

# The **GSE** REPORT™

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## ***Major Events***

President Bush nominates James B. Lockhart, III to head OFHEO
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- President Bush has named Deputy Commissioner of the Social Security Administration James B. Lockhart, III to be acting director of OFHEO and, if confirmed by the Senate, to take the post permanently for a five year term. On May 2, Lockhart assumed the position of acting OFHEO director, succeeding Steve Blumenthal, who served as OFHEO's acting director since May 2005. Blumenthal is expected to resume his role as the agency's deputy director. While serving in the unpaid position as acting director of OFHEO, Lockhart is also retaining his position at SSA during his tenure. White House spokesperson Erin Healy said, "The President wanted him to get started immediately and get down to business at OFHEO. He will be wearing two hats." Healy added, "Upon confirmation, he would need to step down from the Social Security job." Observers speculate that Lockhart also may bring with him to OFHEO Edward DeMarch, a SSA deputy who previously served as director of the Treasury Department's office of financial institutions policy, responsible for overseeing GSEs.
- Some analysts view Lockhart's appointment and his close relationship with the White House as an indication that the Bush administration plans to renew its push for GSE regulatory reform legislation. "This [appointment] will mean a far better, coordinated approach between the executive branch and legislators - we are about to see more ratcheting up and coordination on the Hill than we have seen before," said Josh Rosner, the head of financial services research at Medley Global Advisors. Observers view Lockhart as a pivotal player in the GSE regulatory reform debate, carrying clout with the White House and taking the reins at a time when other Bush administration policymakers [former White House chief-of-staff Andrew Card and National Economic Council staff member Kevin Marsh] have left their positions, creating a perceived "power vacuum" in the GSE debate. Most observers believe Lockhart is a strong supporter of the administration's call for strict limits on GSE mortgage portfolios.
- The appointment comes weeks before the release of OFHEO's report on its special examination into Fannie Mae's accounting, which is expected to be released "in the next couple of weeks," according to OFHEO spokeswoman Corinne Russell [on May 4]. The *American Banker* reported that "GSE representatives privately expressed relief at [Lockhart's] appointment and said they believed he was put into place to ensure that the [OFHEO] report did not overreach. The GSE representatives have expressed concerns that acting OFHEO director Steve Blumenthal might use the report to 'settle old scores against Fannie.'"

- Senate Banking Committee Chairman Richard Shelby (R-AL) called the Lockhart appointment a “positive step.” He added, “OFHEO requires strong and independent leadership, and the Senate Banking Committee will hold a hearing on the nomination of Mr. Lockhart as expeditiously as possible.” Shelby said he expects OFHEO’s report on Fannie Mae’s accounting problems and the nomination of a new OFHEO director to generate momentum for GSE regulatory reform legislation.
- Before joining the Social Security Administration in 2002, Lockhart co-founded NetRisk, a Connecticut-based consulting and software firm that works with financial services companies. Previously, he served as executive director of Pension Benefit Guaranty Corp from 1989 to 1993 and was the director of the Association of Private Pensions and Welfare Plans from 1993 to 1995. Lockhart has a long-time friendship with President Bush dating back to their days at prep school at Phillips Academy Andover, as well as college days at Yale University and Harvard Business School. (*Reuters*, Kristin Roberts, 04/27/06; *Washington Post*, Kathleen Day, 04/28/06; *Bureau of National Affairs*, Richard Cowden, 04/28/06; *American Banker*, Patrick Rucker, 05/01/06; *Dow Jones Commodities Services*, Damian Paletta, 04/28/06; *Reuters*, 04/28/06; *Dow Jones Newswires*, Damian Paletta, 04/27/0; *National Mortgage News Online*, 05/04/06)

<p>Federal Reserve Chairman Bernanke urges Treasury to limit the GSEs’ debt issuance if Congress fails to pass GSE regulatory reform legislation</p>
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- In testimony before the congressional Joint Economic Committee, Federal Reserve Chairman Ben Bernanke said that the Treasury Department should consider limiting the debt Fannie Mae and Freddie Mac can sell if Congress fails to pass GSE regulatory reform legislation. “In terms of making sure that this is done right, [I] hope that the Congress could make clear to the [GSE] regulator what the expectations of the Congress were and what the powers of the regulator were,” said Bernanke. Noting that Treasury has power to limit Fannie’s and Freddie’s debt issuance and perhaps power over terms and maturities of that debt, Bernanke said, “If we are unable to achieve progress through Congress, I don’t think Treasury should abandon that power. I think [Treasury] should consider using it if it believes that the systemic risks being generated by the [GSEs’] portfolios greatly outweigh the benefits that are mandated by the affordable housing mandate.”
- While Treasury officials regularly discuss the agency’s authority over Fannie’s and Freddie’s debt sales, the agency has always stressed that Congress should act. According to sources, Treasury will consider limiting those debt sales if Congress does not pass a bill this year. Treasury Secretary John Snow said he was focused on the legislative effort to curb the portfolios, but would not be drawn into a discussion on timing. “I think we have very, very broad authorities here [to regulate GSEs],” said Snow. “I much prefer to see the legislation; I think it is a better framework for dealing with this complex issue.” Snow added that he has ongoing discussions with Senate Banking Committee Chairman Richard Shelby (R-AL) and remains optimistic

that a GSE regulatory reform bill can advance this year. (*Dow Jones Newswires*, Brian Blackstone, 04/27/06; *American Banker*, Patrick Rucker, 04/28/06; *Reuters*, 04/27/06; *Reuters*, 04/26/06; *National Journal's CongressDaily*, Bill Swindell, 04/26/06)

- In an April 27 editorial, the *Wall Street Journal* wrote, “Portfolio limits [for the GSEs] are ...in the interest of American taxpayers and the integrity of the financial system. The law requires that the bonds that Fannie and Freddie issue explicitly deny that they are backed by the federal government, but plainly no one believes that. Otherwise, who in their right mind would purchase the debt of Fannie Mae, a company with no financial statements and \$11 billion in overstated profit? This type of situation was foreseen when Fan and Fred were chartered. Which is why the same sections of the U.S. Code that require Fannie and Freddie to disavow any government backing of their debts also require the companies to get the approval of the Treasury Secretary before issuing any debt. Specifically, the law pertaining to Fannie reads: ‘[T]he corporation is authorized to issue, *upon the approval of the Secretary of the Treasury*, and have outstanding at any one time obligations having such maturities and bearing such rate or rates of interest as may be determined by the corporation *with the approval of the Secretary of the Treasury ...*’ (our emphases). The section of the law dealing with Freddie Mac has similar language.”
- “As we read that, Treasury already has the power to limit Fannie’s and Freddie’s borrowing. What’s more, that authority appears to have been granted specifically out of concern that the debts of the pair might someday be laid at Treasury’s doorstep. But without massive borrowing, neither Fannie nor Freddie could afford to hold the hundreds of billions of securities that they currently do. So limiting their borrowing would require them to decrease the size of their portfolios -- and hence the risk to the economy of a blow-up. Meanwhile, their regular business of securitizing mortgages and selling them would be unaffected. It is their repurchase of those mortgages with subsidized credit that needs to be limited.”
- “The Bush Administration has been forceful in calling for Congress to reform how Fannie and Freddie are regulated and run. But if it wants its effort to succeed, it is going to have to show Fan and Fred and their friends on the Hill that Treasury will act if Congress doesn’t.” (*Wall Street Journal*, 04/27/06)

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

Setting the stage for GSE regulatory reform debate
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- The nomination of a new OFHEO director and a soon-to-be released report on Fannie Mae's accounting problems by OFHEO will likely put GSE regulatory reform on the congressional radar, say industry observers. "Political changes are sufficient for us to say that prospects [for GSE regulatory reform] are brightening rather than dimming," said Jaret Seiberg, an analyst at the Stanford Washington Research Group.
- Senate Banking Committee Chairman Richard Shelby (R-AL) said he is continuing to push for a new GSE regulator but appears to be unwilling to "soften" a bill the Committee passed along party lines last year. "We think we have a good bill," Shelby told reporters on May 4. "I've said that over and over." When asked by reporters if he is working on a compromise bill with the Democrats, Shelby responded, "We like our bill." In an interview with *Bloomberg After Hours*, Shelby said, "This [GSE regulatory reform] legislation is meaningful and we hope that we can pass it before the year's out. This is a crucial time to be looking at it seriously and we plan to do that. We're going to bring it before the Senate. ... [T]hese two government-sponsored enterprises, they need a strong regulator. Everything points to that. Everybody knows that. They have a powerful lobby group everywhere on the hill to try to prevent any legislation that will bring about a powerful regulator."
- Senator Paul Sarbanes (D-MD), the ranking minority member of the Senate Banking Committee, told *Reuters News* that the Bush administration should reconsider its position on the mortgage portfolio provision. Sarbanes said, "The administration has to, I think, rethink its position because they've been very adamant. The House has got a bill over there, which seemed to me to be a pretty good bill. We had general agreement with the exception of a couple of issues in the committee." When asked if the OFHEO report would impact the GSE reform legislation, Sarbanes responded, "I'd have to see what's in the OFHEO report before I can answer that." Sarbanes also said he had heard positive reports about James B. Lockhart, the Bush administration's nominee for OFHEO director. "From all reports, he has done an acceptable job [at the Social Security Administration]," said Sarbanes. "Obviously, we will have to take a very careful look at him because it's a very important position."
- In an interview with James Tyson at *Bloomberg News*, Senator Robert Bennett (R-UT) said that the Federal Reserve is open to having the GSE regulator direct the GSEs to justify the size of their holdings and sell those assets that are "irrelevant" to their mission. Under such a bill, "the regulator says, 'OK, if you can justify this you can have it,'" said Bennett. "I had that conversation with Fed officials and they indicated a willingness to move in that direction." Bennett, who serves on the Senate Banking Committee, declined to identify the officials at the Fed with whom he had this conversation. In a subsequent interview, Senate Banking Committee Chairman

Richard Shelby (R-AL) said, “We’ll consider it,” but added that the revised provision had not been formally submitted for consideration.

- Banking Securities Subcommittee Chairman Chuck Hagel (R-NE) and Senator John Sununu (R-NH) have circulated a “Dear Colleague” letter, asking Senate leaders to bring GSE regulatory reform legislation to the Senate floor. The Senators wrote, “We are concerned that if effective regulatory reform legislation for the housing finance government-sponsored enterprises is not enacted this year, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall financial system, and the economy as a whole.”
- On May 2, Representatives Scott Garrett (R-NJ) and Jeb Hensarling (R-TX) sent a letter to HUD, saying that Fannie Mae and Freddie Mac should not be allowed to take advantage of “regulatory distractions, financial uncertainties and capital ambiguities” by starting new activities in the midst of the current congressional debate about the GSEs’ futures. “We respectfully request that HUD, as the GSEs’ regulator for new programs under current law, address Fannie Mae’s new ventures, particularly its plans to increase its construction-finance business,” they wrote. The Members also asked HUD to assess a new multi-family finance product announced by Freddie Mac in January, which “picks one firm [with] which it will do business, circumventing loan-to-value ratios designed to limit credit risk in this often volatile business line.” They concluded, “It is clearly not in the public interest for any GSE to launch any substantive new venture unless or until its financial house is in order, as certified by its auditors,” OFHEO, and the SEC.
- According to Stanford Washington Research Group’s analyst Seiberg, a late-session compromise between Senator Richard Shelby (R-AL) and Democrats on the Banking Committee on the GSE portfolio provisions is the only path to congressional action this year. “Shelby will make a political decision by late summer on whether he believes he can get the bill done. If he sees an opening, we expect him to take it,” said Seiberg, who believes that there a 33% chance of passage of GSE reform this year. (*Reuters*, Kristin Roberts, 05/04/06; *CongressDaily*, 05/05/06; *Dow Jones Newswires*, Damian Paletta, 05/04/06; *CQToday*, Michael R. Crittenden, 05/01/06; *Bloomberg News*, James Tyson, 05/03/06; *Bloomberg After Hours*, Senator Richard Shelby, 04/25/06, 05:27:49 PM; *American Banker*, Damian Paletta, 05/05/06; *Dow Jones International News*, Damian Paletta, 05/05/06; *Correspondence to the Honorable Alphonso Jackson*, Representatives Scott Garrett and Jeb Hensarling, 05/02/06)

Senators Hagel and Sununu question SEC Chairman Cox about his agency’s treatment of Fannie Mae
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- In a hearing before the Senate Banking Committee, SEC chairman Christopher Cox defended his agency’s stance in allowing Fannie Mae to continue trading on the NYSE, even though the GSE has failed to file its annual report for two consecutive

years. During the hearing, Senate Banking Committee members said they were concerned about the lack of SEC action against Fannie Mae, which is working on a multi-year restatement resulting from an estimated \$11 billion of accounting errors. Banking Securities and Investment Subcommittee Chairman Chuck Hagel, (R-NE) said he was astonished Fannie Mae was still allowed to continue trading on the NYSE. “I would have a concern for investors when a public company has not presented financials since the second quarter of 2004 and still is allowed to trade in a major stock exchange,” Hagel added. In response, Cox said he shares Hagel’s view of compliance for publicly traded stock, but added that Fannie Mae was undergoing an “unusual circumstance” to assure compliance in its accounting statements. Cox said, “We are within reach of getting what we expected [from Fannie Mae],” adding that the SEC has worked out a timeline in which Fannie Mae will complete its accounting restatements and submit filings with the SEC. Although Cox didn’t reveal the timetable’s dates, Fannie Mae has said publicly that it “aims” to complete the restatement later this year. Citing his concern for protecting investors, Hagel said, “I strongly suggest that we need to take a further look at this. It sends the wrong message to the market.”

- Senator John Sununu (R-NH) was not persuaded by Cox’s comments, arguing that Fannie Mae more likely did not have to undergo a mandatory delisting proceeding because of its large market capitalization. “I think your answer was effectively: ‘Well, we hope they can move forward and get this restatement issue done,’” said Sununu. “In the near term, we all hope that. But the fact is the exchange had very clear procedures regarding delisting, and it chose to craft an exemption for this one firm. What happens when a similar exemption is sought for Exxon or for General Electric, for Google, for Philip Morris, or for any one of those companies that have a larger market capitalization than Fannie Mae? Is the SEC going to agree or concur this is a good idea?”
- “No,” answered Cox. The exemption was made because Fannie Mae is a government-sponsored company that only recently announced it would register its stock under compliance of the 1934 Securities Exchange Act, Cox added.
- Sununu disagreed with Cox’s statements, noting Fannie’s financial statements “had much more to do with irregularities in the accounting process and accounts to manipulate earnings than any specific changes that came as a result of their participation in complying with [the act].”
- The incident occurred over a tight time frame, replied Cox. On March 31, 2004, Fannie Mae first registered for compliance under the act. Six months later, OFHEO uncovered financial accounting problems. Fannie later sought guidance from the SEC on FAS 133 treatment. “That confluence of events that I refer to, I think, makes this different than Google or any other private company,” said Cox. (*Bureau of National Affairs*, Rachael McTague, 04/26/06; *Washington Post*, 04/26/06; *Dow Jones International News*, John Connor, 04/25/06; *CongressDaily*, Bill Swindell, 04/26/06)

- In a May 2 comment letter on OFHEO's strategic plan, the Consumer Mortgage Coalition urged the agency to get tough with Fannie Mae and Freddie Mac by clamping down on activities that violate their government charters. CMC noted that OFHEO has cease-and-desist powers, which HUD lacks that should be used to stop the GSEs from engaging in unauthorized activities. "We respectfully urge that OFHEO use its strategic plan to clarify that it has and will use these very important powers," said CMC executive director Anne Canfield. The CMC also asked OFHEO to set up an Office of Ombudsman to handle industry complaints about the GSEs' activities. "OFHEO could conduct its own inquiry through the examination process, and could reach a determination whether a GSE was engaging in programs without first obtaining HUD approval, in violation of its charter act," said Canfield. CMC also urged OFHEO to add a fourth strategic goal to its plan, calling for agency to "seek legislation where necessary to provide OFHEO with the mandate, resources, and regulatory tools needed to provided effective supervision of the Enterprises." (*National Mortgage News Online*, 05/03/06; *Correspondence to Susan S. Jacobs*, Anne C. Canfield, 05/02/06)
- In a May 3 comment letter on OFHEO's strategic plan, FM Policy Focus (FMPF) suggested that the agency "take as its top priority in its new strategic plan a set of supervisory and regulatory actions to ensure that all of [Fannie Mae's and Freddie Mac's] past failings are quickly, demonstrably, and lastingly remedied." FMPF believes that OFHEO should update its regulations to "ensure ample advance prudential scrutiny of any and all new GSE ventures." Specifically, FMPF suggests that OFHEO's strategic plan address the major internal audit, risk management and compliance failures at Fannie and Freddie. OFHEO should issue enforceable guidance, similar to the banking agency examination manuals, regarding the qualifications of key personnel, reporting lines, board access, and similar matters. Further, FMPF recommends that steps be taken to ensure that OFHEO officials hold themselves accountable for action on specific steps to be taken in implementing the plan. OFHEO should issue and provide public guidance on GSE compensation practices to ensure that incentives do not compromise the GSEs' safety and soundness and are in line with the Enterprises' mission. OFHEO should also assess the degree to which the GSEs use their market positions to advance political objectives, rather than their chartered missions. FMPF also urged OFHEO to review the GSE new business ventures in light of the GSEs' risk-based capital rules and, where necessary, revise the risk-based capital rule to ensure that adequate capital is in place as a new activity begins. OFHEO must also use its examination authority to identify new GSE programs to ensure that the GSEs do not violate their charters by engaging in new programs without first obtaining HUD's prior approval. (*Correspondence to Susan S. Jacobs*, Mike House, 05/03/06)

### House approves lobbying reform legislation by narrow margin of 217-213

- Despite the defection of 20 Republicans on the final vote, House Republicans were able to attract eight Democratic votes to achieve passage of a lobbying and ethics reform bill (H.R. 4975). The House bill would increase disclosure filing requirements by lobbyists; provide new disclosure for legislative earmarks, gifts to lawmakers, and campaign contributions; impose a moratorium on privately funded travel for lawmakers until later this year; and limits donations to Section 527 political organizations. Specifically, the bill would increase the lobbyists' filing requirements from twice a year to four times a year via electronic transmissions which are publicly available on-line. The bill maintains a post-employment ban for one-year for House members and senior staff. The bill suspends privately funded travel and requires the House Ethics Committee to develop a new system that certifies that travel complies with ethic rules by June. The bill also takes away the retirement benefits of members convicted of bribery or acting as a foreign agent while in office. The House bill now goes to conference with the Senate, which passed its own bill (S. 2349) on March 29. The outlook for final passage of lobbying reform legislation appears to be uncertain, however, given the Democrats weak support for the S. 2349 and near-total rejection of H.R. 4875. Democrats have threatened to block any conference report that contains language cracking down on 527 groups. (*Associated Press*, 05/03/06; *CQ Today*, Isaiah J. Poole and Martin Kady II, 05/04/06; *Bureau of National Affairs*, Heather M. Rothman and Kenneth P. Doyle, 05/04/06)

### Treasury's former undersecretary of domestic finance moves to the private sector

- Brian Roseboro, the former Treasury Department undersecretary for domestic finance, has been named a managing director for the Promontory Financial Group. Based in their New York office, Roseboro will specialize in financial markets trading and regulation, derivatives, complex structure transactions, risk management, and corporate governance. (*American Banker*, Patrick Rucker, Joe Adler and Stacy Kaper, 05/01/26)

### Watchdog groups are demanding more transparency in corporate political donations

- Watchdog groups, such as the Center for Political Accountability, have expanded their activities this year to include monitoring the political activities by 501(c)4 trade associations and 501(c)6 social groups and tracing corporate dues payments through those organizations into the nexus of issue advertising. Over the past sixteen months, the Center for Political Accountability has been working with public companies to encourage them to adopt new corporate policies that requires the board of directors to review all soft money political contributions annually and requires the company to post a complete list of corporate political contributions on its website. As a result of the Center's efforts, political transparency and accountability policies have been

adopted over the past 16 months by ten publicly-traded companies, including McDonald's, Morgan Stanley, Johnson & Johnson, Pepsico, Coca Cola, and Eli Lilly. The Center for Political Accountability recently added Microsoft, Fannie Mae, Freddie Mac, General Mills and Symnatec to its list of shareholder-voting targets. (*The Hill*, Elana Schor, 04/25/06; *Center for Political Accountability Press Release*, 04/05/06)

- The National Legal and Policy Center (NLPC) plans to submit a shareholder proposal to Freddie Mac, requiring the company to periodically disclose information on contributions to non-profit groups, the benefits of the donations, and the personnel making such decisions. This proposal is part of the NLPC's efforts to increase pressure on publicly-traded companies to disclose charitable donations, particularly those linked to the Reverend Jesse Jackson. In 2006, the Center has submitted similar proposals to the shareholders of Pepsi, Boeing, and Citigroup, which received approval from 6%, 9.5% and 10% of the companies' shareholders, respectively. [First-time shareholder proposals which get more than 3% of the vote qualify for inclusion in the company's proxy the following year, according to the SEC.] NLPC president Peter Flaherty concedes that his group's proposals are doomed from the start, "but we also wanted to raise the issue, and it's been very valuable for doing that." The Center's goal is to pressure companies to divest from Jackson-led efforts, including the Rainbow/PUSH Citizen Education Fund, which in 2001 provided payments to Jackson's former mistress. (*Chicago Sun-Times*, Cheryl V. Jackson, 05/04/06)

## ***Fannie Mae***

### Fannie Mae's retained portfolio grows at 0.5% annualized rate in March

- In March, Fannie Mae's mortgage portfolio grew by an annualized 0.5% in March to \$721.1 billion. The company's modest mortgage growth was largely the result of a cheapening of mortgage-backed security spreads, said Fannie Mae spokesman Jason Lobo. "The company remains an opportunistic buyer and we saw very little profitable opportunities to buy during the month," Lobo added. In March, Fannie Mae's portfolio purchases of \$14.2 billion offset \$11.4 billion in liquidations and \$2.5 billion in portfolio sales. The company's mortgage purchase agreements totaled \$16.58 billion at the end of March, up from \$9.70 billion at the end of February. Fannie Mae also said its duration gap averaged zero months in March, unchanged from the prior four months. (*Reuters*, 04/27/06; *Dow Jones Newswires*, Allison Bisbey Colter, Neil Shah, and Danielle Reed, 04/27/06)

### Fannie Mae's CEO Mudd has bonus target of \$2.61 million for 2006

- Fannie Mae has set the bonus target for CEO Daniel H. Mudd at 2.75 times his salary or \$2.61 million for 2006. Mudd will receive a base salary of \$950,000 in addition to performance bonuses in 2006. (*Dow Jones Newswires*, Ed Welsch, 04/28/06)

### Fannie Mae plans to file a Form 12b-25 with the SEC and schedules a conference call for investors on May 9

- Fannie Mae announced plans to file a Form 12b-25 [notification of late filing] with the SEC on the morning of May 9, informing the agency that the company is delaying its first quarter 2006 10Q as it continues work on the restatement its financial restatements. At 4:00 p.m. (Eastern), Fannie Mae will host a conference call for investors to discuss the SEC filing and answer questions from analysts and investors. Information regarding the conference call is available on the company's Web site. An audio replay of the call will be available on the Web site starting at 7:30 p.m. on May 9 through midnight May 23. (*Dow Jones Newswires*, Robert Schroeder, 05/02/06; *Fannie Mae Press Release*, 05/02/06 )

#### Fannie Mae announces second quarter dividends

- Fannie Mae's board of directors declared the company's second quarter dividend of \$0.26 per share, unchanged from the first quarter of 2006. The board also declared dividends on the company's preferred stock in accordance with the terms of the respective issues. (*Fannie Mae Press Release*, 04/25/06)

#### Senior lobbyist Nathan Gatten leaves Fannie Mae to join a private lobbying firm

- Nathan J. Gatten, a Fannie Mae vice president and senior lobbyist, has announced his plans to leave the company in the next few weeks to join Larson Stewart Myrick & Link, LLC, an outside Washington lobbying firm which has represented Fannie Mae since 1994. Gatten, a Republican who formerly worked for Senator Robert F. Bennett (R-UT) on the Senate Banking Committee, joined Fannie Mae in 1999. He is the third lobbyist to leave the company in the past 13 months. (*Dow Jones Newswires*, Damian Paletta, 05/05/06)

#### KPMG rejects subpoena from Ohio attorney general seeking documents for shareholder class action suit against Fannie Mae

- KPMG, Fannie Mae's former auditor, has refused to comply with a subpoena by the Ohio Attorney General Jim Petro, seeking documents related to \$10.8 billion in accounting errors by the GSE. KPMG plans to retain the information requested by Petro until a District Court judge in Washington determines if the lawsuit filed by Franklin Managed Trust and other institutional investors against KPMG, Fannie Mae, and current and former Fannie Mae executives should be dismissed. (*Washington Post*, 04/27/06)
- In *National Mortgage News*, Paul Muolo noted that Freddie Mac recently settled the class action lawsuit filed by shareholders, agreeing to pay \$410 million in damages for having understated its earnings by \$5 billion. On the other hand, Fannie Mae, who is also being sued by its shareholders, cooked its books to hide \$11 billion in losses. "If Freddie's settlement cost it \$410 million, what's Fannie's going to cost?" asks Muolo. "If I were a betting man (and I'm not), I'd wager that it could be close to \$1 billion. I wonder how Fannie's directors will react to that? After all, most of the 'Frank Raines-era' board is still employed by the Company, and according to the shareholder suit filed in Washington, the board just rolled over and played dead for Mr. Raines..." (*National Mortgage News Online*, Paul Muolo, April 29-30, 2006)

### Still on the job at Fannie Mae?

- According to the May issue of *Corporate Counsel*, the Rudman Report didn't paint a "flattering picture of the legal advice provided by lawyers at Wilmer Cutler Pickering Hale and Dorr to Fannie Mae." *Corporate Counsel* wrote, "Rudman and his colleagues concluded that there was no evidence that Wilmer lawyers 'knowingly provided false information' to Fannie Mae's board during the course of a special examination of its books by the mortgage bank's regulator, the Office of Federal Housing Enterprise Oversight. The report does say, however, that Wilmer's lawyers should have provided clearer information about the scope of an audit by Ernst & Young. Rudman's team also found that Fannie Mae and its lawyers had taken an unnecessarily combative approach when it came to interactions with the regulator."
- "Management and its counsel focused unduly on OFHEO's motives in conducting the special examination, which led them to dismiss the accounting issues as merely "OFHEO's arguments" and "disagreements,"" the report states. 'It turned out, of course, that management and the lawyers were wrong.' Though Wilmer continues to work for Fannie Mae, Latham & Watkins has taken over as lead counsel in the matter (former Latham partner Beth Wilkinson became Fannie Mae's new General Counsel in December). Wilmer co-managing partner William Perlstein declined comment, citing the continuing investigations." (*Corporate Counsel*, Jason McLure, 05/01/06)

### Rudman Report demonstrates that Sarbanes Oxley is "insufficient"

- Former Speaker Newt Gingrich has urged Congress to reform Sarbanes Oxley (SOX), pointing to the recent Rudman Report on Fannie Mae as an example of SOX's inefficiency. "Judging from what we have learned from the Rudman Report on Fannie Mae, it appears the reliance that Sarbanes-Oxley puts on audit committees and boards of directors were insufficient to prevent the financial deception by management into this high profile case," said Gingrich. "It is examples like this one that makes it possible to question whether the cost associated with Sarbanes-Oxley compliance is not simply a deadweight loss to the economy." (*Market News International*, Margaret Chadbourn, 04/27/06)

### Just-in-time settlement

- In an April 23 article in the *Washington Post*, Kathleen Day wrote, "[S]ettlements sometimes do save time and aggravation. In October 2003, mortgage giant Fannie Mae reached a settlement with Roger L. Barnes -- who claimed the company effectively demoted him when he questioned its accounting -- by paying him a reported \$1 million-plus the day before the deadline expired for Barnes to file a claim with the Labor Department. Barnes, who was a mid-level manager in Fannie Mae's controller's office, has been identified by federal regulators as a key figure in helping

them uncover accounting irregularities that ultimately led to the biggest earnings restatement in history. (*Washington Post*, Kathleen Day, 04/23/06)

Franklin Raines and his investor group  
won't be playing baseball in Washington, DC

- Frederic V. Malek assembled a “world-class” group of prominent investors, including former Fannie Mae chairman and CEO Franklin Raines, to bring baseball back to Washington. But on May 3, the Major League Baseball awarded the Washington Nationals to a rival investment group headed by Bethesda developer Theodore N. Lerner. According to the *Washington Post*, reports “flew” during the competition for the franchise that Malek’s group had done too much lobbying, while Lerner’s group wasn’t diverse enough. (*Washington Post*, Michael E. Ruane, 05/04/06)

Another Fannie Mae “alumni” in the news

- According to *National Mortgage News*, “[F]ormer Fannie Mae president Larry Small is in the news again and the news isn’t good. Mr. Small, who now heads the Smithsonian, was president of the GSE when some of its accounting problems took place. The inspector general of the Smithsonian is now probing the accounting practices of the museum’s business division. Also, Mr. Small’s salary as head of the Smithsonian -- \$813,000 -- is raising eyebrows...” (*National Mortgage News Online*, April 29-30, 2006)

Financing a home is like financing a car—the borrower has no “skin in the game”

- In an April 24 speech at the National Association of Realtor’s Regional Summit on Housing Opportunities, Fannie Mae CEO Daniel H. Mudd said, “...[I]t’s getting to the point where financing a home is like financing a car—the borrower doesn’t put any skin in the game, at least not up front. According to figures from the NAR, 43% of first-time home buyers last year borrowed the entire cost of their home, while 68% percent financed more than 90% of it.” Mudd believes that ultimately there will be a flight towards safer financing caused by either by changes in the regulatory environment, [rising interest rates], [and/]or market corrections.
- Mudd outlined three ways that Fannie Mae is playing a critical role in bringing affordable capital to the housing market. Mudd said, “First, we work with lenders to help them approve working families who have modest incomes and little cash on hand. For example, we offer a suite of affordable mortgage options called MyCommunityMortgage. They have low down payments, flexible credit parameters and lower mortgage insurance costs. We also tweaked our underwriting system to be friendlier to lower-income families we serve under our regulatory housing goals.

We've started investing in 40-year, fixed-rate mortgages, which lets you stretch out and lower your monthly payments.

- "...Second, along with the mortgage financing, we're also teaming up with housing partners to invest in building up the affordable housing stock. We have debt and equity and low-income housing tax credit and historic tax credit investments all over the region to build more affordable homes, and preserve affordable rentals. We're going to keep growing our portfolio of affordable housing investments throughout the Washington area and across the country. We have pledged to lead the market in lending to minority families and underserved communities. We have committed trillions of dollars to serve the nation's toughest housing needs. Over the next decade, we will focus especially on areas along the Gulf Coast to help rebuild and finance the half million homes that were destroyed or damaged by last year's hurricanes.
- Third -- and let me admit this -- Fannie Mae needs to do more. Our regulators, investors and the market all demand that we run a responsible, low-risk enterprise. But low-risk does not mean avoiding risk entirely. We exist to understand and manage the performance and risk of mortgages. Our job is to look deeply into our mortgage data and try to stretch our tolerances so we can serve more people who need serving the most -- working families struggling to own or rent a home." (*Prepared Remarks at the National Association of Realtor's Regional Summit on Housing Opportunities*, Daniel H. Mudd, 04/24/06)

Fannie Mae announces mortgage relief for tornado victims in Middle Tennessee
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- Fannie Mae has authorized servicers to implement mortgage relief provisions for Middle Tennessee borrowers facing hardships as a result of tornados that caused widespread damage in the area on April 7. Under Fannie Mae's disaster relief provisions, lenders are authorized to make individual case-by-case evaluations as to the appropriate relief measures needed and can help borrowers in several ways, including suspending mortgage payments for up to three months, reducing the payments for up to 18 months, or in more severe cases, creating longer loan payback plans. (*Fannie Mae Press Release*, 04/26/06)

## ***Freddie Mac***

### Freddie Mac restates three lobby filings with FEC

- After paying a record \$3.8 million fine in a settlement with the Federal Election Commission in April, Freddie Mac recently restated a trio of lobbying disclosure reports for all of 2004 and the first six months of 2005. While the amount of money that Freddie Mac reported for 2004 (\$15.4 million) and the first six months of 2005 (\$7.3 million) remained unchanged, the company added a handful of lobbyists who had not previously been disclosed. Freddie Mac spokesman Doug Duvall said company officials re-examined past lobbying reports and concluded that the GSE “probably should have included” additional employees to the disclosure who “technically” met the FEC’s threshold for employees spending at least 20% of their time supporting lobbying activities and making a certain number of lobbying contacts with government officials. Freddie Mac’s 2004 reports were amended to include Lisa Ledbetter, Jeff Markowitz and Wendell Chambliss, all of whom work for Freddie Mac’s legal division and the company’s mid-year 2005 forms added Susan Gates and Craig Thomas from Freddie’s public policy unit. (*Roll Call*, Kate Ackley, 05/03/06)

### Should politicians give back money raised at Freddie Mac’s illegal fundraisers?

- In May 4 edition of *The Guardian* (UK), David Boaz wrote, “Politicians are falling all over themselves to return political contributions from disgraced lobbyist Jack Abramoff and his associates. Those giving the money back (or passing it on to charity) have included President Bush, the three top House Republican leaders, Democratic governor Jim Doyle of Wisconsin, three Republican senators, and three Democratic senators - though not Senate Democratic leader Harry Reid, who says there’s no reason for Democrats to give back tainted money from Republican lobbyists.”
- “So why isn’t Michael Oxley, best known as the author of the hyper-regulatory Sarbanes-Oxley Act, which some studies claim has cost the American economy a trillion dollars, returning all the money he received at fundraisers of suspect legality? Newspapers reported last month that Freddie Mac, the giant government-sponsored mortgage company, agreed to pay a record \$3.8 million fine to settle civil charges that it violated federal election law by using corporate resources to raise \$1.7 million at political fundraisers, most of them for Republican members of Congress and many involving House financial services committee chairman Michael G. Oxley (R-Ohio). Freddie Mac’s chief lobbyist boasted of holding more than 40 fundraising dinners and other events for Oxley.”

- “Oxley is a great example of the permanent ruling class in Washington: after law school he spent about three years in the private sector before serving nine years in the Ohio legislature and more than 25 years in Congress. No wonder he passes complex regulatory schemes with little thought to their impact on the companies that must comply with them.”
- “The contributions from Abramoff, his associates, and his clients were legal; they were returned because they became embarrassing. But Freddie Mac was using corporate resources to raise funds for members of Congress, which is illegal. It’s doubly offensive because Freddie Mac and its corporate sibling Fannie Mae have a special status: they’re officially private corporations but as “government-sponsored enterprises” they’re exempt from state taxes, they don’t have to register their securities, and they get preferential loan rates because they’re perceived to be backed by the federal government. Keeping all those benefits makes it important for Freddie and Fannie to curry favor with members of Congress.”
- “So if Freddie Mac effectively concedes that its fundraisers for Oxley and others violated federal election law (though in the settlement it did not admit or deny illegal activity), shouldn’t Oxley and his colleagues return the money raised at those tainted fundraisers? At last report Oxley had about \$1 million in his campaign accounts, so he could clearly return at least some of the dubious receipts. Perhaps a line buried in one of the few news stories explains his unresponsiveness: ‘Oxley isn’t running for reelection in November.’” (*The Guardian*, David Boaz, 05/04/06)

Freddie Mac’s retained portfolio grew at 17.2% annualized rate in March
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- In March, Freddie Mac’s retained portfolio surged at an annualized rate of 17.2% to \$715.4 billion, bringing its year-to-date growth to an annualized 3% for the first quarter. (At the end of the first quarter, Freddie Mac’s retained portfolio was less than 1% smaller than Fannie Mae’s portfolio of \$721.12.) Freddie’s growth in March came from purchases of non-agency securities and its own fixed rate participation certificates. In March, the company also agreed to purchase \$32.1 billion in mortgage debt, portending a rise in mortgage purchases in future months. The company’s total mortgage portfolio, comprised of its retained portfolio and Freddie Mac PCs held by outside investors, grew 6.1% in March for an annualized increase of 11.0% for the first quarter of 2006. Freddie Mac also reported that its duration gap remained at zero in March, unchanged from February. (*Reuters*, 04/24/06, *Market News International*, 05/24/06; *American Banker*, 04/25/06, *Washington Business Journal*, Barton Eckert, 05/24/06)

Freddie Mac announces timeframe and process  
for submitting shareholder proposals for its annual meeting

- To be considered in the company's proxy statement, shareholder proposals must be submitted in writing to Freddie Mac's corporate secretary by May 24, 2005. The procedural requirements for submitting proposals and the process by which Freddie Mac will process shareholder proposals are set forth on the company's Web site. (*Freddie Mac Press Release*, 04/24/06)

Freddie Mac extends hurricane relief until August 31  
to hardest hit Gulf Coast counties

- On May 1, Freddie Mac announced that it is extending many of its emergency hurricane relief policies through August 31 in the Gulf Coast counties and parishes affected by Hurricanes Katrina and Rita. "The May 1 Bulletin continues to give servicers the authority to extend relief to borrowers with properties in the worst disaster areas, while recognizing that there are now more Gulf Coast counties and parishes with the economic strength to justify a return to pre-Katrina business operations," said Janet Eakes, senior vice president of Freddie Mac's operations division. The Bulletin is available at <http://www.freddiemac.com/sell/guide/bulletins>. (*Freddie Mac Press Release*, 05/02/06)

Freddie Mac's cash-out refinances highest in 15 years

- During the first quarter of 2006, Freddie Mac's cash-out refinances rose to 88% of the company's owned loans that refinanced, the highest level since 1990. According to Freddie Mac vice president and chief economist Frank Nothaft, the higher level of cash-out refinances may be explained in part by rising interest rates, which have slowed refinancings in general, and blocked many homeowners from being able to refinance for a lower mortgage rate. During the quarter, many homeowners with adjustable-rate second mortgages were motivated to refinance their mortgages using cash-out refinancings to pay-off their home equity loans and lines of credit. Ultimately, rising interest rates should put a drag on both home price appreciation and the absolute dollar amount of cash taken out, added Nothaft. (*Dow Jones Newswires*, Danielle Reed, 05/02/06)

Global callable debt is Freddie Mac's top priority

- In the April issue of *Euromoney*, Kathryn Tully wrote, "Greater activity in the global callable debt market, in particular, is going to be a top priority [for Freddie Mac]. Although Freddie has issued \$25.7 billion of [medium term note] callables so far this year, it has not issued any syndicated non-callable notes since its \$1 billion five-year

non-call one in February 2005, compared with more than \$15 billion of syndicated callables in 2004. Issuance of callable notes, which are much shorter in duration than non-callable paper, is one thing that has lowered the convexity in the mortgage portfolio, which means Freddie Mac is less reliant on derivatives hedging. As a result, derivatives hedging has dropped to about \$500 billion. It used to be at least twice that. In fact, now there is \$250 billion of callable debt outstanding, which funds more than 50% of the fixed-rate mortgage portfolio.” (*Euromoney*, Kathryn Tully, April 2006)

Freddie Mac’s <i>eMortgage Timeline</i>
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- According to Freddie Mac’s April 25 *Single-Family Guide Bulletin*, the company has published *Freddie Mac’s eMortgage Timeline*, which outlines the GSE’s implementation timeline for developing new business processes that support the sale and servicing of eMortgages, as well as steps lenders can take to prepare for the adoption of eMortgages. The *Timeline* is available on Freddie Mac’s Web site at <http://www.freddiemac.com/singlefamily/news/newsletter/2006/04/emortgages.html>.
- According to the Guide, Freddie Mac is purchasing electronic notes in very limited quantities and, based upon market demand, intends to expand both the number of loans purchased and the number of lenders from whom it will accept electronic notes. Lenders who are interested in selling electronic notes to Freddie Mac should contact their Freddie Mac representative to discuss becoming an approved electronic mortgage Seller/Service. (*Single-Family Guide Bulletin*, Freddie Mac, 04/25/06)

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

FHLBs urge the Finance Board to shelve proposal  
to increase the Banks' retained earnings

- The chairmen of the 12 FHLBs have asked the Federal Housing Finance Board to withdraw the agency's recent proposed rule, creating a new retained earnings standard, restricting cash dividends until the Banks raise their retained earnings, and prohibiting the FHLBs from issuing stock dividends. In a joint letter to Finance Board chairman Ronald A. Rosenfeld, the FHLBs' chairmen alleged that the agency's March 8 proposal had "far-reaching significance" to the Banks' businesses and could result in "significant unintended consequences and other negative ramifications. We therefore strongly urge that the Finance Board withdraw the current proposed regulation." Instead, the Bank executives asked that the Finance Board develop a more open-ended proposal and give the industry more time to offer input.
- John von Seggern, president and chief executive of the Council of Federal Home Loan Banks, said, "There is a great deal of unanimity [among the FHLBs] that this is a proposal that needs to be changed. We think that this proposal has not adequately looked at the consequences that it will put into the system. ... It's too harsh, it's too short a time frame [to implement], and it's too simplistic."
- The FHLB Cincinnati was the first Bank to voice its opposition to the Finance Board's proposed rule. In an April 28 comment letter to the Finance Board, FHLB-Cincinnati chairman Charles Koch said that the proposed rule would hurt the Bank's credit rating, threaten the "viability of the community banking system," and possibly violate the Gramm-Leach-Bliley Act. "Our smaller members depend, to a significant extent, on the bank for their dividends to support earnings and access to our services," wrote Koch. "We believe the end result of the proposed rule for the [FHLB-Cincinnati] will be lower capital levels, lower liquidity, and lower profitability." According to Koch's letter, the board of directors of the FHLB-Cincinnati "unanimously and strongly calls for the Finance Board to withdraw the proposed regulatory rule." The Bank's board also provided the Finance Board a separate letter from outside legal counsel that questioned the agency's legal basis for implementing the proposal. "From a legal perspective, the proposed rule appears to reach well beyond the reforms intended to be imposed by Congress on the [FHLBs] by the [Gramm-Leach-Bliley] Act, to exceed the authority granted to the Finance Board and to erode the powers specifically delegated to, or reserved for, the individual [FHLBs]," wrote Melvin S. Shotten, a lawyer with the Cincinnati-based firm of Taft, Stettinius & Hollister LLP.
- On April 25, tensions escalated when Rosenfeld met with close to 100 directors and staff members from each of the 12 FHLBs in Washington, DC. In a luncheon speech, Rosenfeld reportedly "harshly criticized" the FHLB-Cincinnati for its April 20

decision to temporarily suspend two voluntary housing programs, including a \$15 million grant program to help victims of Hurricane Katrina. According to several participants, Rosenfeld said that the FHLB-Cincinnati was overreacting to the proposal and that the FHLBs should not commit to fund charity work and then renege. A number of participants told a reporter with *The American Banker* that they were surprised by Rosenfeld's "very tough," and "forceful" comments. Finance Board spokesman Daris Meeks told reporters, "The decision of the [FHLB-Cincinnati] is within their prerogative. However, the decision not to honor its commitment to the Katrina relief effort is very disappointing."

- Alex Pollock, a fellow with the American Enterprise Institute and former president of the FHLB-Chicago, said "[The Finance Board's proposed rule] is going to suppress returns, at least at many of the Federal Home Loan Banks, quite dramatically and put them into a losing position." Pollock added, "It could hamper all of the business lines of the Home Loan Banks, including the mortgage business line. I think members are very rightly dubious about it."
- Pollock expanded upon his criticism of the Finance Board's proposal in an April 28 article in the *American Banker*, calling the "the Finance Board's position ... misguided and conceptually confused." Under 1999 Gramm-Leach-Bliley Act (GLB), Pollock wrote, "[T]he withdrawal right is completely trumped by the statutory prohibition of any withdrawal if the required capital ratio would be breached. Under GLB, there can then be no withdrawals whatsoever. Hence, capital equal to 4% of assets cannot be withdrawn -- and 4% is a very conservative capital ratio, given the low risk of FHLBs. So fear of capital withdrawal is six years out of date."
- "But the Finance Board's confusion runs to a deeper level. They are worried that the par value for members might not be protected. Suppose an FHLB lost money (this has happened, though very infrequently), and the value of its shares dropped below par. Wouldn't it be terrible if the value of the members' stock was \$99, instead of \$100? Maybe the accountants would make them write down the carrying value by \$1. Two observations: [1] No, it wouldn't be so terrible -- the economic effect on members is exactly the same as cutting dividends by \$1; [2] The Finance Board seems to think FHLB stock is a money market fund. Note that this issue is not about the safety and soundness of the FHLBs or about protecting bondholders and depositors. It is all an issue inside the equity account."
- "In its proposal to force the FHLBs to cut dividends and increase retained earnings as a buffer for the par value, the Finance Board is telling the member shareholders: 'Here's how we will protect you from yourselves. We will take away a dollar from you today. You can never have this dollar back. In exchange, you will be protected from the minor chance that you might lose a dollar someday in the future.' This is roughly equivalent to offering to buy a dollar from you for a nickel. No one would find such a deal sensible, and naturally, the FHLB members don't. Of course, the idea is not to offer it as a deal, but to impose it as a regulatory mandate."

- “The situation is made even worse by another part of the Finance Board’s proposal, which would force increased taxes on the FHLB members. It would do this by mandating that all dividends be paid in cash, which subjects the members to corporate income taxes. FHLBs have always had the option of paying stock dividends, which result in deferred income taxes for the members. Because of this effect, the Finance Board proposal is even more expensive for the members.”
- “It is possible that a good many of them are wishing the GSE reform bills pending in Congress, which would create a new regulatory structure, would get moving.” (*American Banker*, Rob Blackwell and Patrick Rucker, 05/04/06; *Dow Jones Newswires*, Damian Paletta, 05/03/06; *Market News International*, Margaret Chadbourn, 05/03/06; *American Banker*, Alex Pollock, 04/28/06; *Dow Jones Newswires*, Damian Paletta, 05/04/06)

#### FHLB-Cincinnati buys back \$378.7 million in excess stock

- On April 27, the FHLB-Cincinnati bought back \$387.7 million in stock from former members, which the Bank’s board of directors authorized on April 20, 2006. (*Dow Jones Newswires*, Damian Paletta, 04/28/06; *Form 8-K*, Federal Home Loan Bank of Cincinnati, 04/28/06)

#### FHLB-Chicago works on new way to fund its Mortgage Partnership Finance program

- The FHLB-Chicago is working on a new way of funding its Mortgage Partnership Finance program. The Bank’s spokesperson Nancy Schachman said, “We are looking for off-balance-sheet ways of funding the mortgage program” with partners outside the FHLB system as a possible strategy to fund its MPF program, but added that Bank is still in the planning stage. While the Finance Board has signed off on the concept, the FHLB-Chicago will have to go back to agency for final approval, according to sources. The Finance Board’s director of supervision Stephen Cross dismissed the idea that the FHLB-Chicago would be able to securitize mortgages. “A [FHLB] is not permitted to do a securitization and securitization is not on the agenda of the Federal Housing Finance Board,” said Cross. (*National Mortgage News*, 04/24/06)

#### FHLB-Pittsburgh forms “shadow board” to help cope with vacancies on its board

- To help the cope with vacancies on its board of directors, the FHLB-Pittsburgh has picked three former board members to form a “shadow board” to help the elected board of directors. “We asked them to serve as consultants, but they act in every way, shape, and form as members of the board,” said Marvin Schoenhals, the Bank’s chairman. [However, shadow board members are not empowered to vote.] Each shadow member has signed a contract to abide by the same standards of confidentiality, ethics, and disclosure as official board members, said Schoenhals.

“This is a way for us to get the skills, views, and diversity of opinion that we have not had.” (*American Banker*, Patrick Rucker, Joe Adler, and Stacy Kaper, 05/01/06)

FHLBs announce 4<sup>th</sup> quarter results and first quarter dividends

- The FHLB-San Francisco announced that its net income for the first quarter of 2006 was \$119 million, 91.9% higher than its first quarter earnings in 2005. However, the net effect of fair value adjustments on trading securities, derivatives, and hedged items resulted in a net fair value loss of \$3 million in the first quarter of 2006 compared to a net fair value loss of \$29 million in the first quarter of 2005. As of March 31, the cumulative effect of FAS 133 was a net unrealized gain of \$35 million. Total assets grew to 2% to 3.6 billion during the first quarter, while the FHLB advances grew \$1.1 billion with a record \$164.0 billion in FHLB advances outstanding on March 31. Based upon the Bank's first quarter results, the FHLB-San Francisco plans to pay a dividend for the quarter at an annualized rate of 5.03%, up from 4.25% for the first quarter of 2005. (*Business Wire*, 04/25/06)
- The FHLB-Boston announced that net income for the first quarter totaled \$45.6 million, an increase of 42.9% from the first quarter of 2005. The Bank's assets rose 6.4% to \$61.4 billion, up 6.4% from year-end 2005. Asset growth was fueled primarily by increases in FHLB Advances, which increased 6.6% to \$40.6 billion. Mortgage assets declined modestly to \$4.8 billion, compared to \$4.9 billion at yearend 2005. The Bank's capital increased 7.4% to \$2.9 billion as of March 31. (*PR Newswire*, 05/01/06)
- The FHLB-Cincinnati reported that its first quarter income totaled \$59.6 million, representing a 17.2% increase from the same period in 2005. The Bank's assets increased 2.5% to \$79.1 billion on March 31, while the Bank's Advances rose 6.7% to \$42.8 billion from year-end 2005. During the first quarter, the Bank's mortgage loan portfolio grew 0.1% to \$8.3 billion. On March 31, the Bank reported total capital of \$59.6 million, up 17.2% from the first quarter of 2005. Retained earnings grew \$217.7 million to \$9.9 million on March 31. At its April 20 meeting, the Bank's board of directors adopted a new dividend declaration policy, providing that dividends be declared and effective after the close of a quarter based upon the quarter's actual earnings and average stock balances. Thus, dividends declared and paid during the second quarter will be based on first quarter 2006 earnings and average stock balances. (*FHLB-Cincinnati Press Release*, 04/21/06)
- The FHLB-New York's board of directors approved a cash dividend for the first quarter at a rate of 5.25% (annualized), representing a 75% payout of net income for the quarter. Net of the first quarter dividends, the FHLB-New York's retained earnings will approximate \$256 million as of March 31. Previously, the Bank paid a 5.11% annualized dividend rate for the fourth quarter of 2005. In a letter to members, the Bank's president Alfred A. DelliBovi said the Bank anticipates it will meet the Finance Board's retained earnings target well before the rule becomes effective, and,

consequently sees no impact upon the Bank's future dividend payments or its operations. (*FHLB-NY Press Release, 05/02/06*)

FHLB-Chicago announces live audiocasts of the Bank's regional meetings

- The FHLB-Chicago will offer live audiocasts of its upcoming regional meetings to be held May 4 at Caseyville, IL; May 10 at Peoria, IL; and May 22 at Olympia, IL. Bank members who are unable to attend the meetings can dial in, register with a phone attendant, and listen to the entire meeting via the telephone beginning at 10:00 a.m., Central Time, and concluding at/around 11:15 a.m. The Bank's management will discuss the recently announced plans to pursue key initiatives affecting capital stock redemptions for members and investors, and the Bank's retained earnings, dividends, and long-term business strategies. Within 48 hours of each meeting, a recording of the audiocast will be available at the FHLB-Chicago's website at [www.fhlbc.com](http://www.fhlbc.com). (*FHLB-Chicago Press Release, 05/01/06*)

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

FCA expands the system's lending powers through "pilot programs"

- In the April issue of *Farm Credit Watch (FCW)*, Bert Ely examines the FCA's use of pilot programs to broaden the FCA System's lending powers. Ely wrote, "In 'Rural America Bonds' (RABs) represent the latest initiative by the Farm Credit Administration (FCA) to broaden the FCS's lending powers, by simply calling a 'loan' an 'investment.' The FCA very quietly authorized RABs in a January 11, 2005, 'Informational Memorandum' that does not use the RAB term -- instead it refers to 'Pilot Investment Programs,' or PIPs. The Informational Memorandum and other materials about RABs obtained from the FCA under a Freedom of Information Act request, filed by *FCW*, clearly indicate that RABs are intended as a forerunner to the powers the FCS is seeking under the HORIZONS Project. While characterized as a pilot project, RABs have the potential to become the HORIZONS Project in all but name, unless Congress puts a halt to it -- the FCA certainly won't."
- "RABs represent an audacious attempt by the FCA to stretch the notion of what is an investment to empower FCS institutions to extend credit in those situations where they do not have the authority to make a loan. FCS investments theoretically serve the same purpose as bank investments -- to provide liquidity, specifically by giving a financial institution the ability to manage short-term variations in the demand for lendable funds on the asset side of the balance sheet. Investments are not intended as a way to avoid lending restrictions."

- “RABs and the PIPS clearly conflict with the narrow, liquidity-oriented view of investments sets forth in the FCA regulations. The Investment Purposes regulation states that ‘Each Farm Credit bank is allowed to hold eligible investments ...in an amount not to exceed 35 percent of its total outstanding loans, to comply with the liquidity reserve requirement ...manage surplus short-term funds, and manage interest rate risk.’ Nothing is said about using investments as a subterfuge to avoid the lending restrictions Congress has imposed on the FCS. As an aside, it now appears that the FCA, which last year raised the investment limit to 35% of loans from 30%, did so to give the FCS banks and direct-lending associations the opportunity to hold RABs and other types of illiquid, long-term investments which in fact are loans.”
- “While the FCA regulations set out conservative, and reasonable, investment criteria, in accord with the requirement that FCS investments meet the need for a ‘liquidity reserve,’ to ‘manage surplus short-term funds,’ and to ‘manage interest rate risk,’ one subsection in the regulations created a loophole that the FCA has driven a gigantic tractor through. It reads ‘Other investments approved by the FCA. You may purchase and hold other investments that we approve. Your request for our approval must explain the risk characteristics of the investment and your purpose and objectives for making the investment.’ Congress certainly did not intend for the FCS’s investment power to be used to evade the Farm Credit Act’s lending restrictions, but that certainly is how the FCS intends to use the quoted regulation.”
- “The terms under which FCS institutions can invest in RABs reveals their true intention – ‘to help meet the growing, changing, and diverse financing needs of agricultural enterprises, agribusinesses, and rural communities by providing a flexible flow of money to rural areas through investments in [RABs].’ Not only do thousands of banks meet the financing needs of rural America, but Congress has not authorized the FCS to lend, or invest, throughout rural America -- the FCS is primarily an agricultural lender, with very limited off-farm lending authority. The FCA goes even further by broadly defining a ‘rural area’ as ‘(1) an area that is located outside a standard metropolitan statistical area (MSA), or (2) within a community that has a population of 50,000 or less inhabitants.’ [In turn,] ‘community’ ...can mean ‘any territory within an MSA that is not within an urbanized area.’ This means the FCS can make loans (structured as investments) in areas that are not even rural, as that term is generally understood.”
- “The RABs’ investment purpose is quite broad, too. RABs can be ‘issued by public and private enterprises, corporations, cooperatives, other financing institutions, and rural lenders ..to support farmers, ranchers, agribusinesses, and their rural communities, residents, and businesses.’ The language FCW underlined goes far, far beyond what Congress has authorized the FCS to do, as does the FCA notion of permissible investments addressing ‘rural business concerns,’ including ‘legal business entities that create or preserve jobs in rural areas. Such businesses should primarily provide products or services to rural areas and residents and not otherwise service a broad market of both urban and rural areas.’ Of course, a RAB could fund a business which serves a narrow market in both urban and rural areas. Perhaps

bankers should be pleased that ‘this investment authority does not extend to debt offerings of major national corporations,’ but that does not bar investing in RABs issued by large regional corporations.”

- “The FCA has authorized two Farm Credit banks -- AgFirst and Texas -- and their 44 affiliated associations to invest in RABs during a three-year “pilot” period. The banks’ associations serve an arc which reaches from Pennsylvania to Florida and west to New Mexico. However, the FCA has approved investments by four large associations elsewhere in the country that look suspiciously like RABs, including a \$3 million equity investment in a renewable energy fund. The PIPs increasingly look like a permanent, nationwide program, and a precursor of the HORIZONS Project. Congress should closely examine the PIPs and the RABs.” (*Farm Credit Watch*, Bert Ely, April 2006)

Farm Credit System reports net income of \$544 million for first quarter
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- The Farm Credit System reported net income of \$544 million for the first quarter, up 11% from the corresponding period in 2005. The System’s assets increased 2.4% during the first quarter to \$143.3 billion, while its capital increased \$380 million to \$18.984 billion on March 31. The System’s capital to assets ratio was 16.1% at March 31, as compared to 16.3% at yearend 2005. (*Business Wire*, 05/01/06)

## ***Postal Service***

Is the perfect storm brewing for postal reform?
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- According to the April 28 issue of *e-NAPUS Legislative & Political Bulletin*, “A number of related and unrelated events are creating a new and potentially volatile dynamic that could accelerate and influence the deliberations of the H.R. 22 Conference. These events include the announcement of the 2006 Omnibus Rate Case, a letter sent by House Government Reform Chair Tom Davis to USPS BoG Chair regarding the case, a letter sent by members of the Iowa Congressional delegation to PMG Potter regarding a consolidation, and a recent APWU filing in Federal Court regarding the END program.”
- “[T]he USPS Board of Governors is expected to announce the 2006 omnibus rate case at its monthly meeting, May 3. The last such rate case dates back to 2001. Consequently, considerable issues, involving rates, rate relationships, and mail classifications will be included in the rate filing. This filing could be the last rate case argued prior to enactment of Postal Reform. Needless to say, the anxiety level is high within the mailing community. The rate structure established through this rate case

(i.e. after the Postal Rate Commission conducts its protracted regulatory proceeding) will be the rate foundation in the post-reform rate environment, particularly for market-dominant postal products. Moreover, mailers fear that they could be subject to another 2007 omnibus rate case, or an amended 2006 case, depending if and when H.R. 22 is signed into law. Consequently, members of the mailing community may seek prospective rate relief from H.R. 22 Conferees. At the same time, the USPS could anticipate the mailer-articulated wish list to the Conferees, as part of its filing. The PRC will have to sort this all out.”

- “Anticipating this confusion and the mailer fear factor, Chairman Davis sent USPS BoG Chairman Jim Miller a letter, requesting that the USPS delay the 2006 rate case until H.R. 22 is ‘closer to resolution.’ According to an April 26 article in *Congressional Daily*, the Mailing Industry CEO Council also sent Chairman Miller a letter. On Monday, Chairman Miller responded to Davis by stating that a rate increase was needed to deal with a ‘debt increase of at least \$1 billion.’ Notwithstanding Chairman Davis’ delay request, the anticipated rate case could encourage the Conferees to resolve House-Senate disagreements expeditiously and try to beat the case to the finish-line. If not, the Conferees could be attempting to address mailer reaction to a rate increase within H.R. 22.”
- “The continuing controversy over the Evolutionary Network Development (END) program may also impact Conference deliberations. Senators Grassley (R-IA) and Harkin (D-IA), and Representative Steve King (R-IA) want a face-to-face meeting with the PMG over the possible consolidation of the Sioux City mail processing facility. These Members of Congress believe that the USPS failed to provide community input in evaluating the impact of the consolidation, and is keeping its consolidation study under wraps, except for a one-page summary.”
- “Representative King asserted that he would work the H.R. 22 Conferees on behalf of community input. Sen. Harkin successfully added a provision to S. 662, requiring community input when the USPS contemplates a plant consolidation. (Communities already have specific statutory due process rights regarding the closing or consolidation of their post office.) On a related note, [on April 21,] the APWU filed a complaint in Federal Court asking that the court stop the END program, until the PRC issues its advisory opinion on it. The union alleges that the USPS violated Title 39 of the United States Code by not seeking public input in 2001, when it began the Network Integration and Alignment (NIA) program, which involved network development. APWU argues that END is merely a continuation of NIA. (Interestingly, the APWU established its ‘standing’ to sue the USPS as a ‘mailer,’ not as a union.) Although the APWU suit and the IA plant consolidation are not necessarily legislative matters, the degree to which the issues are garnering media and Congressional attention could very well affect Conference deliberations. As you may recall, the President’s Commission on the U.S. Postal Service highlighted network redesign and standardization as a necessity. The [GAO] also believes that such an effort is essential. What appears to bother Members of Congress who are critical of the USPS efforts is not necessarily the result, rather it’s the process. The Senators

and Representatives, reflecting their constituents, are arguing for greater transparency and input. In fact, a GAO Report referenced in a previous *e-NAPUS Legislative & Political Bulletin* urged the USPS to establish specific and identifiable criteria when evaluating facility consolidations and closures. This is an issue which may be part of Conference discussions.”

- “The combination of the rate case, Congressional reaction to it, and the continuing controversy over the END program create a challenging scenario for the USPS, postal employees, and for the mailers themselves. In response to non-conferee congressional pressures, conferees may have to revisit some previously settled provisions and open up new areas of inquiry...” (*e-NAPUS Legislative & Political Bulletin*, 04/28/06; *APWUNews Bulletin*, 04/25/06)

Postal rates going up (again)
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- The Postal Service proposes to raise the cost of a first-class stamp by 3 cents to 42 cents due to the costs of fuel and health-care benefits for employees and retirees in 2007. The increase in postal rates, which follows a 2 cent increase in the cost of a first class stamp that went into effect on January 1, would take effect in the spring of 2007, if approved by the Postal Rate Commission. The USPS’s omnibus rate case also includes a package of rate changes for other categories, including Standard Mail (9.0% increase), Priority Mail (13.8%), Express Mail (12.5%) Package Services (13.4%) and Special Services (11.2%).
- The USPS also announced it will begin selling a “forever stamp” next year, which would be good for first class mail “no matter how prices might change beyond 2007,” and would eliminate the inconvenience for consumers of having to buy new stamps every time postal rates increase. The details for the forever stamp will be worked out over time, said Stephen Kearney, vice president for pricing and classification. (*Washington Post*, Fred Barbash, 05/03/06; *Associated Press*, 05/03/06)
- The Postal Service’s proposal to increase postal rates drew grim reactions from lawmakers working to pass postal reform legislation. “I am disappointed the Board of Governors did not see fit to wait until comprehensive postal reform legislation becomes law before making a decision on whether to seek rate increases,” said House Government Reform Chairman Tom Davis, (R-VA). “The news ...of the U.S. Postal Service’s proposal to increase postage rates is not surprising given the rising energy costs and the agency’s costs of doing business,” said Davis. “However, a 13.5 percent hike in just over two years borders on the excessive - and that’s just the increase in first class postage. Other products would go up by more than 25 percent. Postal reform legislation that Congress is poised to enact would limit such extreme rate hikes, instead linking them to the Consumer Price Index, while also providing tools to ensure the future solvency of the Postal Service.” Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins, R-Maine, hinted that the USPS’s rate increase heightens the urgency to push the postal reform legislation.

Collins said the reform bill awaiting conference “would modernize the rate-setting process to provide more predictability for its users.” (*CongressDaily*, Jessica Brady, 05/04/06); *PostCom.org*, 05/03/06)

- In response to the Postal Service’s filing for an 8.5% average postal rate increase, PostCom President Gene Del Polito noted that “those who will be most adversely affected represent a segment of society that is responsible for generating some \$900 billion economic activity... and for the existence of some 9 million American jobs nationwide.” While mailers understand that postage rates eventually must go up to pay for increases in operating expenses, Del Polito said that the current system provides for no predictability and no opportunity for mailers to budget for the higher rates. “It’s essential that Congress complete its postal reform work with dispatch,” said Del Polito. “Without reform, our nation will continue to suffer a fiscal burden that has nothing to do with improving the quality of the mail services we receive.” (*Association for Postal Commerce Press Release*, 05/06/06)

House still hasn’t named conferees

- House members working to pass a Postal Service reform bill continue to put off naming conferees to negotiate a compromise that will meet the White House’s approval. Although the House passed its bill in July, a veto threat has stymied the bill as White House aides push lawmakers to eliminate provisions that were in both the Senate and House bills. Senate conferees were appointed last February, after that chamber passed the legislation. House Government Reform Committee Chairman Tom Davis (R-VA) said that recent changes in the administration’s staffing has delayed discussions between the Senate conferees, House members and the White House staff. (*CongressDaily*, Jessica Brady, 05/01/06)

First class mail volume slips again in first quarter,  
while standard mail and Priority volume grows

- According to *DMNews.com*, “The U.S. Postal Service’s revenue and expenses rose in the first three months of 2006 versus the year-ago period, acting chief financial officer Robert Pedersen told the agency’s Board of Governors at its meeting in Washington. From Jan. 1 to March 31, revenue was up 7.7 percent while expenses rose 4.5 percent, Mr. Pedersen said. For the first six months of the fiscal year, revenue is up 2.9 percent while expenses have climbed 4.2 percent. Also for the fiscal year to date, First Class volume is 1.3 percent below the same period last year while Standard Mail volume has grown 1.5 percent and Priority volume is up 7 percent. Transportation costs, including fuel-related expenses, are 11.7 percent higher.” (*DMNews.com*, Melissa Campanelli, 05/05/06)

## USPS lifts embargo for magazines, newspapers, and periodicals in Gulf Coast region

- Postmaster General John Potter announced that the Postal Service will lift its embargo of magazines, newspapers, periodicals and most advertising mail on May 8. “We’ll be right back to pre-Katrina service,” said Potter. (*PostalWatch.com*, 05/03/06)

## TVA

### North Carolina’s litigation expenses against TVA exceed \$484,000

- North Carolina’s Council of State approved spending more than \$326,000 for legal expenses related to its air pollution lawsuit against TVA, bringing the state’s total expenses to \$484,336. The state had retained two Washington, D.C.-based law firms, Resolution Law Group and Ayres Law Group, to help N.C. Attorney General Roy Cooper prepare the case, which claims that North Carolina citizens have suffered ill health from pollutants from TVA’s 11 coal-fired power plants in Alabama, Kentucky and Tennessee and that the state’s environment and economy have been harmed by the utility’s emissions. TVA has asked the court to dismiss the suit. According to the *Associated Press*, meetings are being scheduled to discuss settlement terms. (*Raleigh News & Observer*, Wade Rawlins, 05/02/06; *Associated Press*, 05/03/06)

### TVA’s Brown Ferry reactor on schedule to re-start in May 2007

- TVA told a federal review panel that its \$1.9 billion project to restart Unit 1 at Browns Ferry Nuclear Plant by next May is on schedule. If the U.S. Nuclear Regulatory Commission (NRC) gives the utility permission to restart Unit 1, TVA would generate electricity from the plant’s three reactors for the first time in 23 years. TVA’s vice president Masoud Bajestani told the NRC committee that work on the Unit 1 restart is 83% completed. TVA is early in the process of testing the systems for Unit 1 and turning them over to operations staff, said Joe Shea, chairman of the NRC oversight committee. “The rubber hits the road when you try to turn these systems over to the operator,” Shea added.
- On May 4, the NRC chairman signed license extensions for all three reactors, which extended the licenses for Unit 1 until 2033 and for Units 2 and 3 until 2014. (*Birmingham News*, Kent Faulk, 05/03/06)

### Alabama legislature passes law distributing more TVA monies to TVA-served counties

- Alabama Governor Bob Riley (R) has signed a bill requiring the state to pay a larger share of the money it collects in lieu of taxes from TVA to 16 counties where the

agency provides electricity. Under the law, the current 75% of TVA monies distributed to these counties will increase to 78% by 2007. The state estimates that that the TVA-served counties will divide an additional \$1.5 million in 2006 and \$3.2 million in 2007. The state plans to make up its share of TVA funding, which drops from 20% to 17%, through sales taxes for corporations that sell to the state. (*The Decatur Daily*, M.J. Ellington, 04/29/06)

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