

# The **GSE** REPORT™

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## ***Major Events***

In a 65-5 vote, House Financial Services Committee passes GSE reform legislation

Bush administration says House bill lacks *essential* core principles for GSE reform

GSEs and its allies embrace H.R. 1461, as other critics voice reservations

### In a 65-5 vote, House Financial Services Committee passes GSE reform legislation

- With bipartisan support, the House Financial Services Committee passed H.R. 1461, the Federal Housing Finance Reform Act of 2005, which, the Committee reports, will tighten the regulatory oversight of Fannie Mae and Freddie Mac, but does not specifically restrict the size of the GSEs' mortgage portfolios. Committee chairman Michael Oxley (R-OH) engineered the committee's 65-5 vote by adding provisions to the bill that would raise the GSEs' conforming loan limit in high-cost metropolitan markets and require the companies to contribute 5% of their after-tax profits to a new affordable housing fund. Oxley also secured Democratic support by resisting the administration's call for placing strict limits on the GSEs' mortgage portfolios. Instead, the bill authorizes the regulator "to adjust the [GSEs'] portfolios" to increase safety and soundness or in terms of mission compliance, according to Oxley and Representative Richard Baker (R-LA).
- H.R.1461 would create the Federal Housing Finance Agency (FHFA), an independent regulator for Fannie Mae, Freddie Mac, and the FHLBs, which would be independently funded by assessments on the GSEs, occurring outside the congressional appropriations process. The FHFA would be responsible for overseeing the achievement of the GSEs' housing mission, as well for their safety and soundness. The bill would establish a five-person advisory board, consisting of the secretaries of Treasury and HUD, two presidential appointees, and the agency's director. H.R. 1461 provides the new regulatory agency's director with powers comparable to federal banking regulators in raising minimum capital requirements, taking enforcement actions, approving new business activities, and placing a financially distressed GSE in receivership, if necessary. Under H.R.1461, the FHFA would have the power to increase minimum capital and risk-based capital standards. The legislation would grant the regulator authority to adjust the portfolio holdings of the GSEs for either the purpose of increasing safety and soundness of the enterprises or fulfilling the housing mission. The regulator would have to approve both new programs and new business activities of the GSEs. Like bank regulators, the new agency could take prompt corrective actions and would have other enforcement powers. The director also may undertake a process of conservatorship or receivership, if a GSE becomes critically undercapitalized. The legislation includes a

controversial new affordable housing fund which would be created with the GSEs contributing five percent of their after-tax earnings. The bill contains corporate governance improvements, enhanced authority to hire financial experts, and a requirement that the GSEs must register at least one class of stock with the SEC. Chairman Oxley made some last minute changes to the bright line provision to distinguish primary versus secondary mortgage market activity. Oxley's revision would explicitly let the GSEs continue using their automated loan underwriting systems and would specifically designate mortgage originations as an off-limits primary market activity. The bright line revision would require the regulator to define the differences between primary and secondary activities when approving new products, and would permit the GSEs' automated underwriting programs to evolve.

- The committee debated more than 20 amendments, to H.R. 1461 before approving the following provisions by voice vote:
  - An amendment by Representative Paul E. Gillmor (R-OH) to increase disclosure of the GSEs' charitable contributions.
  - Representative Luis V. Gutierrez (D-IL) amendment that would define the term low-income area.
  - Representative Spencer Bachus (R-AL) amendment that would authorize the Comptroller General, in consultation with the federal banking agencies and the new director of the FHFA, to conduct a study of the pricing, transparency, and reporting of guarantee fees charged by the GSEs.
  - Representative Artur Davis (D-AL) amendment to require the new director to formulate standards by which mortgages are characterized as subprime for the purposes of identifying the extent to which each GSE participates in the subprime market.
  - Representative Edward R. Royce (R-CA) amendment to make the new director a member of the Federal Financial Institutions Examination Council.
  - Representative Gregory W. Meeks (D-NY) amendment to require the GSEs to review disparities in interest rates charged on mortgages for minority borrowers.
  - Representative Maxine Waters' (D-CA) amendment would prevent the distribution of subgrants to nonprofit entities.
  - Representative Rick Renzi (R-AZ) amendment to expand the definition of rural to include tribal lands in order to foster mortgage lending on sovereign lands.
  - Representative Luis V. Gutierrez (D-IL) amendment to provide safe harbor to the GSEs and their employees when reporting suspicious activities to the director of the FHFA.

- Representatives Jeb Hensarling (R-TX) and Tom Feeney (R-FL) co-sponsored an amendment requiring the new regulator to produce a comprehensive study on privatizing the housing GSE system.
- Representative Jim Gerlach (R- PA).amendment to require an affordable housing study related to long-term-care facilities.
- Representative Edward R. Royce (R-CA) amendment to strike the age limitations on Fannie Mae and Freddie Mac board members.
- During markup, Representative Scott Garrett (R-NJ) argued that the safety and soundness language in H.R. 1461 prevented the regulator from acting to downsize the GSEs' portfolios until there is a crisis and urged the committee to adopt the administration's proposal for portfolio limits. Representative Barney Frank (D-MA) defended the bill's provision by arguing that the regulator doesn't have to "sit there like a dummy" until a crisis develops. "The fact is this is a very powerful regulator. He has powers specifically to adjust the portfolios and also to raise capital," Frank said. Garrett withdrew his amendment, after Baker said that Treasury should determine a methodology and target goals for reducing the GSEs' portfolios. "Adopting [the Bush administration's] language today may be getting ahead of ourselves," Baker concluded. The administration might press for a vote on portfolio limits when H.R.1461 comes up for debate on the House floor, or they might concentrate their efforts in the Senate Banking Committee, which is expected to markup a GSE bill in June. As one mortgage lobbyist noted, "Let's face it: this whole bill can be rewritten in conference." Banking committee chairman Richard Shelby, R-Ala., supports portfolio limits but he also wants to secure Democratic support for his bill. "It remains my hope that we will be able to consider and pass a strong bill in the Senate," Sen. Shelby said last week. However, he has not yet announced a timetable for a markup.
- Representative Ed Royce (R-CA) sought to remove a provision requiring Fannie Mae and Freddie Mac to contribute 5% of their after-tax income into the GSEs Affordable Housing Fund, sponsored by Oxley as part of a manager's amendment. "This is an experiment in socialism," said Royce, characterizing the set-aside as a "slush fund" for liberal advocacy groups. "I think the focus of this legislation should be on the safety and soundness risks of the GSEs, said Royce, arguing that the establishment of the fund "takes this legislation in an entirely different direction." The ultimate effect of such a measure would direct Fannie and Freddie to "create their own quasi-governmental [HUD]," said Royce. Representative Garrett argued that the proposed set-aside is a "tax on the mortgage market." Garrett asked, "[With this tax], will we not be ...be simply putting a greater pressure on the GSEs to expand their portfolios?" Representative Feeney voiced concerns about these funds ultimately going to advocacy groups for what he calls the "poverty industry." Feeney warned, "There will not be enough regulators on the planet to watch the dollars that are going to spread out to these hungry advocacy groups if we establish this fund." Baker

supported most provisions in Oxley's amendment, but opposed the affordable housing provision. Baker said the new affordable housing fund would cost Fannie and Freddie excessive amounts--at least \$3 billion over five years—and the bill did not provide an appropriate process to disburse the money collected. This onerous “tax,” however, would be popular with legislators and mayors and would buy more political support for Fannie and Freddie. To increase the size of the AH grants, politicians would have an incentive to encourage the GSEs to keep expanding to increase their profitability. By giving the GSEs a bigger role in public-housing policy, the fund would reinforce the perception among investors that the GSEs are instruments of the federal government. Representative Mel Watt (D-NC) warned that if the provision for the 5% set-aside were removed, H.R. 1461 would lose much of its support among Democrats. “I hope we don’t destroy the balance in this bill,” Watt said. “This is an important ingredient to the passage of this bill.” After much debate, many Republicans, including Financial Services Housing Subcommittee Chairman Bob Ney, (R-OH), supported the proposed AH fund and voted with Democrats to reject Royce’s amendment on a vote of 53-17. “I think what we have done is a good thing [by preserving the AH fund],” said Ney.

- The committee also rejected by a vote of 35-35, an amendment proposed by Financial Services Capital Markets Subcommittee ranking member Paul Kanjorski (D-PA) to maintain a requirement that the boards of Fannie Mae and Freddie Mac include five members appointed by the president, and the FHLBs’ board members include six independent members appointed by their regulator. The panel also rejected Frank’s amendment, which would have created an executive board structure at the new agency, rather than advisory board with a director with executive powers. The committee also voted down an amendment which would have included the Farm Credit System in H.R. 1461 and an amendment to cut off the GSEs’ line of credit to the Treasury.
- As noted, the committee voted to let Fannie Mae and Freddie Mac to expand their reach into the jumbo market, by lifting restrictions on high-value loans in high-cost markets. Specifically, the provision would increase the size of loans that Fannie and Freddie may buy, raising the current loan limits of \$359,650 in high cost areas to the lower of 150% of the national limit or to the area’s median home-purchase price, boosting the current loan limit to well over \$500,000 in booming real estate markets like California. Critics say that this provision allows Fannie and Freddie assist wealthier borrowers at the expense of low- and moderate-income consumers. By expanding the GSEs’ conforming loan size in high cost markets, Fannie Mae and Freddie Mac have the potential to access *another* 25% of the home loan market, by some estimates, in addition to the companies’ current market share of 47%. “It’s the law of unintended consequences,” said Lawrence J. White, professor of economics at NYU’s Stern School of Business and a former bank regulator and Freddie Mac director. “Now here’s Congress expanding their powers, expanding their possibilities, rather than cutting back.” Brian Gardner, vice president at Keefe, Bruyette & Woods, said, “[The increase in conforming loan limits in high cost markets] may be the most substantial piece of the legislation—and very few people

are talking about it. It has implications beyond just the GSEs—we need to see what the ripple effect will be.”

- The House vote on H.R. 1461 illustrates Congress’ reluctance to make major changes in the corporate structure of Fannie Mae and Freddie Mac, heeding the GSEs’ supporters warnings that slashing the size of companies would risk hurting the housing market. Under the provisions of H.R. 1461, the House Financial Services Committee not only left in place the GSEs’ hedge fund business model, but also expanded the companies’ market reach by increasing the GSEs’ conforming loan limits in high cost markets. The five committee members who voted against H.R. 1461 were Representatives Ed Royce (R-CA), Tom Feeney (R-FL), Scott Garrett (R-NJ), Jeb Hensarling (R-TX) and Ron Paul (R-TX). (*House Financial Services Press Release*, 05/25/05; *American Banker*, Rob Blackwell and Michelle Heller, 05/26/05; *Bureau of National Affairs*, Richard Cowden, 05/26/05; *American Banker*, Rob Blackwell, 05/27/05; *CQ Today*, Michael R. Crittenden, 05/26/05; *Wall Street Journal*, Dawn Kopecki and James R. Hagerty, 05/26/05; *Washington Post*, Annys Shin, 05/26/05; *Associated Press*, Marcy Gordon, 05/25/05; *Wall Street Journal*, James R. Hagerty, 05/27/05; *CongressDaily/A.M.*, Molly M. Peterson, 05/26/05; *National Mortgage News*, Brian Collins, 05/30/05; *Dow Jones Newswires*, Dawn Kopecki, 05/26/05; *FDCH Political Transcripts*, House Financial Services Committee, 05/25/05)

#### Bush administration says House bill lacks essential “core principles” for GSE reform

- Following the House Financial Services passage of H.R. 1461, Bush administration officials said the legislation lacks several measures “essential” to reforming the regulation of GSEs. “[H.R. 1461] fails to include key provisions the administration considers essential to protect the safety and soundness of the housing finance system,” said White House spokesman Trent Duffy. The bill doesn’t give the new GSE regulator enough authority to adjust their capital levels and falls short on the powers needed to review and approve the GSEs’ new and existing projects, said Duffy. Moreover, the legislation also doesn’t address the administration’s concern that Fannie’s and Freddie’s mortgage portfolios carry too much concentrated interest rate and credit risk and need to be cut, he added. “We remain committed to bring regulatory and market discipline to bear on the housing GSEs. And we stand ready and look forward to working closely with the Congress to ensure fundamental reform prevails,” said Duffy. The legislation also must ensure that the GSEs’ ability to meet their annual affordable housing goals remains a top priority, Duffy added. “The administration believes the GSEs’ mission should be focused on expanding housing opportunities for low- and moderate-income Americans.”
- U.S. Treasury Secretary John W. Snow said that the bill passed by a House Financial Services Committee “needs to be strengthened in several material respects” to bring it in line with White House policy. Snow said, “[A]ction by the House Financial Services Committee on GSE reform legislation moves the process forward. As the

process continues, we will be working with the House and Senate to ensure that the bill is strengthened so that the final product provides for a strong, independent regulator which has all the necessary tools to do the job. Directing the regulator to place limits on the size of the GSE's retained mortgage portfolio is a critical element of reform."

- HUD secretary Alphonso Jackson said, "The administration is concerned that some core principles, essential to ensuring the GSEs fully carry out the mission granted to them by Congress of promoting affordable housing and homeownership, have not been included [in H.R. 1461]...I will continue to monitor progress as the legislative process moves forward to ensure that the GSEs' housing mission is focused on expanding housing opportunities to low- and moderate-income Americans." In a subsequent speech to real estate journalists, Jackson reiterated the shortcomings of H.R. 1461. "The House Financial Services Committee failed to include some core principles that we believe are essential to that bill, and let me stress essential," he said. "Congress must ensure that the [GSEs'] portfolios don't place the financial system at risk." (*Dow Jones Newswires*, Dawn Kopecki, 05/25/05; *Reuters*, 05/25/05; *Dow Jones Newswires*, Dawn Kopecki, 05/25/05; *Reuters*, 05/27/05; *Dow Jones Newswires*, Dawn Kopecki, 05/26/05; *Reuters News*, 06/02/05)

#### GSEs and their allies embrace H.R. 1461, as other critics voice reservations

- Fannie Mae senior vice president Chuck Greener said, "The legislation passed by the House Financial Services Committee today, under the leadership of Chairman Oxley, Subcommittee Chair Baker, and Ranking Members Frank and Kanjorski, is a significant step forward in the process of strengthening the safety and soundness oversight of our company and the GSEs. While work remains to be done, we are committed to working cooperatively and constructively with members on both sides of the aisle as the legislation continues to progress through the House and Senate, and we are hopeful a bill will be signed into law this year." (*Bureau of National Affairs*, Richard Cowden, 05/26/05)
- According to the *Wall Street Journal*, "Some Fannie Mae and Freddie Mac loyalists - not company officials or spokespersons, of course - are crowing about how the empire has struck back and how the threat of onerous regulation, including meaningful portfolio limits, was strangled in the crib. Other descriptions of the House committee's bill from the off-stage chorus include regulation-lite, harmless and benign. The official company lines, by contrast, feature such phrases as 'a significant step forward' and 'a tough bill.'" (*Wall Street Journal*, John Connor, 05/26/05)
- Jerry Howard, EVP and CEO of the National Association of Homebuilders said, "Chairman Michael Oxley (R-OH), Ranking Member Barney Frank (D-MA) and GSE Subcommittee Chairman Richard Baker (R-LA.) have worked diligently to craft a bill that would reform the [GSEs]... However, there are still a number of provisions of this bill we find troublesome. We recognize that various competing constituencies

had to be served and the legislation that emerged yesterday from the House panel represents a good starting point as the debate moves forward. It is tough legislation that, on balance, contains several elements that will strengthen GSE regulation, maintain confidence in the nation's housing finance system and enable the housing finance entities to successfully fulfill their congressional mandate to provide low-cost and readily available housing credit to consumers."

- The Mortgage Bankers Association (MBA) commended Chairman Michael Oxley (R-OH) and the House Financial Services Committee for advancing legislation that creates a new, world class regulator to oversee the activities of the housing GSEs. "MBA is pleased that the committee understands the need to provide clarity to the GSEs' charter," said Kurt Pfotenhauer, SVP of government affairs at MBA. "Compromises made by the parties involved have produced what we believe is a solid bill, and we applaud Chairman Oxley and Congressman Baker for their leadership on this legislation." (*Mortgage Bankers Association Press Release, 05/26/05*)
- In a press release, the Financial Services Roundtable (FRS) and its Housing Policy Council (HPC) applauded the successful reporting out of H.R. 1461 from the House Financial Services Committee. "We were pleased that the Committee passed this much needed legislation which contains the core principles for effective GSE Reform that the Roundtable and Housing Policy Council have advocated," said John Dalton, President of the HPC. "The bill would create a new, strong, independent regulator for Fannie Mae and Freddie Mac with oversight and enforcement authority similar to the major federal banking regulators." (*Financial Services Roundtable Press Release, 05/25/05*)
- The House Financial Services Committee's toning-down of a so-called bright-line provision in H.R. 1461 has drawn mixed reactions from stakeholders who had opposed the original language. "The changes were helpful, but we'd like to see maybe a different approach or further improvements," said Steve Verdier, SVP and director of congressional relations at the Independent Community Bankers of America. "But it's too early to say what tactics one might pursue to make those improvements," Verdier added. John Taylor, president of the National Community Reinvestment Coalition (NCRC), said that while the original bright-line language could have barred many products and activities that are important to Fannie Mae's and Freddie Mac's affordable housing mission, the modified bright-line provisions are a reasonable compromise. Taylor said the NCRC is urging Senate Banking Chairman Richard Shelby (R-AL) to incorporate similar "middle ground" language into the Senate's GSE bill. (*CongressDaily/P.M., 05/27/05*)
- The Council for Citizens Against Government Waste (CCAGW) reacted "unenthusiastically" to the markup of a manager's amendment to a bill to reform the nation's housing government-sponsored enterprises (GSEs). "The Federal Housing Finance Reform Act of 2005 (H.R. 1461) ...is now encumbered with amendments that have weakened the bill and could create new dangers for taxpayers," said CCAGW. "The House bill was insufficient to begin with," CCAGW President Tom

Schatz said. “CCAGW held out hope that the members of the House Financial Services Committee would enhance and strengthen it before it went to the floor for a vote. One would think that accounting scandals and investigations at both GSEs would convince representatives to protect taxpayers from a potentially massive GSE bailout. Instead, it appears that members of the House have succumbed to the pressure of Fannie, Freddie, and their lobbying allies to *dumb the bill down until it is virtually meaningless*. While the White House has held out hope the House bill can be improved, taxpayers will likely have to look to the Senate for any hope of real GSE reform.”

- In a letter to the panel, CCAGW had urged the House Financial Services Committee to make improvements to H.R. 1461 in six critical areas:
  - **Effective date of legislation.** *The bill creates a one-year gap during which the GSEs will not be subject to safety and soundness supervision.* H.R. 1461 winds down OFHEO and the Federal Housing Finance Board during the first year after enactment, but establishes the new regulator with an effective date only one year after enactment. (S. 190 does not have this unnecessary gap).
  - **GSE Expansion.** H.R. 1461 raises the conforming loan limits in high cost markets to \$540,000. CCAGW writes, “It is unconscionable for the House to confer taxpayer subsidies on the wealthiest of America’s homebuyers, especially in view of the fact that Fannie Mae and Freddie Mac have consistently failed to satisfy their congressional mandates to help their target population, low and middle-income families. GSE subsidies are not needed for rich homeowners in half-million dollar houses, even in high-cost areas. Furthermore, it should be noted that Freddie Mac has not filed financial statements in three years and Fannie Mae may not be able to file financial statements for years to come due to its ongoing accounting scandal. It is patently unwise to expand their market share when neither will file financial statements, and the amount of reported fraud, not bookkeeping or accounting errors, is actually escalating.”
  - **Portfolio Restrictions.** H.R. 1461 does not adopt the Treasury Department’s language giving the regulator the authority to limit GSE portfolios. CCAGW writes, “Federal Reserve Chairman Alan Greenspan has made a strong case that this provision is *essential* to protect the financial system against systemic risk from the GSEs’ activities. Because the GSEs could continue to securitize virtually unlimited numbers of mortgages, the housing market would be unaffected by this change.”
  - **New Program Approval.** H.R. 1461 grandfathers all GSE mortgage activities until 2006 and does not allow the new regulator to exercise prior approval authority over GSE activities, except in limited circumstances with respect to mortgage “programs”. CCAGW notes that the new GSE regulator is likely to have difficulty exercising his authority under this bill to disapprove new activities,

- once the GSEs have entered the new lines of business with the usual large scale of their operations.
- **Capital Requirements.** H.R. 1461 bill does not authorize the GSE regulator to adjust minimum capital requirements according to the circumstances of the enterprise. CCAGW writes, “This authority, available to the federal bank regulators, is needed in cases such as the present, when an enterprise has lost its internal controls. The lack of this provision could well undo the current cease-and-desist authority that OFHEO reached with Freddie Mac and the negotiated agreement that OFHEO reached with Fannie Mae to add a capital surcharge to reflect the increased risk of the two enterprises. In that sense, the new bill is weaker than current law.”
  - **Enforcement Powers.** CCAGW notes that the enforcement powers of the GSE regulator are undercut by weak language. CCAGW writes, “For example, the bill does not expressly allow the new regulator to use cease-and-desist authority to enforce an order against the enterprises. This makes many of the provisions of the bill difficult or impossible to enforce effectively. The bill also lacks authority for the regulator to issue or enforce directives to assure that the enterprises adhere to their required capital standards. This is a significant shortcoming compared to the authority of federal bank regulators.”
  - In his letter to the House Financial Services Committee, Schatz wrote, “Taken together, the chairman’s mark amounts to a retrenchment compared to current law. The enterprises would be able to expand market share and in return would be subject to weaker regulation than bank regulation. In addition, the bill fails to protect the financial system and the taxpayers against systemic risk as is urgently needed.”
  - In a May 31<sup>st</sup> editorial, the *Charleston Gazette* wrote, “In April, Federal Reserve Chairman Alan Greenspan warned that two strange creatures, Fannie Mae and Freddie Mac, pose significant risks to the nation’s financial system and urged that they be restricted in size. Give President Bush credit. He tried. But last week, politics won out over caution, and a House committee passed a bill that rather than reduce the holdings of these government-sponsored enterprises, would actually allow them to expand.
  - “The number of people who have a perfect understanding of what Fannie Mae and Freddie Mac do can be counted on the fingers of one hand, but the bottom line is that if they get in trouble, taxpayers would be expected to save them. That would be a very large task. The mortgage finance companies are the nation’s largest buyers of home mortgages, with \$1.5 trillion in holdings. That’s nearly a fifth of the residential mortgage debt in the United States. ...Greenspan urged that the companies’ holdings be reduced over time to a fraction of the current \$1.5 billion. That would have the effect of limiting taxpayers’ exposure in case of trouble. But the House Financial Services Committee rejected that approach. It opted instead to create a stronger regulator of the two companies, but also allowed them to buy larger mortgage loans

in high-cost states like California. Housing industry, 1, taxpayers, 0. Let's hope taxpayers get more consideration from the Senate Banking Committee. If the famously understated Greenspan is concerned, taxpayers should be, too." (*Charleston Gazette*, 05/31/05)

- Richard Nacht wrote on *The Mortgages Weblog*, "The House Financial Services Committee has approved a bill that would establish a new independent regulator to oversee Fannie, Freddie and the [FHLBs]. Features include an increase in conforming limits in high cost markets, required contributions to an affordable housing fund, a lack of authority by the regulator to reduce the size of Fannie and Freddie's portfolios and no restrictions on their AU systems. *And we thought the GSEs had lost some capital hill mojo with the absences of Raines and Brendsel.*" (*The Mortgages Weblog*, Richard Nacht, 05/27/05)
- Fannie Mae's and Freddie Mac's stock posted solid gains the day following the House Financial Services Committee vote to strengthen the GSEs' regulatory oversight. "Though much work remains, we see this as a step in the right direction, and see any reasonable resolution as a positive catalyst," wrote Citigroup Inc.'s Smith Barney analyst Matthew L. Vetto in a research note. Fannie's shares rose 4.1% and Freddie's 2.3%, while the *American Banker* index of 225 banking stocks was up 0.87% and the S&P 500 rose 0.64%. (*American Banker*, Jim Cole, 05/27/05)

Fannie Mae selects interim CEO Mudd as its president and CEO
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- On June 1, Fannie Mae's board of directors voted unanimously to name Daniel H. Mudd as President and Chief Executive Officer of the company, effective immediately. Mudd has been serving as Fannie Mae's interim CEO since the board named him to the position on December 21, 2004, following the retirement of Franklin D. Raines, as the company's chairman and CEO. In its announcement, Fannie Mae also affirmed that Stephen B. Ashley will continue in his role as Chairman of the Board.
- "I am pleased to announce that the Board of Directors has unanimously selected Dan Mudd to lead Fannie Mae as the company's next Chief Executive Officer," said Stephen B. Ashley. "Over the past six months, he has demonstrated an ability to lead a large financial institution through a major and challenging transition, including the ability to reach out and rebuild confidence with our regulators, Congress, customers, housing partners, shareholders and many stakeholders. After an extensive, nationwide search, and careful and deliberate consideration, the Board recognized that the CEO we wanted was the interim CEO we had. We believed that the person most qualified to transform Fannie Mae for the future was the individual who had been leading the transformation and change over the past six months." Prior to joining Fannie Mae, Mudd, 46, was President and Chief Executive Officer of GE Capital, Japan. He is the son of veteran journalist Roger Mudd.

- Stephen Blumenthal, acting director of the OFHEO congratulated Fannie Mae on its hiring of Mudd, saying he “has played a key role in the transformation of Fannie Mae and I look forward to continuing the development of a strong, constructive relationship between Fannie Mae and OFHEO.”
- While the appointment of Mudd was praised by some on Capitol Hill, some congressional staff, analysts and lobbyists for financial services companies questioned Fannie Mae’s choice of an insider, who was present during the time the company was employing questionable accounting practices. “He is part of the problem, and therefore not part of the solution,” said Bert Ely, Alexandria, VA consultant and long-time Fannie Mae critic, who called Mudd’s appointment “at the least, incredibly, naively impolitic,” and “at worst, it represents the height of political arrogance that may come back to haunt Fannie, and Freddie, too,” as Congress works on GSE regulatory reform legislation. Others questioned whether Fannie Mae was unable to find a heavyweight from outsider to serve as CEO, due to the company’s accounting scandal and the pending legislative debate over the GSE’s future. “It’s not just a company that’s been going through some tough times,” said one Republican staff member in the Senate. “No, this is Congress, this is politics, and who are the consummate politicians who can come in and make this happen? It’s a smaller field.”
- Other industry observers said Mudd’s hiring signaled some return to normalcy at Fannie Mae. Some of the company’s “bulls” described the choice of Mudd as reasonable, if perhaps not a shot in the arm. “There may have been some expectation that they would bring in a wunderkind, but Mudd certainly has had his feet to the fire during the past few months and made pretty good progress,” said David Dreman of Dreman Value Management. Mudd’s appointment could also mean that Fannie Mae will speak with greater authority as it heads into the crucial weeks ahead, when the Senate Banking Committee marks up GSE reform legislation later this month. “It could help because it resolves an open question as to who will be leading Fannie Mae going forward,” said Karen Thomas, director of government relations for Independent Community Bankers of America. “It removes an unknown and that could help the legislative process in that respect.”
- In an interview with *Reuters*, Ashley said Mudd was the best choice, and not the only one. “In the short-term perspective, it might have been easier to announce an outside candidate, but that wouldn’t have been right decision for the company,” he added. According to sources close to the company’s search for a new chief executive, Fannie Mae also considered hiring former New York Federal Reserve President William McDonough, former CEO of insurer Conseco William Shea, former Senator Phil Gramm (R-TX), and David Coulter, vice chairman of J.P. Morgan & Chase Co. (*Fannie Mae Press Release*, 06/01/05, *Reuters*, 06/01/05; *Dow Jones Newswires*, John Connor, 06/01/05; *Financial Times*, Richard Beales and Stephen Schurr, 06/01/05; *BNA’s Daily Report for Executives*, Richard Cowden, 06/02/05; *OFHEO Press Release*, 06/01/05; *Bloomberg News*, James Tyson, 06/01/05)

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

All eyes turn to the Senate, as the Banking Committee turns to GSE regulatory reform

- Despite the House Financial Services Committee's bipartisan vote for H.R. 1461, the bill's chances are uncertain in the Senate, where the Bush administration is expected to push for restrictions crackdown on the GSEs' mortgage portfolios. Senate Banking Committee Chairman Richard Shelby (R-AL) would not comment on how his bill would address that key issue. "We think our bill ... will address a lot of the concerns of everybody regarding the GSEs," Shelby told reporters. "We hope to be ready when we're ready. We don't think it will be too long. We'll certainly thoroughly examine what the House does," he said. H.R. 1461 is expected to go to the full House for a vote soon. The Senate Banking Committee plans to work on its GSE regulatory reform bill in June and expected to markup a bill late in the month. A full House vote could come this summer in the House; final passage is not expected before fall in the Senate.
- A number of issues that H.R. 1461 was designed to address remain unresolved with debate likely to become contentious as its moves through the House and Senate. The Bush administration will be pushing Congress to include stricter language in the legislation, restricting Fannie Mae's and Freddie Mac's investments—a reform the administration views as critical to protect the safety and soundness of the U.S. financial system. Another contentious feature of H.R. 1461 is its provision requiring Fannie and Freddie to set aside 5% of its after-tax profits to promote low-income housing, which many see as a "slush fund" for liberal advocacy groups. Finally, the House Financial Services Committee vote did not resolve the lingering debate over whether the new GSE regulator should define the kinds of businesses that Fannie and Freddie should engage in. The GSEs' competitors argue that the regulator should draw a "bright line" between what the GSEs can and cannot do.
- One outside variable that many analysts anticipate will impact the Congressional debate over GSE regulatory reform is the pending release of Fannie Mae's internal investigation, being conducted by former Senator Warren Rudman (R-NH). Some say that new revelations of mismanagement at Fannie Mae disclosed in Rudman's report could turn the political tide against the GSEs and build support for the White House's more restrictive legislative provisions. In an interview with *Dow Jones Newswires*, Fannie Mae's chairman Ashley said that Rudman's review of Fannie Mae's operations is a work in progress that will probably spill over into the fall.
- Opinions on the prospects for GSE regulatory reform are varied. On the one hand, key lobbyists for housing groups believe that some version of H.R. 1461 will reach the White House by year-end. But, Kurt Pfothauer, top lobbyist for the Mortgage Bankers Association, said the Administration is now indicating it can clamp down on Fannie Mae and Freddie Mac by regulatory fiat if Congress doesn't take a tougher

stance. The administration's "body language" says "we don't need a bill," Pfothenauer added. (*Washington Post*, Annys Shin, 05/27/05; *National Mortgage News Online*, 06/03/05; *Dow Jones Capital Markets*, John Connor, 06/02/05)

Fannie and Freddie "reform" their lobbying practices, relying heavily on their allies

- In the past, Fannie Mae and Freddie Mac were known on Capital Hill as the "800-pound gorillas," according to Representative Paul E. Kanjorski (D-PA), who hired a combined 88 K Street lobbying firms between 1998 and 2004 and employed about a dozen in-house lobbyists. According to Senate Office of Public Records, Fannie and Freddie spent a combined \$109 million on lobbying over the 1998-2004 period and gave a combined \$13.3 million in individual, PAC, and soft money donations, according to the Center for Responsive Politics. Through the GSEs' philanthropic organizations, the companies built ancillary advocacy machines, through the Fannie Mae Foundation's disbursements of \$153 million in grants and the Freddie Mac Foundation's disbursement of \$64.9 million from the 2000 to 2003. As one Congressional staffer put it, "Fannie Mae and Freddie Mac have the best friends that money can buy."
- In the wake of their accounting scandals, Fannie Mae and Freddie Mac have replaced their bullying tactics with an eagerness to listen and to make its executives accessible. Fannie Mae has reduced its army of lobbyists by a third and has instructed them not to swarm the Capitol as it once did. Fannie no longer targets lawmakers with "acid-toned" television commercials touting the American Dream, but instead has turned to the housing industry to protect the GSEs' interests. Both Fannie Mae and Freddie Mac have adopted a strategy of "staying below the radar" as the GSEs' primary lobbying tactic and striking a more conciliatory tone with Capital Hill.
- In the GSEs' place, the National Association of Home Builders (NAHB) and the National Association of Realtors (NAR) have taken up the charge of protecting the GSEs' from regulatory constraints that might adversely impact the growth of the housing market. Both groups are worried that a Congressional crackdown on the GSEs will stall the housing boom. In 2004, NAHB played a key role in scuttling Congressional efforts to pass GSE regulatory reform. During the 2004 election cycle, NAHB's PAC distributed \$2.2 million to federal candidates—approximately 66% to Republican candidates and 33% to Democratic candidates—and spent \$1.34 million in lobbying fees in 2003. NAR also came to the rescue for Fannie and Freddie, contributing \$3.8 million to their PAC in the 2004 election cycle (with 52% going to Republican candidates and 48% to Democratic candidates) and spending \$14 million on lobbying in Washington in 2004. NAR president Al Mansell said, "We'll call out the dogs," if their group sees legislation that poses a threat to the real estate market. When the White House pushed for a provision to limit the GSEs' portfolios, NAHB, NAR, the National Low Income Housing Coalition and the Independent Community Bankers Association all mobilized to lobby against the administration's proposal. In

a sign of how much things have changed, Fannie Mae had no comment on the proposal.

- Apparently, NAR’s lobbying efforts caused some consternation for some House Republican members. Before the panel’s vote on H.R. 1461, House Financial Services Committee Chairman Michael G. Oxley told GOP colleagues in a letter that he had “been informed by committee members that certain industry representatives have misrepresented my position on key provisions of the bill in recent days. Some members have been told that I ‘released’ Republican members to vote to weaken safety and soundness protections in the bill,” Oxley wrote. “In addition, late last week the [NAR] spread the rumor that I had decided to cancel ...markup, when in fact I have never entertained such a notion.” A day later Oxley introduced a bill, along with Representative Barney Frank (D-MA), that would let banking companies enter the real estate brokerage and property management businesses. Most industry observers said they believed the normally mild-mannered Oxley was just fed up with the Realtors and wanted to send them a message. (*National Journal*, Bara Vaida, 05/27/05; *The Washington Post*, Jeff H. Birnbaum, 05/23/05; *American Banker*, Rob Blackwell and Michelle Heller, 05/26/05; *American Banker*, Rob Blackwell, 05/31/05)

The debate over GSEs’ 5% set-aside begins
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- Now that the House Financial Services Committee has passed H.R. 1461 with a provision for the 5% set-aside of the GSEs’ profits in a special fund for affordable housing, the public campaign for this provision has begun. In the *Washington Post*, David Broder wrote an article entitled “Affordable Housing Hope.” In this article, Broder called the GSE set-aside “the silver lining in this financial scandal cloud,” which will provide families that are ‘locked out of decent shelter by the shortage of affordable housing.’ Noting that it has been 10 years since the federal government has put any substantial sums into building affordable housing, “a glimmer of hope appeared from an unexpected source...—a bipartisan bill from the Financial Services Committee.” (*Washington Post*, David Broder, 06/01/05)
- In a May 28th editorial, the *Daytona Beach News* wrote, “[H.R. 1461] includes an important provision that would shift 5 percent of the two companies’ after-tax profits to an affordable-housing fund, an increasing necessity in a market where the median price of existing homes has topped \$200,000 for the first time. The goal is to keep Freddie Mac and Fannie Mae true to their mission of encouraging homeownership affordably. The mission is worth preserving, not constraining.” (*Daytona Beach News*, 05/28/05)
- In the *American Banker*, Elisabeth Goodridge wrote an article titled “FHLBs Now Sing Praise of Housing Set-Asides,” in which she writes, “To listen to FHLB executives discuss affordable housing program now, it would be easy to think that they always supported it.” Alex Pollock, resident fellow at AEI points out that the

FHLB program's structure insulated it from criticism and ensured its success. "It's a bottom-up program, not a top-down program," Pollock said. "These things start off with a partnership between the member bank and the non-profit. There's not some committee in Washington telling people what to do."

- During a conference call with investors, Fannie Mae president and CEO Daniel Mudd indicated that his company does not want to see its affordable housing initiatives turned into a grants program where its investments are not repaid and it cannot earn a profit. "Our basic view is that the greater extent to which the fund utilizes the mechanisms that Fannie Mae has developed (which are basically invest money, monitor the use of the investment and get paid back over time) is a better use of Fannie Mae -- than to ask Fannie Mae to do something that Fannie Mae is not in the business of doing, such as grant making," said Mudd. (*National Mortgage News Online*, 06/03/05)
- It's always helpful to remember that "interest groups advocating ...reform want to expand their activities while pushing the tab onto taxpayers [or, in the case of the set-aside, the mortgage market]." (*The Weekly Standard*, Jay Weiser, 06/06/05)

#### Bush administration watch

- SEC chairman William Donaldson has submitted his resignation effective June 30. President Bush has nominated Representative Christopher Cox, (R-CA), as the next chairman of the SEC. Cox, 52, has been considered an ally of business groups, helping to rewrite securities laws to make investor lawsuits more difficult to file and waging efforts in Congress to repeal the estate tax, the capital gains tax on savings and investment, and taxes on dividends. (*CNN/Money*, 06/02/05)
- Gregory Zerzan, the Treasury Department's acting assistant for financial institutions and point man in the administration's efforts to tighten regulation of Fannie Mae and Freddie Mac, is resigning effective June 20. Zerzan is leaving to return to his native Oregon. The Bush administration has not yet named Zerzan's successor. (*Reuters News*, 05/27/05; *Dow Jones Newswires*, Campion Walsh, 05/27/05)

#### Handicapping the race for chairman of the House Financial Services Committee

- With Representative Michael Oxley's six year term as chair of the House Financial Services Committee set to expire in January 2007, "there's a lot of jockeying" behind the scenes to be his successor, said Robert Rusbuldt, chief executive of the Independent Insurance Agents and Brokers of America and personal friend of Oxley's. "Everyone knows it. It's not a state secret, but anyone who is trying to predict the winner is either making it up or it is wistful thinking," Rusbuldt added.

Representatives Richard Baker (R-LA), Deborah Pryce (R-OH), Spencer Bachus (R-AL) and Bob Ney (R-OH) are expected to make a bid for the position.

- Baker, 57, is first in line for the post, because of his seniority, and is considered by most to be the leading candidate. Sources close to leadership say Baker is not guaranteed to get the nod, because he is not as prolific a fundraiser as other contenders, who are seen more as team players than he is. Baker's supporters praise him for championing issues that he believes in—such as GSE regulatory reform—and sticking with them, even if they are politically unpopular.
- Most observers believe that Baker's main challenger would be Pryce, who began positioning herself for a possible run for committee chair in January, when she left the powerful Rules Committee to join the House Financial Services Committee. From 1993 to 1995, Pryce sat on the former House Banking Committee and retained her seniority; she now ranks just behind Baker on the panel. Given Pryce's position in House leadership as its fourth-ranking member and her close relationship with House Speaker Denny Hastert (R-IL), some believe that chairmanship is hers, if Pryce wants it. When her spokesman was asked if Pryce was interested in the committee chairmanship, he responded, "This is nothing more than a rumor. She has no interest at this point in making any moves from where she is right now. She is very happy serving in House leadership."
- Another contender for the chairmanship is Bachus, 57, the fifth ranking Republican on the panel, who chairs the financial services subcommittee. Bachus is well-liked and has proven to be an effective fundraiser for the Republican Party.
- Ney, 50, is considered to be the "longest shot" for the chairmanship with an outside chance at the post, ranking 10<sup>th</sup> on the seniority ladder. The "wild card" for the post is Representative Dreier (R-CA), a 52 year-old longtime House member and former real estate developer. Having served on the House Banking Committee from 1981 to 1990, Dreier has retained his seniority and would rank ahead of Baker, if he rejoined the committee. His spokeswoman wouldn't comment on Dreier's plans beyond 2006, saying "He's focused on his job right now as chairman of the Rules Committee."
- Some view the GSE regulatory reform battle as the "ultimate proxy" for the race for the chairmanship. By unveiling a substantially toned down bill from his earlier proposals, Baker demonstrated an ability to compromise and work with other members of the committee, characteristics that the party leadership look for in selecting panel chairmen. "[Baker] was demonstrating that he could behave like a committee chairman, stepping out of his usual role of trying to get attention on an issue that's nowhere near anyone else's radar screen," said an unnamed lobbyist.
- Speculation over Oxley's future plans covers the gamut. Some believe Oxley leave Congress and become a lobbyist, while others think he will seek a 14<sup>th</sup> term in Congress. (*American Banker*, Michele Heller, 06/02/05)

Federal Reserve recommends that sellers of interest-rate options test their ability to withstand the possible failure of Fannie Mae or Freddie Mac

- In a recent report, the Federal Reserve recommended that banks and other sellers of interest-rate options conduct tests of their ability to withstand shocks, including the possible failure of mortgage companies Fannie Mae and Freddie Mac. “If a GSE failed, its counterparties would need to sell huge volumes of options (individually and especially in aggregate) and receive fixed rates on a very large volume of swaps,” the Fed report said. “Other things equal, these actions by dealers would send options prices and swap spreads tumbling.” Concurrently, a GSE failure would also make investors more risk averse, placing “considerable upward pressure on options prices and swap spreads,” the report said. “The net effect of these forces is not clear.” The Fed recommends that market participants “make more of an effort to think about counterparty risk and market risk in an integrated way when evaluating counterparty credit exposures to large players.” (Bloomberg News, AL Yoon and Karen Brettell, 05/24/05)

In an analysis of the GSE business model, the Congressional Research Service note areas of concern: safety and soundness, utility, and accountability

- In an analysis of quasi government organizations, the Congressional Research Service writes, “Defenders of the current GSEs and the economic concepts upon which they are based argue that GSEs continue to meet a national need that would not otherwise be met or be met poorly by corporations fully in the private sector. Further, they contend that the current GSEs are well managed, financially sound, and assist less advantaged mortgage borrowers. They maintain that the subsidy retained from the presence of the federal implied guarantee of GSE obligations is passed on to the consumer in the form of lower mortgage rates.”
- “...The economic rationale for GSEs is the belief that without such a government sponsored institution, a critical area of necessary debt financing would go unserved, or would be serviced at an expensive or inefficient level. Government, according to this rationale, should use some of its sovereign powers (e.g., full faith and credit of the U.S. Treasury) to encourage the development of private financial intermediaries to serve selected markets. In terms of meeting their original congressional objective, that was to liquify the mortgage credit markets on a national rather than regional or state basis, the GSEs have been remarkably successful. But with this success have come reservations and questions.”
- “There is nothing modest about the size and scope of GSEs. Due to the implicit federal backing for their notes, GSEs have become some of the largest financial institutions in the United States. The combined debt outstanding of Fannie Mae and Freddie Mac is approximately \$1.4 trillion. The [FHLB] System has \$710 billion in

consolidated debt outstanding. Implicit or market-inferred federal backing helps GSEs to grow rapidly. On the average, the combined size of the Fannie Mae and Freddie Mac has more than doubled every five years between 1968 and 2002.”

- “Two issues stand out when discussing the finances of GSEs; safety and soundness, and the utility and accountability resulting from their status as a government instrumentality. GSEs primarily act as financial intermediaries to assist borrowers in housing, education, and agriculture. Although they are privately owned, they benefit financially from government sponsorship. Their securities can collateralize public deposits (e.g., Social Security Administration deposits), and can be held in unlimited amounts by most banks and thrifts. They are not subject, with one exception (Farmer Mac), to Securities and Exchange Commission (SEC) registration, and their corporate earnings are exempt from state and local income taxes, the latter practice attracting particular controversy. They may borrow virtually unlimited amounts of money in the federal agency credit market on favorable terms and up to \$2.25 billion from the Treasury, at the latter’s discretion. Most importantly, the credit market perceives that this federal sponsorship results in an implied federal guarantee of their corporate debt and obligations. These factors enable GSEs to borrow monies at a significantly lower interest rate than competitors. Reviewing these special privileges (subsidies), it is not surprising that some argue that GSEs grow rapidly at the expense of would-be competitors.”
- “...Primary accountability of GSE management is not to the federal government, or to the borrowers, but to the corporation’s shareholders. Investors come first. As Sallie Mae’s then-Chief Executive Officer told a Senate oversight subcommittee some years ago: ‘We are a private corporation and as such, with stockholders and bondholders, we have a fiduciary responsibility to those individuals .... We are not charged with subsidizing the guaranteed student loan program or subsidizing the students.’ The accountability issue for GSEs, and for much of the quasi government, involves the allocation of benefits and risks between private parties and the federal government and taxpayer. One observer, Harold Seidman, has remarked: ‘Intermingling of public and private purposes in a profit making corporation almost inevitably means subordination of public responsibilities to corporate goals. We run the danger of creating a system in which we privatize profits and socialize losses.’ Supporters would respond to this assertion by contending whatever profits they make are ultimately returned to benefit the public through lower mortgage rates.”  
(Congressional Research Service, *CRS Report for Congress: The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics*, 05/18/05)

Issuance of long-term federal agency debt down 43.5% in first quarter 2005
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- Issuance of long-term debt by federal agencies totaled \$186.5 billion in the first quarter of 2005, 43.5% lower than the \$330.5 billion issued in the first quarter of 2004. [Totals exclude issues by Sallie Mae, which completed its privatization in

December 2004]. During the first quarter, Freddie Mac issued \$26.6 billion in long-term debt, down 71% from the first quarter of 2004. Fannie Mae issued \$57.8 billion in long-term debt (down 38%), while the FHLBs issued \$90.8 billion (down 32%) during the first quarter.

- The federal agencies' short-term debt issuance was down 8.0% for the first quarter to \$625.8 billion, from \$680.6 billion issued in the first quarter of 2004. The Farm Credit System issued \$9.9 billion of short-term debt for a 15.4% decline from the first quarter of 2004. The FHLBs issued \$144 billion in short term debt (down 14.4% from the first quarter 2004) and Fannie Mae issues \$283.3 billion (down 10.8%) in short-term debt. Freddie Mac reported \$186.6 billion in short-term borrowings, a 3% increase in borrowings compared to the first quarter of 2004. (*The Bond Market Association Research Quarterly*, May 2005)

OFHEO house price index shows 12.5% increase over past 12 months
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- OFHEO reported that average U.S. home prices increased 12.5% for the 12 months ending March 31, 2005. Appreciation for the first quarter of 2005 was 2.21%, or an annualized rate of 8.82%. "The House Price Index shows the rise in house prices continues at an extremely strong pace and raises the potential for declines in some areas later on," said OFHEO Chief economist Patrick Lawler. (OFHEO Press Release, 06/01/05)

Federal Reserve study finds drop in home prices possible with rise in interest rates
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- A Federal Reserve Bank of Chicago study concludes that rising mortgage interest rates this year could lower home prices between 6.5% and 15.5%. If mortgage rates jump from 5.8% to 6.5% by the fourth quarter, home prices could drop 6.5%, concluded Richard Rosen, a Chicago Fed senior economist and economic adviser. If interest rates rise as high as 7.5%, Rosen said home prices could fall 15.5%. If nervous investors sell at the first sign of dropping prices, prices could fall even faster, he said. "In this case, homeowners would lose roughly three years' worth of price increases," Rosen concluded. The pricing drop could be more extreme for expensive homes, he added. (*American Banker*, Damian Paletta, 06/01/05)

Foreclosures are on the rise
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- According to Foreclosure.com, mortgage foreclosures rose in 47 states in March, with rates in Florida, Texas and Colorado more than twice the national average. Some policymakers say the rise in foreclosure rates leads to a larger question: Is the push to boost homeownership backfiring? Some argue that as home prices and personal debt rise to record levels, homeownership has become an albatross for millions of

Americans which destroys, rather than creates, personal wealth. “We’ve had a national agenda that’s putting people into homeownership who are not ready for it,” said A. William Schenck III, Pennsylvania’s secretary of banking. “This is a fact that the nation must deal with unless we want to wreck the credit of a lot of middle-class Americans.” Schenck’s Pennsylvania Banking Commission recently hired the Reinvestment Fund, a Philadelphia-based think tank, to analyze 22,979 foreclosures in 14 counties –urban, suburban and rural—and found that foreclosures had spiked in each county over the past four years. The study found a problematic profile of homeowners, most of whom are blacks, Latinos or working-class whites, who live close to the “economic margin.” More than 70% of these borrowers relied on subprime mortgages to finance their homes. (Washington Post, Michael Powell, 05/30/05)

#### Follow the money

- According to a recent study by the international consulting firm Mercer Oliver Wyman, nonconforming and home equity loans account for less than half of mortgage lending volume, but generate 85% of the industry’s profits from loan origination and servicing. (National Mortgage News, Ted Cornwell, 05/30/05)

#### The last mile in e-mortgages: The electronic closing table

- In an interview by *Mortgage Technology*, Richard Jones, Countrywide Home Loan’s senior managing director and chief information officer, said that there is no doubt in his mind that e-mortgages will be widely adopted over the next decade –and more quickly than many imagine. Jones said, “Certainly there are no technology obstacles remaining to be solved. Countrywide has already fully automated the process from prequalification, application, underwriting, appraisal, to electronic document creation, finalization, and delivery - basically the whole process all the way to the closing table. The closing of the loan, including e-sign, funding, registration and recording of the loan involves several parties - closing agent, title company, notary, county recorder, document custodian, GSE, and so on - and *that is where the final adoption challenge lies*. Even here, these technologies exist and have been in use for some time. You can think of this as an ‘electronic closing table’ that brings together all parties to review and approve the electronic instruments needed to fully close and fund the loan. In the telephone or cable business you hear people say, “It’s all about the last mile.” In the mortgage banking industry, it’s ‘all about the closing table.’ Agreement on data standards is critical to make this work. That’s why the Mortgage Bankers Association and MISMO play such a critical role in getting all parties past the last mile - and why Countrywide is actively involved in the creation and implementation of these standards.” (*Mortgage Technology*, June 2005)

## *Fannie Mae*

Fannie Mae CEO Mudd vows to change Fannie Mae's culture and make it "humbler"

- In a move to rebuild the trust of the company's investors and customers, Fannie Mae's new CEO Daniel H. Mudd pledged to change the GSE's culture and set the hiring of a corporate ethics officer as one of his top priorities. As a part of his ongoing fence-mending efforts, Mudd held a town hall meeting with more than 1,000 of Fannie's approximately 5,000 employees and spoke with investment analysts via a conference call on June 3. Mudd told analysts that Fannie would be successful again when it "regained the trust" of its investors and customers and had become "an institution you can feel confident and comfortable investing in." To achieve that goal, Mudd said one of his immediate priorities is to hire a chief ethics and compliance officer, as required in Fannie Mae's regulatory agreement with OFHEO, as well as a chief financial officer and chief risk officer.
- Mudd said he wants to establish accountability and "an attitude of service" toward Fannie's customers and investors as high priorities for his employees. Mudd acknowledged that the company's culture has been "too slow, too bureaucratic" and that shareholders have not "always been at the center of the equation." One of his goals, Mudd said was to make Fannie Mae "a little bit more humbler, to be a little more listening in the process." He also pledged that Fannie Mae would be more transparent. If the independent review of Fannie's books by former senator Warren B. Rudman uncovers additional accounting violations, the company will disclose it, Mudd promised.
- In response to an analyst's question about Fannie's shrinking market share, Mudd said the company will continue to shrink its mortgage portfolio until it reaches its mandated capital requirement set by OFHEO. When asked about when the company would provide current financial statements, Mudd said that Fannie Mae is working "expeditiously" to restate its past financial statements and is making "decent to solid progress," but declined to give a time line for when the restatement would be completed.
- Mudd said that Fannie Mae is now working with Congress, OFHEO, and others and aims to "play a positive role" in the development of GSE regulatory reform legislation. He said, "At the beginning of the year, it is fair to say we had no seat at the table, but at this point we have a voice and are playing a constructive role that leads us to be positive ...about a bill being signed into law this year." While there is a general consensus that the new GSE regulator should be given "bank-like" authorities and powers, Mudd believes there is less agreement on the issue of limiting the size of the GSEs' mortgage portfolios. When asked how much weight Federal Reserve Chairman Alan Greenspan's concerns had in the discussions over the new GSE regulator, Mudd responded that it is "not wise not to take concerns" of the Fed

chairman into account. “My view is that if you compare the basis on which our business is risk-managed with the way other financial institutions are, this is not an area for excess concern,” he said. (Dow Jones Newswires, Allison Bisbey Colter and Madeleine Lim, 06/02/05; *Washington Post*, Annys Shin, 06/03/05; *American Banker*, Rob Blackwell, 06/03/05)

Fannie Mae’s investment portfolio shrinks for the sixth straight month

- Fannie Mae’s mortgage investment portfolio shrank for a sixth straight month in April, contracting \$12.7 billion or 16.3% on an annualized basis to \$851.9 billion. The company’s portfolio shrank as a result of limited purchases and a higher prepayment rate in April, rather than the heavier sales of previous months. Fannie Mae’s asset liquidations totaled \$20 billion in April for an annual liquidation rate of 27.82%, their highest point since June 2004. Fannie’s purchases of mortgage assets fell 21% in April to \$8.8 billion, the lowest level since January 2004, while it reported \$1.7 billion in outright mortgage sales. Fannie Mae said it had contracts to buy \$5.7 billion in mortgages in April, down from \$10.6 billion in March. David Hochstim, an analyst with Bear Stearns, said the GSE’s lower sales volume is a good indicator that Fannie Mae is well on its way to meeting regulatory capital requirements by September 30. “Certainly if they were anxious or desperate, they could have had much larger sales in January or February, when spreads were very, very tight,” Hochstim said. However, Fannie Mae spokeswoman Janis Smith said that a decline in the company’s sales for one month should not lead people “to the conclusion that ... [the selloff is] over.” (*American Banker*, Matthew Quinn, 05/31/05; *Bloomberg News*, Al Yoon, 05/27/05)

Three years before Fannie Mae can complete the cleanup of its accounting problems?

- In a *National Mortgage News* interview, Armando Falcon, Jr., former director of OFHEO, said it could take Fannie Mae as long as three years to implement reforms and clean up its accounting problems. Falcon also predicted that OFHEO will not complete its special examination of Fannie Mae before year-end. (*National Mortgage News*, Brian Collins, 05/23/05)

After pledging to cut back on its political activities,  
Fannie Mae hires two prominent Republican lobbyists

- To make certain that its voice is heard on GSE regulatory reform, Fannie Mae has added extra lobbying muscle, by hiring Marc Racicot, a partner at Bracewell & Giuliani LLP and the chairman of the Bush-Cheney 2004 reelection campaign, and Jack Oliver, the head of Oliver Group Inc. and the former deputy finance chairman for the Bush campaign, to Fannie’s roster of outside lobbyists on Capitol Hill. In

March, Fannie Mae also hired Steve Elmendorf of Bryan Cave Strategies. Elmendorf served as chief of staff for former House Minority leader Richard Gephardt (D-MO). (*Congress Daily AM*, 05/26/05; *American Banker*, Rob Blackwell, Jody Shenn and Hannah Bergman, 05/31/05)

Fannie Mae's EVP of regulatory agreements and restatement speaks to state treasurers about his company's efforts to "get its house in order"

- On May 23, Mike Williams, Fannie Mae's EVP for regulatory agreements and restatements, spoke at the National Association of State Treasurers' Legislative Conference to describe the steps that his company is taking to "get its house in order." Williams said that Fannie Mae's priorities for 2005 are "The Rs"—becoming a first rate regulated company, restoring its capital, restating its earnings, and rebuilding relationships. Williams told the audience that Fannie Mae has embarked on a major internal review, in response to OFHEO's findings from its special examination of the GSE. "We embraced this opportunity to not only comply with the regulatory agreements, but to broaden the scope by creating a company-wide blueprint for a stronger structure, oversight, and controls for all these areas," said Williams. He warned the audience that external and internal reviews of the company's accounting continue. "New problems may come to light -- and when they do, we will address them; just like we are addressing the problems identified so far," said Williams. Noting that Fannie Mae is rebuilding its relationships with a wide array of constituents, Williams said, "Most importantly, we are rebuilding our relationship with our regulators."
- Williams acknowledged that in light of Fannie Mae's accounting issues, regulatory issues, business challenges, investors ask how they can maintain confidence in Fannie Mae, particularly in the credit-quality of our debt securities. He said, "The best answer I can give to that question is to point to the consistently high credit ratings we have continued to receive through everything that has gone on the past year. The credit rating of our senior debt securities remains triple A with a stable outlook at all three of the leading rating agencies." (*Prepared remarks for Mike Williams, EVP for regulatory agreements and restatement*, 05/23/05)

Correlation found between "large frauds" with high earnings growth

- A recent study by Kees Cools of the Boston Consulting Group concluded that companies with large frauds [such as Fannie Mae] had profit growth targets of 15% to 20% per year, and executive compensation packages to match, while "non-fraud" companies had mere 6% profit targets. (*The Weekly Standard*, Jay Weiser, 05/06/05)

- Fannie Mae plans to significantly cut mortgage insurance requirements on MyCommunityMortgage, a product suite aimed at lower-income homebuyers. Fannie Mae spokesman Alfred King said that the change is intended to make the products more competitive with adjustable-rate mortgages, piggybacks, and other solutions for low down payments, but stressed that Fannie is not adjusting its pricing on these loans. Tony Lucente, the vice president of emerging markets for United Guaranty Corp.(UGC), said Fannie's "very positive change" would lower UGC's premiums for MyCommunityMortgage loans with less than 3% down payments by 48%, which would likely increase demand for the products as a result.
- While Fannie and Freddie Mac are legally prohibited from buying loans with less than 80% down payments without mortgage insurance or other credit enhancement, the GSEs have some flexibility in how much credit risk they take on such loans. On July 24, insurance for MyCommunityMortgage loans with less than 3% down payments can cover as little as 20% of potential losses; currently there is a 35% floor, while the required coverage will drop to 6%, from 25% for loans with 15% to 20% down. Mary Morstadt, specialty lending manager at National City Corp.'s mortgage unit, called Fannie's insurance change "the best news" she has heard at a recent meeting with the company. "When we do some of the calculations of the cost of the monthly mortgage insurance, it can be pretty significant and put off some of the potential borrowers," Morstadt said.
- A spokeswoman for Freddie Mac, which rolled out a similar group of affordable products called Home Possible this year, said it is "reviewing the industry changes and evaluating them." (American Banker, Jody Shenn, 06/02/05)

## ***Freddie Mac***

### **Freddie Mac's loan portfolio grows for third month**

- Freddie Mac's loan portfolio grew for the third straight month, increasing by \$5.3 billion to \$662.1 billion in April for a 9.8% annual rate for the month and 4.2% for this year. Freddie Mac's growth is in contrast to the contraction of the portfolio by Fannie Mae, which is building a 30% capital surplus mandated by OFHEO. Freddie Mac meets the same surplus requirement imposed by its regulator following the company's manipulating its accounting and restating profits. Freddie Mac's mortgage growth was at a "good clip" considering the slowdown in mortgage growth in the market last year, said Edwin Groshans, a Fox-Pitt, Kelton Inc. analyst. "This is showing that Freddie Mac sees opportunities out there to meet internal rate of return hurdles, and Fannie Mae is missing that."
- Freddie Mac agreed to buy \$20.3 billion of mortgages last month, down 36.6% from \$32 billion in March. The company's holdings of private-label mortgage bonds issued by lenders increased by 4.8% to \$197.2 billion, while its investments in Freddie Mac and Fannie Mae mortgage securities dropped 7.4% to \$43.7 billion.
- Freddie Mac's duration gap was at zero months in April, unchanged from March. (Bloomberg News, Al Yoon, 05/24/05; American Banker, 05/25/05)

### **Freddie Mac declares second quarter dividends**

- Freddie Mac's board of directors has declared a second quarter dividend on the corporation's voting common stock of \$0.35 per share. The dividend is payable on June 30, 2005 to stockholders of record as of June 13, 2005. The board also declared the quarterly dividends on the corporation's preferred stock in accordance with terms of the issues. (*Freddie Mac Press Release*, 06/02/05)

### **Freddie Mac announces that John McCoy won't stand for re-election to its board**

- Freddie Mac announced that John B. McCoy will not stand for re-election to the company's board of directors at the meeting of stockholders on July 15, 2005. McCoy's decision to retire from the board is consistent with Freddie Mac's plan to engage in an orderly board transition, which is being implemented with the approval of the OFHEO. "John has been a stalwart of the Freddie Mac board since 1990," said Freddie's chairman and CEO Richard F. Syron. "He has provided wise counsel through thick and thin, and has been a key figure in the organization's turnaround. He is an outstanding human being and a great director who will be sorely missed." (*Freddie Mac Press Release*, 05/26/05)

Freddie Mac appoints Kevin McCullagh multifamily vice president, risk management

- Effective May 31, Freddie Mac has appointed Kevin J. McCullagh multifamily vice president of risk management, responsible for the overall credit quality of Freddie Mac's multifamily mortgage portfolio. McCullagh will report to Adrian Corbiere, the company's multifamily senior vice president. McCullagh comes to Freddie Mac from Bank of America, where he was senior executive for credit risk management of BofA's North East Commercial and national homebuilders portfolios. Previously, McCullagh was a senior credit risk executive responsible for Fleet Bank's \$13 billion commercial real estate portfolio. (*Freddie Mac Press Release, 05/26/05*)

Freddie Mac introduces new multifamily mortgage product

- Freddie Mac announced a new multifamily mortgage option for select loans and borrowers that could significantly reduce the lease-up occupancy requirements, extend the rate-lock option and increase liquidity for newly construction or rehabbed properties. The new execution, called Premier Lease-Up, was developed from talks the company has had with members of in the multifamily mortgage industry on how Freddie Mac could help owners and lenders respond to an increasingly competitive market. Under Premier Lease-Up, Freddie Mac in conjunction with a Program Plus Seller/Servicer, will lock a rate much earlier in the construction and lease-up cycle for a newly constructed or substantially rehabilitated apartment community. Specifically under this execution, qualified borrowers can lock the interest rate well in advance of property stabilization, at as low as 50% construction completion and 40% occupancy. Certain borrowers may close the loan before property stabilization, at a minimum occupancy of 65% and net operating income level equivalent to a 1.05x debt to credit ratio, set by Freddie Mac at rate-lock. Qualified owners may also have more flexibility with their capital because of reduced loan enhancement requirements during the period between loan closing and property operating stabilization at the underwritten levels. "Locking the rate earlier eliminates the interest rate risk for a borrower much earlier in the process," said Mitchell W. Kiffe, multifamily vice president of flow sourcing. "In the current environment this is a critical feature since most market observers expect rates to increase over the coming months." (*Freddie Mac Press Release, 05/26/05*)

Freddie Mac plans to expand its purchase of option ARMs this year

- Later this year, Freddie Mac plans to buy option adjustable-rate mortgages that allow for negative amortization in bulk from more lenders and to introduce a standard option ARM product in mid-2006, said James Cotton, Freddie's vice president of

single-family marketing. Freddie has been buying option ARMs, but “on a very limited basis,” he added (*American Banker*, Jody Shenn, 06/03/05)

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

In the shadow of Fannie and Freddie, the FHLBs lobby to keep a regulator separate

- Lawrence Parks, senior vice president of external and legislative affairs for the FHLB-San Francisco, said the FHLBs are lobbying Congress to keep regulation of the Home Loan Bank system separate from the oversight of Fannie and Freddie. With the Banks’ regional nature and their distinct business model as wholesale banks that are cooperatively owned, Parks said that the FHLBs want any new federal GSE regulatory agency to have two separate deputy directors –one to oversee Fannie and Freddie and one to oversee the FHLBs. (*National Journal*, Bara Vaida, 05/28/05)

Former OTS Director Gilleran named president of FHLB-Seattle

- The troubled FHLB-Seattle has named James Gilleran, the former director of the Office of Thrift Supervision (OTS), as its next president and chief executive. Gilleran began his new job with the Bank on June 1, replacing interim CEO James Faulstich. While the Bank’s board preferred hiring someone from the private sector, sources said the board hired Gilleran for his regulatory expertise and experience in turning around ailing thrifts. In May, Gilleran, 72, stepped down as director of the OTS, a job he had held since 2001. Previously, Gilleran was served as CEO of Bank of San Francisco and superintendent of banking for California. In a press release, Gilleran said, “While the Bank is facing significant challenges, it appears to be making good progress toward improving its regulatory and financial position.”
- Bert Ely, a banking consultant in Alexandria, Va., said Gilleran was a good choice for the FHLB-Seattle. “He has a lot of experience and credibility as a regulator and that gives him a certain gravitas in dealing with the Federal Housing Finance Board,” said Ely. “He certainly stirred the waters.” (*Seattle Times*, Melissa Allison, 05/24/05; *Dow Jones Newswires*, Dawn Kopecki, 05/24/05; *American Banker*, Rob Blackwell, 05/24/05)

In 2004, participation in MPF grows as volume sharply declines

- During 2004, 147 new financial institutions joined the FHLBs' Mortgage Partnership Finance (MPF) program, bringing the number of participating FHLB members to 855, up 21% from a year earlier. The vast majority of MPF participants, about 83 percent, are comprised of "community financial institutions" with assets of less than \$567 million, followed by 12% of midsized institutions with assets ranging from \$567 million and \$5 billion, and 5% of large institutions with assets exceeding \$5 billion. "Smaller mortgage lenders have fewer secondary mortgage options," said Mike Thomas, president and CEO of the FHLB-Chicago, which created the MPF program. "The MPF program is an attractive alternative for them. They can offer their customers fixed-rate mortgages, while transferring the interest rate risk to the FHLBank. They also can keep their customer relationships and get paid to manage the credit risk of the loans they originate."
- While participation in the MPF program grew, the volume of MPF mortgage originations declined sharply in 2004 to \$18.4 billion from \$72.1 billion in 2003, reflecting the general drop-off in fixed-rate mortgage originations. (*Community Banker*, 05/01/05)

#### FHLB notes draw record foreign investments

- Foreign investors bought a record 65% of a new Federal Home Loan Bank \$4 billion global note issue on June 1, displaying their fever-pitched quest for safe U.S. assets. The FHLB's two-year deal yielded 3.69%, 17 basis points above U.S. Treasuries. Asian investors purchased 55% percent of the notes, overshadowing the 35% sold in the United States, 4% in Europe and 6% in other regions. (*Reuters News*, Lynn Adler, 06/02/05)

#### FHLB-San Francisco announces first quarter dividends

- The FHLB-San Francisco announced that the dividend rate for the first quarter of 2005 is 4.25% (annualized), up 30 basis points from the Bank's 3.95% (annualized) dividend rate for the first quarter of 2004 was 3.95%. (*Business Wire*, 05/25/05)

## ***Farm Credit System / Farmer Mac***

AgFirst, in Columbia, SC, first to launch three year pilot program  
to securitize rural home mortgages

- On May 10, the Farm Credit Administration approved AgFirst Farm Credit Bank's three year pilot program for buying pools of rural home mortgages. The \$16.8 billion institution based in Columbia, SC plans to create a secondary market for rural home loans where there essentially is none. Leon T. Amerson, AgFirst's CFO, said his institution hopes to start buying rural home mortgages by mid-June from mortgage lenders, who would buy loans from other banks and other lenders, package them as securities, and sell them to AgFirst. He hopes this pilot test might encourage some larger lenders to take a more active interest in rural lending and thus give borrowers more options. "What we're trying to do is encourage the lenders who have clout in the market to pay attention to the rural market," Amerson said. AgFirst is also seeking to diversify its holdings through this program and increase its investment income. While as a member of the Farm Credit system it cannot lend outside its specified territory, this program will allow AgFirst to buy securities backed by loans made anywhere in the county.
- AgFirst's biggest challenge is finding a partner in the secondary market. While Fannie Mae, Freddie Mac, and Farmer Mac all buy rural home loans, no one packages and sells securities secured exclusively by rural loans. AgFirst will not be able to get its program up and running until a secondary-market entity begins packaging these loans as securities. Amerson said three large mortgage companies have said they are interested in assembling pools of rural home loans to sell to AgFirst, but declined to name names.
- Rural housing advocates say AgFirst's plan would address a liquidity need in rural America, by creating a secondary market for rural home loans to free up more funds for lenders to make more such loans. "Generally, anything that increases mortgage availability, including secondary-market activity, is a good thing," said Leslie R. Strauss, a spokeswoman for the Housing Assistance Council in Washington. Community bankers' trade groups seem less enthusiastic about AgriBank's plan, because many of bankers view Farm Credit lenders as their archrivals. John Sorensen, the president and CEO of the Iowa Bankers Association, questioned AgFirst's intentions in setting up the program, because it lets the cooperative invest in loans outside of its territory. "Our preference would be that they stay focused on assistance for small and beginning farmers," he said. (*American Banker*, Ben Jackson, 05/25/05)

- In *Farm Credit Watch*, Bert Ely reports that collectively the 83 directors (and their affiliated interests) for the five Farm Credit Banks had borrowed a total of \$1.546 billion, 1.6% of the FCS loans outstanding at the end of 2004. In his analysis of the 2004 Annual Information Statement for FCS, Ely concluded that at least 65 of the 83 directors were active farmers. Ely writes, "The average amount borrowed by each director was \$18.6 million; the averages varied from \$10.9 million each for the 18 directors at AgriBank, which serves the upper Midwest, to \$37.9 million each for the 14 directors at U.S. AgBank, which serves California and the Southwest. The 19 directors at AgFirst, serving the Southeast and Mid-Atlantic regions, had average borrowings of \$12.4 million; the 26 directors at CoBank, which also funds five associations in New England, New York, New Jersey, and the Northwest, had borrowed an average of \$17.2 million, and the six directors of the Farm Credit Bank of Texas borrowed an average of \$22.7 million."
- "Only AgFirst provides any data about the size of each director's farming operations. For example, one AgFirst director farms 4,000 acres of row crops and has 1,000 acres of timber; another has a dairy, a 900-acre row-crop farm, and a 200,000 broiler operation; a third farms 2,700 acres of corn, soybeans, and wheat and has a 300,000 capacity broiler operation; a fourth is in a family partnership with a 5,900 acre farming operation; a fifth has an 1,850 acre row-crop operation; and so forth. Clearly, each one of these directors is a large-scale, financially successful farmer, which is highly commendable, but also each of these directors could easily finance his farming operations with commercial banks and other genuine private-sector lenders. While the other banks don't provide acreage numbers on the size of their directors' farming and ranching operations, the average amounts borrowed strongly indicate that these directors, too, are very successful farmers and ranchers. Every one of these folks is undoubtedly highly bankable in the private sector. They clearly are not who the FCS was created to serve."
- "Directors' fees are restricted by the FCS; in 2004, they generally ranged from \$26,000 to \$34,000. The interest subsidy these directors received is far greater. The subsidy consists of the FCS tax breaks and the ability of the FCS to borrow at lower interest rates due to its implied federal backing. The subsidy is passed through to borrowers in the form of below-market interest rates. Because the profits on FCS real estate lending are exempt from all corporate income taxes, the FCS real-estate lending subsidy probably exceeds 200 basis points. The subsidy is less on non-real estate lending. Conservatively, assuming an overall lending subsidy of 100 basis points, the 83 directors enjoyed a \$15.5 million interest subsidy in 2004, or an average of \$187,000 per director. Assuming a 150 basis-point subsidy rate raises the average interest subsidy for these directors to \$280,000. This certainly is great supplemental compensation, and never intended by Congress." (*Farm Credit Watch*, Bert Ely, May 2005)

- On May 12, the *Wisconsin State Journal* reported that the four FCS direct-lending associations serving Wisconsin have changed the name of their umbrella promotional group from “Wisconsin Farm Credit System” to “FC Wisconsin.” According to FC Wisconsin’s spokeswoman, the name change “is meant to counter the misconception that these lenders serve only full-time farmers.” A second spokesperson said, “[H]obby farmers and other home buyers, who come seeking the rural life, are increasingly important.” In *Farm Credit Watch*, Bert Ely writes, “...Wisconsin’s 309 banks and thrifts, most of which are much smaller and more locally focused than the four FCS lenders, already are active lenders in rural and small-town Wisconsin and can readily meet the credit needs of rural borrowers.” Ely adds that the blurring of what the FCS is can be seen by one of the four participating associations, United FCS, headquartered in Minnesota, which calls itself FCS Financial Services. “These ongoing rebranding initiatives within the FCS are a strong indication that the FCS has outlived its public purpose,” concludes Ely. (*Farm Credit Watch*, Bert Ely, May 2005)

## *Ginnie Mae*

Ginnie Mae's plummeting market share has some in Congress starting to ask questions

- Ginnie Mae's plummeting market share leads directly to the door of the FHA, whose weak loan production has weighed down any progress Ginnie Mae has made to regain lost market share. The decline has led even some in Congress to start asking questions about what should be done with Ginnie Mae. For decades, Ginnie Mae was the predominate secondary market corporation, whose issuance volume soared while loan volume boomed in FHA loans. In the mid-1980s, Fannie Mae and Freddie Mac captured the lead in the mortgage-backed securities market, until 2004 when private conduits grew faster than Fannie, Freddie and Ginnie, when the total MBS market shrank by 42.6% to \$1.76 trillion, down from \$3.07 trillion issued in 2003. While private label MBS increased 12.4% to \$387.4 billion in 2004, Ginnie Mae's guaranteed mortgage securities volume declined 42.1% to \$126.7 billion and Fannie's and Freddie's volume dropped by 51% and 56%, respectively. According to Inside Mortgage Finance, Ginnie Mae holds less than 7% of outstanding MBS, down from its 25% market share in 1990.
- While many factors account for Ginnie Mae's shrinking market share, the biggest factor by far is Ginnie's reliance on FHA to produce home loans to package into securities. The bottom line is that FHA is losing market share, and Ginnie Mae's ability to keep pace with the market, much less grow, stands at a cross roads. While Ginnie Mae is a capable and respected secondary market entity, the government-tied corporation with its charter restrictions is saddled with baggage that effectively holds its ability to grow hostage to the moribund FHA. Today's robust mortgage market in which typical FHA borrowers have many more lending options coupled with aggressive conventional lenders appear to be factors are behind FHA's dwindling market share. Interestingly, the agency's measures to curb fraud also are cited as a factor. Michael F. Petrie, chairman of the Mortgage Bankers Association (MBA), attributes FHA's dramatic drop in market share to FHA's program changes that have "primarily focused on mitigating the program's risk with respect to fraud."
- The resulting market share declines at FHA and Ginnie Mae has fueled debate about a disconnect between the federal government's key vehicle for achieving its mission of having FHA loan production securitized by Ginnie Mae. To stimulate this debate, Representative Bob Ney (R-OH), chairman of the House Subcommittee on Housing and Community Opportunity, has requested a GAO evaluation of Ginnie Mae's loss of market share. In his September 8 letter, Ney asked GAO to address the questions: "What factors are influencing Ginnie Mae's loss of market share? What are the prospects for Ginnie Mae? What are the consequences of Ginnie Mae losing market share? What responses could Ginnie Mae make to address its loss of market share? What are the pros and cons of such responses? Does this trend jeopardize the viability of Ginnie Mae to meet national homeownership goals in the future?" Ney

plans to hold hearings later this year on the FHA and will likely leverage the GAO report to advance discussions on needed reforms for FHA and Ginnie Mae. (*Mortgage Banking*, Anita Willis-Boylard, 04/01/05)

## ***Postal Service***

Hopes remain high for postal reform legislation in 2005
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- Expectations remain high among lawmakers, legislative aides, and stakeholders for completing a postal reform bill this year, following the approval of H.R.22 by the House Government Reform Committee on April 13. The Senate Homeland Security and Governmental Affairs Committee is expected to complete work on S. 662 in early summer. While House Majority Leader Tom DeLay (R-TX) supports moving H.R. 22 to the floor, he is waiting for House and Senate negotiators to smooth out the few differences between the bills, according to a Republican leadership aide.
- H.R. 22 and S. 662 are much more alike than different, representing the closest the Senate and the House have been on postal reform in more than a decade. Both reform bills increase financial transparency by requiring the Postal Service to prepare quarterly and annual reports, containing the same information that publicly traded corporations file with the SEC. The bills also share identical provisions regulating the Postal Service's discretion to enter into work-sharing agreements with the private sector and the operation of the proposed Postal Service Competitive Products Fund. Both bills define various postal products and services as "competitive" or "market-dominant" and prohibit USPS from subsidizing competitive products with revenues from market-dominant products. According to a recent Congressional Research Service (CRS) report, the bills include different definitions of "market-dominant products." While both bills include first-class, library, media mail, and postcards in their definitions, the Senate bill includes sealed parcels and single piece parcel post, while the House bill does not. According to the CRS report, the inclusion or non-inclusion of a product in the "market-dominant products" classification concerns mailers and competitors of the Postal Service because of the possible impact on product prices. Under both bills, products that are not defined as market-dominant would fall into the "competitive products" category and would have to fully attribute the costs of providing them. Some believe that including parcels in the competitive products category would lead to increased prices for parcel delivery service, which competitors would likely favor and large mailers would likely disfavor, said the CSR report.
- While the bills are similar on the components and goals of the new ratemaking system, the CSR report noted significant differences remain. While both bills require the Postal Service cap the prices of market dominant products at the Consumer Price

Index (CPI), the Senate bill requires the new ratemaking system to permit USPS to exceed the rate cap under “extraordinary” circumstances; under the House bill, USPS would be allowed to exceed the rate cap if the Postal Rate Commission held a public hearing and determined that breaking the rate cap “is reasonable and equitable and necessary.” The Postal Service would like to have the rate-cap escape clause because management believes that staying below the CPI will be “extremely challenging” due to the agency’s falling revenues, its growing number of delivery points, and its limited control over its costs, according to the CSR report. The House bill would prohibit USPS from raising the postage rate of any subclass of mail more than the CPI without permission from PRC, while the Senate bill applies this restriction at the class level, a more flexible provision for adjusting rates that the Postal Service prefers. The House bill would require the new ratemaking system to establish a “fair and equitable” schedule for rates and the classification system; while S. 662 requires that the new rate system to “allocate the total institutional costs of the Postal Service equitably between market-dominant and competitive products,” according to the CSR report.

- S. 662 encourages injured postal workers of retirement age to retire rather than go on disability leave, by reducing a full disability payments from 66% of monthly pay to 50%. The House bill doesn’t carry this provision and is favored by USPS unions. Both bills would return the obligation for postal worker benefits attributable to military service to the Treasury Department and establish a Postal Service Retiree Health Benefits Fund for the purpose of pre-funding retiree health benefits. The bills have different approaches to the unfunded retiree health benefits liability. The House bill requires the Postal Service to make annual payments into the fund consisting of a contribution to cover predicted retirement health care costs of current postal workers and interest on the contribution owed for both current and future annuitants with two-thirds of the annual escrow “savings” be devoted to the fund. The Senate bill requires an annual contribution to the fund to cover predicted retirement health care costs of current postal workers and an installment payment on an amortization schedule to reduce the unfunded liability. The Postal Service prefers S. 662 because it does not include the two-thirds provision that limits USPS discretion, said the CSR report. “USPS also has said that having a predictable annual amortization payment would make operating under a rate cap easier,” the report added.
- Both bills would amend current law so that members of the Board of Governors would be chosen “solely on the basis of their demonstrated ability in managing organizations or corporations [in either the public or private sector] of substantial size.” The House bill defines “substantial size” as 50,000 employees, while the Senate bill provides no definition of the term. The Senate bill would reduce the term of a governor from nine to five years, while the House bill would not. The House bill requires that an early vacancy on the Board of Governors be filled by a person nominated with the concurrence of labor unions; but the Senate S. 662 would not. (*Bureau of National Affairs, Derrick Cain, 06/01/05*)

- The Alliance for Nonprofit Mailers report that the Senate Committee on Homeland Security and Government Affairs might markup S. 662 early in June. According to the Association for Postal Commerce, “Look for the House postal reform bill (H.R. 22) to go to the House floor sometime in mid-June.” It is unknown when the S. 662 might go to the Senate floor for debate. (*Alliance for Non-Profit Mailers*, 05/24/05; *PostalWatch.com*, 05/25/05)

Senate panel approves postal nominations
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- On May 25, the Senate Homeland Security and Governmental Affairs Committee approved the nominations of Carolyn L. Gallagher and Louis J. Giuliano to serve on the U.S. Postal Service Board of Governors, and Tony Hammond to serve on the Postal Rate Commission. In 2004, the nominees were placed in the positions by President Bush through “recess appointments” that expire this fall. If, as expected, these nominees are approved by the full Senate, Gallagher and Giuliano will serve nine-year terms on the Board of Governors and Hammond will serve a six-year term on the PRC. In 2003, Gallagher served as the chairwoman of the Workforce Subcommittee of the President’s Commission on U.S. Postal Service, which recommended a wide array of reforms to the Postal Service. (*APWU Web News Article #24-05*, 05/27/05)

Postal rate increase may take effect January 19, 2006
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- The Direct Marketing Association is hearing that postal rates will increase 5.4% across the board as soon as January 19 if things go according to plan, said DMA senior vice president of government affairs Jerry Cerasale. However, several factors still could influence that date, said Cerasale. A number of groups have raised concerns over settling the current expedited rate case. Those groups include the American Postal Workers Union, the American Bankers Association, the Consumer Advocate of the Postal Rate Commission and Valpak. Since the Postal Service is doing better than postal officials expected, the agency may be able to reduce the proposed increase or delay it until later in 2006. With or without postal reform, another rate case will likely be filed next year to take effect in 2007, Cerasale added, which would likely be in the 4% to 5% range. If the current rate case doesn’t go in 2006 through as proposed, that next case would be more than 10%, he predicted. (*DMNews.com*, Ted Clarke, 05/26/05)
- Gene A. Del Polito, president of the Association for Postal Commerce, writes in *Direct*, “But if [postal rate case for 2005] is simple [5.4% increase], you ain’t seen nothin’ until you get a gander at what [the postal rate case for] 2006 will be like. Yes, that’s right: The postal service will be filing another rate increase request about this time next year with an eye toward implementation in early 2007. And it promises to be the mother of all rate cases. In R2005, the USPS has put off (for the sake of

expediency) any effort to redefine the relationships that exist within and among the various classes. These costing, pricing and rate-design issues, however, are sure to surface in a very big way in R2006....This is a time when 'postal transparency' will be needed most. What does the USPS intend to do in R2006? What must mailers do to prepare for the changes that will be coming from it?" (*Direct*, Gene A. Del Polito, 05/26/05)

- "The APWU is troubled by the Postal Service's recent request for an across-the-board rate increase," said union President William Burrus. "We are studying the proposed rates, and reviewing thousands of pages of data the USPS submitted to support its case. Based on an initial review, we are concerned by what we are finding," he said, noting that the rate application proposes to increase the size of the discounts offered to companies that pre-sort their mail. "Over the years, the mailing industry has established and expanded so-called 'worksharing' discounts for mailers who 'pre-sort' their mail by bundling it according to its destination, and adding bar codes," Burrus said. "But the discounts far exceed the costs the USPS would incur if it sorted the mail itself. The USPS rate proposal exacerbates that dangerous policy." (APWU Web News, 04/01/05)

## **TVA**

TVA loses \$24 million for second quarter due to higher fuel costs and lower power sales

- TVA reported a loss of \$24 million for the second quarter, compared to a net income of \$118 million for the same quarter last year. The utility attributed the loss to higher fuel costs, which rose by more than 13%. "Like other power companies around the nation, TVA is faced with rising costs for coal, natural gas and purchased power," TVA director Skila Harris said in a statement. "For the six months ending March 31, TVA's cost for fuel and purchased power increased more than 13 percent over the same period last year." TVA's operating revenue for the second quarter was \$1.84 billion, down 2.1% from a year ago, while its operating expenses were up 7.8% from 2004 to \$1.56 billion. "Operating expenses are expected to increase as the costs for coal and natural gas continue to escalate," said TVA director Bill Baxter. "Based on current estimates, coal and transportation costs are projected to increase by 13% in the next two years, and natural gas prices are expected to increase 7% in 2006 and 2007. Future events could affect these estimates, but if they are on the mark, it will likely increase TVA's costs for power it buys from other suppliers." Electricity sales were down slightly from \$41.9 million a year ago to \$41.7 million this quarter due to milder weather, said TVA officials said. Through its debt refinancing, TVA's net interest expense decreased by 3.4% from a year ago to \$315 million. TVA also announced a new debt refinancing of \$500 million in 30-year global power bonds with a coupon rate of 4.65%, the lowest rate ever on a 30-year U.S. corporate or U.S. agency transaction. (*Associated Press*, 06/05/06)

Senator Lamar Alexander (R-TN) urges TVA to stop building wind mill generators

- In a letter to TVA's board of directors, Senator Lamar Alexander (R-TN) called the agency's windmills costly, unreliable and unsightly and urged the board to stop building wind turbine generators. After building 18 wind turbines over the past three years, the TVA directors said they don't plan to construct any more windmills during the next two years. Wind-power "enthusiasts" took exception to Alexander's letter. Stephen Smith, executive director of the Southern Alliance for Clean Energy, said Alexander's comments were "...reckless, mean-spirited attacks on renewable energy."
- On May 13, Alexander and Senator John Warner (R-VA) introduced the Environmentally Responsible Wind Power Act of 2005 (S 1034), which would limit tax credits for the construction of new wind farms. (*Associated Press*, 05/24/05)

TVA Inspector finds subcontractor overcharged the utility by more than \$250,000

- The TVA inspector general has concluded that the contractor, who advised TVA on the \$1.8 billion restart of a mothballed nuclear reactor in Alabama, overcharged the utility by more than \$250,000. Bechtel Power Corp's extra fees for labor, computer costs and overhead represent about 1% of the contractor's \$26.4 million bill for "detailed scoping, estimating and planning" to revive the Browns Ferry Unit 1 reactor in Athens, AL. (*Associated Press*, 05/28/05)

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