

# The **GSE** REPORT™

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## *Major Events*

Federal Reserve Chairman Greenspan urges Congress to rein in GSEs' growth by limiting their portfolios to Treasury bills for liquidity, assets required for mortgage securitization, and mortgages that cannot be readily securitized

- Reiterating his view that the GSEs' portfolios pose a "systemic threat" to the economy, Federal Reserve Chairman Alan Greenspan said the new GSE regulator should require Fannie Mae and Freddie Mac to justify why they must retain mortgage purchases. "One way to limit the GSE portfolios is to create a strong presumption that almost all mortgage-related assets can be securitized," Greenspan said. "The GSEs would need to establish, with their regulator, that any asset held in their portfolio could not be securitized. In other words, the method of GSE financing most consistent with their missions is to securitize assets first and to hold in their portfolios only those assets that are very difficult or unduly expensive to securitize," along with assets needed to meet liquidity needs and facilitate the securitization of mortgages. If Congress does not limit the GSEs' portfolios, "we run the risk of solidifying investors' perceptions that the GSEs are instruments of the government and that their debt is equivalent to government debt," warned Greenspan, which have enabled the GSEs to "grow virtually without limit" and place the financial system essentially at the mercy of the companies' ability to manage risks in their portfolios.
- Acknowledging that statutory limits on the GSEs' assets would require "a substantial liquidation" of mortgage-backed securities and "an equivalent redemption of GSE debt," Greenspan said such a liquidation "should pose no significant difficulties." He added, "The amassing of GSE portfolio assets is a simple grossing-up of mortgage assets, which can be initiated and reversed in quite large volumes with relative ease." Moreover, "GSE sales of MBS, matched with redemptions of debt, will be readily absorbed in the vast market without a significant change in the relative interest rate spreads of such investments," Greenspan said. While "the grossing-up and liquidation of MBS and the corresponding GSE debt might conceivably affect the MBS-GSE interest rate spread at the margin," Greenspan denied there would be any significant effect on mortgage interest rates or on homeownership.
- Greenspan argued that the Federal Reserve sees little evidence to support the claim that the availability of fixed-rate mortgages is tied to the size of the GSEs' mortgage portfolios, adding that it was "difficult to see" how Fannie's and Freddie's portfolios can influence home ownership since much of the growth in home ownership in recent years is attributable to growing household income levels and low borrowing costs. Specifically, he noted that in 1992 when the GSEs' portfolios were small, 80% of originations were fixed rate. In contrast, in 2004 when the GSEs' portfolios totaled about \$1.5 trillion, 66% of mortgage originations were fixed rate. "Clearly, these data do not support the position that the size of the GSEs' portfolios positively contributes to the availability or popularity of fixed rate mortgages," Greenspan said.

In times of crisis, the GSEs' investment portfolios would only support the mortgage market, if they consisted of liquid, non-mortgage debt such as Treasury securities, Greenspan pointed out. "Indeed, only such highly liquid portfolios would be consistent with the [GSEs'] mission of providing primary mortgage market liquidity during a crisis, particularly during a financial crisis," he said.

- If Congress does not take steps to restrict the size of the GSEs' balance sheets, Greenspan said, "We put at risk our ability to preserve safe and sound financial markets in the United States, a key ingredient of support for housing. Huge, highly leveraged GSEs subject to significant interest rate risk are not conducive to the long-term financial stability that a nation of homeowners requires." (*Dow Jones Newswires*, Prepared remarks of Federal Reserve Chairman Alan Greenspan, 05/19/05; *The Main Wire*, Steven K. Beckner, 05/19/05; *Associated Press*, 05/19/05; *Reuters*, 05/19/05; *American Banker*, Rob Blackwell, 05/20/05)
- In a May 20 newspaper editorial, the *Wall Street Journal* wrote, "When it comes to judging risk to the financial system, whom do you trust more: Alan Greenspan, or the Congressman [Representative Michael G. Oxley (R-OH)] who helped give us Sarbanes-Oxley? That's not a trick question. We trust Mr. Greenspan more, too, but in Washington that isn't always how it works. So we were glad to hear the Fed Chairman use his bully pulpit again ...on behalf of limiting the mortgage-backed securities portfolios of Fannie Mae and Freddie Mac. Limiting those MBS portfolios -- which have climbed to \$1.5 trillion from \$132 billion in 1990 -- is emerging as the key issue in how to prevent Fan and Fred from running into trouble that would stick taxpayers with a bailout tab. Michael Oxley, a Ohio Republican who runs the House Financial Services Committee, wants to give Fan and Fred a pass on MBSs. But Mr. Greenspan said that limiting MBSs is the only way to reduce the interest-rate and other risks that Fan and Fred have been taking as they build these gigantic portfolios. Friends of these two "government-sponsored enterprises" claim that limiting MBSs would hurt homeownership. But Mr. Greenspan also noted that "The Federal Reserve Board has been unable to find any credible purpose for the huge balance sheets built by Fannie and Freddie other than the creation of profit through the exploitation of the market-granted subsidy." The subsidy he's referring to is the financing advantage the companies have -- roughly 40 basis points -- from the marketplace assumption that the government will never let them fail. Private profit, public (taxpayer) risk: That isn't how capitalism is supposed to work, as Mr. Greenspan knows but some Republicans still need to learn." (*Wall Street Journal*, 05/20/05)

Fannie Mae announces it violated FAS 115, requiring the reclassification of its held-to-maturity portfolio

Fannie Mae's internal investigation of its accounting improprieties delayed "indefinitely"

- Acknowledging that it violated FAS 115 requirements, Fannie Mae announced it must reclassify all of its "held-to-maturity" securities as "available for sale," an accounting change that will show previously undisclosed losses and gains in the company's balance sheet. On June 30, 2004, Fannie Mae reported \$453 billion of mortgage investments and \$5.5 billion of non-mortgage investments in the held-to-maturity category. In an SEC disclosure, Fannie admitted it "employed an operational practice that, upon review, was determined to result in securities being transferred from the held-to-maturity category to available-for-sale, which is generally not permitted under FAS 115." At an April Congressional hearing, outgoing OFHEO Director Armando Falcon testified that the company's practice "permits Fannie Mae to wait until the end of the month in which a trade settles to make a decision on whether to sell or hold. Such decisions on [FAS] 115 designations could be based upon gains or losses accrued after the trade date, or upon further analysis of the collateral underlying the mortgage-backed securities." This practice allowed Fannie to sort through its mortgage-backed securities and retain the highest-quality loans while selling off the rest, a policy referred to internally as "keep the best, sell the rest." Fannie Mae must now retroactively redesignate all of its securities previously categorized as held-to-maturity into the available-for-sale category for all periods affected by the error. Moreover, Fannie will lose the ability to classify securities as held-to-maturity "until two years after the last transaction giving rise to this error." While the reclassifications won't impact the company's earnings or have a "material impact on minimum capital," the accounting change is significant because unrealized losses and gains in its assets and liabilities will show up in Fannie's balance sheet and shareholder equity, reflecting how well Fannie Mae is hedged and how volatile its portfolio is.
- Fannie Mae also said it wouldn't file its first-quarter earnings on time because of its pending restatement for fiscal years 2001 through 2004, and doesn't anticipate offering 2005 results until its restatement process is completed. In its filing, Fannie said its administrative expenses during the first quarter rose by 15% to \$440 million from \$383 million for the first quarter of 2004. The company also reported it is facing stiff competition from banks, investment funds and other investors buying mortgage assets and issuing their own MBS. As a result, Fannie Mae's market share of mortgage-backed securities dropped sharply to 29% in 2004, compared to 45% in 2003. During the first quarter of 2005, the company's market share dropped further to 24%. Fannie said its purchase volumes for multifamily housing have been "further constrained by our assessment of the mixed real estate fundamentals." Fannie added, "Low mortgage rates have led to a record number of first-time homebuyers, many of whom were formerly renters." Rental vacancies are higher than normal and expected

returns on investment in rental properties have fallen to extremely low levels, said Fannie, “which we believe reflects other investors’ willingness to accept greater risk.” (*Dow Jones Newswires*, Dawn Kopecki, 05/11/05; *American Banker*, Rob Blackwell, 05/11/05; *Reuters*, 05/11/05, *Federal National Mortgage Association Form 8-K*, 05/11/05; BNA’s Banking Report, Richard Cowden, 05/16/05)

Fannie Mae’s internal investigation of its accounting improprieties delayed “indefinitely”

- Fannie Mae’s accounting investigators will indefinitely postpone reporting their findings because of evidence of more bookkeeping errors at the company, said former Senator Warren Rudman, a partner with law firm Paul, Weiss, Rifkind, Wharton & Garriso LLP, who is conducting an external probe on behalf of Fannie’s board. “There are a lot of new issues, a lot of governance issues, a lot of internal control issues,” said Rudman. “We have a huge amount of work behind us, and we’ve got a huge amount of work ahead of us.” To date, investigators have gathered as many as 1.5 million documents dating prior to 1998, and interviewed almost 100 people, he added. In part, the probe has been delayed by the review of information related to a Feb. 22 filing by OFHEO, raising questions about the company’s internal controls, systems and journal entries related to amortization adjustments, Rudman said. Rudman acknowledged that he would not provide details about Fannie Mae’s accounting errors before Congress votes on GSE regulatory reform legislation. “We can’t be concerned about that,” Rudman said. “We have a serious obligation to the board and to the regulators to do a thorough investigation and frankly we can’t tie it to other extraneous events which we cannot control.” (*Bloomberg News*, James Tyson, 05/12/05)

H.R. 1461 gains momentum, as Majority Whip Blunt signs on as cosponsor

- House Majority Whip Roy Blunt (R-MO), the number three Republican in the U.S. House of Representatives, said he will cosponsor the Federal Housing Finance Reform Act of 2005, offered by Ohio Representatives Michael Oxley (R-OH) and Richard Baker (R-LA). “Chairmen Baker and Oxley have done the hard work of crafting thoughtful legislation that will protect consumers, homebuyers and taxpayers,” said Blunt. “Their legislation [H.R. 1461] will strengthen regulatory oversight of the GSEs and help ensure confidence in our housing market.” House Majority leader Tom Delay also backs the creation of a stricter GSE regulator, said Delay’s spokesman Dan Allen. Delay is “supportive of a strong, independent regulator to ensure the soundness and safety” of the GSEs, he added. Blunt’s support is an indication that the bill will have the backing of other top House Republicans and greatly enhances its chances of passing this year, even if Democrats oppose the legislation. Blunt’s co-sponsorship is also notable, given his close friendship with Delay, who has largely been silent on GSE issues.

- Through the Delay Foundation for Children, Delay has close ties to Fannie and Freddie's top lobbyists. According to the Foundation's 2004 tax returns, Duane Duncan, Fannie's top lobbyist, and Mitch Delk, Freddie's former top lobbyist, are members of the Foundation's board, along with Delay's personal ethics attorney Ed Bethune and former Delay chief of staff Ed Buckman. Now a lobbyist with the Alexander Strategy Group, Buckman is linked with Delay's most recent ethics complaint concerning a foreign agent funding several overseas trips for Delay and other lawmakers in violation of House ethics rules. While Delay said he didn't realize the group was a registered foreign agent, Buckman helped the Korea-U.S. Exchange Council register as a foreign agent in 2001. The Delay Foundation for Kids has come under increasing public scrutiny for its prominent corporate donors, close ties to Delay allies and the comparatively sparse number of charitable projects it has sponsored for children. *The New York Times* reported that the Foundation's largest project, a housing complex outside of Houston for foster children, is being built by Bob Perry, a Texas contractor and large Republican donor who provided the initial funding for the Swift Boat Veterans for Truth. The Delay Foundation for Kids raises a bulk of its money through its annual golf tournament. (*Dow Jones Newswires*, Dawn Kopecki, 05/13/05; *Reuters*, Kristin Roberts, 05/13/05; *Representative Roy Blunt Press Release*, 05/13/05; *Bloomberg News*, James Tyson, 05/13/05)

<p>OFHEO classifies Fannie Mae as “significantly undercapitalized” for the 4<sup>th</sup> Quarter 2004 and “adequately capitalized” for the 1st Quarter of 2005</p>
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- Fannie Mae was “adequately capitalized” as of March 31, with a projected surplus over its minimum capital requirements that is sufficient to absorb the uncertain impact of accounting errors on its capital based upon current information, said OFHEO. Due to Fannie Mae's small surplus at year end 2004, OFHEO retained the “significantly undercapitalized” designation for the company as of December 31, 2004. “[G]iven the significant control weaknesses and the remaining uncertainties associated with the ongoing review of Fannie Mae's financial controls and accounting policies, a significant risk remains that accounting adjustments could deplete Fannie Mae's core capital to an amount below the required minimum for this time period,” said OFHEO.
- To improve its capital position, Fannie Mae has halved its dividend, issued \$5 billion in preferred stock, and sold portions of its huge portfolio of mortgages and related securities. As a result, OFHEO estimated Fannie's core capital as of March 31 stood at \$35 billion, up from \$32.64 billion on December 31 and \$28.86 billion on September 30. OFHEO's analysis is based on Fannie Mae's “current best estimates” of its financial position, adjusted for previous accounting errors, and is subject to change as Fannie completes its financial restatements. Fannie Mae will still need to raise additional capital in the second and third quarters of this year to meet its 30% capital surplus on September 30, as set forth in its regulatory agreement with OFHEO. If the surplus requirement had been in effect on March 31, Fannie Mae

would have been approximately \$5.3 billion short of its \$9.3 billion of surplus capital requirement. OFHEO noted that Fannie Mae appears to be on track toward meeting its capital requirement over time. (*OFHEO Press Release*, 05/19/05; *Reuters*, 05/19/05; *Dow Jones Newswires*, Dawn Kopecki, 05/19/05; *Wall Street Journal*, James R. Hagerty, 05/20/05; *American Banker*, Rob Blackwell and Barbara A. Rehm, 05/20/05; *Dow Jones Newswires*, Dawn Kopecki, 05/19/05)

FHLB-Seattle obtains resignations of two board members
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- Two directors have resigned from the FHLB-Seattle, following an internal investigation conducted by outside directors into stock repurchases last year. Allan Landon, the chairman and chief executive of Bank of Hawaii, and Roy Whitehead, the vice chairman and chief executive of Washington Federal Savings, have resigned from the Bank's board, but maintain they did nothing wrong, said the FHLB-Seattle. In October, the Bank of Hawaii and Washington Federal sold back \$25.4 million and \$48 million of B1 activity stock, just before the FHLB-Seattle cut its dividends and restricted future stock redemptions. The FHLB-Seattle said that its internal investigation concluded that while neither director had acted maliciously, the directors had to leave the board because they failed to disclose the deals ahead of time which left an "appearance of impropriety." In addition, the FHLB-Seattle said that the stock transactions would be reversed. The investigation also reviewed the Bank's repurchase of \$229 million of B2 excess stock from Washington Mutual Federal (WaMu), whose vice chairman is on the Bank's board. The investigation found that there was "no wrongdoing, policy violation or appearance of impropriety" regarding WaMu's stock sale. Libby Hutchinson, WaMu's spokeswoman, said her institution's stock redemption had been prearranged with the FHLB-Seattle several months beforehand.
- Finance Board chairman Ronald Rosenfeld said, "We are pleased to see that the Seattle board took the necessary and appropriate steps to resolve the situation." The FHLB-Seattle has notified the SEC of the situation as a part of its registration process, said the Bank's spokesman Colin Johnson. The SEC has not indicated if it plans to open its own inquiry, he added.
- The FHLB-Seattle's board is now seeking replacements for the two directors and is also considering a final vote on a new president for the Bank. In a press release concerning the dismissal of the Bank's directors, the Bank reiterated its gloomy earnings forecast for the foreseeable future, which management expects will place additional limits on the suspension of future dividend payments and stock redemptions. "...[T]he Seattle Bank is forecasting minimal net income, or possibly net losses, over the next few years." (*Business Wire*, 05/12/05; *Dow Jones Newswires*, Dawn Kopecki, 05/12/05; *American Banker*, Damian Paletta, 05/13/05; *National Mortgage News*, Paul Muolo, 05/16/05)

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

### *The Main Event: GSE regulatory reform*

House Financial Services Committee schedules markup of H.R.1461 for May 25

Bush administration pushes House lawmakers to severely cut the GSEs' portfolios

Fannie Mae supporters go to bat for the GSEs, as NAR invades Capitol Hill

Newspaper editorial boards speak out on limiting GSE portfolios

Fannie Mae critics speak out in support of strong GSE regulatory reform

### The main event: GSE regulatory reform

- The year-long campaign to overhaul the regulation for Fannie Mae and Freddie Mac may soon pass a milestone, as the House Financial Services Committee prepares to vote on a reform measure before Memorial Day. Negotiations on GSE regulatory reform legislation are reaching a crescendo on Capitol Hill, as lawmakers debate three key legislative provisions regarding the GSEs' minimum capital, prior regulatory approval for GSE activities, and limits on GSE portfolios. Coupled with the Federal Reserve Chairman Alan Greenspan's May 19<sup>th</sup> speech on curbing the GSEs' mortgage portfolio, the Bush administration has stepped up its lobbying efforts to push for a strong provision in the legislation, restricting the GSEs' portfolios. The National Association of Realtors and National Association of Homebuilders, longtime allies of the GSEs, have put on the full court press on Capitol Hill, urging lawmakers not to do damage to the housing markets by unnecessarily restraining Fannie Mae and Freddie Mac from supporting the market by purchasing mortgage assets or by placing restrictions on the GSEs' ability to develop new products. While the House Financial Services Committee's staff works furiously on final language for H.R. 1461, the Senate's attention is distracted by its debate over the President Bush's judicial nominees and Republican's threat to detonate the "nuclear option" to end the Democrats' filibusters of judicial nominations. Life is never dull on Capitol Hill.

### House Financial Services Committee schedules markup of H.R.1461 for May 25

- The House Financial Services committee is currently reworking sections of H.R. 1461 for committee action expected on May 25. "We're moving along on that track" for a May 25 vote, said committee spokeswoman Peggy Peterson. A House Democratic staffer said compromise language is coming together to increase the GSEs' financing of affordable housing in exchange for a provision that would give

the new regulator broad authority over the size and growth of Fannie's and Freddie's portfolios. "It's looking likely that there will some type of [GSE] reform," said the Democratic aide. Assuming Oxley secures bipartisan support for H.R. 1461, the House bill may then advance to a vote in the House by August 1, said Representative Richard Baker (R-LA). "It is likely if [H.R. 1461] comes out of committee with a bipartisan vote that is significant," the leadership "would want to move on it pretty quickly," Baker said. Representative Barney Frank (D-MA), the ranking minority member on the House Financial Services Committee, said that they are working to find a bipartisan consensus on H.R. 1461. While the May 25<sup>th</sup> session will likely be contentious, the committee is expected to approve the bill. "It is not quite there yet, but I think the differences, they're not huge," Frank said. "We're in the middle of negotiations." He said it is "very likely" that a proposal that Fannie and Freddie set aside 5% of their profits to fund affordable-housing projects and expand homeownership by low-income Americans will be included in the bill. Frank hopes that the bill will change the affordable housing goals, which will "tighten them up and increase them."

- The *Wall Street Journal* reports that Oxley is trying to win Democratic support for a draft amendment to H.R. 1461, expanding the GSEs' mandatory financing targets for low- and moderate-income homebuyers and setting up a regulatory board to oversee the GSEs' rental housing funds. The provision would revamp the GSEs' low-income financing goals to target lower-wage earners, by reducing the income criteria defining low- and very-low-income families as those earning 80% and 50% or less than an area's median income, respectively. The amendment also requires the GSEs to "lead the market" in financing homes for very low-, low- and moderate-income families in manufactured housing; affordable housing "preservation," including federally subsidized housing projects, such as rental housing assistance under the Section 8 program; and rural housing and other underserved markets. The amendment also increases flexibility under current law in evaluating the GSEs' performance in expanding affordable housing opportunities by directing the regulator to take into account new loan products, flexible underwriting guidelines, outreach to qualified loan sellers, along with the volume of loans purchased. Sources say that lawmakers are hoping to strengthen the amendment by prohibiting Fannie and Freddie from counting so-called loan buybacks toward their affordable housing goals. Oxley's amendment also calls on the GSEs to set aside 5% of their after-tax profits in separate affordable housing funds to be overseen by a seven-person board appointed by the GSE regulator. The board would be comprised of one representative from the GSEs' regulator, HUD, the Agriculture Department, and four affordable housing officials from the private and non-profit sectors. While the GSEs would control their respective funds, regulations would ensure that the grant process be competitive and transparent. Fannie and Freddie would submit an annual plan to the oversight board for distributing the funds, which would be subject to quarterly reviews. Neither the GSEs' plans nor their quarterly reviews would be available publicly for review. The GSEs would be required to use 90% of the funds to finance the "production, preservation and rehabilitation of affordable rental housing," targeting households with incomes at or below 50% and 30% of an area's median income and the

remainder of the funds devoted to “homeownership activities and down-payment assistance for low- and extremely low-income families,” and first-time homebuyers.

- The Senate Banking Committee Chairman Richard Shelby (R-AL) is still assembling his legislative proposal, which he is unlikely to unveil before June, said his spokesman Andrew Gray. “We’re in early discussions with members,” said Gray. He added that certain House Democrats are “engaged” in “moving a strong and substantive bill,” which “is positive.” Senator John Sununu (R-NH) said that House and Senate lawmakers will craft a provision in the GSE regulatory reform legislation that directs the GSEs’ new regulator to reduce the companies’ vast portfolios in line with their congressional missions. “I think in both the House and Senate (bills) there will be language that will give discretion and general policy guidance to the regulator to determine whether the portfolios are beneficial to the mission of the (government-sponsored enterprises) and increase systemic risk” and reduce assets where needed, Sununu said in a speech at a luncheon hosted by Citizens Against Government Waste. “[While] no one is talking about liquidation of the portfolios” to a specific cap over a prescribed period of time, Sununu said he doesn’t see any evidence that the GSEs’ portfolios aid the companies in accomplishing their mission. Further, there is no empirical evidence that the GSE portfolios help reduce mortgage rates, increase market liquidity during financial distress or expand access to mortgage credit for consumers, he said. Sununu told the audience that the Senate Banking Committee plans to markup the panel’s version of GSE regulatory reform legislation during the last week of June. (*Bloomberg News*, James Tyson, 05/13/05; *Dow Jones Newswire*, Dawn Kopecki, 05/19/05; *CQ Today*, Michael R. Crittenden, 05/20/05; *Bloomberg News*, James Tyson, 05/17/05; *The Main Wire*, Claudia Hirsch, 05/17/05; *Dow Jones Newswires*, Dawn Kopecki, 05/18/05; Bureau of National Affairs, Richard Cowden, 05/20/05)

#### Bush administration pressures House lawmakers to severely cut the GSE portfolios

- On May 19, Treasury Secretary John Snow hand delivered to members of the House Financial Services Committee a draft amendment for H.R. 1416, which specifically instructs the GSEs’ regulator to write rules that prevent the companies from holding assets that otherwise trade freely in the open markets. The practical effect of this provision would dramatically reduce the size of Fannie’s and Freddie’s aggregate \$1.5 trillion portfolio over a three to five year period through run-off or divestiture of assets. The provision specifically directs the GSE regulator to mitigate the broader systemic risks posed by the GSEs by reducing their assets to a diminutive amount needed to fulfill their public housing missions. Under the proposal, the GSEs could only hold in their portfolios pipeline loans that are awaiting resale to other investors, mortgages that fulfill their low-income financing goals, and Treasury bills. The provision would specifically forbid the GSEs from holding assets in their portfolios that could otherwise be packaged as securities and sold in the secondary mortgage market and prohibit them from investing in asset-backed securities that are not directly related to their housing missions, such as receivables, auto loans and airplane

leases. Another provision for which Treasury officials are seeking House backing would prohibit Fannie and Freddie from launching new programs, products or activities that are inconsistent with their federal charters, safety and soundness or “the public interest.” Treasury officials are trying to get House Financial Services Chairman Michael Oxley (R-OH) to include their proposed provisions in legislation the panel is scheduled to vote on May 25. While it is unclear whether House lawmakers will accept the Treasury proposal to place drastic curbs on the GSEs’ assets, the amendment appears to have a better chance in the Senate where the Banking Committee under Chairman Richard Shelby, R-Ala., is more likely to accept the Federal Reserve’s and administration’s recommendations on portfolio limits. (*Dow Jones Newswires*, Dawn Kopecki, 05/19/05; *Washington Post*, Annys Shin, 05/20/05)

- In a May 20<sup>th</sup> interview with *Bloomberg News*, Minority leader Barney Frank (D-MA) was quick to speak out against the Bush administration’s proposed changes to GSE regulatory reform legislation. Frank said the House Financial Services Committee is unlikely to support a Bush administration proposal to reduce the size of the GSEs’ portfolios, saying it “will not go down well” with the committee. “There isn’t support for portfolio limits on the committee,” Frank added. “The Bush administration is out of touch with their own members of Congress on this issue.” Michael DiResto, spokesman for Representative Richard Baker (R-LA), said that H.R. 1461’s language, which “doesn’t go as far as the administration would like,” remains “as is” ahead of next week’s committee vote. DiResto added, “I don’t think we have any plans to tinker with it as of this moment. Others may try to offer amendments to it. We’ll just have to see what they are and whether they’re weakening or strengthening.”
- In fact, Republican lawmakers face the “daunting task” of crafting legislative language that would give the new regulator control over the GSEs’ portfolios without alienating either the White House or Congressional Democrats, according to analysts and observers. *National Mortgage News* reports that one lobbyist said the Treasury Department will not cave on the issue of reducing the size of the GSEs’ portfolios. One mortgage banker close to the Bush administration said “Treasury is playing tough. The question now being asked is whether a bill passes--will the president veto it?”
- Some market participants see the open-ended provision of H.R. 1461, providing broad discretion over the GSEs’ retained mortgage portfolio, as a lack of resolution for the GSEs, said Nancy Vanden Houten, government agency and policy analyst at Stone & McCarthy Research Associates. “The risk of this situation is that we’re even more uncertain of what the [GSEs’] portfolio size is going to be,” she said. “From the market’s perspective, it’s potentially the worst of both worlds because of heightened uncertainty.” The markets appear to have priced in regulatory reform and are more vulnerable to lawmakers’ failure to complete GSE legislation, she added. Charles Gabriel, political strategist at Prudential Securities in Washington, D.C., said, “This bill, which will empower a potentially very intrusive new regulator, will only perform

half of the surgery in the extreme makeover of Fannie and Freddie. The rest will be determined by who has control of the White House and Congress in the coming years.” (*Bloomberg News*, 05/20/05; *The Main Wire*, Claudia Hirsch, 05/20/05; *National Mortgage News*, Paul Muolo, 05/16/05)

### Fannie Mae supporters go to bat for the GSEs, as NAR invades Capitol Hill

- The week of May 9-13, the National Association of Realtors pulled out all the stops by sending more than 8,500 realtors to Capitol Hill to push for policies protecting the affordable housing mission of Fannie Mae and Freddie Mac. Realtors called on lawmakers to increase conforming loan limits for mortgages purchased by the GSEs, arguing that the current loan limit of \$359,650 for single family residences in most states is too low in today’s marketplace. “We’re not proposing a number, but the current number is too low,” said NAR spokesman Steve Cook. Realtors also urged lawmakers not to restrict the size of the GSEs’ portfolios, which would make it more difficult for Fannie and Freddie to provide financing for affordable housing. NAR also opposes the “bright line” provision of H.R. 1461, arguing that the language would preclude many GSE activities and products that support housing. The NAR “spends big,” when it comes to lobbying; its 2004 expenditures totaled \$13.5 million, up 37% from its 2003 lobbying expenses of \$9.84 million, placing the trade group in the top 10 of all organizations lobbying in Washington, according to PoliticalMoneyLine.com. (*CongressDaily PM*, 05/09/05; *National Journal*, Bara Vaida, 05/07/05)
- On May 19, A “diverse cross section of the nation’s mortgage finance industry” sent letters to leadership of the House Financial Services Committee and Senate Banking Committee to outline their concerns about “important areas” in GSE regulatory reform debate that shift the focus of the legislation from creating a robust safety and soundness legislator into areas that would give the regulator “authority to fundamentally reshape the housing finance playing field.” The mortgage lenders addressed their concerns in five specific areas. With regard to the administration’s proposal to restrict the GSEs’ retained portfolios, the groups strongly oppose hard caps on the GSEs’ balance sheets and argue that identified risks should be addressed through regulatory capital requirements, not arbitrary caps. Further, the groups argued that the regulator should have the power to set minimum capital only if it is tied to safety and soundness concerns. While the groups’ support providing the new GSE regulator with approval of new programs and new business activities, they argue that the lawmakers should include provisions that clearly permit “new mortgage products” to be introduced on a prior notice basis with a minimal waiting period. The groups argue against the “bright line test,” saying the provision provides the GSE regulator with the authority to make wholesale changes in lender-GSE relationships and to enforce a rollback of existing products and services. They argue that the GSEs’ AU systems increase competition in the mortgage market by permitting lenders to fund and sell to the best pricing in the market. The groups also argued against the call for a new GSE regulator to establish a “one-size-fits-all” approach to

setting guarantee fees. Instead, they argue this approach would not improve competition and would actually undermine the safety and soundness of the GSEs. The 34 signatories included eight national lenders [including Countrywide Financial Corporation], two mortgage cooperatives, and 24 regional lenders. (*Correspondence to Chairmen Michael Oxley (R-OH) and Richard Baker (R-LA), and Ranking Members Barney Frank (D-MA) and Paul Kanjorski (D-PA)*, 05/19/05; *Correspondence to Chairman Richard C. Shelby (R-AL) and Ranking Member Paul Sarbanes (D-MD)*, 05/19/05)

### Newspaper editorial boards support placing limits GSE portfolios

- On May 9, the *Wall Street Journal* wrote in an editorial, “It was too good to be true. After two accounting scandals and years of denial, Congress finally seemed ready to protect taxpayers from the financial high-flying of Fannie Mae and Freddie Mac. But that was before Republican Mike Oxley and others on Capitol Hill decided to ride to their rescue. ...[T]he draft reform bill that he’s introduced in the House falls well short of what’s needed to protect taxpayers, not to mention the U.S. economy, from a financial crisis. The disappointment is especially acute because the reform effort had been going along so well. Both the Federal Reserve and the Bush Administration have been focusing on the major source of risk at the giant mortgage companies -- their portfolios of mortgage-backed securities, or MBSs.”
- “Fan and Fred’s main business is buying home mortgages and then packaging them into MBSs for sale, thus adding more liquidity to the mortgage market. But in recent years they have also been buying some of those MBSs back for their own investment portfolio, using their inside knowledge and the financing edge they have from government subsidy to ‘cherry pick’ the most profitable. The problem is that this subjects Fan and Fred to substantial risk if the mortgage or real estate markets come under pressure. Credit risk -- if a borrower defaults on a loan -- is well known. But there’s also prepayment risk -- if borrowers decide to exercise their option to pay back a loan earlier than its full term, thus reducing expected income. Fan and Fred run trillion-dollar derivative books to hedge these risks, but they don’t hedge completely because that would limit their profit from buying MBSs. In any case, their derivative accounting has been exposed as a ‘black box’ mess. The sensible policy response is to wind down their portfolio of MBSs. As Fed Chairman Alan Greenspan has testified, repurchased MBSs do little or nothing to fulfill the companies’ Congressional mandate to promote housing. Apart from a small amount needed for liquidity, they merely pad Fannie’s private profit while increasing the public risk to taxpayers if something goes awry. Mr. Greenspan and Treasury Secretary John Snow have thus recommended that the portfolio of MBSs be limited via law or Congressional policy guidance.”
- “Enter Mr. Oxley, who wants to toss the MBS question to the new regulator that Congress is creating to monitor Fan and Fred. That regulator in turn would be able to pare back the MBS portfolios only if they posed a threat to safety and soundness. By

the time any regulator came to that conclusion, of course, a crisis would be well under way -- or such a judgment might trigger one. This means there are effectively no MBS portfolio limits in the Oxley bill. The Congressman also punts on the power of the regulator to approve new businesses for Fan and Fred. He borrows language from current law that our sources say would make it difficult for any regulator to challenge the companies' desires -- especially given their political clout. And by delaying this provision until a year after any bill passes, he grandfathers anything the companies now plan to do."

- "We should have known the two mortgage giants wouldn't change without a fight. Their new, post-scandal, executives are talking a nice, cooperative game. But their allies in the homebuilding trades are deluging Congress with the usual fears that reining in Fan and Fred will hurt home ownership. They're even playing the race card, as in the email we received from Mary Mancera of the National Association of Hispanic Real Estate Professionals. 'Reform Proposals Will Limit Latinos Access to Homeownership,' she declared, apparently with a straight face. There is no evidence -- none -- to support this."
- "...Mortgage finance can be technical, and most Members of Congress barely understand it. They bend instead to the strongest political incentives, which means the Beltway homebuilders and Realtors who've been in bed with Fan and Fred so long that they don't even care that their repurchased MBS portfolios do nothing for home ownership. Mr. Schumer and other politicians are in it for the campaign contributions, and it is especially amusing to see liberals fight for MBS portfolios that merely enrich already rich Fannie executives. "
- "However, there is a larger issue of protecting taxpayers, and the financial system, from the risk of a Fannie or Freddie crisis. This is what has worried us for years, and worried the Fed and Treasury more recently. Fannie's friends on the Hill want a Potemkin reform that solves their political problem while letting them return to subsidy-as-usual. We hope the Bush Administration and Republicans on the Senate Banking Committee don't flinch the way House Republicans have. If Mr. Oxley insists on weak reform, then better to pass nothing and leave Fan and Fred to cope with continuing political risk, including the consequences of whatever new accounting surprises emerge. Maybe by then House Republicans will figure out their own political risk from doing nothing." (*Wall Street Journal*, 05/09/05)
- In a May 16<sup>th</sup> editorial, *The Christian Science Monitor* wrote, "A group of some 8,500 realtors ...members of the 1.2 million strong National Association of Realtors, saturated Capitol Hill last week, arguing that homeownership would be jeopardized if [Fannie Mae and Freddie Mac] are shrunk. Balderdash. Both companies have long gone way beyond their mandate to make homeownership more affordable to low-income Americans. Federal Reserve Chair Alan Greenspan says the two giants need stronger regulation and should greatly reduce their combined portfolios. One unfortunate result of all the lobbying: a reform bill in the House that simply doesn't have enough teeth. For example, it gives a new regulator authority to reduce Fan and

Fred's portfolio size, but only if he or she felt it posed a threat to the country's financial safety. The bill also doesn't give a new regulator explicit authority to approve new business ventures for Fannie and Freddie, which both need in order to keep them in check. (Their portfolios grew tenfold between 1990 and 2003.)"

- "For far too long, Fan and Fred have enjoyed special privileges - such as a line of credit with the Treasury Department, that's allowed them to borrow money more cheaply than the banks. They also don't have to pay certain taxes. It's time for both to be privatized and put on a level playing field with banks and other lenders. Short of that, Congress should approve a regulator with the power to force them to reduce their portfolios. To put it bluntly, if the financial risk isn't reduced, American taxpayers could be forced to bail the two out. And no one wants that. (*The Christian Science Monitor*, 05/16/05)

#### Fannie Mae critics speak out in support of strong GSE regulatory reform

- On May 16, the Shadow Financial Regulatory Committee issued a statement saying, "[T]he Committee strongly endorses the administration's proposal for limiting the portfolios of Fannie and Freddie, recently advanced by Secretary Snow in testimony before the House Financial Services Committee. That proposal would direct the GSEs' new regulator to reduce the size of their portfolios to the level necessary to support their securitization activities. This would be a much lower level than the portfolio's current size, yet would enable the companies to continue the functions for which Congress chartered them. Unfortunately, the only legislation currently on the table in Congress does not go far enough to limit the risks that Fannie and Freddie create through their accumulation of large portfolios. H.R. 1461, drafted by Chairman Michael Oxley and Subcommittee Chairman Richard Baker, would place the responsibility for reducing GSE portfolios solely on the shoulders of the new regulator, but without any direction by Congress and without any workable standard except a finding by the regulator that such a reduction is 'consistent with the safe and sound operation of the enterprises.' The Shadow Committee believes that this standard is deficient in a number of respects. It does not direct the regulator to reduce the size of the GSEs' portfolios, but only to do so if the portfolios threaten their safety and soundness. Unfortunately, by the time this becomes clear, the losses that Congress fears will have occurred. If, as the Committee believes, the GSEs can carry on their functions entirely through securitization, there is little reason for the taxpayers or the economy to be exposed to the interest rate risk associated with the GSEs' accumulation of portfolios. Finally, without a clear direction from Congress, it is unlikely that a regulator will be able to challenge these two powerful companies when Congress itself seems fearful of doing so. If the risks associated with the portfolios of Fannie and Freddie are ever to be limited, Congress must summon the political will to give this direction to the regulator, and the best way to do that would be to substitute the administration's proposal for the language currently in the H.R. 1461."

- “The Committee also suggests strengthening the provisions of H.R. 1461 that authorize the regulator to appoint a receiver in order to bring them closer to the mechanisms already in place for resolving failing banks. In particular, the draft bill now authorizes the regulator to appoint a receiver if a GSE becomes critically undercapitalized, but does not require the regulator to do so or specify the capital ratio at which this action must be taken. However, we know from the S&L crisis that discretionary authority of this kind provides the opportunity for forbearance, which is a natural tendency of regulators confronting politically painful actions. Accordingly, the bill should be amended to make the appointment of a receiver mandatory if a GSE becomes critically undercapitalized.”
- “Finally, Congress should adopt a number of additional provisions that will reduce the impression among investors that Fannie and Freddie are backed by the government. Thus, Congress should repeal their exemption from state and local taxes, their so-called line of credit at the Treasury, the authority for national banks to make unlimited investments in their securities, and the fact that their securities may be used to collateralize Treasury’s deposits in banks. In addition, as appropriate for organizations that receive a government subsidy, the GSEs should be prohibited from making political contributions and their lobbying activities should be limited.”  
(*Statement of the Shadow Financial Regulatory Committee on Limiting GSE Portfolios*, Statement 218, 05/16/05)
- In AEI’s *Financial Services Outlook*, Peter J. Wallison writes “After years of trimming around the edges of the GSE problem, Congress--with the help of Chairman Alan Greenspan--has finally come to the nub of the issue. If Congress can bring itself to overcome the furious political opposition of the GSEs and their supporters, it will direct the new GSE regulator to reduce the size of Fannie’s and Freddie’s portfolios and endorse a workable standard by which to measure the proper size of the smaller portfolios that result. This will solve, finally, the problem of two entities using their implicit government backing to control the residential mortgage market, which creates massive risks for the taxpayers and the economy in general. If Congress cannot take this essential step, however, no amount of additional authority--given to a purported ‘world class regulator’--will significantly change the course of events. Fannie and Freddie will continue to grow, and one day--as Alan Greenspan has predicted--there will be a massive default with huge losses to the taxpayers and systemic effects on the economy. We should be grateful that Congress finally has before it a serious proposal that is equal to the seriousness of the problem. But we should also worry about whether Congress can find within itself the political will necessary to see the task through to its logical conclusion. (*American Enterprises Institute Financial Services Outlook*, Regulating Fannie Mae and Freddie Mac: Now It Gets Serious, Peter J. Wallison, May 2005)

House Financial Services Committee study concludes that Fannie and Freddie  
“cut corners” to hit their affordable housing goals

- An analysis by the House Financial Services Committee concluded that Fannie Mae and Freddie Mac engaged in dubious transactions to meet their affordable housing goals over several years. The nine page report said Fannie Mae and Freddie Mac bought mortgage pools containing commercial properties; bought pools with loans that were more than 20 years old; counted properties toward their goals that they never actually owned; and double-counted some mortgages. “There is a legitimate question as to whether the GSEs violated the spirit of the housing goals,” if not the letter of the law, the staff concluded. “If the purpose of the goals is to increase access to affordable housing, it is questionable whether the purchasing and securitizing of large pools of loans actually accomplishes this goal.”
- The report highlighted several transactions that were “inappropriate” and did not meet affordable housing needs. In one example, Freddie Mac entered into several transactions with General Motors Acceptance Corp., that involved the purchase of commercial properties, including a pool that collateralized by a Wal-Mart; Sam’s Club; Bed, Bath & Beyond; and Winn-Dixie. Only one-third of this pool contained residential mortgages, the report said. The staff concluded that the GSE’s purchase of commercial mortgage-backed securities “drives funds from Freddie Mac away from affordable-housing projects and helps supply liquidity to some of the largest corporations in the United States.” In a credit enhancement transaction for a pool of tax-exempt bonds backed by a pool of multifamily mortgage loans held by Merrill Lynch, Freddie did not own the properties but used them nevertheless toward counting to its affordable-housing goals, the report said. The report highlighted a variety of questionable incentives, such as cash subsidies, price premiums, lucrative transaction fees and reinsurance transactions, which were paid by Fannie and Freddie to lenders for loans that met their AH goals. “[O]ne of the most troubling aspects of this review [was that the GSEs] double-count loans that have been securitized once, repurchased by a financial institution, and then resold to the GSE,” said the report. “This is in direct conflict with the spirit of the affordable-housing goals and amounts to nothing more than a shell game with the mortgage pools. It is likely that financial institutions sold these mortgages to one of the GSEs, repurchased them, and then resold them to the second GSE.” (*American Banker*, Rob Blackwell, 05/13/05; *Dow Jones Newswires*, Dawn Kopecki, 05/18/05)

Outgoing OFHEO Director Falcon’s parting advice:  
“Do your job as objectively and at times as forcefully as necessary”

- Outgoing OFHEO Director Armando Falcon Jr. recommends to his successor to stay focused. “Do your job objectively and at times as forcefully as necessary, and don’t bow to political whims, because, as these past five years [at OFHEO] have

demonstrated, your critic today could be your friend tomorrow,” Falcon said. “Director Falcon led OFHEO with skill and resolve under extraordinary circumstances, and without a hint of partisanship,” said Reginald Brown, a former special assistant to President Bush who played a key role in developing the administration’s views on GSE reform. “His job was one of the toughest and most thankless in Washington, and he managed to not only survive, but to establish himself in the end as one of the town’s most savvy and effective regulators. It will be tough to find a successor of his caliber,” Brown said. (*American Banker*, Rob Blackwell, 05/18/05)

- With his resignation effective May 20, Falcon handed over the reins to his deputy, Steve Blumenthal, who will serve in his place on an interim basis. Some observers said that the White House might appoint another acting agency head or nominate a permanent replacement. The candidates include Mark Sullivan, the Treasury Department’s director of European Bank for Reconstruction Development and FDIC Don Powell, sources said. Sullivan is very familiar with GSE issues, having worked for Fannie Mae as special Counsel in the early 1980s and served as Treasury’s general counsel from 1988 to 1989. Powell has been mentioned as both a temporary and permanent successor to Falcon. According to sources, Powell wants to serve concurrently as the FDIC chairman and acting OFHEO director, which raises the question of the legality of a dual role. Some point out that similar moves have been made in the past, when Nicolas Retsinas was appointed head of OTS, while he also served as HUD’s assistant secretary for housing and a director of the Federal Housing Finance Board. Sources say that Powell doesn’t want to give up his seat at FDIC for a temporary post at OFHEO. According to sources, Blumenthal is not the Bush administration’s top pick as (permanent) interim director. Blumenthal, who is not a political appointee, took himself out of consideration by telling the White House he doesn’t want to be considered for the top job. Ronald Rosenfeld, chairman of the Federal Housing Finance Board and former president of Ginnie Mae, is said to be the top candidate to head the new GSE regulator, if and when GSE regulatory reform legislation is passed by Congress. Since Finance Board rules preclude Rosenfeld from simultaneously holding another position, he is not a candidate to serve as interim director at OFHEO, said people familiar with the matter. (*Dow Jones Newswires*, Dawn Kopecki, 05/10/05; *American Banker*, Rob Blackwell, Barbara A. Rehm, Michele Heller, and Elisabeth Goodridge, 05/09/05; *American Banker*, Rob Blackwell, 05/18/05)

More leadership changes on the horizon
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- More than a year before Representative Michael G. Oxley (R-OH) relinquishes his chairmanship of the House Financial Services Committee due to term limits, replacements are already jockeying for position. The early favorite is Representative Richard H. Baker (R-LA), chairman of the subcommittee on capital markets, who has taken steps to repair his sometimes-rocky relationship with Oxley by compromising on his bill to overhaul the regulation of GSEs. Two members of the House GOP

leadership could “trump” Baker, if they want the powerful post: Republican Conference Chair Deborah Pryce (R-OH) or House Rules Committee Chair David Dreier (R-CA.). (*Business Week*, 05/23/05)

- At Paddypower.com, the Ireland-based online gambling network, you can place your bet on who will be the next chairman of the Federal Reserve, following Chairman Alan Greenspan’s retirement in late January 2006. On May 13, early favorites were Ben S. Bernanke, the Fed governor and former chairman of Princeton’s economics department who is awaiting Senate confirmation to become the chairman of the White House Council of Economic Advisors with odds of 13-8, and Glenn Hubbard, former chairman of the council. Other picks include president of the National Bureau of Economic Research Martin Feldstein with odds at 4-1; former Treasury Undersecretary of International Affairs John Taylor with odds of 13-2; and Fed governor Donald L. Kohn with odds of 15-2. An online poll of 87 Wall Street professionals conducted by the economics firm Stone & McCarthy found Bernanke was the most likely candidate to succeed Greenspan, followed by Feldstein, and Hubbard. (*American Banker*, Damian Paletta, Rob Blackwell, and Michelle Heller, 05/16/05; *USA Today*, Sue Kirchoff, 05/19/05)
- Federal Reserve Governor Edward Gramlich announced he is resigning at the end of August to return to teaching, creating a second opening at the central bank. Gramlich has served on the board since November 1997, where he has played key roles in pushing major changes to the Fed’s Home Ownership and Equity Protection Act and the HMDA regulations. In a statement, Chairman Alan Greenspan praised Gramlich’s contributions to the Fed by saying, “Our deliberations have been enriched by his keen insights, his good humor, and his lively mind.” (*USA Today*, Sue Kirchoff, 05/19/05; *National Mortgage News*, 05/19/05)

Federal Reserve Chairman Greenspan, noting froth in the real estate market, calls housing “speculation” unsustainable
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- Federal Reserve Chairman Alan Greenspan said that some regions of the U.S. housing market show signs of unsustainable speculation and “froth” based on rapid sales, which may ease as homes become less affordable. “It’s pretty clear that it’s an unsustainable underlying pattern,” Greenspan said in response to a question following his speech on energy to the Economic Club of New York. “People are reaching to be able to pay the prices to be able to move into a home,” he said. “There are a few things that suggest, at a minimum, there’s a little froth in this market.” While “we don’t perceive that there is a national bubble,” he added, “it’s hard not to see that there are a lot of local bubbles.” Greenspan’s comments represent his strongest comments to date on rising home prices, on the heels of an April 22 speech by Fed Governor Donald Kohn, who said that rising home prices now “raise questions.”
- Greenspan told the audience that a national bubble is unlikely because the U.S. real estate market is composed of individual regions with different pricing trends, making

a collapse that damages the overall economy unlikely. Further, home purchases and sales have high transaction costs, making it hard to speculate, he said, adding that most people buy homes to live in. Fed economists have concluded that second home purchases are partly responsible for driving up the ratio of sales to the existing housing stock, Greenspan said. Since buyers can sell second homes without facing relocation costs, he said the more rapid pace of second home purchases may reflect speculation in some markets.

- Greenspan said there's a risk that consumer consumption may decline if the housing market slows. "If it occurs, and eventually it will, it will reduce the fairly large and still accelerating degree of extraction of equity from existing homes," he said. "This has been a major force in financing consumption expenditures." Greenspan concluded that he expects the surge in home prices to "simmer down," noting that buyers have to resort to unusual financing techniques, such as interest-only loans, to afford homes today.
- Aided by a low interest rate environment, combined sales of new and existing homes, townhouses and condominiums set four records in each of the past four years. According to the National Association of Realtors, the median price of a previously owned home in March rose 11% from a year earlier, the biggest 12-month gain since December 1980. A March 1<sup>st</sup> NAR survey found that 23% of homes sold in 2004 were purchased by investors. "When you get speculation, there are only a couple of ways for it to end, and they are not good," said Jay Mueller, senior portfolio manager at Wells Capital Management, a division of Wells Fargo & Co. "We are nowhere close to income growth matching house price appreciation."
- Concerned about the growing risks in the mortgage market, the Fed Reserve and other banking regulators announced that they are planning to issue new guidelines for mortgage lenders by early next year. Regulators are now turning their attention to first mortgages, after recently issuing their first-ever guidelines for credit-risk management for home equity loans. In the home-equity guidelines, regulators warned banks that they should tighten controls on home equity loans that they said are too often offered with no documentation of a borrower's assets. Regulators' concerns about risk in the first mortgage market have been heightened by the growing popularity of adjustable-rate mortgages and interest-only (IO) loans. According to the Mortgage Bankers Association, IO loans accounted for 17% of loan originations in the second half of 2004, while adjustable rate mortgages (excluding IO ARMs) accounted for 46% of originations, based upon the dollar volume of mortgages originated. Approximately 8% of originations consisted of Alt-A loans, typically made to borrowers who have good credit but don't necessarily fit into conforming loan standards. IO loans have been particularly popular in high-cost markets, such as California where IO loans accounted for 61% of mortgages closed in the first two months of 2005, up from 47% in 2004. (*Bloomberg News*, Craig Torres, Alison Fitzgerald, Vince Golle, Howard Liberman and Bernardo Soriano, 05/20/05; *Wall Street Journal*, Ruth Simon and James R. Hagerty, 05/19/05; *Reuters*, 05/18/05)

Federal Reserve Board Governor Bies says regulators on target  
for fall release of Basel II rules

- Work on the Basel II Notice of Proposed Rulemaking (NPR) and related amendments to Basel I is continuing, as regulators review the findings of the Four Quarter Impact Study (QIS4) of Basel II, said Federal Reserve Board Governor Susan Schmidt Bies. Federal regulators appear to be on target for fall release of a rulemaking under the Basel II Capital Accord, as previously planned, she said. On April 29, regulators had announced a delay of the Basel II NPR, when the impact study showed that Basel II could lead to lower overall capital than expected, as well as significant competitive disadvantages for banks that do not adopt the accord. Bies emphasized that the regulators' work on the rulemaking is continuing and stressed that the unexpected results of the impact study show the benefit of conducting such studies. Since the results were more widely dispersed and showed a larger overall drop in capital than was expected, Bies said, "[W]e want to take time to see what we learn from this QIS4 review and really say given that, what changes do we need to make in the NPR." She added, "We must now determine the reasons for the unexpected results from QIS4. Do they reflect actual differences in risk among respondents when prior supervisory information suggested more similarity in credit quality?" While various agencies have different reservations about different issues, they are working together to meet "very tight timetable," Bies said. "I don't want to say that the timetable drives everything, but we do have our folks focused on identifying the issues and addressing them in order to make the time frame." (*Bureau of National Affairs*, Martha Kessler, 05/20/05)

## *Fannie Mae*

Restructuring at Fannie continues with addition of nine new officers to its finance division

- Fannie Mae has added nine new officers to its finance division as the first step of a company-wide reorganization required by OFHEO. “This is the first phase of implementing a very significant reorganization, which the Board has approved. Reorganizing and strengthening our finance area is a top priority as we progress through the review, re-audit and restatement process,” board member H. Patrick Swygert said in a press release. “Strengthening the Controller’s Office is another link in the chain. We are rebuilding Fannie Mae one link at a time,” said interim chief executive Daniel H. Mudd in the release.
- Eight new officers will be in the controller’s office to provide better checks and balances and improved oversight in the company’s restatement process, said Fannie Mae. Four of the hires replace executives who previously oversaw the company’s accounting and remain on the Fannie Mae’s payroll for a year in advisory positions. The new officers include R. Scott Backley, C.P.A., Senior Vice President – Accounting Policy, formerly from American Online; Mary B. Doyle, C.P.A., Senior Vice President- Financial Controls and Systems, who returns to the company from Sallie Mae; Gregory H. Kozich, C.P.A., Senior Vice President-Accounting, formerly with PricewaterhouseCoopers, LLP; Paul A. Noring, C.P.A., Senior Vice President – Finance, formerly with PricewaterhouseCoopers, LLP; James Kelly Ardrey, Jr., C.P.A., Vice President for Assets Accounting, formerly with SunTrust; Patricia Black, Vice President for Financial Controls, formerly with BearingPoint, Inc.[formerly KPMG Consulting]; Nigel D. Brazier, Vice President and Business Unit Controller, formerly with Select Portfolio Servicing, Inc.; James W. Horne, C.M.T., Vice President for Accounting Systems, formerly with BearingPoint, Inc.; and Nicholas Radesca, C.P.A., Vice President Financial Reporting, formerly with Del Monte Foods Company. (*PR Newswire*, 05/18/05; *Washington Post*, Annys Shin, 05/19/05; *Dow Jones Newswires*, Dawn Kopecki, 05/18/05)

Will “Mr. Enron” be the next CEO of Fannie Mae?

- *Dow Jones Newswires (DJN)* reports that Fannie Mae is expected to announce its permanent CEO within weeks, according to people close to the company. While Fannie’s board has kept its slate of candidates tightly under wraps, the search has narrowed to a couple of key executives, former Senator Phil Gramm (R-TX) and JP Morgan Chase & Co. Vice Chairman David Coulter, said sources close to the GSE. In *DJN*, Dawn Kopecki writes, “Gramm, now a vice chairman at UBS Investment Bank..., would be an unusual choice for CEO, considering Fannie’s accounting problems and his close ties to bankrupt energy trader Enron Corp. ...- where his wife Wendy Gramm sat on the board’s audit committee at the height of Enron’s

accounting problems. Wendy Gramm, who chaired the Commodity Futures Trading Commission before joining Enron's board in 1993, joined other former Enron directors recently in agreeing to pay \$13 million to settle a large shareholder lawsuit. ...Gramm ...aided Enron in winning various regulatory exemptions for energy traders when he helped draft the Commodity Futures Modernization Act of 2000 as chairman of the Senate Banking Committee. Once known as one of Washington's preeminent power couples, the Gramms are now referred to around town as Mr. and Mrs. Enron."

- In recent weeks, Gramm has met with Fannie to discuss GSE regulatory reform legislation pending in Congress, and is registered as a lobbyist on the issue, according to a UBS source. Several aides on Capitol Hill and other policymakers said Gramm was instrumental in getting House Financial Services Chairman Michael Oxley (R-OH) and Representative Richard Baker (R-LA) to cut a Federal Reserve provision from their GSE, which would have capped the GSEs' on-balance sheet assets to \$200 billion for each company.
- Coulter has extensive Wall Street experience as the former CEO of Bank of America (BofA). In the late 1990s, he accepted responsibility for BofA's \$1 billion loss stemming from Long Term Capital Management and Russian debacles and resigned after BofA's merger with NationsBank. At JP Morgan, Coulter has risen as one of the company's brightest stars and has recently taken over its West coast operations.
- T. Timothy Ryan Jr., a managing director in JP Morgan's investment bank, has been also been mentioned as a possible Fannie CEO candidate. While Ryan doesn't appear to have as much CEO experience on Wall Street as Coulter, he knows his way around Washington, DC and is highly regarded in Republican regulatory circles, having run both the Office of Thrift Supervision and the Resolution Trust Corp. Ryan also worked as a special counsel in the 1980 Reagan-Bush transition; was solicitor of the Labor Department between 1981 and 1984; and served as special counsel to President Bush's 1988 election effort. Ryan has also worked closely with Fannie and Freddie on regulatory matters, signing several comment letters in recent years arguing against changes in the GSEs' capital rules. Other rumored candidates for Fannie Mae's CEO include former SEC Chairman Richard Breeden, former Consec Inc. CEO William Shea, John Mack, the former CEO of CSFB, the investment banking unit of Credit Suisse Group, Fannie's interim CEO Daniel Mudd, and Bear Stearns Companies' president Warren Spector. At a Morgan Stanley conference in New York, Spector squelched such speculation by saying, "I am not interested in leading Fannie Mae if they were to ask me," adding that while Fannie is a "fine" company, it "certainly has its challenges at the moment." He continued, "I would prefer to keep away from spending all of my time talking to Congress and regulators." (*Dow Jones Newswires*, Dawn Kopecki, 05/16/05; *Reuters*, 05/17/05; *Dow Jones Newswires*, Dawn Kopecki, 05/10/05; *Reuters*, 05/10/05)

Fannie Mae's former CEO Raines joins Revolution LLC as "informal advisor"

- Former Fannie Mae chairman and CEO Franklin D. Raines is now serving as an informal adviser for Revolution LLC, a Washington, DC-based private equity firm launched in April by former America Online chairman Steve Case. Raines, who "is a friend and colleague" of Case's, has had an office at Revolution's downtown D.C. headquarters since mid-April, said company spokeswoman Malin Jennings. While Raines does not hold a title at the company and is not receiving a salary, he is assisting Case and his team in evaluating health care companies that Revolution might invest in, Jennings said. When the company rolls out its health care venture in late May, Raines will be an investor and board member, she added. Raines' relationship with Case dates back to the late 1990s, when Raines became a member of AOL's board of directors, where he remained through the company's merger with Time Warner. Case stepped down from the Time Warner board in 2003; Raines left the board in 2004. Revolution is Case's first major business venture since his departure from AOL, in which he is investing more than \$500 million of his own money into the company, which invests in resorts, spas and health care companies.
- Following Raines' retirement from Fannie Mae in December, he has also stepped down from the boards of Pfizer Inc., PepsiCo and TIAA-CREF in 2005. Raines has continued his role as general partner in the Washington Baseball Club, a group of high-powered Washington business people led by Thayer Capital Partners Chairman Frederick V. Malek and former Advisory Board chairman Jeff Zients, who hope to purchase the Washington National baseball team. (*Washington Post*, Annys Shin, 05/10/05; *National Mortgage News*, 05/16/05)

Déjà Vu: "Don't change things. Don't screw it up," said Franklin Raines in Fall '98

- In the Fall 1998 *Harvard Law Class Notes*, Janet Hawkins wrote about Franklin D. Raines (Class of 1976): "Raines says that Fannie Mae has everything it needs from Congress to grow and prosper, including strong bipartisan support. Unlike those who may dread the prospect of additional Washington gridlock, 'We would be perfectly happy if Congress did nothing,' he says. The mantras of Fannie Mae lobbyists on the Hill, Raines adds, are 'Don't change things. Don't screw it up.'" (*Harvard Law Class Notes*, Janet Hawkins, Fall 1998)

Fannie Mae unloads \$9 billion in subprime mortgage-backed securities

- In an effort to downsize the company to meet its capital requirements, Fannie Mae liquidated select asset-backed securities through \$9 billion in private placement re-REMIC deals, reportedly consisting entirely of subprime mortgage collateral according to sources. "[Fannie Mae has] been heavy purchasers of the triple-A private label securities out there, and this may be a way of getting some of that off the

books, while still retaining a piece of the earnings, and not driving down prices with a big sale,” said Jay Brinkman, Mortgage Bankers Association’s vice president for economics and research. Quincy Tang, senior vice president at Dominion Bond Rating Service, said the setup is unique for a re-REMIC because it consists entirely of senior bonds.

- Fannie’s deals, FNGT 2005-T2 and FASC AAA Trust 2005-2, were managed by RBS Greenwich Capital. Fannie issued three classes off its grantor trust, which included the IA1 tranche, worth \$2 billion with a one year weighted average life; the \$337.3 million II-A2 tranche with a three-year weighted average life; and a \$698.7 million IA3 tranche with an weighted average life of 6.19 years, The tranches priced at one, 12, and 21 basis points over one-month Libor, respectively. According to sources, Fannie will retain a \$2 billion II-A2 class. Off Greenwich’s AAA Trust shelf, \$2.8 billion one-year A1 paper priced at 10 basis points over Libor, while \$698.7 million of 6.12-year A3 notes priced at 37 basis points over one-month Libor. All five offerings received triple-A ratings from Moody’s Investors Service, Standard and Poor’s and Dominion Bond Rating Service. (*Asset Securitization Report*, Allison Pyburn, 05/16/05)

<p>Fannie Mae expands its purchases of 40-year mortgages with securitization of loans expected in July</p>
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- As noted in the April 9<sup>th</sup> issue of *GSE Report*, Fannie Mae will be stepping up its purchases of 40-year mortgages, making the loan a standard product in a formal lender announcement to be issued at the end of the May. Since 2003, Fannie Mae has been purchasing 40-year mortgages in a pilot program with 22 credit unions. While initial volumes haven’t been huge, Fannie Mae sees the product as a way to make homeownership more affordable with rising interest rates rise and rapidly appreciating home values.
- By making mortgage payments over a longer period of time, borrowers can lower their monthly payments, even though interest rates on 40-year loans are higher than those for 30-year mortgages. For a \$200,000 loan with an interest rate of 6% and a 30-year term, the monthly payments would be \$1,199.10; a borrower could reduce payment by \$63.62 a month by taking out a 40-year mortgage with a higher interest rate of 6.25%, based upon a monthly payment of just \$1,135.48. While the savings is small, Fannie Mae spokeswoman Sandra Cutts said it could be just enough to get people into homes they otherwise couldn’t afford. “Over the life of a loan, that could add up,” she added. “The amount saved per month could be spent paying other bills.” The downside is that borrowers end up paying significantly more interest over the life of the loan; moreover, since initial payments during the first few years of a loan go toward interest, borrowers build up equity in their homes more slowly than they would with shorter-term loans. “They’re not for everybody,” Cutts said.

- Lenders may be much more willing to offer 40-year mortgages if they can sell these loans to Fannie Mae. Analysts say Fannie should have no trouble selling 40-year loans in the secondary market, assuming the loans are “attractively” priced. David Montano, head of mortgage-backed securities research for J.P. Morgan, said 40-year mortgages would have be priced at least 25 basis points above the yield of 30-year mortgages of comparable size to attract investors, adding a yield pick-up of 50 basis points would probably make the loans unattractive to borrowers. According to sources, the securitization of 40-year mortgages may be underway, with the first pool of loans appearing in July. Art Frank, director of mortgage-backed securities research at Nomura Securities International, said initially there will be more demand for such a product in the form of collateralized mortgage obligations than as an actively traded pass-through vehicle. (*Dow Jones Newswires*, Allison Bisbey Colter, 05/10/05)

## ***Freddie Mac***

Freddie Mac resolves dispute with IRS over REIT dividends, resulting in \$110 million increase in net income for fiscal year 2004

- Freddie Mac has reached a resolution with the IRS over the tax treatment of dividends paid on preferred stock issued by its two real estate investment trusts (REITs), which will increase its previously reported net income for 2004 by about \$110 million to \$2.9 billion. In 1997, Freddie Mac formed the two REITs, in which it issued \$4 billion in step-down preferred stock to investors through a private placement. Under the IRS regulations in effect in 1997, the company believed that the dividend payments from these shares were fully tax deductible; subsequently, the U.S. Treasury Department issued regulations that retroactively limited tax benefits tied to the REIT preferred shares. On its books, Freddie Mac had accrued taxes to cover costs related to the tax issue, while it negotiated with the IRS about this matter. As a result of the company’s agreement with the IRS, Freddie Mac will record in the first quarter of 2004 a reduction in tax reserves of about \$98 million in the first quarter of 2004, and in the second through fourth quarters of 2004 a reduction in tax reserves of approximately \$4 million each quarter, which will result in corresponding increase in net income in the stated periods. Further, the company will begin to record tax benefits related to the REIT dividend payments “in a manner” consistent with its IRS agreement. “There is no tax liability stemming from this [agreement],” said Freddie Mac spokesman Michael Cosgrove. “We had set up tax reserves in case there was [any additional] liability.”
- Separately, Freddie Mac provided additional information on the compensation of Patricia L. Cook, executive vice president of investments, and Ralph F. Boyd, executive vice president of community relations and chairman of the Freddie Mac Foundation. Cooke received a \$1 million cash bonus in 2004, a \$600,000 salary for

2004 and 2005; and a bonus target of 167% of her base salary with a cap of 200%. On May 6, she received long-term incentive grants of 37,590 stock options with an exercise price of \$62.69 and 17,650 in restricted stock units, both of which vest in four years. At the time of her hiring on August 2, she received a \$2 million signing bonus, a one-time restricted stock grant with an aggregate value on the date of grant of \$750,000, a guaranteed initial long-term incentive grant of \$1.5 million, and the company's relocation package. Boyd received a \$375,000 bonus for 2004, a \$500,000 base salary for 2004 and 2005, and a bonus target of 100% of base salary with a cap of two times his target for the period. On May 6, he received incentive grants of 9,400 stock options with an exercise price of \$62.69 and 4,420 restricted shares, both vesting over four years. According to Freddie, Boyd's target for discretionary long-term performance-based incentive awards would be 200% of his base salary. Boyd also received a \$125,000 signing bonus, when he became chairman of the Freddie Mac Foundation in April. (*Freddie Mac Supplement*, 05/12/05; *Reuters*, 05/12/05; *American Banker*, Marc Hochstein, 05/13/05)

Freddie Mac's president McQuade says the GSEs' competitors are using GSE regulatory reform to weaken the enterprises' business model
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- Speaking at the Lehman Brothers Financial Services Conference, Freddie Mac president and COO Eugene M. McQuade commented on the approach his company has taken on pending GSE regulatory reform legislation. McQuade said, "From our standpoint, keys to a positive outcome on GSE reform legislation are a regulator that provides strong, independent oversight and is committed to housing; capital requirements that ensure safety and soundness, tie capital to risk, and keep the GSEs competitive in an ever-competitive market; and legislation that maintains our unique GSE status and the confidence of global markets. In his testimony before Congress last month, our Chairman and CEO Dick Syron ...reiterated our strong convictions that we would like to see GSE regulatory reform legislation pass and he emphasized our continued commitment to work with the Administration and Congress on establishing a strong, effective regulator. He also made it clear that we would review each legislative proposal against the yardstick of whether it allows us to fulfill our housing mission while at the same time being responsible to our shareholders and debt investors. Our management has adopted a very deliberate approach to our participation in public discussions about legislation: We are using the appropriate forums to articulate our views on the legislation, and avoiding detailed discussions in other, more public arenas. ... [W]e are hopeful that Congress will strike the right balance here – strengthening oversight while allowing us to continue serving U.S. homeowners and generating competitive returns for shareholders. ... [W]e're working hard to resolve the legislative issue that remains our biggest overall risk."
- During a question and answer session, McQuade said, "Many of the critics of the GSEs seem to be using this, under the guise of reform, to weaken our business model." Critics and competitors have been focused on issues of portfolio size and capital requirements, which should be decided by the regulator, not by law, he added.

When asked about a proposed earnings set-aside for affordable housing, McQuade said that taking 5% of the GSEs' profits for such a fund "would be very helpful in increasing affordable housing, and at the same time it drains off the amount of [Freddie Mac's] profit." He added, "Our point to Congress is to increase the affordable housing sector, but it's also in your interest [as shareholders] to have the profits of the GSEs high. It has all the potential for a win-win situation."

- Looking at trends in the mortgage market, McQuade said "There is something of a secular trend" away from fixed-rate mortgages in which Fannie Mae and Freddie Mac specialized. "Customers are more educated in the mortgage process that they don't need to buy 30 year option protection. I expect to see more five- to 10-year" fixed rate portions for loans, he said. "That leaves us with a strategic challenge in what to do about that. We are spending a significant amount of time trying to improve our mortgage product in that intermediate-term mortgage. In order for us to compete, we need to have much stronger products and greater technology" to position Freddie Mac for buying more of those loans. When asked about Fannie Mae's future, McQuade said, "Fannie Mae remains a very strong, vibrant competitor." Commenting on future portfolio growth, McQuade said, "Our overall view is that we probably over time will try to grow our portfolio -- absent legislative constraints -- in line with mortgage debt outstanding. If that grows historically between 5% and 8%, we should be in the lower end of that range, I'd guess." (*Prepared remarks for Eugene M. McQuade, President and COO of Freddie Mac, 05/12/05; Bloomberg News, Al Yoon, 05/12/05*)

CFO Bauman says, "We don't want to get in that position" [of giving up the GSE charter]
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- At the UBS 2005 Global Financial Services Conference, Freddie Mac's EVP and COO Martin F. Baumann spoke to attendees about his company's financial performance and outlook for the future. Baumann told attendees, "Wrong legislative outcomes [for GSE regulatory reform] could adversely impact our financial results and prospects. But we are working hard with Congress and trying to strike the right delicate balance here: strengthening oversight while allowing us to serve U.S. homeowners and generate attractive returns for our shareholders."
- Looking at Freddie Mac's future growth potential, Baumann said, "We expect our business to grow both in the portfolio investment business and the credit-guarantee business roughly in line with the growth in mortgage debt outstanding. But that is a long-term expectation. We are committed to maintain a disciplined approach to growing our business only when it meets our mission and return objectives." He added, "Our debt-funding levels relative to the Libor curve continue to improve, and this combined with improved performance of our mortgage securities means that our funding sources are in terrific shape." Freddie Mac's future growth will be driven by its efforts to tap into the adjustable-rate and subprime markets, which are "high on our radar screens in terms of our initiatives right now," said Bowman. Freddie Mac is

“spending a lot of time thinking about markets beyond” the 15-year and 30-year fixed rate products, he added.

- When asked by an attendee about reports suggesting Freddie Mac could give up its government charter amid increased regulation, Bauman responded, “We certainly don’t want to get in that position.”
- On returning excess capital to shareholders, Baumann said, “Our opportunities are limited. Initially, the 30% add-on created one restriction, but now that we have a substantial surplus, the other restriction is the fact that we don’t have fully timely financial reports. We’re getting pretty close to [providing timely financials]” and are looking for the “right occasion” to return equity to shareholders, he said.
- On the need for GSEs amid increased presence of banks in the mortgage market, Baumann said, “We have ever-changing markets in the United States, as we all know, and in times of crisis we’ve stepped in and made very substantial purchases of mortgages when others weren’t there to do that. Today there’s plenty of liquidity in the market, but you can think of plenty of times in recent recessionary periods when there wasn’t liquidity in the markets, and we were the major buyer at those times.” (*Prepared Remarks for Martin F. Baumann, Executive Vice President and CFO for Freddie Mac*, 05/09/05; *Bloomberg News*, Al Yoon, 05/10/05; *National Mortgage News*, Bonnie Sinnock, 05/16/05)

#### Freddie Mac sheds consultants and adds a lobbyist

- Since last fall, Freddie Mac has laid off 1,500 consultants, representing 44% of its consulting team since last fall. In addition, about 12 outside communications specialist were also let go, bring the number of cuts in the company’s communications and marketing departments to 22. While the company has been trimming its lineup of outside consultants, Freddie Mac has added at least one lobbyist to its rolls with its hiring of Bob Moss. According to Moss’ lobbying registration, he will work on issues related to GSEs and specifically on “legislation dealing with their regulation.” (*National Mortgage News*, 05/09/05; *Roll Call*, Kate Ackley and Tory Newmyer, 05/18/05)

#### Freddie Mac’s next technology frontier: Project Enterprise

- In an interview with *Mortgage Banking Magazine*, Freddie Mac’s EVP of operations and technology Joseph Smialowski described his company’s next technology frontier: Project Enterprise (PE). Smialowski said, “[PE] is basically the mortgage selling and servicing system. We are going through a major overhaul in those two particular areas. Our initial focus was on the selling side, and the objective was to reduce the time that it takes for our customers to sell, deliver and then get their loans funded. It

is Internet-delivered in terms of the capability. One hundred percent of our cash business now is conducted through what we refer to as PE selling. A significant amount of our business is going through guarantor, and our hope by some time early next year is that the majority of our business will be going through that capability. Right now we are focused on customer rollout and adoption. It is being very, very well-received by our customers, and we are getting kudos in this particular area. Our focus, in addition to rollout, is to incorporate new product capability and new flexibility. There is a substantial investment being made to reduce the time to buy, get mortgages delivered and then to get them funded for our customers. That's the first stage. The second stage is to continue to overhaul our servicing capability. This is a very major investment the company is making. We believe that we are in a leadership role with our capabilities." (*Mortgage Banking Magazine*, 04/01/05)

Freddie Mac announces new partnership with Credit Union Mortgage Alliance Network

- Freddie Mac and the Credit Union Mortgage Alliance Network (CUMAnet) have entered into an agreement, permitting CUMAnet to market Freddie Mac's suite of affordable lending products, including Home Possible™, a flexible credit and low-down payment mortgage option designed for first time homeowners. Freddie Mac and CUMAnet will also work together and develop and distribute information that would help more potential borrowers understand the mortgage process, using Freddie Mac's "Homeownership: Let the Truth Move You" campaign materials. "Freddie Mac is excited to work with CUMAnet on this outreach, education and mortgage lending initiative," said Craig Nickerson, vice president of Community Development Lending at Freddie Mac. "Credit unions are often at the center of efforts to increase homeownership in our neighborhoods." (*Freddie Mac Press Release*, 05/18/05)

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

Finance Board chairman Rosenfeld reiterates his support  
for placing limits on the size of the GSEs' portfolios

- In a speech before the Independent Community Bankers, Finance Board chairman Ronald Rosenfeld said he agrees with the Bush administration's position that GSEs should not hold more assets than are needed to carry out their public mission. Rosenfeld said, "The amount of mortgages the GSEs should hold in portfolio should be limited to the amount necessary to meet their mission and only that." He added that he "couldn't agree more" with Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow that the new GSE regulator should have the power to limit the size of the enterprises' portfolios. In Rosenfeld's prepared remarks, he said, "A regulator has to first determine if a business activity truly helps advance a GSEs' mission. A GSE's business is its mission. Dividends [to shareholders] are not." In testimony before Congress last month, Rosenfeld told lawmakers that he doesn't believe that the 12 FHLBs need large portfolios to accomplish their mission of providing liquidity to the nation's financial system
- Rosenfeld said, "Given the size and importance of the Home Loan Bank System and the amount of its debt held by the public, Congress should make SEC registration mandatory for all housing GSEs [as a part of GSE regulatory reform]. ...[A]ny GSE has an inherent responsibility to be a model for corporate governance. This starts with a GSE's board of directors. Just as the Home Loan Bank System has changed, so must the composition of FHLBank boards. FHLBanks today need to have an engaged board of directors made up of qualified, knowledgeable, and skilled people. And these individuals should be elected by the members of the FHLBank. Simply put, the regulator should not appoint the regulated."
- Rosenfeld also reiterated his commitment to set predatory lending standards for the FHLBs. He said, "[A]ll 12 Banks ought to have a uniform standard that outlines the types of loans that are, and are not, acceptable. This standard should apply not only to the mortgages held in portfolio but also to member loans used as collateral. I am committed to address this issue, and I realize that the devil is in the details. It's not a question of 'if' it will happen, but a question of exactly 'how' and 'when.' I expect that soon [the Finance Board] will issue an advisory bulletin that provides FHLBanks with some guiding principles on preventing predatory lending. I realize that the FHLBanks have a mission to fulfill, members to finance, and a business to run. I understand business. By no means do I want to handicap the System, and community banks like yours, with overly prescriptive regulations. But together we must be able to state without question that predatory lending doesn't have a place in a government-sponsored enterprise." (*The Main Wire*, Prepared Remarks by Ronald Rosenfeld, 05/09/05; *Dow Jones Newswires*, Dawn Kopecki, 05/09/05; *Bureau of National Affairs*, Richard Cowden, 05/10/05)

Finance Board approves the FHLB-Seattle's business and capital plan, after the Bank suspends its dividend payments and curtailed its stock purchases

FHLB-Seattle releases its audited statements for fiscal year 2004

- The Federal Housing Finance Board accepted the FHLB-Seattle's three-year business and capital management plan, conditional upon the Bank's adherence to dividend and stock repurchase restrictions. On May 18, the FHLB-Seattle's board voted to suspend dividends on all class of stock going forward. On May 29, the Bank announced it would no longer repurchase stock before the statutory five-year redemption period without a waiver from the Finance Board. In December, the Bank suspended buybacks of class B1 stock, but allowed limited repurchases of B2 shares. (*American Banker*, Marc Hochstein, 05/20/05; *Business Wire*, 05/19/05)

FHLB-Seattle releases its audited statements for fiscal year 2004

- On May 17, the FHLB-Seattle released its 2004 audited financial statements and footnotes, and Management Discussion and Analysis. The Bank's audited statements had been delayed pending the resolution of a review of October 2004 stock repurchases from three member institutions with executives who served on the FHLB-Seattle's board of directors. The FHLB-Seattle's financial results remain unchanged from the unaudited statements it released on April 5, which reflected a net income of \$17.5 million for the fourth quarter and annual net income of \$82.7 million for fiscal year 2004. (*Business Wire*, 05/17/05)

Postmortem analysis of FHLB-Seattle's woes

- Noting that the FHLB-Seattle "earned" its trouble, Melissa Allison wrote in the *Seattle Times*, "When Norm Rice ... [became the FHLB-Seattle's president] in 1998, he brought political savvy to a relatively obscure bank in the low-risk business of lending money to its member banks. Fresh from eight years as [the first African American] mayor of Seattle, Rice had plenty of people skills but little banking experience. His résumé included only two years in banking, managing corporate contributions for Rainier National Bank in the 1970s. He became head of the [Bank] in 1999. His background probably would have sufficed if the [Bank] had stuck to its traditional business. Instead, it waded into the far riskier business of buying mortgages from banks, *setting itself up as a pint-sized competitor to Fannie Mae and Freddie Mac*. By late 2003, miscalculations left it with billions of dollars that could not be profitably reinvested in mortgages. In a desperate measure to remedy those errors, the Bank compounded its problems in 2004 with an unorthodox move to purchase a whopping \$8 billion in debt from the Home Loan Bank System itself. That strategy set off alarm bells at the bank's regulator, leading to a public rebuke and detailed scrutiny of its business. ... The missteps drove down the Bank's earnings by

42% last year to \$82.7 million. At the end of the year, the Bank still had about \$260 million in paper losses that could drain earnings for years to come, and Bank officials have warned members that it might post some quarterly losses over the next few years.” (*The Seattle Times*, Melissa Allison, 05/08/05; *Fortune Magazine*, 07/22/02)

Paul Clabuesch elected chairman of the FHLB-Indianapolis

- Paul Clabuesch, the chairman and president-CEO of Thumb National Bank (Pigeon, MI), has been elected chairman of the board of directors at the FHLB-Indianapolis. Clabuesch, who replaces William White, chairman, and president-CEO of Dearborn Federal Savings, will complete the last year of White’s two year term as chairman and will stand for reelection as chairman in 2006. (*Michigan Banker*, Bill Perry, 04/01/05)

HUD counsel moves to Finance Board

- HUD associate counsel John P. Kennedy has joined the Federal Housing Finance Board to serve as its new general counsel, replacing Mark Tenhundfeld who left the agency to join a private firm. (*National Mortgage News*, 05/16/05)

On the heels of its commissioned study on the future prosperity of rural America, the FHLB-Des Moines pledges \$500 million to spur Midwest rural development

- According to a recent study commissioned by the FHLB-Des Moines, rural America needs more capital to deal with poverty and a dwindling population. To address this need, the Bank is committing \$500 million to funding rural economic development. To help its members address this issue, the \$50 billion-asset Bank will lend \$500 million at cost to its member banks in Iowa, Minnesota, Missouri, North Dakota, and South Dakota over the next five years for rural development. The program will provide member banks more flexibility by allowing them to borrow as little as \$25,000, a quarter of the current FHLB-Des Moines’ minimum. Since the Bank will be lending at cost, it expects members to charge below-market rates for these funds. The FHLB-Des Moines, which began offering the funds May 2, had received 14 applications and advanced nearly \$9 million on May 12. Patrick J. Conway, the FHLB-Des Moines’ president, said the Bank’s focus on rural economic development was developed in its board’s strategic planning session three years ago. “One of the outcomes was trying to transform the Home Loan Bank of Des Moines into the Home Loan Bank of Rural America,” he said. (*American Banker*, Rob Blackwell, 05/16/05)

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

### FCA approves revised regulatory capital standards rule

- The Farm Credit Administration has approved new rules updating the capital adequacy regulations Farm Credit institutions, bringing them in line with those of federally insured commercial banks, thrifts and credit unions. The new rule, which provides a market-based approach to risk, will be effect 30 days after publication in the Federal Register. (*American Banker*, Ben Jackson, 05/16/05; *Dow Jones Newswire*, Deborah Lagomarsion, 05/13/05)

## ***Postal Service***

### USPS needs better realignment planning, says GAO

- In the face of declining mail volumes and excess capacity, the UPSP lacks a clear plan for realigning its infrastructure, according to a new GAO report. The Postal Service “has outlined several seemingly different strategies” for realignment in the past three years, the GAO noted. Most recently, the GAO said, the USPS announced an “evolutionary” plan for change, addressing opportunities for realignment as they arise, but has given no details about this plan. “This evolutionary strategy and the lack of detailed information about it raise many issues, including what the strategy is and whether it will enable the Service to meet the challenge of removing excess capacity in its infrastructure by closing unnecessary facilities,” the report said. The GAO contends that the strategy lacks criteria and specific processes to eliminate excess capacity as well as performance standards to evaluate the results of decisions. Further, a lack of communication with stakeholders makes it hard for mailers to help keep costs of the mailing network down and for USPS employees and the public to understand how changes affect them, the GAO said. (*DMNews.com*, Scott Hovanyetz, 05/11/05)

### USPS places hiring freeze at its D.C. headquarters

- In a letter to all Postal Service headquarters personnel, Postmaster General wrote, “The 2006 budget will be very challenging. Headquarters must make a sizeable contribution to the overall cost-reduction effort. The Postal Service has launched many new program initiatives over the past few years. I am sure that not all have been successful. Those that have not met your expectations should be eliminated as soon as possible. As cuts are made in program budgets, please ensure that staffing

resources are redirected. Another area to be addressed in the Transformation Plan is organizational structure. I believe there are opportunities to streamline our personnel costs, particularly the use of contract employees. I expect an aggressive review of the use of contract employees at Headquarters. Effective immediately, while the organizational structure is under review, all Headquarters hiring is frozen.”  
(*PostalWatch.com*, 05/19/05)

Postal Service reports net income of \$275 million for second quarter

- The USPS reported net income of \$275 million for the second quarter, down from \$741 million last year. The agency reported revenue of \$17.3 billion for the quarter ended March 31, up \$17 million over \$17.28 billion last year. Mail volume for the quarter was 52.1 billion, up 600 million pieces over last year. The Postal Service CFO Richard Strasser said, “There was a dip in revenue and volume in January and slight increases in February and March. [There were] increased expenses due to cost inflation, [and] additional volumes and deliveries were contained by productivity gains through work hour savings.” The number of delivery addresses continued to increase, up by 400,000 in the second quarter, bringing the total number of delivery points to 143.2 million, up 1.8 million more addresses than a year ago.  
(*PostalWatch.com*, 05/12/05)

## **TVA**

Six TVA coal plants named among the nation’s worst polluters in the industry

- According to Environmental Integrity Project’s new study, six TVA coal plants located in Alabama, Kentucky and Tennessee are among the 50 dirtiest in the nation. In 2004, TVA’s worst plants for sulfur dioxide pollution were its Johnsonville, TN and Kingston, TN plants, which produced more than twice as much sulfur pollutants per unit of electricity generated than the average plant, the study showed. Other TVA facilities listed among the top 50 largest polluters, included plants in Cumberland, TN, Shawnee, KY, Paradise, KY and Widows Creek, AL. TVA is in process of implementing a \$6 billion program to curb air pollution at its coal plants. “We’re spending more than \$1 million a day on the most aggressive control program in the country,” said John Shipp, TVA’s vice president of environmental policy. “We’re doing it about as fast as we can and as quickly as the ratepayers can reasonably pay.” TVA’s sulfur-dioxide emissions fell to 493,000 tons last year, 78% less than its peak emission level in 1977. In 2004, nitrogen oxide emissions from TVA plants also were down by 78% from 1977, according to the agency’s records. (*Associated Press*, 05/12/05)

TVA's unfinished nuclear plant in Scottsboro, AL a candidate to be acquired  
by NuStart Energy for completion as an operating plant

- TVA's Bellefonte Nuclear Plant, an unfinished site located in Scottsboro, AL, is one of six sites being considered by the nuclear power consortium, NuStart Energy, as a prospective site for a new nuclear plant. In October, NuStart plans to select two locations for which it will apply for licenses to build and operate nuclear power plants. The six sites under consideration by NuStart are owned either by a consortium member or by the Department of Energy. While a license to construct and operate a new nuclear plant in the U.S. has not been issued since 1973, President Bush has backed renewed construction of nuclear plants as part of his energy policy. As an indication of a possible shift in public opinion, a few environmentalists have said they are willing to revisit nuclear power because, unlike fossil fuel, it doesn't produce emissions tied to global warming. Additionally, designs for new generation plants include smaller reactors that create less radioactive waste. NuStart will evaluate the sites on 75 factors including seismic activity, availability of water and emergency preparedness issues and determine what state and local financial incentives might be available to attract the location of a plant in a given community. The NuStart consortium is comprised of nine utilities: Exelon, Entergy, and Duke Energy, as well as nuclear reactor manufacturers GE Energy, a unit of General Electric, and Westinghouse Electric Co., a unit of BNFL Plc. Under the Department of Energy's Nuclear 2010 program, half of the estimated \$520 million cost of the project would be shouldered by the Energy Department and half will be paid by the consortium members. NuStart expects to apply for licenses in 2008, begin construction in 2010 and complete the facilities in 2014. (*MSNCB.com*, 05/20/05)

Senator Alexander stirs up a storm with his windmill bill

- Environmentalists and representatives of Tennessee's fledgling wind power industry "savaged" Senator Lamar Alexander (R-TN) for introducing legislation that would restrict tax credits for new windmills. The bill would give local governments veto power over wind farm projects and require environmental impact statements for windmill construction in offshore areas and within 20 miles of scenic areas and military bases.
- Stephen Smith, executive director for the Southern Alliance for Clean Energy (SACE), said Alexander's legislation is "the most direct assault on wind power we've ever seen by a United States senator." Wind power should be a part of an energy mix that includes other clean, renewable power sources, he said. SACE would like to see tax credits for windmills extended for another five years to give the industry a boost, Smith added. Jaime Steve, a lobbyist for the American Wind Energy Association, claimed that wind energy could bring \$4.2 billion in investment and as many as 4,500 new jobs in Tennessee over the next five or six years. Tax credits would help generate 2,500 megawatts of wind-powered electricity by the end of the year, he said. Without the credits, the industry would only add about 400 megawatts, Steve added.

Marlin Laidlaw, president of the one year old windmill manufacturer, Aerisyn LLC, based in Chattanooga, TN, said tax credits would allow him to double the business. Laidlaw, who has invested more than \$7 million in equipment and would like to add another \$3 million to \$4 million worth soon, said his company employs 50 people and could expand to 400 with increased business. Without tax credits, he would probably cap employment at 75. "I was baffled," Laidlaw said, by Alexander's proposal.

- Alexander said his bill would protect scenic areas and give local citizens more control. "It keeps these 100-yard-tall, monstrous structures away from Signal Mountain, Lookout Mountain, Roan Mountain, the Tennessee River Gorge, the foothills of the Smokies and other highly scenic areas," said Alexander. "As for jobs, every Tennessee job is important, but I fear that hundreds of these giant windmills across Tennessee's ridges could destroy our tourism industry, which could cost us tens of thousands of jobs." In remarks on the Senate floor, Alexander said the windmills are large, unsightly, noisy contraptions that bother nearby residents. He criticized a recent proposal to require power companies to increase their use of renewable energy sources to 10 % by 2025, saying it's essentially a Congressional mandate to build more windmills. Alexander argued that the \$3.7 billion earmarked for windmill tax credits would be better spent on hybrid vehicle subsidies or loan guarantees for coal gasification and nuclear plants. "I hope we decide that we need a real national energy policy, instead of a national windmill policy," said Alexander.
- The Tennessee Valley Authority has no plans right now to build more wind farms or add turbines to its Buffalo Mountain site, TVA spokeswoman Michelle Sherrard said. About 1 percent of TVA's power comes from windmills. (*Knoxville News-Sentinel*, Scott Barker, 05/20/05)

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