

The **GSE** REPORT™

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Major Events

Dow Jones Newswires reports new accounting violations at Fannie Mae

Fannie's new problems heighten concerns about the systemic risks of the GSEs

Market reaction to Fannie Mae's new accounting problems

Congressional reaction to Fannie's new accounting violations

Probes at Fannie Mae continue, as company morale deteriorates

Dow Jones Newswires reports new accounting violations at Fannie Mae

- Investigators who are examining Fannie Mae's finances have found new and pervasive accounting violations, according to people familiar with the examination who spoke exclusively to *Dow Jones Newswires*. These new findings include evidence that Fannie Mae may have overvalued assets, underreported credit losses and misused tax credits, according to "sources close to" or "previously involved" in the inquiries. Specifically, the way Fannie Mae booked its credit losses and certain tax credits have emerged as new, and potentially significant, problems for the company, according to sources. Investigators have discovered widespread problems and GAAP violations in how the company was reporting its credit losses, which appear to affect a far greater proportion of its assets than previously believed, say people familiar with the matter. Investigators have also discovered accounting violations with tax credits related to Fannie's use of a controversial and lucrative tax credit it collected as a minor investor in the synthetic fuel industry. Sources say that Fannie's tax credits tied to its low-income housing investments are also under scrutiny. Some sources said evidence also indicates that Fannie Mae may have bought finite insurance policies to hide losses after they were incurred. [Recently, securities regulators have been cracking down on corporations that they say bolstered their earnings by using "abusive" reinsurance policies which are substantively more akin to loans and transfer little or no risk to the insurer.] The sources indicated that the alleged new accounting violations were designed to help Fannie conceal losses and are in addition to the violations that the company and OFHEO previously disclosed. According to Dawn Kopecki in the *Dow Jones Newswires*, "[Sources] said that Fannie's restatement is likely to show that its total cumulative losses will be higher and will include more 'realized' losses, as opposed to paper losses, than the company has previously disclosed and many investors anticipate."
- "The question these new revelations really raise is fraud," said Bert Ely, a frequent critic of the company. "Were these accounting errors done intentionally? If they were intentional, we are beginning to approach record levels of deceit." Jon D. Markman

writes on the *TheStreet.com*, “If the [*Dow Jones*] story is accurate -- and there’s no reason to suspect it isn’t, as the reporter [Dawn Kopecki] has done a good job of covering Fannie for some time -- it may be a bombshell. These are the kind of allegations that could move the story out of the realm of mere incompetence and fair-minded disputes of accounting arcana, and closer to potential fraud.” To take just one example, Markman writes, the use of finite insurance is a game, uncovered by New York Attorney General Eliot Spitzer, that “has been revealed elsewhere to be an elaborate Ponzi scheme used to either hide losses and deceive investors about the erratic nature of quarter income, or to falsely shore up reserves.”

- On September 28, Fannie Mae released a statement, noting that OFHEO had found that the company was “adequately capitalized” at the end of the second quarter of 2005 and that Fannie believed it was “on track” to reach OFHEO’s mandated 30% capital surplus requirement by the end of September. Specifically, the agency said that Fannie Mae exceeded its risk based capital requirement by \$13.083 billion and its minimum capital requirement by \$5.914 billion as of June 30, 2005. OFHEO noted that its analysis is based upon Fannie’s current best estimates that have been “certified and represented by management.” The agency said that Fannie’s \$5.9 billion capital surplus was “sufficient to absorb uncertainties in the estimated impact to capital of the accounting errors, based on current information.” Further, OFHEO stressed that its capital assessment of Fannie Mae could change “as additional information becomes available, such as Fannie Mae’s certification of its financial statements; and OFHEO’s completion of its special examination of accounting policies and practices at the company.” It appears that OFHEO released its analysis of Fannie’s capital compliance several days ahead of its traditional month end schedule, perhaps to allay market concerns about the company’s financial condition in light of the *Dow Jones* report about its new accounting problems.
- When asked by reporters about the on-going investigations of its accounting practices, Fannie Mae said, “We will continue to provide updates through our regulatory filings as issues are identified and resolved.” Fannie CEO Daniel Mudd told *Dow Jones Newswires* “we are current on all of our disclosures,” when asked if the company’s losses will be higher than previously estimated. In an October 7th 8-K filing with the SEC, Fannie Mae indicated that it won’t likely detail the impact of new problems uncovered in its ongoing accounting probe until sometime in November. In its October filing, the company did not address recent reports of new and widespread accounting violations at Fannie Mae. Instead, the company said it will detail those matters “when the issues have been identified and resolved in accordance with our accounting policy review procedures” which call for the information to be released in its regular quarterly disclosures to the SEC.

Fannie’s new problems heightened concerns about the systemic risks of the GSEs

- The new accounting problems at Fannie Mae have elevated concerns among regulators and lawmakers, who have renewed their calls to rein in the GSEs’ operations. “These firms create a continuing risk to the economy, should there be a

solvency problem, given the scale of the firms. Their scale is so immense and there are so many who rely on the assets,” said St. Louis Fed President William Poole. Noting that Fannie has plenty of capital and he doesn’t foresee a “solvency issue,” Poole said, “what these problems do, clearly, is to add to the case for some fundamental reform.” Senate Banking Chairman Richard Shelby (R-AL) said, “It is not entirely surprising that serious new accounting irregularities and internal control deficiencies may have occurred at one of the government-sponsored enterprises. For the past several years, there has been a steady stream of disturbing revelations as the companies have progressed through their restatements and come under increasingly close scrutiny by investigators, their regulator and Congress. Clearly, the case for enhanced regulation of the GSEs has already been made,” he said.

- Fannie Mae and Freddie Mac are the fourth and fifth largest financial services companies, respectively, in the U.S., who hold an aggregate \$1.5 trillion of loans and guarantee another \$2.4 billion of mortgage-backed securities. Their operations permeate nearly every corner of the U.S. financial system with municipalities, mutual funds, pension plans, overseas investors, U.S. and foreign banks, insurance companies and other institutional investors investing heavily in the GSEs’ debt, MBS, and common and preferred equity. Fannie and Freddie are believed to be the two biggest fee payers on Wall Street, as investment banks analyze the GSEs’ equity, rate their credit, broker their derivative contracts, and manage their debt, MBSs, and equity trades. Moreover, the mortgage industry is heavily depended upon Fannie and Freddie, which owned or guaranteed roughly 42.3% of the nation’s approximately \$9.2 trillion of residential mortgages outstanding on June 30. Regulatory officials and lawmakers are concerned that the GSEs, which are the world’s largest user of interest rate hedges with a combined \$1.5 trillion in derivatives contracts, will eventually need more derivatives than the market can supply. As they grow, “the ability of the GSEs to quickly correct the inevitable misjudgments inherent in their complex hedging strategy becomes more difficult,” said Federal Reserve Chairman Alan Greenspan. Regulators are concerned that Fannie and Freddie could disrupt the broader markets, if their interest-rate hedges are wrong and a sudden and unexpected rate shift occurs in the opposite direction. Instead, interest rate risk can be “markedly contained, and the accompanying risks to systemic stability reduced, by diversifying the concentration away from two large, highly leveraged portfolios [of Fannie and Freddie] for which significant misjudgments can have quick and destabilizing consequences,” argues Greenspan.
- Reducing the GSEs’ mortgage portfolios would also reduce the companies’ need to issue debt, which totals approximately \$1.6 trillion. Increasingly, Fannie and Freddie have relied heavily on overseas investors for the sale of MBS and debt in recent years, which has also raised concern among regulators. On July 30, total foreign holdings of agency debt and MBS totaled approximately \$827.1 billion, representing 19.0% of all foreign debt investments in the U.S. “The systemic risk that we were concerned about was not just U.S. systemic risk, but also the possibility that it could spill over into other markets and other countries,” said former OFHEO Director Armando Falcon.

- Regulatory concern has heightened in light of Fannie Mae's recent accounting troubles, which the company estimates will result in a \$10.8 billion reduction in earnings. Most recently, investigators have found evidence of even more accounting violations that "embellished" Fannie's earnings, according to sources close to the inquiries. Alarm bells rang in the halls of Congress, as Jason Thomas, an economic policy analyst for the U.S. Senate Republican Policy Committee warned lawmakers that Fannie Mae's borrowing costs have actually decreased "[i]n the face of ...internal disarray and financial uncertainty," again illustrating the market's perceptions of a federal backstop for the GSEs. In an email to Senate Banking Committee Republicans, Thomas wrote, "...Fannie's interest rate spread over Treasuries has declined by 15% since March, despite all of the revelations of wrongdoing and losses since that time." Fannie's recent declining debt costs illustrates "a perversity of the current arrangement: Since Fannie Mae is relieved of the successive rounds of credit rating downgrades and increased borrowing costs that would face any fully-private corporation with as dysfunctional an internal control system, and as large a financial restatement, Fannie Mae's net credit subsidy from the government actually *grows* in proportion to the scale of its management malfeasance!"
- In 2003, St. Louis Fed President William Poole sounded one of the first alarms regarding the systemic risks of the GSEs, by saying, "The enormous scale of their liabilities could create a massive problem in the credit markets. If the market value of GSE debt were to fall sharply, because of ambiguity about the financial soundness of GSEs and about the willingness of the federal government to backstop the debt, what would happen? I do not know, and neither does anyone else."

Market reactions to Fannie's new accounting irregularities

- The news of possible new accounting irregularities at Fannie Mae triggered a sell-off in its stock, which dropped 10.7% to \$41.71, its worst trading session since the stock market crash of 1987. The dead cat bounce occurred the following day with Fannie Mae's stock rising \$3.18 or 7.6%, prompting investors to speculate whether institutional holders were intentionally pumping up Fannie Mae's shares to stave off losses. On a Yahoo! Finance message board, an investor noted, "Whenever very bad news come[s] out on a stock with massive market cap, the large stakeholders will 'hold their noses and buy more' to make the naive investor think the news was not that bad and protect their massive investment. But at the same time they simultaneously ' earmark' the stock for 'disposal' on future manufactured stock market rallies. Fannie will go up less than the overall market and down more as these large stakeholders unwind their positions over months."
- Fannie Mae's stock is trading at an "unwarranted" premium to Freddie Mac, even after a 37% decline in 2005, said Fox-Pitt, Kelton analyst Edwin Groshans. With Fannie's stock trading at 1.5 times book value compared to 1.2 times for Freddie Mac, "the premium is unwarranted and we would expect the companies to trade

closer to parity,” said Groshans. Eventually, Fannie Mae’s “premium will erode more from reductions in Fannie Mae’s share price rather than multiple expansion for Freddie Mac,” he added. “If you don’t need to be in the space [housing GSEs], don’t be in it,” said Groshans. “If you have to be in, we like Freddie Mac better.”

- Morgan Stanley analysts surmised that Fannie’s estimated \$10.8 billion earnings restatement may only require a “small” increase following the report of new accounting errors by *Dow Jones*. “It is not clear that the issues raise in the *Dow Jones* report would be material financially,” said Morgan Stanley analyst Kenneth Posner in a research report. The use of finite insurance to manage credit losses and “questionable” tax credits are “likely to have a relatively small impact on the restatement,” said JPMorgan analyst George Sacco. “The impact of these new issues was likely around \$1 billion.” A number of analysts took comfort from OFHEO’s finding that Fannie Mae was adequately capitalized as of June 30, 2005, which would have taken into account the new accounting problems when it made this determination. Jim Vogel, executive Vice president for FTN Financial, wrote in a research note, “For OFHEO to follow yesterday’s [*Dow Jones*] story about new accounting problems with that announcement is an indication any accounting difficulties since February are limited in scope to \$1 billion or less.” Vogel estimates that Fannie Mae has a capital cushion of about \$1.5 billion over and above the 30% capital surplus requirement, before taking into account the latest accounting violations.
- For Fannie Mae’s stock to come back to life, analysts said the company needs a dose of certainty about its future. Specifically, Fannie Mae needs to provide current and regular financial reporting, which will not occur before the second quarter of 2006; a deal in Congress regarding GSE regulatory reform; and the issuance of the company’s internal report about Fannie’s bookkeeping being prepared by former Senator Warren Rudman. For now, “what’s not known is what ends up moving them,” said Ken Posner of Morgan Stanley.

Probes at Fannie Mae continue, as company morale deteriorates

- Former Senator Warren Rudman and his law firm, Paul, Weiss, Rifkind, Wharton & Garrison L.L.P., continue their work on the independent review of Fannie’s finances on behalf of the company’s board of directors. Rudman anticipates that his investigators may need until January to complete their report on the more than \$10.8 billion in bookkeeping errors at Fannie Mae. “We are looking at all the accounting issues we have looked at all along, and at this point, we don’t have any conclusions,” he said. “We are still hoping to wrap up the investigation by the end of December, and if we don’t make it, we’ll do it in January.”
- In addition to the board’s internal review, OFHEO, the SEC, the Justice Department, the IRS and the Labor Department are conducting their own separate Fannie probes. Also, the company must defend itself in eight class action lawsuits. While declining to comment on specific aspects of their examination, OFHEO spokeswoman Stefanie

Mullin said the agency expects to issue its final report on the its special investigation of Fannie Mae by March 31, 2006.

- According to sources close to the company, morale at Fannie Mae continues to worsen and several top executives are considering leaving. “A lot of very good people have already left,” said one source. One executive said that a few weeks before the *Dow Jones* report on new accounting problems, Fannie Mae CEO Dan Mudd sent out an “impassioned’ email imploring employees to stay with the company. (*Dow Jones Newswires*, Dawn Kopecki, 09/29/05; *Dow Jones Newswires*, Dawn Kopecki, 10/07/05; *Dow Jones Newswires*, Allison Bisbey Colter, 09/29/05; *Dow Jones Newswires*, Dawn Kopecki, 09/29/05; www.bigcharts.marketwatch.com; *Dow Jones Capital Markets*, Allison Bisbey Colter, 09/29/05; *TheStreet.com*, Jon D. Markman, 09/30/05; *The Motley Fool*, Rich Duprey, 09/29/05; *Dow Jones Newswires*, Allison Bisbey Colter, 09/29/05; *Bloomberg News*, James Tyson, 09/29/05; *New York Post*, Roddy Boyd, 09/29/05; *Bloomberg News*, James Tyson, 09/30/05; *The Times*, Caroline Merrell, 09/29/05; *Bloomberg News*, James Tyson, Al Yoon, Brian Sullivan, and Matt Keenan, 09/29/05; *Market Watch International*, Robert Schroeder, 09/29/05; *Market Watch International*, Robert Schroeder, 10/05/05; *National Mortgage News*, Paul Muolo, 10/03/05; *Federal National Mortgage Association Form 8 K*, 10/07/05; *Dow Jones Newswires*, Dawn Kopecki, 10/07/05; *OFHEO Press Release*, 09/28/05; *Dow Jones Newswires*, Dawn Kopecki, 10/06/05)

Federal Reserve Chairman Alan Greenspan warns that the growing use of riskier new mortgages could result in “significant losses” for lenders and borrowers
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- In a September 26 speech to the American Bankers Association Annual Convention, Chairman Alan Greenspan said, “The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other, more-exotic forms of adjustable-rate mortgages, are developments that bear close scrutiny. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is adding to the pressures in the marketplace.”
- “Over the past few years, a great deal of attention has focused on the growing range of loan choices available to mortgage borrowers. The menu, as you know, now features a long list of novel mortgage products, not only interest-only mortgages but also mortgages with forty-year amortization schedules and option ARMs, which allow for a limited amount of negative amortization. These products could be cause for some concern both because they expose borrowers to more interest-rate and house-price risk than the standard thirty-year, fixed-rate mortgage and because they are seen as vehicles that enable marginally qualified, highly leveraged borrowers to purchase homes at inflated prices. In the event of widespread cooling in house prices, these borrowers, and the institutions that service them, could be exposed to significant

losses.” (Remarks by Chairman Alan Greenspan to the American Bankers Association Annual Convention, 09/26/05)

Fannie Mae and Freddie Mac

Hurricane recovery efforts continue:

Hurricane Katrina’s and Rita’s devastation is quantified

Fannie Mae and Freddie Mac estimate their losses in the Gulf Coast region

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Representative Baker outlines a proposal to form the Louisiana Recovery Corporation to rebuild storm ravaged areas

Other relief efforts being considered by Congress

Hurricane Katrina’s and Rita’s devastation is quantified

- According to FEMA records, Hurricane Katrina displaced approximately 1.3 million Gulf Coast households to communities in every state in the U.S. with about 75% of the households moving to Baton Rouge and other communities within 250 miles of New Orleans. Roughly 240,000 went to Houston, San Antonio, Dallas, Atlanta, and other cities within 500 miles of the battered coastal area. About 26,000 evacuees went to cities such as Chicago, Detroit, and Baltimore, 750 to 1,000 miles away. At least 34,000 moved more than 1,000 miles to cities such as Seattle and Boston.
- The American Red Cross estimates that more than 350,000 homes were destroyed by Hurricanes Katrina and Rita and an additional 146,000 homes have major damage. Overall, 850,791 housing units were damaged, destroyed or inaccessible – dwarfing the impact of Hurricane Andrew in 1992 in which 28,000 homes were lost. The number of homes destroyed represents 17% of annual home construction of approximately two million units a year. According to Mortgage Bankers Association of America, there are 530,000 mortgage loans in the storm-affected areas, with principal amounts totaling \$70 billion. The rebuilding effort must also address the fact that nearly 60% of the counties declared disaster areas after Hurricane Katrina, had poverty rates exceeding 20% and large numbers of substandard housing before the storms came ashore. Approximately 50,000 households that had been receiving federal housing aid were displaced by the storms. The Insurance Services Offices

(ISO), a private company which provides industry data, estimated the storms caused \$34.4 billion in insured property losses related to homes, boats, and business interruptions. ISO's property damage estimate does not include losses to utilities, agriculture, aircraft, ocean marine (including oil drilling platforms), property covered by federal flood insurance, or uninsured losses.

- In the aftermath of Hurricanes Katrina and Rita, the United States has "...never absorbed a one-two punch before that knocked out this much energy refining capacity; created this many evacuees; disrupted transportation systems, the chemical industry and agriculture; or required such a vast rebuilding effort—including more than 200,000 homes badly damaged or destroyed," said Freddie Mac chairman and CEO Richard F. Syron.
- In an update to their September 6th analysis, CBO said that the effects of Hurricanes Katrina and Rita "appear more modest than initial estimates, and much of the impact could be over by the fourth quarter of 2005. GDP is projected to grow "about a half a percentage point more slowly over the second half of 2005" due to the storms, but "most of the slowing will occur in the third quarter," said CBO. "With private and government support for recovery and rebuilding, GDP growth will not be much affected in the fourth quarter of 2005, and could even be somewhat higher than was projected before the hurricanes," said CBO Director Douglas Holtz-Eakin in a letter to House Budget Committee Chairman Jim Nussle (R-IA). "Overall, GDP will return to its previous trend by early 2006," said Holtz-Eakin. "Hurricanes Katrina and Rita have temporarily reduced the growth of economic output, but the effects that rebuilding will have on economic activity may more than offset the drag by early next year," said CBO. Holtz-Eakin warned, "The disasters will also have a significant impact on the federal budget," as Congress prepares additional spending beyond the \$62.3 billion already approved and tax cuts in addition to an emergency \$6 billion package already enacted. CBO noted that spending on flood insurance claims "is [also] expected to rise substantially."
- "The direct, immediate reduction in employment" related to areas impacted by Hurricane Katrina "now appears to be between 280,000 and 400,000 jobs," while the impact of Hurricane Rita will be much smaller, said CBO. "By early next year, the pace of reconstruction will probably cause the net effect of hurricanes on jobs nationwide to be minimal," said CBO. Consumer prices will be higher in the second half of 2005 than previously expected due to higher energy prices, "but consumer price inflation should revert back to pre-Katrina rates in the first half of 2006, if, as generally expected, energy prices ease part of the way back to their pre-Katrina levels," said CBO. The agency said its estimates are "necessarily uncertain" due to emerging information from the Gulf Coast area regarding the extent of damage and the uncertainties regarding the timeliness of insurance and government relief payments, the rate at which energy prices will decline, and how quickly the Gulf Coast region can start the rebuilding process. (*Dow Jones Newswires*, Rob Wells, 09/29/05; *Realty Times*, Broderick Perkins, 10/07/05; *Associated Press*, 10/06/05; *USA Today*, Haya El Nasser and Paul Overberg, 09/29/05; *Wall Street Journal*, Evan

Perez, Jeff D. Opdyke, Valerie Bauerlein, Christopher Cooper and Chad Terhune, 10/06/05; *USA Today*, Sue Kirchhoff, 10/06/05; *Prepared remarks for Richard F. Syron*, Freddie Mac Press Release, 09/29/05; *Barron's Online*, Jim McTague, 10/09/05)

Fannie Mae and Freddie Mac estimate their losses in the Gulf Coast region

- In a Form 8K filing, Fannie Mae said it expects to incur third quarter losses ranging from \$250 million to \$550 million related to Hurricane Katrina and Rita damage. Despite these losses, Fannie Mae said it expects to exceed its 30% capital surplus requirement required by OFHEO as of September 30, 2005. (*Fannie Mae 8K*, 10/07/05; *Associated Press*, 10/07/05)
- Freddie Mac estimated that its after-tax losses will be in the range of \$150 million to \$300 million in the third quarter of 2005 as a result of Hurricanes Katrina and Rita. The company expects these losses to stem from its guarantee of timely payment of principal and interest on mortgage-backed securities and its holding of loans and securities secured by homes devastated by the storms. Freddie said that this estimate represents most of the losses from storm-related damage. (*Dow Jones Business News*, Alistair Barr, 10/05/05; *Dow Jones Newswires*, Judy Lam, 10/04/05; *Freddie Mac Press Release*, 10/04/05)

Freddie and Fannie step up to help with recovery efforts

- Fannie Mae and Freddie Mac, along with mortgage insurers and servicers, are providing mortgage relief to borrowers impacted by Hurricanes Katrina and Rita. Fannie Mae mortgage lenders are authorized to suspend payments for up to three months, reduce payment for up to 18 months, and in severe cases create longer loan payback plans. Under Freddie Mac's policies, servicers may reduce or suspend mortgage payments for up to 12 months for borrowers in declared major disaster areas. Freddie is also encouraging the servicers to expedite the release of insurance proceeds, waive the assessment of penalties or late fees and not report forbearance or delinquencies to the credit bureaus. "Our goal is to help families affected by Hurricane[s] Katrina [and Rita] to keep their homes," said Freddie Mac chairman and CEO Richard Syron.
- Freddie Mac is also temporarily easing several underwriting requirements to make it easier for storm victims who have lost their jobs, income or financial documents to qualify for a mortgage. These special underwriting guidelines apply to mortgages closed after August 30 for Hurricane Katrina victims and on or after September 25 for Hurricane Rita victims and are set to expire on October 3. Freddie Mac also announced that it will ease some of its policies in order to purchase an estimated \$300 million worth of single-family mortgages that were closed between June 1 and August 29th and secured by properties impacted by the hurricanes. Given the special circumstances regarding these mortgages, Freddie Mac said it would purchase these loans for its retained portfolio to provide lenders with immediate liquidity relief.

Freddie Mac's move illustrates how the company's practice of retaining some loans can be put to good use, said company officials. By taking Katrina-related loans, the portfolio "is doing what it's supposed to do," said spokesman Brad German. Freddie Mac has also committed \$900,000 to the Mississippi Home Corporation for acquisition of 35 travel trailer units for use as temporary housing by recent hurricane victims. The Freddie Mac Foundation has also donated \$475,000 to the Archdiocese of Washington (formerly Catholic Charities) to help survivors of Hurricane Katrina who relocated to the Washington, D.C. area. The money will pay for housing expenses for 33 families for three months. Freddie Mac employees will also adopt 33 families and will donate goods and volunteer time to help the families get back on their feet. (*Freddie Mac Press Release*, 09/26/05; *PR Newswire – First Call*, 10/03/05; *PR Newswire (U.S.)*, 10/04/05; *Freddie Mac Press Release*, 10/07/05; *Mortgage Servicing News*, Jennifer Harmon, October 2005)

Representative Baker outlines a proposal to form the Louisiana Recovery Corporation to rebuild storm ravaged areas

- On October 7, Representative Richard Baker (R-LA) issued a white paper outlining the proposed structure for the Louisiana Recovery Corporation (LRC or Corporation), which will insure the economic stabilization and redevelopment of the devastated areas of the state in consultation with state and local officials. To execute its economic stabilization mandate, the LRC will locate and acquire commercial and residential real property for the purpose of (1) restoring the economic stability of underinsured or uninsured consumers by negotiating to acquire real property and to retire mortgage debt; and, (2) restoring the solvency of financial institutions with loan portfolios secured by damaged collateral. In executing its redevelopment mandate, the LRC will (1) package for sale acquired real property in substantial tracts of land; and (2) make improvements to such tracts of land so as to make the land suitable for sale and development, including such basic improvements as neighborhood roads, water and wastewater infrastructure, and, similar activities necessary to maximize the return on acquired real property. The LRC will execute its mandates in a manner that generates a maximum rate of return for the Corporation.
- Baker proposes that the LRC be governed by a board of directors, comprised of seven individuals appointed by the President, subject to the advice and consent of the Senate, with one appointee designated as President of the Board and Chief Executive Officer (CEO) of the Corporation. "To ensure the greatest amount of experience, expertise and leadership, the board will be selected from among citizens with expertise in environmental land reclamation, economic development, housing development, land use, urban planning, and civic service," proposes Baker. The Corporation will employ staff, which will report directly to the LRC's CEO. Each department will be led by a Senior Vice President that will be named by the board, but who will report directly to the CEO. The Corporation will organize departments for at least, but not limited to, the areas of Environment and Land Use Management, Economic Development, Property Acquisition, Property Management, Property Disposition, and Urban Homestead and Community and Faith-based Organizations.

The CEO will name an Inspector General (IG) with the approval of the board. The IG will report to the board, which will set compensation and retain dismissal authority by a majority vote.

- The LRC will not be funded by an annual appropriation, but will instead request funding through general debt obligations of the U.S. government to be issued solely at the direction of the Secretary of the Treasury. The LRC's CEO, with the Board, will submit jointly to the OMB and the Secretary of the Treasury quarterly reports and an annual report on its expenses and progress fulfilling its mission and purpose, which will be publicly available. The LRC will return any revenues in excess of operation and mission execution costs to the U.S. Treasury for the purpose of retiring debt issued on the Corporation's behalf.
- In consultation with state and local officials, the LRC will dispose of property through a competitive bidding process, with purchasers and developers being selected based on an ability to meet select criteria, which will include, but not be limited to, (1) capacity to oversee major development projects through a community-based collaborative process; (2) experience and expertise in urban planning and traditional neighborhood design; (3) integration of the area's historical architecture and cultural heritage; (4) commitment of private capital; (5) deployment of Fannie Mae, Freddie Mac, Federal Home Loan Bank, and federal or state tax or financial resources (LIHTC, NMTC, EZ, HUB Zone) to ensure construction of affordable housing; (6) employment of Louisiana corporations and Louisiana workers; and, (7) scale of local job creation.
- The Corporation will assist in the implementation of an urban homestead program by providing (1) land to the federal government for development as urban homesteads; (2) down payment assistance and other seed money to enable homestead construction; and, (3) coordination with not-for-profit and faith-based organizations in the construction and development of urban homesteads.
- To ensure the maximum opportunity to achieve its mission and purpose, the Board will, in consultation with state and local officials, operate as an independent extension of the federal government to facilitate recovery in disaster-affected communities in Louisiana. At the minimum, the LRC will have the sole executive power to (1) place other federal financial resources (i.e. grants, tax credits) at its disposal to further its mission and purpose; (2) after consulting with state and local officials and affording due process of law, exercise a limited power of eminent domain only to the extent necessary to accomplish its mission and purpose; (3) act under its own authority to enter into litigation and to represent itself in any litigation that may be required to fulfill its mission and purpose; and, (4) after providing due process, void existing contracts awarded to, and prohibit further contract awards to, any individual or firm found to be in breach of contract or in violation of Corporation rules.
- The LRC's charter will expire at the end of the ten-year period beginning on the effective date of its authorizing statute.

- According to Michael DiResto, Baker’s press secretary, the Congressman carefully constructed the proposal for LRC, based upon discussions on this concept with high-level administration officials and the “highest levels” of the White House, along with House leaders and members of the Louisiana congressional delegation. Baker plans to work on this proposal over the congressional break to continue consultations with Washington and Louisiana leaders with the goal of introducing legislation to create LRC, which is in process of being drafted. (*The Louisiana Recovery Corporation*, Representative Richard Baker, 10/07/05; *Representative Baker’s Press Secretary Michael DiResto email*, 10/07/05)

Other relief efforts being considered by Congress

- On September 27, 29 House Democrats introduced Hurricane Katrina and Hurricane Rita Flood Insurance Buy-In Act (H.R. 3922), which would allow Hurricane Katrina and Rita victims to buy flood insurance retroactively for property owners who were not subject to mandatory purchase requirements of the national flood insurance program. In testimony before the Senate Finance Committee on September 28, Governors Haley Barbour (R-AL) and Bob Riley (R-AL) urged Congress to provide assistance to homeowners who could not get federal government flood insurance because they were not in the federally designated flood zone. Such a program would allow – and even encourage—the storm victims to rebuild their communities and maintain their good credit standing.
- In a September 28th article in the *Washington Post*, Steven Pearlstein argued that extending flood insurance retroactively to owners of damaged homes along the Gulf Coast might sound reasonable at first blush – but the hidden winner in such an arrangement would be the mortgage industry. Responding to Pearlstein’s comments in an online chat, Anne Canfield, executive director of the Consumer Mortgage Coalition, responded that mortgage lenders are not seeking a bailout. “Nothing could be further from the truth,” Canfield wrote. “In addition to the consumers who have been so hard hit by the storm, the business entities that will suffer the great losses on mortgage loans are the pension funds, money market funds, and similar investors who own them. The mortgage lenders do not hold this risk. Mortgage lenders want to continue to lend in the affected communities, but if investors will no longer be willing invest in loans in the areas, consumers will pay much more for loans in the future. Mr. Pearlstein would, in essence, draw a gigantic red line around these states.” (*Representative Gene Taylor (D-MS) Press Release*, 09/27/05; *American Banker*, 09/29/05; *Sarasota Herald-Tribune*, Cory Reiss, 10/03/05; *Washington Post Letters to the Editor*, Anne Canfield, 09/28/05; *Washington Post*, Steven Pearlstein, 09/28/05)
- The Justice Department announced that it will ease some requirements under the new bankruptcy law for victims of Hurricane Katrina and Rita. Residents of the effected areas of Louisiana and Mississippi who file for bankruptcy will not have to go through credit counseling. Judges will also consider income loss, increases in

expenses and other storm factors, when determining whether to require the filers to repay their debts or cancel them. They will not mandate that hurricane victims produce income statements and other documents which were lost in the storm. (*American Banker*, Michele Heller, 10/06/05)

- Former Republican vice presidential candidate Jack Kemp told a Senate panel that Congress should consider a modified flat tax with no capital gains to help ravaged Gulf Coast economies to recover quickly. “We have a golden opportunity to ‘green line’ the Delta and Gulf Coast with government policies that facilitate and empower the private sector and private citizens,” said Kemp. This would “prove to these policies also will work in the rest of the country,” he added. To encourage housing finance, Kemp proposed that Fannie Mae and Freddie Mac be allowed to purchase non-interest bearing mortgages from Habitat for Humanity to improve funding for low income mortgages. “[Under current law,] the GSEs cannot provide liquidity to Habitat for Humanity as it does for the rest of the housing market,” he added. “We have an enormous opportunity to replace outmoded government programs and bureaucracies with public-private partnerships and new private institutions.” Kemp said, these alliances would be “built upon the foundation of individual ownership, private property rights, personal property rights, personal responsibility and social justice that a stake holder society brings.” (*Dow Jones Newswires*, Rob Wells, 10/06/05)

GSE regulatory reform update:

In the House, GOP conservatives broker deal on GSE regulatory reform legislation

Senator Hagel (R-NE) hopes for full Senate vote on GSE regulatory reform this year

H.R. 1461 is “not the bill we can support,” says HUD Secretary Jackson

Wall Street Journal warns about systemic political risk

In the House, GOP conservatives broker deal on GSE regulatory reform legislation

- House Republicans have reached a compromise on GSE regulatory reform legislation, which could bring the legislation (H.R. 1461) to the House floor for a vote as early as October 17. A House GOP aide said that the Republican Study Committee (RSC) accepted a compromise proposal by Financial Services Chairman Michael G. Oxley (R-OH) that revises the affordable housing fund language in H.R. 1461. “The Oxley counter-offer was accepted this morning [October 7], which includes plenty of safeguards to ensure that the funds are used for affordable housing only. This clears the way for floor action as early as late this month,” said a House Republican aide. “This is not the same proposal that Oxley and [Representative Richard] Baker (R-LA) originally floated,” said another Republican aide. “There is language in here that says

groups that engage in federal election activity cannot receive any of this money. If the entity participates in these activities - period - they are excluded and banned for a year.” The compromise provides that the fund expire after five years with 3.5% of the GSEs’ annual profits going in the fund for the first two years and 5% of profits accruing to the fund over the remaining three years to finance mostly rental housing projects for very low- and low-income people. Funding preference would also be given to projects and programs that aid victims of hurricanes Katrina and Rita. A portion of the funds would also be used to repay the REFCORP debt issued to fund the savings-and-loan bailout of the late 1980s. Representative Barney Frank (D-MA), ranking member on the Financial Services Committee, said some of the changes to the bill “don’t do any harm. Others I’d rather not have seen.” But Frank said he was pleased to see the bill moving forward, calling the affordable housing fund “a fundamental breakthrough in housing policy.”

- Negotiations on H.R. 1461 were thrown in turmoil when Representative Tom DeLay (R-TX) was forced to step down as majority leader on September 28th, following his indictment on campaign finance violations and a subsequent money laundering charge. Representative Roy Blunt (R-MO), who was a co-sponsor of H.R. 1461, is filling in temporarily as majority leader.
- The ultimate fate of the AH provision is also unclear, since it has provoked the ire of administration officials, Federal Reserve Chairman Alan Greenspan, and Senate Banking Chairman Richard Shelby (R-AL), who believe the provision is antithetical to reform efforts. They argue that such a provision would reinforce Wall Street’s perception that Fannie and Freddie are backed by the federal government and the AH fund would create a new incentive for the GSEs and Congress to grow their investment portfolios and take on more risk. Shelby said recently, “We must provide the right motivation for the GSEs to promote homeownership. Structuring a program that creates incentives for the GSEs to grow larger, and take on more risk, is the fundamentally wrong approach.” (*Congressional Quarterly*, Michael R. Crittenden, 10/07/05; *Dow Jones Newswires*, Dawn Kopecki, 07/06/05; *Market News International*, Claudia Hirsch, 09/29/05; *CongressDaily*, Molly M. Peterson, 10/07/05; *Dow Jones Newswires*, Dawn Kopecki, 10/07/05; *Washington Post*, Annys Shin, 10/08/05)

Senator Hagel (R-NE) hopes for full Senate vote on GSE regulatory reform this year

- Senator Chuck Hagel (R-NE) said he still hopes for a full Senate vote on GSE regulatory reform this year and differences with a House version of the bill are best worked out after passage. Hagel believes that S. 662 will go to the floor with little or no change from the version passed by the Senate Banking Committee in July. “I suspect that we go to the floor as it is, and those who disagree with the bill, specifically the Democrats who voted against it in committee, would have an opportunity to introduce amendments,” said Hagel. Full consideration of the bill depends partly on the pace of hurricane recovery legislation and how quickly the House can take up action on its bill. “There will have to be a reconciliation,” Hagel

said. "If you just take the differences between the two right now -- the House and Senate committee bills -- there are some pretty vast differences, but if you can get these bills or any variation of these bills through the two bodies, then in conference you're going to have a lot of work to do." While he does not believe that there would be any major risks to the GSEs if regulatory reform legislation slips into 2006, Hagel said it was "important that we get this bill done."

- Senate Banking Committee Chairman Richard Shelby (R-AL) is holding ongoing discussions with Republican Senate leadership on bringing S. 662 to a vote, said Shelby aide Andrew Gray. (*Reuters*, David Lawder, 09/27/05)

H.R. 1461 is "not the bill we can support," says HUD Secretary Jackson

- The Bush administration doesn't back the House version of GSE regulatory reform (H.R. 1461) because it would create a weak regulator, said HUD Secretary Alphonso Jackson. "Right now it's not the bill that we can support," he added. "We would hope that the House would come closer to the Senate bill. The Senate bill is closer to what we perceive is very important." According to lobbyists and Hill staff familiar with negotiations, the White House has threatened to issue an official statement of administration policy opposing H.R. 1461, if the House leaders bring it to the floor in its current form. The administration's statement is likely to condemn the bill as lacking key elements of reform, including limits on the companies' portfolios and regulatory authority to freely raise their capital requirements or liquidate their assets if either should fail, according to sources. (*Bloomberg News*, James Tyson, 09/27/05; *Dow Jones Newswires*, Dawn Kopecki, 09/29/05)

Wall Street Journal warns about systemic political risk

- In a September 30 editorial, the *Wall Street Journal* wrote, "In spite of their Tom DeLay preoccupation, we hope Mike Oxley and the House GOP leadership have been paying attention to the continued implosion of Fannie Mae's finances this week. Republicans are in danger of making themselves responsible for whatever happens next at the mortgage giant."
- "When we first raised doubts about Fannie's accounting more than three years ago, we were derided as irresponsible, or tools of the shorts. Turns out we had understated things. Dawn Kopecki of *Dow Jones Newswires*, who has owned this story, reported this week that investigators have uncovered even more accounting 'irregularities' -- including overvaluation of assets, attempts to hide derivatives losses and the possible improper use of tax credits. Investors who had trusted the Wall Street analysts who said the worst was over took a big hit, as the stock fell to an eight-year low of \$41.71 on Wednesday. Fannie shares did a dead-cat bounce yesterday, but they remain well below their highs at the start of the year ...and far off what they were in their glory days of zero market scrutiny before 2002."

- “Which brings us to Mr. Oxley, the House Financial Services Chairman who is pressing a ‘reform’ for Fannie and its sibling, Freddie Mac, that fails to address their core financial risks. His bill does nothing to reduce their huge portfolios of mortgage-backed securities (MBSs) and the derivatives they use to hedge those portfolios. Reducing their MBSs would dent their profitability. But a meltdown in their black-box hedging operations could have far worse consequences, and the ramifications wouldn’t be limited to Fan’s and Fred’s shareholders. Federal Reserve Chairman Alan Greenspan refers to this as ‘systemic risk,’ a polite way of saying that the damage could spread throughout the U.S. financial system and beyond. With Fan and Fred between them controlling about one-fourth of the multitrillion-dollar MBS market, that is no exaggeration.”
- “In 2003, Freddie Mac revealed that it too had misstated earnings. But Fred was lucky and earnings were revised upward. Fannie has yet to complete a multiyear earnings restatement, which awaits the conclusion of the current investigation. But Fannie has estimated that close to \$11 billion in profits could be wiped out for the period between 2001 and mid-2004. The latest news suggests that even Fannie insiders had no idea what they were doing with its derivative book.”
- “Mr. Greenspan points out that Fan and Fred don’t need to hold the \$1 trillion in MBSs in order to provide liquidity to the mortgage market or to lower borrowing costs. They hold them because they can profit from the spread between the yield on those securities and their own (government-subsidized) cost of capital. Reducing those portfolios would greatly reduce the companies’ need for complex and risky hedging operations and thus the systemic risk that the mortgage giants pose to the financial system.”
- “Mr. Oxley knows all this but he punted on real reform to appease the homebuilders lobby that has several wholly owned subsidiaries on his Committee. His proposals are worse than doing nothing because they give the appearance of reform while further entrenching Fan and Fred politically. They would also make Republicans responsible for whatever economic and financial damage follows. The phrase for this is systemic political risk, and we trust that’s something every Member of Congress understands.” (*Wall Street Journal*, 09/30/05)

<p>“This is the time to draw on the GSEs’ unique strengths--not sacrifice them,” says Freddie Mac CEO Syron</p>

- In September 29 speech at the Chief Executives’ Club of Boston, Freddie Mac CEO Richard F. Syron outlined the actions that his company has taken in the aftermath of Hurricanes Katrina and Rita, arguing that responding to crisis is part of the role of the GSEs. Syron said, “This is the kind of thing we do, the kind of crisis we were built for. And it is why fundamental changes to our structure would be so counterproductive. For this is a time to draw on the GSEs’ unique strengths – not to sacrifice them.”

- “The GSEs also enhance stability routinely, in a more systemic way. We make sure that households do not have to bear the interest-rate risk associated with their mortgages – unless they choose to. Working within the free-market system, we manage and disperse this risk out to the capital markets, which are better equipped to handle it. We do this largely by supporting longer-term, fixed rate prepayable mortgages – what I’ve called ‘the American Mortgage.’ As shown by recent research for the U.K. Treasury and by the International Monetary Fund, this kind of lending is good for a nation’s economy, making it less prone to boom and bust. It’s also good for households. The American Mortgage is a major national advantage. Its broad availability in this country is almost unique in the world. The key reason is the GSEs.”
- “But all this is not free. The risk has to go somewhere. By having the GSEs manage and distribute a good share of the risk – even if our share has become limited by competition – the U.S. incurs less systemic risk than by relying solely on depository institutions and hedge funds. There are a number of reasons why the current GSE system involves less risk than a pure depository model. For one thing, the GSEs provide more risk disclosures and satisfy more demanding capital stress tests than anyone. On the interest rate risk side, we mark-to-market our exposure daily and publish the average monthly. On the credit risk side, we make extensive disclosures; use credit enhancements; and produce credit losses at a tenth the rate of depository institutions’ residential mortgage portfolios. And we pass a stress test for capital that simulates a collapse worse than any since the Great Depression.”
- “Second, we have a big comparative advantage in keeping our mortgage portfolios in balance, thanks to our extensive use of callable debt. This vehicle is especially well-tailored for creating a tight match between our assets and liabilities. Freddie Mac finances roughly 50 percent of the fixed-rate mortgages in our retained mortgage portfolio with callable debt. By contrast, most depositories rely far more on short-term deposits to fund mortgages. This leaves them vulnerable if interest rates increase dramatically.”
- “Third, we use derivatives far less than depositories – and we use them only to reduce risk, not to place bets. Our three federally insured competitors employ more than 55 percent of all notional derivatives outstanding – more than 60 times the exposure of Freddie Mac. So if the real concern is about derivatives, then the GSEs’ critics are barking up the wrong tree.”
- “Fourth, we have mortgage risk expertise that few other institutions can match. This is the only thing we do. We have the data, the models, the systems and the people in place to manage the risk.”
- “My fifth point is about our critics’ claim that the GSEs pose unacceptable ‘concentration risk,’ meaning that even if we’re well managed, we are just too big and something could go wrong. They emphasize that thousands of banks own mortgage-backed securities – but ignore the fact that fully 40 percent of MBS are concentrated

among three large banks. Since 2001, the very largest banks have increased their share of mortgages substantially, so they will soon rival us in the size of their mortgage portfolios.”

- “As a result, eliminating the GSE retained portfolios would only further concentrate risk in the financial system, as the largest banks would grow even bigger. Lacking our access to callable debt, they would be forced to choose between leaving their mortgage holdings unhedged, or increasing their already large position in derivatives. The result would be more systemic risk, not less. And it would also mean, over time, less support for the fixed-rate mortgage that is good for the U.S. economy and household sector.”
- “Finally, our critics dismiss the detrimental effect on mortgage rates if the GSEs were barred from buying mortgages and issuing debt. They claim that GSE debt and mortgage-backed securities are simply fungible – including in the eyes of foreign investors. This is belied by history; unsupported by sound research; defies common sense; and is not consistent with the real-world views of the financial markets. Frankly, the two instruments are not close substitutes – foreign central bankers tell me that. If GSE debt were out of the picture, we estimate a disinvestment of hundreds of billions of dollars from certain investors leaving the U.S. housing sector. It’s untenable to claim this wouldn’t affect the markets, cost consumers or raise mortgage rates. Instead of risk reduction, this would be market experimentation – with high stakes, under conditions of uncertainty.”
- “We’ve tried the one-model system before, in which depositories with an explicit federal guarantee fund the majority of fixed-rate mortgages. The unhappy result was the Thrift Crisis. There, you had plenty of seeming diversification – thousands of Savings & Loans – but they all faced the same interest rate risks and inherently bet the same way. Today, we have a better system, with our eggs spread in two baskets: the depository model and the capital markets model of housing finance. This dual system has a proven track record of success. We should let it keep working.”
(Prepared remarks for Richard F. Syron, Freddie Mac Press Release, 09/29/05)

Let the FHLBs run Fannie’s and Freddie’s affordable housing fund?

- Alex J. Pollock, resident fellow of American Enterprise Institute, notes that one of the most controversial elements of GSE reform legislation is the affordable housing fund provision, which critics fear would create a large slush fund for Fannie and Freddie to organize political support for their allies and reward them financially. And, given the GSEs’ history of using their financial clout to enhance their political power, such concern is understandable. To overcome these concerns, Pollock makes an “extraordinarily” simple suggestion: “Give [Fannie’s and Freddie’s] 5% contributions to the Home Loan banks to disburse and administer.” Pollock adds, “The cost to Fannie and Freddie would be the same. The slush-fund problem would disappear. Affordable housing would be well served. We would build on success

and existing nonpolitical infrastructure. Local financial institutions would be even more involved in community development. Everybody would be happy.” (*American Banker*, Alex J. Pollock, 09/30/05)

Keeping your powder dry

- In *National Mortgage News*, Paul Muolo writes, “Sources say the Department of Housing and Urban Development is sitting on two reports that deal with the business operations of Fannie Mae. The first report is a review of Fannie’s ‘partnership offices’ which -- until recently -- were well known for the ‘photo ops’ they held with politicians who later did their political bidding. The other is a report on Fannie Mae and Freddie Mac’s ‘black boxes’ or automated underwriting systems...” (*National Mortgage News*, Paul Muolo, 10/08/05-10/09/05)

“...It’s a good idea not to exaggerate the problems [with the GSEs]”

- In the July/August edition of *Saturday Evening Post*, Duane D. Freese wrote a 1,900-word article titled “The Great American Mortgage,” which trumpets the role of Fannie Mae and Freddie Mac in our housing finance system. Freese said, “Some critics of the GSEs worry that the portfolio purchases, which reached \$1.5 trillion in 2003, pose a risk to the whole financial system. Others, for ideological reasons, simply would like to see the agencies fully privatized, figuring that a free market can meet all of the nation’s housing needs. Safety and soundness, of course, need to be assured. But it’s a good idea not to exaggerate the problems. After all, the GSEs’ \$1.5 trillion debt is \$900 billion less than the \$2.4 trillion goal set for them by the Clinton administration to support low-income housing.” (*Saturday Evening Post*, Duane D. Freese, July/August 2005)
- That said, it appears that the network news may be taking things a bit too far in “not exaggerating” the problems with the GSEs – specifically with regard to Fannie Mae’s recent accounting violations. While Wall Street took notice of reports of more accounting problems at Fannie Mae, the network news continued to ignore the burgeoning scandal at the company, reports Media Research Center’s *Newsbusters.org*. In the six months from April 5 to October 5, the three broadcast networks combined mentioned Fannie Mae just twice, even though the company’s market capitalization dropped almost \$30 billion in value in 2005. One of the reports made a passing mention about Fannie Mae mortgages, while the second report provided a spirited defense of the company by Representative Barney Frank (D-MA), who complained that “you have the administration in an ideologically driven attack on Fannie Mae and Freddie Mac.” Unlike the broadcast networks, Fox News and CNN have acknowledged the Fannie Mae problem. Fox was the only network to do a complete story on the issue, while CNN addressed the topic twice. (www.newsbusters.org, Media Research Center, 10/06/05)

Just how high will conforming loan limits rise in 2006?

- Fannie Mae's and Freddie Mac's conforming limits for 2006 are set to increase soon, and analysts are predicting agency limits to top \$400,000 next year, based up the Federal Housing Finance Board's survey of average home prices from October to October. In August, the average price in the Finance Board's survey was \$301,900, approximately 14% higher than the \$264,540 average in October 2004, noted Merrill Lynch analysts. Barring a significant decline in the Finance Board's survey average in September and October, Merrill analysts estimate the 2006 conforming limit will be approximately \$410,000.
- With the political spotlight focused on the GSEs, sources said that political pressure could be exerted on Fannie and Freddie not to increase limits to the maximum allowable threshold. "The GSEs have to consider the perception that they have become too powerful, and an over \$400,000 conforming limit could become a political hot potato," said one analyst. Another school of thought argues the GSEs would set the limits as high as possible before GSE regulatory reform legislation is passed, which places limits on the companies' balance sheet growth. (*Asset Securitization Report*, Karen Sibayan, 10/03/05)

Federal Reserve Bank-NY "pleased" with banks' plans
to address credit derivatives issues – but the devil is in the details

- Officials at the Federal Reserve Bank of New York were reportedly pleased with a draft September 30 letter from leading credit derivatives dealers, which outlined how they propose to eliminate the paperwork logjam for credit derivatives. According to an email circulated to participating investment banks, "The Fed reviewed the draft...and [was] generally comfortable with the content, but they wanted to give further thought to the confirmation backlog targets." A source close to the discussions told the *Bureau of National Affairs*, "The Fed has seen the draft which I think they're happy with, and I think we're there on virtually everything--there are some minor technical issues that are still being worked through." According to sources, the banks' letter explains that the industry will provide documentation to regulators charting progress on eliminating back-office backlogs of unresolved trade confirmations and automating and normalizing credit derivative transactions. One of the areas being finalized is the establishment of target dates and levels for reducing written confirmation backlogs, said the source. After the metrics have been agreed upon, the banks will begin reporting their backlog data to the Fed for them to monitor, and will work to reduce the paperwork build up. The participating banks include Bank of America, Barclays Capital, Bear Stearns, Citigroup, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs Group Inc., HSBC, JP Morgan Chase, Lehman Brothers Inc., Merrill Lynch & Co., Inc., Morgan Stanley, UBS, and Wachovia. (*Bureau of National Affairs*, Kip Betz, 10/03/05)

Interest rate derivatives total more than \$201 trillion, according to ISDA

- According to a September 28 report by the International Swaps & Derivatives Association, the notional outstanding volume of the equity derivatives market is \$4.83 trillion; the notional amount of the credit derivatives market is \$12.43 trillion; and the notional principal outstanding volume of interest rate derivatives is \$201.4 trillion. (www.techcentralstation.com, “Derivative Thinking,” Dominic Basulto, 10/05/05)

FASB plans to ease draft guidance on limits on special purpose entities that are used in transfers of financial assets

- On October 5, FASB “tentatively” decided to change proposed staff guidance on limits on derivatives held in certain special-purpose entities that are used in transfers of financial assets. The board’s decisions have the effect of easing draft rules that banks and accounting firms had argued would be costly and not practical to carry out. The planned guidance, expected in late October, will be significant to large banks with worldwide operations and which use qualifying special-purpose entities (QSPEs) in securitizations of receivables and other financial assets that then are sold.
- “To address the market-making and other trading activities, FASB accepted a staff recommendation to revise the proposed FSP to permit a [QSPE] to hold passive derivatives that pertain to beneficial interests later purchased by the transferor, held temporarily, and reported as trading securities in accordance with Statement No. 115, on certain investments in debt and equity securities,” reports Steve Burkholder in the *Bureau of National Affairs*. “Under that standard, trading securities are marked-to-market, with changes run through earnings. Such fair value-based treatment, coupled with the not-explicitly-defined ‘temporary’ nature of the holdings, was proffered by Citigroup and others as a reason for the lack of need or inappropriateness of the FASB staff’s original provision in the guidance on the relevant passages in Statement No. 140--paragraphs 40(b) and 40(c)”
- A detailed summary on the issue, including language on transition to the planned guidance, is available at www.fasb.org, under “Action Alert” and “Board Meeting Handouts.” [Click on “Current Meeting Handouts.”] A webcast of the October 5 FASB meeting is available under “Board Meeting” and “Audio Webcast.” (*Bureau of National Affairs*, Steve Burkholder, 10/07/05)

Former Federal Housing Commissioner Weicher rejoins Hudson Institute

- Former Assistant Secretary for Housing and Federal Housing Commissioner John Weicher has rejoined the Hudson Institute. Hudson Institute CEO Kenneth Weinstein said, “We are delighted to bring a distinguished economist like John Weicher to

Hudson, especially as the country faces the most dramatic housing crisis we have ever faced in the aftermath of Hurricane Katrina. John will bring a useful and original perspective to the policy debate.” (*U.S. Newswire*, 09/28/05)

Fannie Mae

Fannie Mae repurchases \$5.0 billion of callable debt securities

- On September 29, Fannie Mae announced that the company repurchased \$4,998,715,000 of callable debt securities in a tender offer ending September 19, 2005. (*Asian Pulse*, 09/29/05)

Fannie Mae’s retained portfolio shrinks at an annualized rate of 27.1% in August

- For the tenth consecutive month, Fannie Mae’s holdings of mortgage securities declined by \$20.5 billion to \$768.28 billion for an annualized rate of decline of 27.1%. In August, Fannie Mae said portfolio liquidations remained high at \$19.62 billion compared to \$18.56 billion in July. Fannie Mae added \$11.56 billion of mortgage securities in August, which were more than offset by \$12.51 billion of sales. The company also entered in to agreements to sell a net \$20.96 billion in August, suggesting that its portfolio will continue to decline in September as it faces a 30% capital surcharge from OFHEO at month-end. Fannie Mae also said its duration gap was zero months, compared to one month in July.
- “Continued run-off at this pace dents the outlook of some mortgage-backed securities analysts that Fannie Mae will return to a buying mode once its capital levels are certified as of September 30,” said Jim Vogel, head of agency debt research at FTN Financial. “According to our estimates, Fannie Mae has already reduced the retained portfolio enough to meet the 30 percent excess requirement, but we suspect it is building additional cushion and will likely reduce the portfolio size by another \$20 billion in September,” said Bruce Harting, an analyst at Lehman Brothers Inc., who rates Fannie Mae “overweight/neutral.” (*Bloomberg News*, Al Yoon, 09/28/05; *Dow Jones Newswires*, Allison Bisbey Colter, 09/28/05)

Sleepless nights at Fannie?

- Paul Muolo writes in *National Mortgage News*, “If there is a single transaction that’s causing sleepless nights (as in possible jail time) for certain former Fannie Mae officials, it’s the one that occurred back in 1998. It was in that year the GSE -- then headed by Franklin Raines -- paid \$27 million in bonus money, all of it tied to Fannie

reaching its earnings goals. How did Fannie ‘make its numbers?’ Answer: By deferring \$200 million in expenses to later years. Not only did the executives ‘make their numbers,’ they made 100% of the bonus goal. ...In case you’re wondering, as one seasoned investment banker told us: The manipulation of earnings to pay bonus money is a crime. ‘Among those who have left, there is a great amount of angst over that transaction,’ said one former Fannie executive, requesting anonymity. (*National Mortgage News*, Paul Muolo, 10/03/05)

Fannie Mae’s to-do list

- While Fannie Mae is “not about to implode,” the company “just isn’t getting the job done fast enough” and “It’s high time Fannie Mae ...get its house in order,” writes Amey Stone in *Business Week Online*. Specifically, Stone outlines five goals that Fannie Mae needs to tackle. First, the GSE should speed up its timetable for restating 2004 financial statements, which is scheduled to be completed during the second half of 2006. Analysts say that’s just not fast enough. “We’re basically running blind,” said Jason Seo, equity analyst with Standard & Poor’s. “From my perspective, they should get it done faster.” Given the decline in Fannie’s stock price and pessimism of many stock analysts, investors are clearly running out of patience.
- Second, Fannie Mae needs to “get Congress on its side,” writes Stone, arguing that the company’s biggest risk is that Congress will rewrite its charter. Specifically, Congress may force Fannie to divest itself of much of its mortgage holdings, from which the majority of the company’s earnings are generated. Pressure in that direction seems to be growing, says Edwin Groshans, an analyst with Fox-Pitt Kelton in New York. “[Fannie and Freddie] have a duty to make sure they are on top of the [GSE regulatory reform] legislation and protecting shareholders’ interests,” said Phil Livingston, vice-chairman of compliance software firm Approva and past president of Financial Executives International.
- Third, Fannie Mae needs to shrink its mortgage portfolio faster than OFHEO now requires. Shrinking its portfolio even faster might head off legislators at the pass and stop them from demanding draconian cuts, argues Stone. “I don’t think that alone would be sufficient to convince Republicans that there should not be serious restrictions on Fannie Mae’s portfolio holdings,” said Jaret Seibert, an analyst for Stanford Washington Research Group. “But it would lessen the immediacy of the need for the legislation. And the longer the delay, the less likely they will get a severely restrictive law.”
- Fourth, Fannie Mae needs to provide investors more information, while it works on the financial restatement. Stone argues that Fannie “can do more to create that all-important buzzword that investors crave: Visibility.” Livingston said, “They should put out whatever information they can in the interim. They have to overdo it for a while in order to regain confidence.” Morningstar equity analyst Ryan Batchelor said

he would like more information on Fannie Mae's use of derivatives. Batchelor also said that Fannie should at least give a more detailed timetable for getting the financial restatement completed. "I think they could try to be a little more open with investors," he said.

- Fifth, Fannie needs to do a better job at public relations. Although Fannie Mae started the year with a new CEO, Daniel Mudd, who appears to be doing a lot of the right things to turn around the company, the public sees few signs of progress. "It appears someone else told their story instead of them telling it," says Tom Vogel, practice leader for the crisis management communications firm Sitrick & Co., referring to the September 29th *Dow Jones* report alleging additional accounting problems at the company. "They have a good story to tell," Vogel said, pointing to OFHEO's September 28th report that said Fannie was adequately capitalized. "But instead of good news, the news that people heard about was something else," he added.
- While Mudd and his new management team have to get Fannie Mae back in shape, they also must let Congress, investors, and customers see more progress along the way, concludes Stone. (*Business Week Online*, Amey Stone, 10/06/05)

The gift that keeps on giving

- Over the past five years, the Fannie Mae Foundation has pumped \$500 million into "highly visible and heavily promoted projects and grants in an effort to sway public opinion and to shape federal regulations," reports Dr. Ronald D. Utt, Falmouth senior research fellow at the Heritage Foundation. (*PRNews*, 10/05/05)

Former Fannie CEO and CFO ask that shareholder suit against them be dropped

- In pleadings filed jointly, former Fannie Mae CEO Franklin D. Raines and former CFO J. Timothy Howard asked a federal judge to dismiss a shareholder lawsuit against them on the grounds that the plaintiffs have not produced any "direct evidence" that the former executives knew about the company's accounting problems or intended to deceive investors. Raines' and Howard's attorneys disputed the plaintiffs' claim that the executives were motivated by the lure of bonus checks and stock options, saying their compensation was not tied to reported earnings but to an alternate measure of profitability. The plaintiffs countered that the accounting violations also affected the alternate measure as well. The defendants' lawyers also took issue with the allegation that the former executives knew of and disregarded a September 2002 memo from Roger L. Barnes, a manager in Fannie Mae's controller's division, warning of "serious financial improprieties." The defendants contend in court filings that Barnes' claims were thoroughly investigated and largely

had to do with accounting issues other than those which have triggered an estimated \$10.8 billion earnings restatement.

- University of Mississippi law professor Mercer E. Bullard said the defendants' arguments are "classic securities law defenses." To keep the lawsuit moving forward, the plaintiffs must convince U.S. District Judge Richard J. Leon that Raines and Howard understood "the choices they were making, the likely impact of those choices, and that there was a lack of transparency to the markets about the choices they were making," said Duke University law professor James D. Cox. (*Washington Post*, Annys Shin, Magda Jean-Louis, 10/05/05)

Is Fannie Mae "quietly" accepting more automated valuation models?

- Paul Muolo reports in *National Mortgage News* that Fannie Mae "is quietly increasing its acceptance of automated valuation models when it buys mortgages in the secondary market, according to one vendor doing business with the company." (*National Mortgage News Online*, Paul Muolo, 10/01/05-10/02/05)

Freddie Mac

OFHEO certifies that Freddie Mac was capital compliant on June 30, 2005

- On September 28, OFHEO certified that Freddie Mac met its regulatory capital requirements on June 30, 2005. On that date, Freddie Mac exceeded its risk-based capital requirement (\$11.144 billion) by \$24.955 billion and exceeded its minimum capital requirement (\$24.073 billion) by \$12.067 billion. (*OFHEO Press Release*, 09/28/05)

Freddie Mac's board authorizes \$2 billion stock repurchase

- Freddie Mac's board of directors has authorized the company to repurchase up to \$2 billion of its common stock and issue up to \$2 billion of non-cumulative, perpetual preferred stock "from time to time depending on market conditions." Freddie Mac chairman and CEO Richard F. Syron said, "This is a first step in managing our capital position to generate better value for shareholders, while at all times remaining well capitalized and well positioned to take advantage of market opportunities. As we move forward, the board and management will continue to focus closely on the company's capital management." The company's press release indicated that OFHEO had blessed the stock buyback plan, which replaces \$13 million in unused repurchase authority that remained under a plan approved by the board in September

1997. Freddie Mac spokesman Michael Cosgrove said the company hadn't repurchased common shares since 2002, when it bought back 9.1 million shares.

- The timing of Freddie Mac's announcement caught some on Wall Street by surprise, who didn't expect a buyback until early next year when the company registers with the SEC. UBS analyst Eric Wasserstrom noted that the \$2 billion repurchase authorization represents about 5% of Freddie Mac's common shares, which is "largely in line with our estimates." If Freddie chooses to repurchase all \$2 billion worth next year, there could be earnings upside of \$0.25 to \$0.30 a share, said Wasserstrom. Freddie's shares rallied 5% on the buyback news, reflecting investors' hopes that a dividend increase will be Freddie's next move, said some analysts. "People expect the next move to be a dividend increase," said Ed Groshans, mortgage finance analyst at Fox-Pitt, Kelton.
- David Dreman, chairman and chief investment officer of Dreman Value Management LLC, in Jersey City, N.J., said that Freddie Mac's ability to return capital to shareholders in the near future isn't nearly as important as its ability to expand its business once market conditions improve. "The main question is whether these companies can go back to their previous models, which were enormously profitable, and provide a major function [to the housing market]," he said. "They need a strong new regulator, but they also have to have the ability to do business as usual." On June 30, Dreman Value Management owned or managed 10.2 million shares of the GSE's common stock, according to the firm's most recent SEC filing. (*Reuters News*, 10/05/05; *Wall Street Journal*, Allison Bisbey Colter, 10/05/05; *Dow Jones Newswires*, Allison Bisbey Colter, 10/05/05; *Freddie Mac Press Release*, 10/05/05)

Former HUD and Finance Board spokesman Doug Duvall joining
Freddie Mac's communications team

- *National Journal* reports that Doug Duvall, a former spokesman for HUD and Federal Housing Finance Board, will join Freddie Mac in a newly created position in the company's communications department. With experience at two different regulators and seven years at Fannie Mae in communications, Duvall said he brings a unique perspective to his new position. "I've sort of been on several sides of the same coin," said Duvall, who will have an opportunity to devise a fresh public image for Freddie Mac. He will also be monitoring congressional developments closely. "We want to be a constructive part of that debate," Duvall said. (*National Journal*, Kellie Lunney, 10/01/05)

Freddie Mac offers Loan Prospector Outreach to help housing counselors assess
homebuyers' ability to qualify for conforming loans

- Freddie Mac is offering "more broadly" the Loan Prospector Outreach (LPO) system, a tool for housing counselors to assess whether would-be homebuyers qualify for

conforming loans. Since LPO is connected to Freddie's automated underwriting engine, Loan Prospector, it will identify more people who qualify than simply looking at product guidelines would, said Tricia McClung, Freddie's vice president of housing and community investment. About a third of the individuals assessed with LPO qualified for a Freddie loan, she said. "The fact that a third of them can be fast-tracked on and moved into the lending process means the ... [counseling agency] just gained that much more capacity to help those who really need it." Most counselors use only "very crude tools" such as manual analysis of debt-to-income ratios or credit scores that do not reflect how an automated system considers such variables in conjunction with others, she added. Freddie has been pilot-testing LPO for more than a year with counseling agencies that work closely with three lenders, including HSBC Mortgage Corp. USA. Freddie Mac is offering the tool for free "for now," in part to ensure counselors use LPO with a broad sample of customers. McClung said that Freddie will make the tool available to even more lenders and counselors over the next year and has considered making the tool available to other intermediaries, such as realty firms, but has no plans to do so yet. Eventually, Freddie Mac will charge counselors for using LPO, which also gathers borrowers' credit bureau information. (*American Banker*, Jody Shenn, 10/04/05)

<p>Former Freddie Mac CEO loses "improper" Maryland lease on land adjoining his Wye Island estate</p>

- On October 26th, the state of Maryland terminated a lease with former Freddie Mac CEO Leland C. Brendsel and his wife, Diane, for 98 acres of state land surrounding their estate on Wye Island. In May, the Maryland Department of Natural Resources (DNR) granted the Brendsels a five-year lease for the Eastern Shore land without putting it up for competitive bid, as the agency had done in prior years. The Brendsels, who bought the 27-acre Wye Hall estate on the island six years ago for \$5.1 million, were paying \$13,676 a year for the use of the land, \$700 less than the previous tenant. After signing the lease in March, they landscaped a portion of the property that led to the entrance of their home and made other improvements to the area. Stephen S. Hershey Jr., assistant DNR secretary for property management, began reviewing the lease after neighbors complained about the Brendsels' landscaping. He concluded that the department erred in leasing the land to Brendsel without competitive bidding and is canceling the lease "to undo a wrong." Brendsel is not alleged to have done anything wrong in the acquisition of the lease. Hershey said that he has given the Brendsels until the end of the year to harvest crops that they have allowed a local farmer to plant on the land. The parcel then will be put up for bid, and Brendsel can try to lease it again. If he is outbid, he may have to remove some of the landscaping that has been installed. (*Washington Post*, Anny Shin, 09/30/05)

Federal Home Loan Banks

FHLBs of Des Moines, Cincinnati, and San Francisco declare dividends

- The FHLB-Des Moines has declared a cash dividend of 1.40% per annum for the three month period that ended August 31, 2005, which will be credited to members' demand accounts at close of business on September 30, 2005. The Bank is currently reviewing its retained earnings policy and anticipates making changes to the policy that could result in increased retained earnings and may result in lower dividends than historic targets. (*PrimeZone Media Network*, 09/29/05)
- The Federal Housing Finance Board's Office of Supervision has approved the FHLB-Cincinnati's third-quarter dividend of 4.875% per annum for the period July 1, 2005 to September 30, 2005, unchanged from the second quarter. This dividend will be paid in the form of additional shares of capital stock on September 30, 2005. The Bank is one of 10 FHLBS which must first get regulatory approval before paying a dividend because it has not registered with the SEC. (*PrimeZone Media Network*, 09/29/05)
- The FHLB-San Francisco announced that its dividend rate for the third quarter of 2005 is projected to be approximately 4.45% (annualized). The Bank expects to calculate and announce the actual dividend rate for the third quarter of 2005 in November, when the Bank files its third quarter 10-Q with the SEC. (*Business Wire*, 09/27/05)

Farm Credit System / Farmer Mac

Why *isn't* Farm Credit System treated like any other GSE?

- In *Farm Credit Watch*, Bert Ely notes that the House Republican Study Committee (RSC) has made two proposals pertaining to the GSEs, which would help raise revenues to pay for the costs of hurricane recovery efforts. First, the RSC proposes levying a 10 basis-point fee on the GSEs' investments. Ely writes, "While the proposal mentioned the other four GSEs (Fannie, Freddie, the FHLBs, and Farmer Mac), it inexplicably left out the FCS. ... [B]ased on FCS investments totaling \$24.4 billion on June 30, a 10-basis-point fee would bring in approximately \$25 million annually, just a small fraction of the \$1 billion annual taxpayer subsidy the FCS now enjoys, in the form of tax breaks (including a complete tax exemption on its real-estate lending) and access to cheap credit." Second, the RSC proposes removing the SEC securities exemption now enjoyed by the GSEs (including FCS), which

would raise \$1.3 billion over five years through SEC registration fees. While FCS is much smaller than Fannie, Freddie and the FHLBs, it would pay roughly \$10 to \$20 million in fees, which could be used toward the recovery costs. Ely writes, “Equally important, treating all the GSEs equally will drive home an important message—in regulatory matters, the FCS should be treated in the same manner as the three housing GSEs, which is why the FCA should be incorporated in the GSE regulatory reform legislation now pending in Congress.” (*Farm Credit Watch*, Bert Ely, 09/05)

FCA: the non-regulator

- Also in *Farm Credit Watch*, Bert Ely writes, “In recent months, the FCA has shifted from merely being a captured regulator to becoming a ‘non-regulator,’ i.e., a regulator who refuses to regulate in situations where it clearly has a regulatory obligation. In an August 2 speech, FCA Chairman Nancy Pellett stated that the ‘FCA has the very difficult job of balancing the realities of the System’s GSE status and public mission as a limited purpose GSE with the desires of the System to expand and grow into new markets.’ She then said that the FCA must ensure that the FCS ‘fulfills its GSE mandate to serve those in agriculture and rural areas.’ In fact, the FCA has a clear statutory obligation -- it cannot authorize FCS institutions to ‘expand and grow into new markets.’ Pellett, though, has clearly signaled to the FCS that it can increase its off-farm lending when she equates serving agriculture with serving ‘rural areas.’ As FCW has pointed out many times, the FCS’s lending mandate does not extend to all of rural America. Pellett’s endorsement of broader FCS lending under existing law is an excellent example of the FCA becoming a non-regulator. The FCA message to the FCS: ‘Go for it!’”
- “The preferred-stock regulation the FCA recently finalized is an excellent example of the FCA not being at home. FCS issuance of preferred stock to its members is one of several backdoor ways in which the FCS takes deposits. Not only has Congress not authorized the FCS to accept deposits, but the one statutory reference to deposit-taking bars CoBank from accepting deposits. While the proposed preferred-stock rule would have required preferred stock to be held by an investor for 12 months before it could be redeemed, the FCS bowed to the wishes of the FCS and dropped that limit from the final rule. The final rule states that each FCS board of directors will ‘establish policy guidance on retirement of preferred stock that is specific to the capital needs of the institution.’ FCA will oversee these policies ‘through our examination process,’ but that begs this question: What guidance will FCA examiners be given? The FCA struck the same pose with regard to limits on how much preferred stock each institution can issue: ‘We expect each System institution to incorporate appropriate limits on preferred stock in its capitalization plan ... FCA examiners will monitor the appropriateness of [these] limitations.’ Again, what guidance will the FCA give to its examiners as to what is or is not appropriate? The FCA has not answered these questions.”

- “The FCA will be tested again when it finalizes its corporate governance regulations for FCS banks and associations. As with the preferred-stock regulation, the FCS has told the FCA to let each FCS institution decide what constitutes good corporate governance. Will the FCA stand up to the FCS and establish good governance regulations or will it again not be at home?” (*Farm Credit Watch*, Bert Ely, 09/05)

Farm Credit Bank of Texas completes \$100 million private placement in preferred stock
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- On September 26, Farm Credit Bank of Texas (FCBT) completed its second private placement of \$100 million in cumulative private preferred stock. Lehman Brothers represented FCBT as the placement agent for the transaction. “The issuance of another \$100 million of preferred stock is part of our strategic objective to maintain a strong capital position without asking existing common stockholders to make additional investments in the bank,” said Larry Doyle, FCBT’s CEO. “In the last three years, the bank has experienced tremendous balance sheet growth. By completing this latest preferred stock offering, we will be able to continue to meet our customers’ wholesale funding needs and pursue business opportunities that will benefit our customer-owners,” Doyle added. At June 30, 2005, the FCBT had \$7.4 billion in total loans outstanding and reported net income of \$27.6 million for the six month period. The bank is the source of funds for its owners—21 rural lending cooperatives in Alabama, Louisiana, Mississippi, New Mexico and Texas, and four other financing institutions. (*Austin Business Journal*, 09/28/05; *Farm Credit Bank of Texas Press Release*, 09/27/05)

Postal Service

Postal reform legislation in limbo

- The Postal Service Board of Governors’ “eleventh-hour criticisms” of postal reform legislation surprised reform supporters on Capitol Hill. “It is very disconcerting,” said Robert Taub, spokesman for Representative John McHugh (R-NY). “[The Board is] complaining that their ‘primary concern’ is the provisions in the bill for strong regulatory oversight. But, hello, that has to be a key component of any reform bill...,” he said. “You can’t have a bill that grants more flexibility in pricing and rates without having strong regulation in place to protect the competition. The Postal Service will remain a wholly government entity under these bills, and the only way to give it additional tools to operate in the marketplace is to have appropriate oversight.” Drew Crockett, a spokesman for Representative Tom Davis (R-VA) said, “If the Postal Service is expecting a bill that will give them complete and total flexibility to operate without oversight, they’re dreaming. To say that the status quo would be better than passing the present legislation is to simply stick one’s head in the sand.”

Senator Susan Collins (R-ME) said “The Postal Service’s eleventh-hour criticisms are disappointing,” adding that the Senate bill had been very carefully crafted and balanced. Six Postal Service governors, Postmaster General John Potter and Deputy Postmaster General Patrick Donahoe said in the September 13th letter to the House Government Reform Committee that H.R. 22 would give a proposed regulatory commission too many sweeping powers to oversee the day-to-day business affairs of the Postal Service. Taub said he isn’t sure that the Postal Service will play a big role in negotiations going forward. “My concern is that if this is all they have to offer, they may be abrogating their role at the table,” he said. (*FederalTimes.com*, Dan Davidson, 09/29/05)

H.R. 22 and S. 662 are second class “reform” bills
that don’t protect the taxpayers says NTU

- In an October 5th Issue Brief, Kristina M. Rasmussen, Government Affairs Manager of the National Taxpayers Union, said, “Far from launching comprehensive reforms to bring the nation’s ailing postal monopoly into the 21st Century, the [postal reform] legislation now grinding its way through Congress merely offers a recycled ‘grab bag’ of reorganization measures. Fortunately, the Senate, and if necessary the President, can still send these bills to the dead-letter bin.” Like many past proposals, the bills offer nothing to taxpayers and likewise fall miserably short of pushing the Postal Service’s \$69 billion operation toward a competitive and privatized system. (*National Taxpayers Union Press Release*, 10/05/05)

Despite next year’s postal rate increase, USPS expects \$2 billion deficit in 2006

- Even with a 5.4% postage rate increase in January, the Postal Service expects to go nearly \$2 billion in the red in 2006. USPS CFO Richard J. Strasser told the agency’s board of governors that rising costs will result in a \$1.8 billion deficiency in 2006, which will be covered through borrowings. “We project revenue of \$72.3 billion, an increase of 3.4 percent, to be offset by a like percentage increase in expenses,” he said. The Postal Service plans cost reductions of \$1.1 billion, including work-hour reductions of 42 million hours. The USPS also faces a congressionally imposed requirement to place \$3.1 billion in an escrow account, which is reflected in its 2006 forecast. Strasser also noted that costs are now expected to be higher than originally planned when the rate increase was approved by the board. (*Associated Press*, 09/27/05; *DMNews.com*, Melissa Campanelli, 09/28/05)

2007 postal rate increase already on its way

- Postmaster General John Potter said there will be a need for a second postal rate increase in 2007 due to rising gasoline prices. Every penny increase in the price of a

gallon of gasoline costs the Postal Service \$8 million to fuel its 212,000 vehicles, he explained. “Our costs are going up just like everyone else’s costs,” said Potter. The amount of the 2007 increase will depend on the economy, the cost of gasoline, mail volumes, and other factors, he said. Since the 2006 postal rate increase will merely cover the \$3.1 billion escrow payments legally-mandated by Congress, growing costs overall will force the second increase in postal rates the following year. Unless changed by Congress, the escrow requirement would increase in subsequent years, Potter added. (*Associated Press*, 10/01/05)

The USPS LPO?

- With every postal rate increase, you hear the same arguments and justifications—but nothing has changed. Steve Marr writes in the *Lincoln Tribune*, “The Post Office needs to be sharpened with more competition, not another rate hike. No government monopoly has ever been a good business model ... or been efficient. Now is the time to open up competition for all mail service. Or better yet, why not just sell the Post Office in one big stock offering?” (*Lincoln Tribune*, Steve Marr, 09/28/05)

The Board of Governors approves the USPS Transformation Plan for ‘06-’10

- The USPS released its Strategic Transformation Plan for 2006-2010, which outlines how the agency plans to respond to changing customer needs, market requirements, technological developments and legal requirements. It builds on the original Transformation Plan that was introduced in 2002. “Transformation became the watchword of the postal service in 2002,” said Postmaster General John E. Potter. “Our goal was to position the postal service to navigate a dynamic market environment and communications landscape successfully. The results speak for themselves.” Postal products and services now are marked by innovation, ease of use and accessibility, he said. “We have reduced costs and increased productivity,” he said. “Our people, the men and women of the postal service, have brought service performance and customer satisfaction to record levels.” In the next five years, the USPS will stay focused on its core business, he said. Details of the plan can be found at www.usps.com/strategicplanning/transform.htm. (*DMNews.com*, Melissa Campanelli, 09/28/05)

TVA

Operating at peak performance, TVA successfully meets peak power demand

- TVA president and COO Tom Kilgore said the utility is operating at peak performance, allowing it to meet extraordinary power demands by its customers in 2005. He noted that TVA was able to meet a record demand for power in July, in which peak demand exceeded 29,000 megawatts for eight straight days. For FY2005, TVA projects that total power sales of more than 170 billion kilowatt hours, which will generate more than \$7.7 billion of revenues. The utility's 11 fossil plants will generate almost 5% more power than they did in 2004, and hydro generation is expected to be 13% above normal. Kilgore said that the TVA reduced its total financing obligations by \$300 million in FY2005. (*Memphis Business Journal*, 09/28/05)

TVA is key player in the formation of a new steel company in Mississippi

- A group of investors has announced the construction of SeverCorr, an \$880 million steel mill in Columbus Mississippi. Initially, the new plant would produce 1.5 million tons of high quality steel sheet a year for use by foreign automakers in the South. "It's an ideal location from a customer standpoint," said John Correnti, former CEO of Nucor Corp., who will be the president and CEO of SeverCorr. Russian steelmaker OAO Severstal Group is investing about \$200 million in the project along with other large investors such as General Electric Co.'s GE Capital, said Correnti. Construction is expected to begin immediately on the 1.2 million-square-foot plant, which will open by the end of 2007 and employ about 450 workers. Mississippi Governor Haley Barbour signed legislation that provides SeverCorr \$85 million in local and state support, including a \$25 million grant to help build infrastructure and \$60 million in loans. Correnti said that SeverCorr will be a low-cost producer with a long-term energy arrangement with the TVA. (*Wall Street Journal*, Paul Glader, 10/04/05)

Fair use – or misuse—of eminent domain by TVA?

- While it doesn't rank with the New London, CT's eminent domain case recently decided by the Supreme Court, TVA's decision to sell land for development that it forced private owners to hand over 40 years ago "is fundamentally and ethically wrong," writes Sam Venable in the *Knoxville News Sentinel*. In the 1960s, TVA purchased about 6,200 acres to "tame" the Tennessee River for flood control and provide hydroelectric power. The utility purchased 118 tracts for \$2.5 million or about \$400 an acre, displacing some 82 families. The TVA board has now voted to auction 578 acres of this public property which it doesn't "use" on Nickajack Lake to

developer John Thornton, who plans to build a \$459 million community of luxury homes on the site. In exchange, Thornton plans to convey to TVA 1,095 acres he owns at Burns Island (220 acres), Cedar Mountain (615) and a farm (260). The *Charlottesville Daily Progress* writes, "If land forcibly obtained from unwilling sellers is now being resold [by TVA] for such a substantial profit, perhaps those original sellers or their descendants should reap the rewards. Let the TVA repatriate to them a share of the profits. After all, the TVA not only took from them land at the fair market value of the time, but also took the owners' ability to hold the land as an investment. TVA's shoreline created the demand for development - the investment potential - even as it prevented former private owners from ever reaping the financial benefits of that development. A belated adjustment would seem in order."

- Venable also warns, "So prepare yourself for more negotiations. As [TVA] chairman Bill Baxter told the press after the deal was OK'd, 'This proposal is going to become a model of what TVA considers in the future.' Translation: The feed trough is open, folks. Come and get it." (*Knoxville News Sentinel*, Sam Venable, 10/02/05; *Charlottesville Daily Progress*, 10/03/05)

One contract worker dies from injury at TVA's Browns Ferry nuclear plant
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- An industrial accident at the TVA's Browns Ferry Plant in North Alabama sent two contract workers to the hospital, one who died from his injuries on October 6. Plant spokesman Craig Beasley said the employees were hurt on October 1st about 11 a.m., while moving heavy equipment in the Unit 1, reactor which fell on the two. The second worker was treated and released the day of the accident. Beasley said that both workers are employed by the Illinois-based L.E. Myers Company. While the accident occurred inside the plant, the workers were not in the radiology controlled area of the Browns Ferry Plant, he added. Unit 1 was shut down in 1985 due to safety concerns and is being prepared for a 2007 restart. (*Associated Press*, 10/04/05; *Athens-News Courier*, 10/03/05; *Associated Press*, 10/07/05; *Associated Press*, 10/08/05)

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