus-Johnson to Senior Vice President and General Counsel and Kevin Gong to Senior Vice President and Chief Corporate Securities Counsel. The Bank has also hired Jeannette Paul to serve as the Vice President, Accounting Policy. Titus-Johnson, who first joined the Bank as staff attorney in 1986, was made vice president, assistant general counsel in 1999. Gong joined the Bank in 1997 as vice president and associate general counsel. Prior to joining the Bank, he was senior attorney with the OTS West region. Prior to joining the Bank, Paul was with Resources Global; she has over 12 years experience in public accounting, most recently with Deloitte & Touche in merger and acquisition services. (*FHLB-San Francisco Press Release*, 04/24/05)

Farm Credit System / Farmer Mac

American Bankers Association lobbies Congress to include FCA
in GSE regulatory reform legislation

- In a recently released white paper, the American Bankers Association called on Congress to include the Farm Credit System in the pending GSE regulatory reform legislation. “One umbrella regulatory institution for all of the nation’s GSEs would improve the system’s safety and soundness and ensure that those who own it are being protected,” said John Blanchfield, director of ABA’s Center for Agricultural and Rural Development. Presently, the Farm Credit Administration oversees the Farm Credit System (FCS), which is comprised of 109 institutions and has just under \$125 billion in assets. The ABA said not including the system in a GSE reform bill will expose the farmers and ranchers who own it to “unnecessary risk.” The ABA argues that an umbrella GSE regulator will be more effective in restraining efforts by the GSEs to expand their activities. Since there is “substantial overlap” in the lending authorities and funding structures of all GSEs, the ABA argues that all enterprises should be subject to uniform safety and soundness standards.
- FCA spokesman Carl Clinefelter said that the FCS is in “extremely safe and sound” condition. He added, “We believe we are a very effective regulator and an arms-length regulator.” Kenneth Auer, president of the Farm Credit Council, called the ABA’s arguments “absolutely absurd,” since the farmers and ranchers are “perfectly comfortable” with the current regulatory system. “What you have is a competitor who is just trying to stir up trouble,” said Auer.
- At this stage, there seems to be scant support on Capitol Hill for granting a new regulator powers to oversee all the GSEs. “Seeing as though [Representative Baker (R-LA)] introduced the bill yesterday and it wasn’t in there, it may be a strong indication of his thoughts at the moment,” said Baker’s spokesman Michael DiResto regarding the inclusion of the Farm Credit System in GSE regulatory reform legislation. Moreover, support for such a proposal in the House and Senate Agriculture Committees appears to be lacking. “The call to change the oversight would be unnecessary since the Farm Credit System is already fully and completely regulated under the FCA,” House Agriculture Committee Chairman Rep. Bob Goodlatte (R-VA). A spokesman for the Senate Agriculture, Nutrition and Forestry Committee said the panel’s chairman, Senator Saxby Chambliss (R-GA), sees no need to change the regulation of the Farm Credit System. (*Dow Jones Newswires*, Deborah Lagomarsino, 04/06/05)

FCS “finds” \$1.26 billion

- According to the FCS’s Annual Information Statement (AIS) for 2004 the System reduced its loan loss reserves by \$1.26 billion as of December 31, 2004, a 61%

decline from year-end 2003's loss reserve. In Farm Credit Watch, Bert Ely writes, "This reduction, like finding money under the couch cushions, resulted from a systemwide review of FCS's loss-reserving techniques. This review revealed that FCS loans overall were not as risky as they were in the late 1980s, when the FCS was still reeling from its reckless lending in the 1970s and early 1980s. This one-time loss-reserve adjustment (\$1.167 billion after-tax) boosted the FCS's 2004 after-tax income to \$2.993 billion, up from \$1.825 billion for 2003. Absent the loss-reserve adjustment, FCS's 2004 net income was up just \$1 million, despite a 6.4% increase in average assets, a 3.8% increase in average loans, and a \$31 million drop in its tax bill. Reflecting agriculture's strong performance in 2004, FCS's non-performing assets dropped to \$767 million at the end of 2004 (0.8% of loans) from \$1.227 billion the previous year-end. Those non-performers were fully covered by FCS's \$792 million loss reserve at December 31, 2004. FCS's huge 2004 profit boosted its capital ratio to 17.1%, an all-time high."

- Ely continues, "...FCS's strong credit quality and high capital ratio should raise serious questions about the future role, if any, FCS should play in financing American agriculture. Clearly, FCS's extremely low loss experience strongly suggests that FCS is increasingly focused on serving America's large, well-capitalized farming operations that can readily obtain credit elsewhere. Excluding the loss reserve adjustment, FCS's 2004 provision for loan losses was just 5.7 basis points of its average loans outstanding for the year while its loan charge-offs were 8.0 basis points of its average loans. These numbers suggest that FCS is providing credit to farmers and ranchers who clearly are low-risk borrowers -- not the farmers and ranchers FCS was created to help."
- Ely concludes, "One interesting revelation from the financial statements is FCS's growing inefficiency, which has occurred despite substantial consolidation within FCS. FCS operating expense as a percent of average loans rose to 141 basis points from 135 basis points in 2003 and 134 basis points in 2002. This is due in large part to some staff growth, higher employee compensation, and very generous employee benefits, which equaled 36% of FCS salaries in 2004. FCS salaries and benefits averaged \$80,527 in 2004, up from \$76,469 in 2003 and \$72,267 in 2002. In contrast, employee compensation and benefits for all banks and thrifts averaged \$60,816 in 2004."
- Ely also notes that FCS continues to "cook" its unaudited numbers for young, beginning and small (YBS) farmers, which is defined by FCS as farmers under 36 years old; a beginning farmer with less than 10 years of farming experience; or a farmer as generating less than \$250,000 annually in agricultural sales. Ely notes that the YBS data has four big problems. A single farmer can get counted as many as three times, if he or she fits all three of the categories set forth by FCS. Ely writes, "Adding up the numbers, FCS asks you to believe that at the end of 2004, it had lent \$61.793 billion to YBS farmers, 78% of its total loans to other than co-ops and to finance international trade. That percentage is far too high." FCS counts loans and loan commitments outstanding, rather than the number of distinct YBS borrowers it

has. Thus, Ely writes, “FCS claims 733,560 loans and loan commitments were outstanding to YBS farmers at the end of 2004, 14,415 more than the total number of loans and loan commitments outstanding. How is that possible?” FCS does not differentiate YBS loans with third-party credit support, such as a guarantee from a parent, from non-guaranteed loans. Ely argues that loans to YBS farmers with third-party credit support should not be counted as YBS loans. Despite its definitions, FCS reported 9,581 loans at the end of 2004 to farmers with annual farm sales over \$250,000; these loans averaged \$470,405. Ely concludes, “...FCS’s YBS loan data is not credible. Next year, FCS should supply audited YBS data.” (*Farm Credit Watch*, Bert Ely, March 2005)

FCA: The enabler?

- In a March 18 speech at Carolina Farm Credit’s ACA Leadership Institute, FCA chairman and CEO Nancy C. Pellett said, “In the past, [the FCA was] generally referred to as ‘the regulator’ and it was not always said in the nicest tone of voice. I believe a lot of people within the Farm Credit System viewed us as an organization that ‘curtailed’ their business activities and ‘prevented’ them from adequately serving their customers. One of my goals is to change that perception. I view my Agency’s role as being an ‘enabler’ whereby we encourage Farm Credit System institutions to fully utilize the authorities that Congress granted them so that they may better serve the needs of all agricultural producers and the rural communities they live in. (*Farm Credit Administration Press Release*, 03/22/05)

Farm Credit Administration considers “tightening rules” to make purchase of members more difficult

- Following the failed merger of Farm Credit Services of America with Dutch lender Rabobank, the Farm Credit Administration is considering rewriting rules that would have allowed FCSA to withdraw from the Farm Credit System (FCS). Supporters of the FCS are lobbying Congress to ban sales of lending cooperatives to private companies. When Rabobank proposed purchasing FCSA last summer, “a lot of us were surprised ...you could buy a piece of the farm credit system,” said Representative Tom Osborne (R-NE), a member of the House Agriculture Committee. Given taxpayers’ backing of the system, including a bailout during the farm crisis of the 1980s, he could “see the logic” of trying to remove provisions that allow individual associations to leave the system, said Osborn.
- The House Agriculture Committee, which would have a key role in making any changes to the FCS, will not likely move a major farm bill authorizing agriculture programs for another year or two. Because changes to the FCS might need to be included in a larger bill, such as the farm bill, it’s unclear if either the Farm Credit Council’s plan to prevent cooperatives from leaving the system will be considered this year. Regardless, Ken Auer, CEO of the FCC, said last year’s debate over the

Rabobank-Farm Credit proposal showed that “no one really contemplated that these regulations would be utilized.” Auer said that the FCA has set a December target date to consider “tightening” regulations to make purchases harder. Meanwhile, Auer said the FCC will try to build support for an outright repeal of the rules.

- Mark Scanlan, the director of agricultural and rural policy for the Independent Community Bankers of America, said while his organization might support changing some regulations, it would fight a repeal. Preventing members from leaving the FCS “goes completely contrary to allowing farmer ownership to make its own decisions on its own future,” he said. (*Omaha World-Herald*, Lori Nitschke, 03/24/05)

Postal Service

Postal reform’s big day: April 14

- According to the Association for Postal Commerce, “April 14 promises to be a big day when it comes to postal reform. In the morning, the House Committee on Government Reform will go through the process of marking up H.R. 22, its version of a postal reform bill. In the afternoon, the Senate Committee on Homeland Security and Governmental Affairs will be holding its last pre-markup hearing on postal reform.” (*Postcom.org*, 04/08/05)

NAPUS comes to Washington to lobby for postal reform

- During the week of April 11, over 1,100 postmasters will ascend Capitol Hill to urge Congress to support “non-discriminatory” postal services for all Americans and safeguard a viable U.S. Postal Service. The effort is being promoted by the 42,000-member National Association of Postmasters of the U.S. (NAPUS). The NAPUS conference will spotlight a joint appearance by Senate Homeland Security and Governmental Affairs Chairman Susan Collins (R-ME) and House Government Reform Chairman Tom Davis (R-VA) on April 13. NAPUS President Wally Olihovik will moderate an in-depth conversation with Collins and Davis on postal reform legislation.” (*Association for Postal Commerce*, 04/08/05)

Consumer and political groups endorse specific elements of postal reform

- In an April 5 letter to the USPS Board of Governors chairman James C. Miller, 13 individuals representing consumer and political groups endorsed six elements for postal reform. The principles endorsed by the groups included financial

transparency; price stability, not flexibility; cost control; no unfair competition in non-postal markets; consolidated facilities, cost cutting efforts; and fully independent audits. The group wrote, "Above all, effective reform must benefit the American people, not just extend the Service's longevity." The letter was signed by John Berthoud, National Taxpayers Union; Merrick Carey, Lexington Institute; Charles Guy, former director of the USPS Office of Economics and Strategic Planning; Kevin Kearns, U.S. Business and Industry Council; Richard Lessner, American Conservative Union; Jim Martin, 60 Plus; Ken McEldowney, Consumer Action; Rick Merritt, PostalWatch; Chuck Muth, Citizen Outreach; Grover Norquist, Americans for Tax Reform; Tom Schatz, Citizens Against Government Waste; Michael Schuyler, Institute on the Economics of Taxation; and Don Soifer, Consumer Postal Council. (*DMNews.com*, Melissa Campanelli, 04/07/05)

The USPS files for a 5.4% rate increase with the Postal Rate Commission

- On April 7, the USPS filed a rate case with the Postal Rate Commission seeking an expedited recommended decision to raise rates and fees 5.4% for virtually all categories of mail to be implemented early next year. The expedited recommended decision would shorten the average 10-month litigation period that usually occurs in rate filings. Assuming Commission approval, the matter then goes before the Postal Governors, who are expected to make the final decision later this year.
- "No postal rate increase is ever good news for businesses and nonprofit organizations that rely on the postal service to get their messages and packages out," said Jerry Cerasale, senior vice president for government affairs at the Direct Marketing Association. "However, this is a significant reduction from the double-digit rate increase that had been previously discussed. Moreover, considering that we will have gone at least 3 1/2 years since the last rate increase, this filing represents relatively good news for all mailers."
- The USPS' filing is unique in that the decision to seek a postal rate increase is solely because of the requirement of the Postal Civil Service Retirement System Funding Reform Act of 2003 that the Postal Service establish a \$3.1 billion escrow fund. "Were we to be able to use these funds for operating expenses, there would be no rate increase until 2007," Postmaster General John E. Potter told attendees at last month's National Postal Forum. Should postal reform legislation be enacted that eliminates the escrow funding requirement, this rate case will be withdrawn, said the Postal Service. (*DMNews.com*, Melissa Campanelli, 04/08/05)

In postal reform debate, disposition of CSRS escrow account is still in limbo

- In a recent update to its members, the National Association of Postmasters of the U.S. stated, "Despite widespread support for H.R. 22 and S. 662, the White House and Congressional postal reform advocates have yet to resolve their disagreement over the

disposition of the CSRS escrow account, and the new obligation that the USPS cover the CSRS military retirement credit on behalf of its current and former employees. In addition, three issues continue to be in play as the pending legislation moves toward a committee vote – the status of “single-piece parcels,” the conditions under which postage rate increases may exceed the consumer price index (CPI), and the ability of the USPS to subject transport of international mail to competitive bidding.” (*Postwatch.com*, 04/01/05)

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