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The GSE REPORT ™

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Major Events

Fannie Mae avoids criminal charges over its accounting scandal

- On August 24, the U.S. Attorney's Office for the District of Columbia informed Fannie Mae that it had "discontinued" its nearly two-year investigation of the firm's 2004 accounting scandal and will not press charges. While the announcement concludes potential criminal actions against the company, it was silent on possible investigations of Fannie Mae officials. When asked if current or former Fannie Mae employees were being investigated, the U.S. Attorney's spokesman Channing Phillips declined to comment. Later, Phillips told the *Washington Post* that the Justice Department is still investigating whether former Fannie chairman and CEO Franklin D. Raines and former CFO J. Timothy Howard committed perjury when they testified about the company's accounting practices before a House of Representatives panel in 2004. In addition, the SEC has not ruled out civil charges against individuals related to Fannie Mae's accounting problems, according to an agency source who spoke on condition of anonymity due to the SEC's policy of not commenting on pending investigations. [The burden of proof is less stringent in civil actions than in criminal prosecutions.] Previously, SEC Chairman Christopher Cox labeled Fannie's accounting mistakes as fraud, a possible warning sign that charges may eventually be brought against individuals.

- Fannie Mae continues to pursue its own independent review of about 30 current and former employees for possible disciplinary action or termination. An OFHEO spokeswoman said the agency is "reviewing potential civil administrative actions against former executives of Fannie Mae," but refused to name the individuals. OFHEO could seek to force out executives or require former and current executives to return compensation received as a result of the company's earnings overstatement.

- It's not clear if the Justice Department's decision to not press criminal charges was based on lack of evidence or a determination that charging Fannie Mae would be contrary to the public's and shareholders' interest. Since the government's prosecution (and conviction) of Enron's auditor Arthur Anderson led to the firm's demise [followed by its conviction being overturned by the Supreme Court], the question of seeking criminal charges against a corporation has become one of the more controversial issues in white-collar law enforcement. Donald C. Langevoort, Georgetown University law professor, said if an employee commits a crime in his role as an employee, then "the company has committed a crime, too, in the eyes of the law." However, the Justice Department exercises discretion. "When you fine the company, you're fining the company's shareholders," said Langevoort. "You're hurting a lot of innocent people." Columbia University law professor John C. Coffee said, "I think generally deterrence really comes from prosecuting individuals and not from indicting and convicting legal entities that don't feel real flesh-and-blood pain. You can't send a corporation to prison." After the Fannie Mae criminal probe was

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initiated, defense lawyers pointed out that the statute of limitations had expired on the 1998 episode in which Fannie allegedly delayed counting $200 million of expenses to inflate the company's profits and enable the company's executives to collect millions of dollars in bonuses. While the Justice Department might have gotten around the 5-year statute of limitation by arguing that a broad, ongoing conspiracy at Fannie Mae had occurred, defense lawyers would doubtlessly have challenged such allegations. In *National Mortgage News*, Paul Muolo wrote, "Well, it looks as though former Fannie Mae officials won't be doing a 'perp walk' after all. …DOJ's decision to scuttle the investigation can be viewed as a major victory for Messrs. Raines and Howard. Their contention that the whole accounting mess was merely a disagreement over arcane FASB rules no longer looks so suspect. It also could hurt civil cases being brought against the company. Stay tuned..."

- Following the DOJ announcement, Fannie Mae CEO Daniel H. Mudd, said, "We will continue to work closely and cooperatively with our regulators as we move forward to carry out the terms of our agreements, complete our restatement and build a better company.'' Wall Street saw the DOJ announcement as a positive development, with Fannie's shares increasing 4.8% to close at $51.53. "You've got a shareholder base that has been thirsting for evidence that Fannie Mae and Freddie Mac are making progress in getting through their time in a barrel," said Charles Gabriel, a senior political analyst at Prudential Equity Group. The end of the Justice Department probe "is like a thirst-quenching first dose of water," he added. Howard Glaser, an independent mortgage consultant in Washington, DC, said, "Now that the Department of Justice has bowed out, it is like saying Fannie is not Enron. It is a big psychological burden off Fannie's back." Other observers and analysts downplayed the news, saying it represented merely a short-term gain. "Fannie is still spending a billion and a half dollars a year on accountants," said Friedman, Billings, Ramsey analyst Paul Miller. "It still hasn't gotten a restatement done. That's the real issue. They still have a capital surcharge on them, and the fundamentals of the business are still weak." Bert Ely, an Alexandria, VA consultant and frequent GSE critic, said, "Politically, I don't see any impact. This is not relevant to the issues that are hanging up the legislation." (*American Banker*, Steven Sloan and Rob Blackwell, 08/25/06; *Reuters*, Lynn Adler, 08/24/06; *New York Times*, Vikas Bajaj, 08/25/06; *Associated Press*, Marcy Gordon, 08/25/06; *Bloomberg News*, James Tyson, 08/24/06; *Washington Post*, David S. Hilzenrath and Carrie Johnson, 08/25/06; *Wall Street Journal*, Damian Paletta, 08/24/06; *Wall Street Journal*, Damian Plaetta and John R. Wilke, 08/25/06; *Bureau of National Affairs*, Richard Cowden, 08/25/06)

- Moody's Investors Services said it "viewed positively" Fannie Mae's announcement that the Department of Justice had concluded its investigation of the company and would not be filing charges. The credit rating agency said it was also encouraged by the company's progress regarding its accounting restatement. Moody's "believes that Fannie Mae should be able to return to its 'A-' bank financial strength rating," once the company returns to timely filing of all financial statements; resolves all material regulatory, operational governance and control issues; reports consistent profits over several quarters; and reports "tight" interest rate risk and credit risk measures.

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Moody’s current Fannie Mae ratings, all with stable outlooks include senior long-term debt at ‘Aaa;’ short-term debt at ‘Prime-1;’ subordinated debt at ‘Aa2;’ non-cumulative preferred stock at ‘Aa3;’ and bank financial strength rating at ‘B+.’ (*Market News International*, 08/31/06)

Freddie Mac vows to return to timely reporting of its financial results in ‘07

- At Freddie Mac’s annual shareholder meeting, chairman and CEO Richard Syron emphasized that his company’s “highest priority” is to return to regular (timely) reporting of its financial results in 2007, but was “wary to make an exact date” when the company could get back on track. While Freddie Mac performed well on its mission, its business, risk management and building a stronger balance sheet and improved capital position, Syron said the company fell short in its financial reporting and remediation and reassured shareholders that up-to-date bookkeeping is our “highest priority.”

- During the annual meeting, shareholders elected 13 directors to the company’s board of directors, which included Barbara T. Alexander, independent consultant; Geoffrey T. Boisi, chairman and senior partner of Roundtable Investment Partners, LLC; Michelle Engler, trustee of the JNL Investor Series Trust and JNL Series Trust; Robert R. Glauber, retired chairman and CEO of NASD; Richard Karl Goeltz, retired chairman and CFO of American Express Company; Thomas S. Johnson, retired chairman and CEO of GreenPoint Financial Corporation; William M. Lewis, Jr., managing director and co-chairman of investment banking at Lazard Ltd.; Eugene M. McQuade, president and COO of Freddie Mac; Shaun F. O’Malley, chairman emeritus of Price Waterhouse, LLP; Jeffrey M. Meek, chairman and CEO of CIT Group, Inc.; Ronald F. Poe, president of Ronald F. Poe & Associates; Stephen A. Ross, Franco Modigliani professor of finance and economics at MIT; and Richard F. Syron, chairman and CEO of Freddie Mac. Freddie Mac’s shareholders also ratified the re-appointment of PricewaterhouseCoopers, LLP as the company’s independent auditor for the fiscal year ending December 31, 2006. The shareholders voted down a shareholder proposal, submitted by the National Legal and Policy Center, which would have required the company to semi-annually disclose its contributions to non-profit groups and provide a business rationale for each donation. [NLPC argued that Freddie Mac’s current disclosure is insufficient to allow board members and shareholders to fully evaluate the charitable use of corporate assets.]

- At the board meeting following the annual shareholder meeting, Freddie Mac’s board of directors re-elected Syron as chairman of the board and O’Malley as lead director. The board also approved Freddie Mac’s regular quarterly dividend of $0.47 a share, payable September 29 to common shareholders of record as of September 18. (*PRNewswire*, 09/08/06; *The Main Wire*, Margaret Chadbourn, 09/08/06; *Associated Press*, 09/08/06; *DSNews.com*, Kristin Campbell, 09/05/06)

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- *American Banker* wants to know when chairman and CEO Syron will relinquish his day-to-day control of Freddie Mac, which he committed to do in three years. When he was hired, Syron said he would stay on as an active "executive chairman" for 18 months after giving up his job as CEO. When *American Banker* requested an interview to find out what Syron had planned for his last four months, they discovered that apparently his plans have changed. Company spokesman Sharon McHale first argued that there is no set deadline, then claimed that the three-year clock was "reset in September 2004," when Eugene McQuade was hired as president and COO. "We don't have a specific, definite date. It will be within a reasonable amount of time. We envisioned a three year mark,… but by December 31 it won't necessarily have happened," said McHale. The confusion throws McQuade's future into question, whose employment contract allows him to leave the company with a lucrative settlement if he is not promoted to CEO by September 1, 2007. Noting rumors of tension between the two executives, sources speculate that extending Syron's term could be a way to ensure that Freddie has sufficient leadership if McQuade elected to resign. *American Banker* reports that Freddie Mac is negotiating this issue with OFHEO. Agency spokeswoman Corinne Russell told *American Banker*, "We simply expect Freddie Mac to comply with their agreement." (*American Banker*, Steven Sloan, 08/24/06)

Freddie Mac settles its ERISA class action suit with $4.65 million payment

- On August 21, Freddie Mac announced it had reached a settlement resolving the Employment Retirement Income Security Act (ERISA) class action litigation that was filed following the company's restatement of financial results for FY2000 through FY2002. Under the terms of the settlement, Freddie Mac will make a payment of $4.65 million without any admission of wrongdoing. The company's payment, which would also cover the fees for plaintiffs' attorneys, will be fully covered by insurance. The proposed settlement is subject to negotiation and execution of final documentation and preliminary and final approval by the court. In anticipation of the settlement, the Department of Labor has closed its investigation of Freddie Mac's Thrift/401(K) Savings Plan and indicated that it will determine if further action is warranted if the settlement is not finalized, approved and implemented, as proposed. Freddie Mac has agreed to retain an independent fiduciary to review and approve the settlement plan for the allocation of proceeds and to appoint an independent fiduciary to oversee the Freddie Mac Stock Fund, one of the investment options under its Thrift/401(K) Savings Plan. The company will also conduct voluntary financial seminars to educate its employees on retirement planning.

- The settlement, when finalized, would tie up one of the loose ends of Freddie Mac's accounting scandal that has resulted in a $410 million settlement in a shareholder class action suit and a $3.8 million settlement with the FEC, regarding allegations of improper political fund raising. Freddie Mac's accounting remains the subject of an investigation by the SEC. (*Freddie Mac Supplement*, 08/21/06; *Washington Post*, David S. Hilzenrath, 08/22/06; *Reuters News*, 08/24/06)

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Fannie Mae and Freddie Mac

Fate of GSE regulatory reform to be determined in next two to three weeks

- Senate Banking Committee Chairman Richard Shelby (R-AL) said that Treasury Secretary Henry Paulson is acting as a "critical" broker in Congressional talks to craft a GSE regulatory reform bill. "We should know in the next two or three weeks if we can get a [GSE reform] bill this year," said Shelby. "We're talking. That's a good thing." The Committee's ranking member Paul Sarbanes (D-MD) said that Democrats support creating a "strong regulator" for the housing GSEs, but said other issues, such as limiting the GSEs' portfolios and creation of an affordable housing fund, are blocking a speedy resolution. "It's going to take Paulson to bring us together—if we can be brought together," said Shelby. "We'll see." (*Market News International*, John Shaw, 09/08/06)

- Representative Barney Frank (D-MA) told *National Mortgage News* that a GSE regulatory reform bill might pass this fall, now that the Treasury Department is moving toward a compromise on GSE portfolio limits. Frank said that "political will" –rather than time—is the issue blocking passage of a bill. (*National Mortgage News Online*, Paul Muolo, September 9-10, 2006)

- Members of the House Financial Services Committee are preparing a letter to send to Senate Banking Committee Chairman Richard Shelby (R-AL) and ranking committee member Paul Sarbanes (D-MD), urging action on a GSE regulatory reform bill. According to a draft of the letter obtained by *Dow Jones Newswire*, the House members write that passing GSE legislation is "one of the most urgent issues" facing the respective committees. "The purpose of this letter is to express our desire to work with you to find creative compromises to achieve our bicameral, bipartisan goal of strengthening GSE oversight and ensuring the stability and accountability of these institutions," said the House members. "This Congress should not close without addressing the serious inadequacies of the current GSE regulatory system." The letter is currently being circulated among the 70 member of the House committee, looking for signatures. "It would be a shame that we've come this far and we couldn't put that across the goal-line and get the President's signature on it in light of all of the revelations that have come out," said House Financial Services Committee Chairman Michael Oxley, (R-OH). "I hope we can continue and not give up," said ranking committee member Barney Frank (D-MA). Representative Richard Baker (R-LA) said, "I am very pleased in my policy discussions with [Treasury Secretary Paulson] in his openness to discuss how we get there. I think we have a team that is pretty closely aligned. I have never seen a window of opportunity that is more promising than where we are right now." Baker said, "I still hold out hope …that the Senate will at least have floor consideration of some proposal" to get a reform bill to a conference committee where a final bill can be hammered out. "I'm not going to

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judge what that product should look like," Baker added. (*Dow Jones Newswires*, Damian Paletta, 09/07/06)

- In an August 30 letter, outgoing House Financial Services Committee Chairman Michael Oxley (R-OH) urged Treasury Secretary Paulson to resolve a deadlock on Senate legislation (S. 190) and seek a strong compromise and Senate action. "With the second session of the 109th Congress rapidly drawing to a close, I want to urge you to redouble those efforts, as the number of legislative working days in the Senate is dwindling quickly," wrote Oxley. "While I can't predict the future, indications are that the next few weeks provide a unique opportunity that will likely never be repeated. As each day passes without news of progress on the other side of the Capitol that will allow the full Senate to act, the likelihood increases that Congress could close without addressing the serious inadequacies of the current [GSE] regulatory system and without protecting taxpayers, investors, and the market." (*Correspondence to Treasury Secretary Henry Paulson*, Representative Michael Oxley, 08/30/06)

- On August 25, the Democrats on the House Financial Services Committee released a 13-page report, calling the Bush administration's handling of the housing situation in the Gulf Coast an "abject failure" and assailing the administration's opposition to an affordable housing fund in proposed GSE regulatory reform bill which could help alleviate housing needs in the area. "The Bush administration has strenuously opposed this affordable housing fund, and has blocked consideration of the broader GSE bill, through its insistence on harsh portfolio limits on Fannie Mae and Freddie Mac," said the report. (*American Banker*, Stacy Kaper, 08/28/06)

- On August 2, Senator Majority Leader Bill Frist said it was unlikely that the Senate would address the GSE bill when it returns in September to largely focus on appropriations measure before breaking again in early October for election campaigns. Frist said that for the measure to be considered in September, it would have to come up under unanimous consent, in which leaders from both parties agree to bring a bill to the Senate floor for a vote. Observers say that ranking minority committee member Paul Sarbanes (D-MD) has little reason to compromise on GSE portfolio limits, since polls indicate that his party has a good chance of picking up seats in both chambers of Congress and possibly taking control of them. "To see change in margins in both houses, much less leadership, there is less and less incentive to compromise on some issues," said Mortgage Bankers Association lobbyist Kurt Pfotenhauer. The only chance of a compromise would likely come from the White House, which continues to demand that the bill include provisions for strict portfolio limits. (*Reuters News*, 08/30/06; *American Banker*, Stacy Kaper, 09/05/06)

- OFHEO Director James B. Lockhart, III and Senator Charles Hagel (R-NE) will discuss the need for GSE regulatory reform legislation at a September 13 breakfast beginning at 9:30 a.m., sponsored by the American Enterprise Institute. (*Dow Jones International News*, Damian Paletta, 09/06/06)

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GSE regulatory reform "inexcusably stalled in the Senate," says *LA Times*

- In an August 26 editorial, the *Los Angeles Times* wrote, "It seems that mortgage powerhouse Fannie Mae — which in May paid a $400-million fine to settle charges of shoddy accounting with its chief regulator, [OFHEO], and with the [SEC]— may finally be winding its way back into the good graces of Wall Street and the federal government. The company is on track to restate past earnings (to the tune of $11 billion) by the beginning of the year. On Thursday, it announced that the Justice Department was dropping a criminal investigation of its practices. Pity that the federal government has done little to make sure that Fannie Mae doesn't have a relapse."

- "Fannie Mae, along with its sister company, Freddie Mac, were chartered by Congress to keep mortgage markets liquid by buying loans from banks and reselling the debt to investors. Even though it was turned over to private investors in 1968, Fannie Mae still enjoyed tax breaks, loose capital restrictions and low borrowing costs that were unavailable to other publicly traded companies. Its special status as a politically powerful 'government-sponsored enterprise' meant that it also got preferential treatment from investors, who assumed that taxpayers would bail it out if it ever got into serious trouble."

- "Fannie Mae and Freddie Mac also face lighter regulation than do other financial institutions. Their regulator, the housing oversight agency, doesn't oversee all aspects of Fannie Mae's business; it doesn't have the authority to litigate against bad actors in the company; and it can't limit risky (but profitable) investments that could endanger Fannie Mae's ability to maintain liquidity in the mortgage market."

- "The Bush administration is backing efforts in Congress to grant Fannie Mae's regulator the same powers that most bank regulators have, but the effort is inexcusably stalled in the Senate. Powerful real estate lobbyists and Democrats who think Republicans are ganging up on the 'affordable housing' champion apparently feel that the health of the housing industry is somehow tied to Fannie Mae's ability to get away with financial shenanigans." (*Los Angeles Times*, 08/26/06)

"Lawmakers stubbornly resists even stepped-up regulation
to limit the size of [Fannie's and Freddie's] portfolios," says *the New York Sun*

- In an August 25 editorial, the *New York Sun* wrote, "The Justice Department's announcement that it won't pursue criminal charges against Fannie Mae lets the mortgage financer off the hook, but pardon the poor taxpayer for wondering when he will be set free. While the end of the criminal probe marks a significant step down the road to recovery for a company that has been racked for nearly two years by a $10

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billion accounting scandal, Fannie and little brother Freddie Mac have yet to be lifted from taxpayers' backs."

- "Fannie and Freddie are congressionally chartered enterprises designed to pump liquidity into the mortgage market by bundling the loans into mortgage-backed securities and creating a secondary market. Over time, however, the two companies have started building their own portfolios in those securities, to a significant extent with borrowed money, as a way to bolster returns to Fannie's and Freddie's shareholders. Those portfolios are subject to interest-rate risks stemming from the fact that homeowners can refinance when rates drop. Fannie's accounting shenanigans resulted from its effort to hedge that risk."

- "The problem is that because of their congressional charters, everyone assumes Congress would never allow Fannie or Freddie to fail. Thus, neither their creditors nor their shareholders pay enough attention to the amount of risk the pair take on. Thanks to low-interest borrowing, Fannie and Freddie between them have been able to expand to the point where their financial obligations, in outright borrowing and in guarantees on the mortgage-backed securities they create, reaches into the trillions of dollars. Their influence is so pervasive in mortgage markets that if one of them were to fail - which could happen if, for example, mortgage rates suddenly moved against them - the failure might spark a crisis in the housing market that would ripple through the rest of the economy."

- "Fannie and Freddie are a classic example of the privatization of profit and the socialization of risk. The risk to taxpayers will only go away once Fannie and Freddie are privatized, but lawmakers have stubbornly resisted even stepped-up regulation to limit the size of the companies' portfolios, despite the fact that those portfolios enrich a few investors at the risk of all taxpayers. Justice's announcement yesterday is good news for those investors. But the only good news for taxpayers will come when Congress passes stronger regulations of the enterprises or, better yet, privatizes them altogether." (*New York Sun*, 09/25/06)

Fannie Mae and its supporters challenge the proposal to restrict the GSEs' portfolios

- In a July 31 letter to lawmakers, Fannie Mae CEO Daniel H. Mudd said the company's mortgage portfolio would shrink dramatically to as low as $10 billion if a bill backed by Senate Republicans passed this year. Depending on the interpretation of the bill's language, the portfolio size could range from $10 billion to $100 billion, said Mudd. Based upon a "literal reading of the bill," he estimated that the bill would only allow Fannie to hold between $2 billion and $20 billion in whole loans and mortgage-backed securities for the purpose of securization; $2 billion to $20 billion in non-securitizable mortgages to meet affordable housing goals; between $2 billion and $50 billion in mortgages to support their guarantee business; and between $2 billion and $5 billion in real estate related foreclosures. The company would also be limited to a range of $1 billion to $3 billion in cash and $1 billion to $2 billion in other assets,

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Mudd added. "We believe the bill would require the company to liquidate approximately $600 billion to $700 billion [of] assets," he wrote in a 39-page letter responding to questions from lawmakers. "We believe that mandating a large reduction in the size of our portfolio could make it difficult for the GSEs to help provide these benefits for low, moderate and middle-income homeowners and renters currently served by the U.S. mortgage market," Mudd wrote. (*Dow Jones Newswires*, Damian Paletta, 08/24/06)

- At a minority housing event sponsored by the National Press Club, the National Association of Homebuilders CEO Jerry Howard criticized the Congressional efforts to restrict the size of Fannie Mae's and Freddie Mac's portfolios, saying "such restrictions would have a domino effect on the housing finance system as a whole" and make housing less affordable. "If you do what some on the Hill are suggesting, in terms of reining in Fannie Mae and Freddie Mac's abilities to hold their own portfolio …then you create a diminishment in either the availability of capital to the housing finance system or the cost of capital," said Howard. "And that will have an impact on housing affordability. There's no question about that." (*Dow Jones Newswires*, Damian Paletta, 08/30/06)

- At a Rebuilding New Orleans Conference sponsored by the Congressional Black Caucus, Paul Taylor, managing member of SRP Development Management, said, "Fannie Mae is under attack to be dismantled. That would be the worst thing that ever happened to the African-American Community. Freddie Mac—the same thing. We will not and should not let that happen." (*CSPAN*, 09/08/06; 22:18:46)

It's *time* for a deal on GSE reform

- In a September 8 article appearing in the *American Banker*, AEI resident fellow Alex J. Pollock wrote, "The director of the Office of Federal Housing Enterprise Oversight, James Lockhart, recently observed that the regulatory agency for Fannie Mae and Freddie Mac had just passed its 13th anniversary. 'I hope it will be OFHEO's last anniversary,' he added. This is a hope widely shared about both OFHEO and the Federal Housing Finance Board, the regulator of the Federal Home Loan banks. Indeed, there is virtually unanimous agreement with the provisions of the current House and Senate GSE reform bills that would replace these two agencies with a new regulator for the government-sponsored enterprises. …But this unanimous agreement is not enough to get GSE reform enacted. It obviously won't happen without a deal on mortgage portfolio limits for Fannie and Freddie. Without such a deal, despite years of legislative effort along with notable accounting scandals, GSE reform will be dead."

- "Over the last year, I heard the argument on several occasions that time was on the side of GSE reform. I did not think so at the time, and now it is obvious that the opposite is true. As Paul Muolo of *National Mortgage News* …has unambiguously predicted: 'There will be no GSE bill this year. None. And if the Democrats take the

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House you can kiss the whole thing good-bye.' And if not this year, why will there be any more impetus next year, even with no change in congressional control, as the Fannie and Freddie scandals cease to be news and fade into the mist of memory and previous management?"

- "Without reform legislation, it seems that the most likely medium-term forecast is for a return to the status quo ante scandals, as the GSE duopoly recovers and resumes its exercise of market power. This would be unfortunate, to say the least. …Indeed, there is only one real issue -- the size of the Fannie and Freddie mortgage portfolios -- and we need only one practical solution."

- "Let's review the current positions. The bill passed by the full House has no legislative portfolio limits. The bill reported out of the Senate Banking Committee would prohibit any purchase of conforming loans or mortgage-backed securities for Fannie or Freddie's investment portfolios. That is a wide bid-asked spread! On this issue the House bill would represent no change, and the Senate bill would represent radical change. As is well known, in its current form the latter cannot move in the full Senate. But between no limitation at all and complete elimination, there is a lot of negotiating space."

- "Here is a straightforward suggestion for a practical compromise. Based on figures from OFHEO, in the 15 years from 1990 to 2005, nominal GDP grew at an a compound annual rate of 5.3%, residential mortgage debt at 8.5%, and Fannie and Freddie's combined mortgage portfolio at 17%! That kind of portfolio growth is certainly not required, represents extremely rapid growth, and if continued would lead to ever greater market dominance. So not 17%. Growing proportionally with the economy going forward would be at about 5% (3% real plus 2% inflation), growing with the mortgage market at about 8%. Fannie and Freddie's portfolios could grow with GDP, which is by definition moderate -- or with the market, which is by definition no gain in market share. Halfway between these two is 6.5%: the average economy plus some, or the average mortgage market minus some. The issues of rapid growth -- whether accounting and controls, hedging, market dominance, or others -- disappear. The rule for Fannie and Freddie portfolios would become moderation, the mean between the two current extremes."

- "So how about a limit of 6.5% a year on portfolio growth? This seems both reasonable and practical. Why not make a deal? It would certainly be better than continuing the status quo." (*American Banker*, Alex J. Pollock, 09/08/06)

Fed study concludes that increased competition in the mortgage market will diminish the GSEs' growth and importance and lead to more risky behavior by the Enterprises

- According to an upcoming Fed study to appear in the *Journal of Money, Credit and Banking*, increased competition in the conforming loan market from the FHLB mortgage purchase programs and the adoption of revised risk-based capital

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requirements for large U.S. banks is likely to reduce the growth and relative importance of Fannie Mae and Freddie Mac and their charter values and effective capital. Authors W. Scott Frame, Financial Economist and Associate Policy Advisor with the Federal Reserve Bank of Atlanta, and Lawrence J. White, Professor of Economics at the Stern School of Business at New York University, conclude that such developments could lead to more risk behaviors by Fannie Mae and Freddie Mac, which "warrants greater supervisory awareness and legal authorities." The authors write, "…[M]embers of the FHLB System and large banks operating under Basel II – are likely to benefit from reduced capital charges for mortgage-related credit risk. This may occur either on-balance sheet for whole loans and MBS (Basel II) or off-balance sheet (the FHLB mortgage programs). These changed incentives are likely to increase depository institutions' retention of residential mortgage assets, directly or indirectly. This development, in turn, is likely to increase competition in the secondary conforming mortgage market, reduce the demand for (and the prices of) Fannie Mae and Freddie Mac credit guarantees, and narrow the spreads that Fannie Mae and Freddie Mac can earn on their retained portfolios. Ultimately, this should increase the transmission of GSE benefits and reduce mortgage interest rates paid by borrowers. By doing this, however, the charter values of Fannie Mae and Freddie Mac will be reduced, and the two GSEs' incentives to take on greater risk will be potentially enhanced. …[OFHEO and HUD] will need be aware of the effect of increased competition on the risk-taking incentives of Fannie Mae and Freddie Mac"

- "…The potential for enhanced competition to reduce Fannie Mae's and Freddie Mac's charter values and heighten risk-taking incentives highlights some of the shortcomings in OFHEO's regulatory powers. These shortcomings are at the heart of the current legislative debate …about GSE regulation. First, OFHEO's ability effectively to monitor risk-taking at Fannie Mae and Freddie Mac is related to its budget. However, unlike bank supervisors, OFHEO's budget is subject to the Congressional appropriations process and, as such, may face political meddling. This may be especially true for a regulator charged with focusing only two large and politically powerful entities, like Fannie Mae and Freddie Mac. This is an argument for allowing OFHEO to fund itself by charging examination fees directly to Fannie Mae and Freddie Mac.

- "Second, OFHEO lacks the legal authority to adjust the minimum (leverage) capital requirements for Fannie Mae and Freddie Mac and is limited in its ability to adjust the broad parameters of the risk-based capital stress test. To the extent that Fannie Mae and Freddie Mac experience 'permanent' changes to their risk profiles, like those arising from heightened competition spurred by regulatory changes, OFHEO should consider raising minimum leverage capital standards. It is important that OFHEO, like bank supervisors, have this discretion."

- "Finally, OFHEO does not have the authority to appoint a receiver to resolve fully an insolvent Fannie Mae or Freddie Mac. To the extent that a book-value insolvent institution is allowed to continue operations in an insufficiently restricted fashion, the

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incentives for inappropriate risk-taking at that time would be strong. Hence, giving OFHEO receivership authority is an important direct step that can be taken to reduce risk-taking at a time when charter value would also be reduced." A copy of this study is available at http://economics.sbs.ohio-state.edu/jmcb/jmcb/04028/04028.pdf. (*Charter Value, Risk Taking Incentives, and Emerging Competition for Fannie Mae and Freddie Mac*, W. Scott Frame and Lawrence J. White)

OFHEO releases draft of its strategic plan for public comment

- On August 31, OFHEO released a draft of its strategic plan for fiscal years 2006-2011. Specifically, the agency's plan outlines a strategy for a strengthened regulatory framework for Fannie Mae and Freddie Mac, including more targeted, in-depth examinations; a review of capital standards for the GSEs; establishment of a new regulatory regime through legislative change; and increased coordination among Federal agencies to enhance the nation's mortgage markets and housing finance system. OFHEO said that it plans to review its existing capital regime and develop "additional measures of capital adequacy, some of which may require legislation." In this review, the agency plans to look at issues related to market risk, credit risk, concentration risk, operational risk, reputational risk, among other things. According to the plan, OFHEO will "perform targeted examinations that explore areas of concern in a more in-depth and focused away, pursuing higher risk issues arising from on-going examinations." To improve transparency of Fannie's and Freddie's risks and conditions, the agency plans to establish new data reporting requirements for the GSEs, similar to "call reports" that financial institutions file with bank regulators. "OFHEO and the housing finance market, including the entities we regulate, Fannie Mae and Freddie Mac, are at a critical juncture," said OFHEO director James B. Lockhart. Comments on the agency's draft are due September 13. (*OFHEO Press Release*, 08/31/06; *Dow Jones Newswires*, Damian Paletta, 09/01/06)

President Bush nominates Goldman executive Robert Steel to serve as Treasury's domestic financial undersecretary

- President Bush will nominate Goldman Sachs's senior director Robert Steel to succeed Randal Quarles as undersecretary for domestic finance. Steel previously was a vice chairman at Goldman Sachs, the firm Treasury Secretary Henry Paulson headed before accepting his position with the administration. Steel was also co-head of Goldman's equities division. [Steel, a senior fellow at Harvard's John F. Kennedy School of Government, is also slated to teach a class on "Current Issues in U.S. Financial Regulation," which includes a session on the history and future of Fannie Mae and Freddie Mac.] Steel will serve as Treasury's point man on the potential regulatory reform legislation for the housing GSEs. (*Dow Jones International News*, 09/05/06; *Dow Jones Newswires*, Damian Paletta, 09/07/06)

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Housing market is cooling in a significant way, says OFHEO director Lockhart

- Housing prices rose 1.17% in the second quarter, the slowest growth rate since 1999, according to OFHEO's recently released House Price Index. On an annualized basis, housing prices rose 4.68%, less than half the 10.06% rate report a year earlier. Of the nation's largest 275 metropolitan areas covered in OFHEO's report, seven regions experienced year-over-year declines in prices. "These data are a strong indication that the housing market is cooling in a significant way," said OFHEO director James B. Lockhart, III. "Indeed, the acceleration appears in almost every region of the country." Patrick Lawler, OFHEO's chief economist added, "We're seeing the sharpest deceleration in places that had increased the most, such as Arizona, Nevada, Hawaii, and Massachusetts." Greenwich Capital analyst Stephen Stanley said, "Looking ahead, home price appreciation will undoubtedly continue to slow, and we would not be shocked to see a quarter or two where the annualized growth rate is measly or even flattish." (*OFHEO Press Release*, 09/05/06; *Washington Post*, Tomeoh Murakami Tse, 09/06/06; *MortgageWire*, 09/05/06; *Dow Jones Newswires*, Janet Morrissey, 09/05/06)

Keeping an eye on the GSEs' technology

- Freddie Mac is overhauling its core loan underwriting system [Loan Prospector or LP] with a focus on automating much of the manual programming required to respond to changing market conditions. This fall, Freddie plans to go live with its third generation of its LP "replatformed" software. The current LP version requires time-consuming, manual programming effort two or three times a year to account for changes in the rules to evaluate loans on the GSE's purchase criteria, said Joe Smialoski, Freddie Mac's EVP of operations and technology. "Given the size of [Freddie Mac's large customers, such as Wells Fargo, Countrywide Home Loans and Bank of America] and the nature of the contracts we have with them, there are typically complete terms and conditions. Our desire is to be able to make a quantum leap in terms of our ability to describe our terms and conditions using rule-based and workflow technology." By using Pegasystems' BMP suite which has a business rules engine, LP's software can be easily updated whenever terms and conditions need to change, said Smialowski As more lenders offer 40- and 50-year mortgages to customers, Freddie Mac will have to update LP to accept these loans. "Our ability to respond to that need [more quickly] puts us in a more advantageous position," Smialowski added. Freddie expects the new LP will cut operating and maintenance costs by 30% and will be fully implemented within 12 to 18 months. (*Computerworld*, Heather Havenstein, 08/21/06)

- In an article on "cutting-edge" AU systems appearing in *Mortgage Technology*, John Le of Portellus said, "The next-generation of automated underwriting systems will comprise a service-oriented enterprise rules management solution that not only

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automates pricing/product eligibility and decisioning in the back office and at the point of sale, but also automates key areas such as data validation, workflow, compliance, best execution, and fee management. There is so much more that rules can automate beyond underwriting." (*Mortgage Technology*, Scott Kersnar, 08/25/06)

Fannie Mae

Fannie Mae's mortgage portfolio increases 0.9% in July

- Fannie Mae's gross mortgage portfolio rose by $533 million to $731.44 billion in July for an annualized rate of growth of 0.9%. When adjusted in accordance to GAAP, the company's portfolio rose to $724 billion in July, $3 billion below OFHEO's regulatory cap on the GSE's portfolio. Fannie Mae reported its duration gap was negative one month in July, unchanged from June. (*American Banker*, Jody Shenn, 08/25/06; *Market News International*, 08/25/06; *Dow Jones Newswires*, 08/24/06)

Goldman Sachs and KPMG named as defendants in Fannie Mae's securities fraud class action suit

- Ohio Attorney General Jim Petro has added Goldman Sachs Group, Inc. and KPMG LLP as defendants in the securities fraud class action against Fannie Mae. In an amended complaint, Petro alleges that Goldman Sachs had a "direct participation in the fraudulent scheme," in which the securities firm was the dealer and underwriter for several REMIC transactions that "had no legitimate economic or business purpose; the sole purpose was to shift $107 million of Fannie Mae's earnings into future years and was part and parcel of the overall scheme to defraud alleged here." Petro also alleges that KPMG "knew or recklessly disregarded that its 2001, 2002, 2003 audit opinions were materially false and misleading." Petro represents the Ohio Public Employees Retirement System, State Teachers Retirement System of Ohio, and the Ohio Bureau of Workers' Compensation, the lead plaintiffs in the class action suit. On August 11, Petro received the courts permission to add the new defendants to the law suit. (*Dow Jones International News*, Damian Paletta, 08/18/06)

- Randall Baron, a partner with lead counsel Lerach Coughlin Stoia Geller Rudman & Robbins, amended its shareholder derivative suit against Fannie Mae to claim that Goldman Sachs and Lehman Brothers aided the company's executives in mismanagement and manipulation of the GSE's earnings. The amended lawsuit, filed with the U.S. District Court for the District of Columbia, contends that Goldman

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Sachs and Lehman Brothers "recklessly participated in the acts of fraud and income-smoothing at Fannie Mae." The suit claims that Goldman executed two multi-billion dollar REIT conduits to shift $107 million of Fannie Mae's earnings in 2001 and 2002 to future years and that Lehman helped the company improperly defer $341 million in taxes in 1998. (*Reuters News*, Al Yoon, 09/01/06)

- According to the Treasury Department spokesman, Treasury Secretary Henry M. Paulson will remain involved in the debate over GSE regulatory reform despite litigation challenging Goldman Sachs's work for Fannie Mae. [The law suit does not allege that Paulson had any direct knowledge of the transactions in question.] "Treasury's ethics attorneys looked at this issue early on and determined that Goldman Sach's role as a former financial advisor to some (government-sponsored enterprises) would not be a cause for recusal on the broad issue of GSE policy," said Treasury spokesman Tony Fratto. "Secretary Paulson would be recused, of course, on any activity related to the new litigation, but we do not expect to have any activity related to the litigation. …The existence of the litigation does not change the original conclusion that Secretary Paulson doesn't need to be recused on our broad GSE initiatives." (*Dow Jones International News*, Damian Paletta and Benton Ives-Halperin, 08/28/06)

Former Fannie Mae execs ask court to force OFHEO to release records

- Former Fannie Mae CEO Franklin Raines and former CFO J. Timothy Howard have asked the U.S. District Court for the District of Columbia to force OFHEO to produce documents related to their defense. The court filing notes that OFHEO signed off on Fannie Mae's accounting systems from 1998 through 2003, even though it later alleged that accounting during this period was flawed. "Unsurprisingly, OFHEO jealously guards against the production of such materials, presumably for fear that the integrity of its own public statements will be called into serious question by the public disclosure of what was available to the agency before it issued its reports," said the complaint filed by Kevin M. Downey, Raines' attorney. The defendants are requesting copies of any records related to the performance of Fannie Mae officers or directors from 1998 through January 31, 2005 and all documents from 1995 through 2005 related to OFHEO's evaluation of the company's accounting. In an August 2 letter, OFHEO associate general counsel Charlotte A. Reid alleges that the defendants' subpoena is "unduly burdensome" and does not allow reasonable time" for response. "To comply with the subpoena, the agency's document review necessarily will involve millions of pages of documents, consuming vast expense, staff effort and time - causing a serious administrative burden on OFHEO staff in contravention of OFHEO's regulations," wrote Reid. Downey rejected Reid's position, saying it "smacks of improperly selective disclosure. …There is a profound irony in OFHEO's stubborn determination to ignore Mr. Raines' subpoenas for documents related to its examinations of Fannie Mae," wrote Downey in his motion to compel. (*Dow Jones Newswires*, Damian Paletta, 08/22/06)

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James Johnson: Fat cats' friend?

- James Johnson, former chairman of Fannie Mae from 1991 to 1998, can't stay away from board rooms, where he sits on the boards of six corporations and serves as chairman of the compensation committee on five of them. Specifically, Johnson is on the compensation committees of UnitedHealth Group and KB Home, both of which are under scrutiny for alleged stock-option backdating practices. In light of these controversies, the AFL-CIO has called for the Johnson's resignation from the six boards of directors that he serves on. In a letter to UnitedHealth board member Gail Wilensky, the AFL-CIO added that Johnson's record as the former chairman and CEO of Fannie Mae was "replete with compensation abuses." (*Saint Paul Pioneer Press*, 09/06/06; *Smart Money*, Jim McTague, 08/21/06)

Jamie Gorelick's "six year gap"

- Wilmer Hale attorney Jamie Gorelick has her own version of Rosemary Woods's famous 18.5 minute gap in the Watergate tapes. Gorelick's professional bio, which appears on her firm's website, no longer lists the six years she spent as vice chairman of Fannie Mae [1997-2003]. According to *Washingtonian*, "The six year gap is audacious because Gorelick was such a visible Fannie Mae official. Gorelick says she had no intent to deceive, as everyone knows she worked for Fannie Mae. I was just trying to refocus the page on my legal practice rather than my corporate work, she says. If it bothers everyone that much, I will put it back." (*Washingtonian*, Kim Eisler and Garrett Graff, September 2006)

Maryland's Secretary of Housing and Community Development joins Fannie Mae

- Maryland's Secretary of Housing and Community Development Victor L. Hoskins is leaving Governor Robert Ehrlich Jr.'s cabinet to join Fannie Mae as lead director for Fannie Mae's Mid-Atlantic Group's Washington, DC Metro Community Business Center. (*Maryland Gazette*, 08/30/06)

Fannie Mae maintains the option to skip monthly debt sales

- Fannie Mae said it will retain the option to skip planned sales of its benchmark debt in 2007 and will keep any potential sales at a minimum of $3 billion. In a departure from past practices, Fannie Mae said it would set coupon payment and maturity dates to days other than the 15th of the month. (*Reuters*, 08/29/06)

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Freddie Mac

Freddie Mac cuts its mortgage holdings in July for the third straight month

- In July, Freddie Mac's retained portfolio fell to $711.02 billion from $722.21 billion in June for an annualized rate of decline of 18.6%--the largest decline in the 12 years that company has reported such data. When adjusted in accordance with GAAP, the company's portfolio totaled approximately $702.6 billion on July 31—about 1% below its June 30 level that establishes its regulatory growth cap. [Under the agreement with OFHEO, the GSE can grow its portfolio by up to 0.5% a quarter or 2% a year from the GAAP June 30 level.] Freddie Mac spokesman Michael Cosgrove attributed the shrinkage to its negotiations with OFHEO, concerning an agreement to limit growth until the company returns to timely reporting of its financial results, and market conditions. Analysts speculated that Freddie Mac may be trying to build extra room under its portfolio cap in preparation for a potential widening of spreads. "They've got a little powder dry with which they can buy in the future," said Arthur Frank, director of mortgage-backed securities research at Nomura Securities International.

- In July, Freddie Mac reported just $2.6 billion of net outstanding commitments, by far the smallest amount this year. [In June, the company reported $19 billion of net outstanding commitments.] Freddie Mac's amount of securities guaranteed by Freddie and held by other investors increased at a 20.3% annual rate to $1.05 trillion. Freddie Mac's duration gap averaged zero months in July, unchanged from June. (*Freddie Mac's Monthly Volume Summary*, July 2006; *American Banker*, Jody Shenn, 08/25/06; *Dow Jones Newswires*, 08/24/06)

Freddie Mac gets banks to pay early on Fed Funds

- In an attempt to avoid overdrafts at the Federal Reserve, banks have agreed to accelerate the return of proceeds on its short-term investments, after the Federal Reserve stopped extending free credit to the GSEs on an intraday basis. Freddie Mac has made the transition under the new Fed policy in part by developing an "early fed funds" market, in which banks must return the money market investments by 9:30 a.m. the day they are due instead of the prior deadline of 4:30 – 5:30 p.m., said Freddie Mac's assistant treasurer John Radwanski. "It hasn't been the big event that people had been concerned of," he added. (*Reuters*, Al Yoon, 09/01/06)

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Freddie Mac bolsters housing initiative for first responders in New Orleans

- Freddie Mac, Chase, Standard Mortgage Corp. and Wells Fargo Home Mortgage announced that they are joining an innovative effort the New Orleans Police and Justice Foundation (NOPJF) created to help New Orleans police, fire and emergency medical personnel buy homes. The NOPJF Mortgage Subsidy program provides eligible employees with subsidies of up to $8,000 to cover downpayment and closing costs. To date the program has helped 245 first responders to become homeowners. The expanded program will expand the initiative and make homes possible for as many as 500 additional families by adding access to flexible mortgage products, including Freddie Mac's HomePossible® suite of affordable mortgage products. (*Freddie Mac Press Release*, 08/29/06)

Federal Home Loan Banks

FHFB chairman Rosenfeld defends proposal to boost FHLBs' retained earnings

- At a September congressional hearing, Ronald Rosenfeld, chairman of the Federal Housing Finance Board (FHFB), defended his agency's proposal to increase the FHLBs' retained earnings. In testimony before the panel, Rosenfeld said that while the FHLBs have grown in size, sophistication and risk in recent years, that many of the Banks were not equipped to deal with those changes and failed to implement appropriate governance and risk management tools. As examples, he sited the FHLB-Seattle and FHLB-Chicago, which continue to operate under Written [Regulatory] Agreements. Rosenfeld noted that the FHLB-Chicago relied on excess stock to grow its mortgage portfolio to 60% of assets, which constituted approximately 60% of its capital stock. He testified, "When the Chicago Bank's earnings declined and dividends were reduced, …member requests that the Bank repurchase excess stock accelerated. To conserve its capital, the Bank halted its repurchase of stock. In response, members holding over a quarter of a billion dollars in stock, elected to withdraw from the Bank. That process began a six-month statutory redemption clock." After analyzing the Bank's capital options, the FHFB authorized the FHLB-Chicago to issue $1 billion in 10-year subordinated debt, which will be used to retire a like amount of excess stock with six months notice. "That solution provides the Chicago Bank's new management team time to work through and resolve the Bank's financial issues," said Rosenfeld.

- In response to their supervisory experiences, the FHFB has required the FHLBs to register with the SEC and proposed the rule on retained earnings and excess stock. Rosenfeld testified, "We are analyzing the 1,066 comments we received and are

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taking an open-minded and cautious approach to the final rule," said Rosenfeld. "We will be guided by some fundamental principles. Specifically, we will do nothing to impede the good business judgment of the Banks; we will not materially alter the value of membership in a Bank; and we will respect lawful actions that were previously taken."

- "Speaking only for myself, some commentaters made valid points and there is room for movement on several important issues. I want to be clear. I will never be apologetic about capital. While the capital level of the Banks exceeds the 4 percent statutory minimum, the composition of the Banks' capital needs to be strengthened. That is the purpose of our proposed rule. Some comments state that our proposed rule is contrary to statutory intent of Gramm-Leach-Bliley and that we have exceeded our regulatory authority. We strongly disagree. The intent of Gramm-Leach-Bliley was to stabilize and strengthen the capital of the Banks. Our proposed rule does exactly that. The rulemaking is fully consistent with our regulatory authority and is an exercise of our regulatory duty. It is our duty to ensure the financial safety and soundness of the Banks. A duty entrusted to us by this Congress. …There has been nothing in the debate to this point in time that would compel me to favor withdrawing the proposal."

- Subcommittee ranking member Paul Kanjorski (D-Pa.) argued that the FHFB's proposed rule would slow progress the FHLBs have made toward implementing capital requirements established by the 1999 Gramm-Leach-Bliley Act. "Specifically, this proposal would impose an inflexible minimum retained earnings level at each bank," said Kanjorsk. He also cited Standard & Poor's assessment of the proposal that said the rule could reduce the Banks' alternatives in managing their capital positions, which and could diminish the system's attractiveness to member institutions.

- Several panel members also expressed concerns that the proposed increases in retained earnings and restrictions on holdings of excess stock would reduce the FHLBs' profits and therefore restrict funds available for the system's Affordable Housing Program (AHP). Representative David Scott (D-GA) said that if the rule makes the FHLBs unattractive to larger members who would elect to leave the system, the result could be to increase the cost of FHLB advances and the cost of homeownership Moreover, the reduced FHLBs' earnings would "dry up" resources for the AHP. The proposal would have the opposite effect in the long run, Rosenfeld responded. "The more retained earnings you have, which are invested, the greater your income is," said Rosenfeld. "So the reality is that by having more retained earnings, that in and of itself increases income and therefore AHP contributions. …What we're trying to do is make sure that those kind of things that reduce earnings of the banks and adversely impact AHP simply don't occur again," singling out the FHLB-Chicago and FHLB-Seattle as the root cause of his agency's concerns.

- Kanjorski asked Rosenfeld if he is concerned that the proposal will drive away large members such as Washington Mutual Inc (Wamu), which cited the proposal's impact

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when it announced plans last week to cut back on advances from the FHLB-Seattle and FHLB-San Francisco in favor of raising funds in Europe. "This is a strong indication that ... [Wamu is] voting with their feet," said Kanjorski. Rosenfeld argued that Wamu is reacting to problems at the FHLB-Seattle--not the FHFB's proposal. "I'm sure one of the very significant reasons Wamu is seeking to withdraw from the Home Loan banks is their experience in Seattle," he said. "Seattle is a terrible situation for Wamu, because you get a big presence and you're getting zero dividends. The reason they're getting zero dividends is that we did not have in place the rules we're trying to put in place."

- Rosenfeld signaled that the FHFB is considering changes to its capital proposal. "Some commentators made valid points [in comment letters]," said Rosenfeld. "There is room for movement on several important issues." Since the 12 FHLBs are well capitalized, many commentators questioned the need for a 50% dividend payout limit while the FHLBs raise their retained earnings to meet the proposed minimum requirement of $50 million plus 1% of non-advance assets. "That is a constructive observation, and we should consider a higher dividend payout ratio, which would extend the time for the FHLBanks to reach the retained earnings minimum," he said.

- Rosenfeld responded to charges that of the 1,066 comment letters submitted on the proposal, less than 0.5% supported the rule-making initiative. He noted that 81% of all of the comments were generated by the FHLB-Cincinnati. Rosenfeld also noted that "eight or nine" of the FHLBs are at or very close of complying with the retained earnings requirements. Similarly, eight Banks already meet the excess stock standards, proposed in the FHFB's proposal. "So this notion of how Draconian [this proposal] is, is simply nonsense," said Rosenfeld.

- While denying allegations that the proposal was designed to coerce the 12 FHLBs into consolidating, Rosenfeld made it clear he believes that consolidation of the FHLB system would be a good idea. "Quite frankly, I don't understand why you need six banks between Pittsburg and Topeka, but if that's what the members want, and that's what the members are willing to pay for, that's their prerogative," said Rosenfeld.

- Retiring Finance Services Committee chairman Michael Oxley (R-OH) and a number of committee Democrats took Rosenfeld to task for the FHFB's failure to appoint new public interest directors to the FHLB boards. "Are you failing to carry out your function as a regulator independently because of this White House is telling you to do?" asked Kanjorski. Rosenfeld responded that his board, which is independent of the White House, has no plans to appoint public interest members to the FHLBs. He added that it would be imprudent to consider board directors while Congress is considering GSE regulatory reform legislation. "I believe the real answer is to have GSE reform," he added. Representative Barney Frank (D-MA) said, "This assertion that we cannot appoint directors because there is legislation pending, then to promulgate the most far-reaching changes in capital structure when that is also a focus of GSE legislation, that's the least logical explanation I have ever heard."

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(*Opening Statement of Ronald A. Rosenfeld before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises*, 08/07/06; *American Banker*, Steven Sloan, 09/08/06; *Dow Jones Newswires*, Damian Paletta, 09/06/06; *Dow Jones International News*, Damian Paletta, 09/07/06; *National Journal's CongressDaily*, Bill Swindell, 09/07/06; *Bureau of National Affairs*, Richard Cowden, 09/08/06; *MortgageWire*, 09/07/06)

Wamu launches first U.S. covered bonds
which will be used to dramatically reduce its FHLB advances

- Washington Mutual (Wamu), Seattle, WA, plans to tap the European capital markets by offering its first covered bond program collateralized by U.S. residential mortgage collateral. This $29 million euro (about $25.6 million) offering, planned for mid-September, is expected to mirror FHLB System advances. Wamu will collateralize these bonds by mortgages with fixed-interest rates for five-years, and adjustable thereafter said Standard & Poor's, which has rated the issue "AAA ". According to S&P, Barclays Capital arranged the program and will serve as lead manger, along with ABM Amro and Deutsche Bank. Wamu plans to issue covered bonds up to six times a year, said S&P analyst Todd Niemy. This move may open the door for other U.S. banks to offer such bonds in the European market. "The significance of this first U.S. program cannot be overemphasized," said S& P in a statement. "The sheer size of the residential mortgage and public sector loan portfolios of U.S. banks" and investor demand is an opportunity for rapid growth.

- As Wamu diversifies its funding options beyond its traditional FHLB borrowings [which totaled $55 billion on June 30], the impact on FHLB system could be dramatic. Wamu, the system's single largest customer, has already cut back its stake in the FHLB-San Francisco to 25% of the Bank's outstanding stock [from 38%]. Critics of the Federal Housing Finance Board's plan to raise the FHLB System's capital say that the proposed limitation on the FHLBs' dividend may result in larger members, like Wamu, to leave the FHLB System for cheaper funding sources. "The proposed limitation on dividend payments could have the consequence of driving large members from the FHLBank System," said Diane Casey-Landry, the president of America's Community Bankers, in a July 12 comment letter. "…This could result in the shrinking of FHLBank assets and earnings." If the FHFB proposal were adopted, Wamu could lose $210 million in dividend income, said Wamu's assistant treasurer Peter Freillinger. "If the dividend policy is changed as currently contemplated, the attractiveness of the Home Loan Bank financing system would change pretty radically." Funding diversification into Europe's covered bond market offers other advantages, such as longer bond maturities of five to ten years compared to the three-year terms offered by the FHLB. Also, collateralization on bonds is driven by rating agencies. Paul Phillips, Wamu's vice president of capital strategies, said that the covered bond program will be an attractive alternative to GSE funding, but will not supplant it. We will continue to be an active borrower in the FHLB

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system, Phillips said. (*American Banker*, Jim Cole, 09/05/06; *Euroweek*, 08/27/06; *Reuters*, Al Yoon, 09/05/06; *MortgageWire*, 09/06/06)

FHLB-Des Moines files second quarter 10Q and announces management appointments

- The FHLB-Des Moines reported net income of $22.2 million for the second quarter of 2006, versus a $117.0 million loss for the second quarter of 2005 [which included net losses on derivatives of $238.3 million for the period]. At June 30, the Bank reported total assets of $43.3 billion, advances outstanding of $22.9 billion, mortgage loans held for portfolio of $12.4 billion, and total capital of $2.3 billion. (*Federal Home Loan Bank of Des Moines 10Q*, 08/28/06)

- The Bank announced the appointment of Steven K. Schuler as senior vice president and chief financial officer and Kelly E. Rasmuson as director of internal audit. Previously, Schuler served as CFO, secretary and treasure of Iowa Wireless Services and corporate senior vice president, CFO, secretary, and treasurer of Brenton Banks. Rasmuson, who has 20 years progressive experience in audit, accounting and financial roles, was formerly the director of internal audit for a variety of business areas at Principal Financial Group. (*PrimeZone Media Network*, 08/28/06)

FHLB-Topeka reports second quarter results

- The FHLB-Topeka reported net income for the second quarter of $32.9 million, down 10% from the first quarter but up almost 30% from a year earlier. The Bank's assets grew 1.7% to $47.4 billion during the second quarter, while advances grew 3.3% to $28 billion. (*American Banker*, Steven Sloan, 08/29/06)

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Ginnie Mae

Uphill battle for FHA reform legislation

- According to a number of sources speaking to *American Banker*, election-year politics have held Democrats back from supporting FHA reform legislation introduced by Senator Jim Talent (R-MO), while a more-limited reform bill sponsored by Senator Hillary Clinton has also languished. Brian D. Montgomery, HUD's assistant secretary in charge of FHA, said when lawmakers return from their recess, "they're not going to be back very long, but we're going to keep pushing on all fronts." Noting that time is of the essence, Montgomery added, "We think it's important to get this [FHA reform legislation] done this year. With FHA's …business basically in free fall for five years now, every day" that passes is another day the issue can lose relevance. (*American Banker*, Jody Shenn, 09/05/06)

International Mortgage Market

U.S.-style mortgages come to Mexico?

- Finance North American [San Diego, CA] has closed what it calls "the first U.S.-style mortgage in San Miguel de Allende, Mexico, a move that expands Americans ability to "use US funding sources for Mexican property investments." Company president Russ Schreier said, "American investment has been stymied by regulations guiding funds from Mexican lenders. We've effectively eliminated those cross-border barriers." (*MortgageWire*, 08/30/06; *PRWEB*, 07/06/06)

Farm Credit System / Farmer Mac

FCS's 2005 hit parade

- According to *Bert Ely's Farm Credit Watch*'s (*FCW*) CEO salary survey for 2005, CoBank's Douglas D. Sims topped the list with total compensation of $1,565,000, followed by F.F.C.B. Funding Corp's Jamie B. Stewart, Jr. ($836,000); Northwest FCS's Jay B. Penick ($730,000); Farm Credit West's Kenneth E. Graff ($670,000) and American AgCredit's Ron Carli ($654,000). [Total compensation figures have been rounded to thousands].

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- *FCW* also notes, "As a going-away present for Doug Sims, upon his retirement as CoBank's CEO, CoBank donated $1 million to the Farm Credit System Foundation. According to its website (www.fcsfoundation.org), the Foundation's 'primary mission is to assist young, beginning, and small farmers and ranchers to thrive as businesspersons in their local and the global agricultural marketplace.' Run as an adjunct of the Farm Credit Council, the FCS trade association, the foundation's grants are clearly intended to advance the FCS's political goals while trying to burnish its badly tarnished reputation as a lender to young, beginning, and small farmers." (*Bert Ely's Farm Credit Watch*, Bert Ely, August 2006)

Incoming chairman of ABA targets the Farm Credit System

- Earl McVicker, chairman-elect of the American Banker's Association, said his main concern as head of the trade group is the encroachment of the Farm Credit System and credit unions into traditional banking services, along with FCS's tax-exempt status. "Farm Credit is always trying to knock on the door of commercial lending and non-agri lending," said McVicker. "We will be working to reform the system." (*High Plains Journal* [Dodge City, KS], Larry Dreiling, 08/25/06)

Postal Service

USPS posts net deficiency of $518 million after escrow allocation in July

- The USPS generated a net deficit of $268 million in July, which increased to $518 million after the escrow allocation. Year-to-date, the Postal Service's net deficit after escrow allocation is $1.2 billion. USPS revenue for July was $5.5 billion, or 0.5% under plan, while its expenses totaled $5.8 billion, or 0.4% above plan. Total mail volume in July was 16.1 billion pieces, 1.1% lower than in June 2005. By class, Package Services increased 4.2%, followed by Priority Mail (2.9%), and International Mail (3.6%). Periodicals decreased 10.9%, followed by Express Mail (2.4%) First Class (1.3%) and Standard Mail (0.9%). (*DMNews.com*, Melissa Campanelli, 09/07/06)

"We'll know by October 1st" on postal reform

- Jerry Cerasale, senior vice president of government affairs for Direct Marketing Association, said, "We'll know by October 1" about the prospects for passage of postal reform legislation. "It is very likely Congress will adjourn early [September 29] to allow congressmen and senators to campaign," he said. "So there's less time in Washington to pass legislation." The House and the Senate committees will confer in

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the next few weeks and talk about the differences in the two postal reform bills and come forward with a conference report, which could be a compromise of both bills. “The two staffs are already talking,” Cerasale said. If a bill does not pass, it will likely be two years before the postal reform issue is brought up again, he added. (*Multichannel Merchant*, Mark Del Franco, 08/30/06)

Former postal exec lived the high life on the Postal Service’s dime

- Azeezaly Jaffer, a former vice president for public affairs and communications for the Postal Service, liked to “live large.” According to postal investigators, Jaffer ran up an $8,252 bill by staying in a Washington hotel suite less than nine miles from his home. In one evening, he spent $3,486.33 for steak dinners and bar hopping for himself and other employees after the unveiling of the new Ronald Regan commemorative stamp in 2005. And in 2003, he tipped two waiters $1,511.66 for serving a seafood dinner for 20 employees and business partners. [As a vice president, Jaffer was allowed to approve his own reimbursement claims under USPS policies.] An inspector general report on the Jaffer’s expense records details more than $46,000 in questionable spending and numerous accusations of sexual harassment, intimidation, and improper conduct. Jaffer, a 30 year USPS veteran earning an annual salary of $164,000, abruptly resigned on June 30, 11 days after the IG report was competed. On September 1, the Postal Service said it will not seek reimbursement for more than $46,000 of questionable spending by Jaffer. (*Federal Times*, Stephen Losey, 08/21/06; *Federal Times*, Stephen Losey, 09/01/06)

Pentagon urges military to get absentee ballots for November election by fax or email

- The Pentagon is counting on its improved website to help an estimated 6.5 million military personnel vote in the upcoming November election. Pentagon officials said that the site includes information on how voters can request and get ballots by fax and email “rather than rely on slower postal service.” (*Associated Press*, Pauline Jelinek, 09/05/06)

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TVA

TVA's three nuclear plants have leaked tritium into groundwater

- TVA's three nuclear power plants have leaked tritium, a radioactive form of hydrogen, into the groundwater. According to the Nuclear Regulatory Commission officials, the leaked tritium has not moved beyond TVA's properties and is not a public health hazard. According to NRC spokesman Kenneth Clark, if the leaked tritium were to reach the Tennessee River, the body of water would dilute the substance until its concentration would not be a "health and safety issue for the public."

- NRC inspector George Kuzo said groundwater sampling at TVA's plants Watts Bar in Spring City, Tenn.; Sequoyah in Soddy-Daisy and Browns Ferry in Athens, Ala. revealed tritium. "At Watts Bar, they actually had a small hole in a pipe," said Kuzo. "We verified that they fixed it." In an Aug. 4 letter to the NRC, TVA officials documented at least seven instances of leaks, spills or leaching at the three plants. All of the leaks or spills either have been fixed or are being worked on. (*Associated Press*, 08/26/06)

The Tennessean urges TVA to "preserve public land"

- In an August 26 editorial, *The Tennessean* [Nashville, TN] wrote, "Give TVA's new board credit for bravery. The directors hadn't been much more than sworn in when they teed themselves up to one of the more contentious, deep-seated issues they may ever face. Also give them credit for judgment; They recognized that a fuzzy policy on land transactions could put the Tennessee Valley Authority in a world of legal, ethical or public relations trouble."

- "In recent years, the previous TVA board engaged in two significant land transactions: It sold 578 acres on Nickajack Lake to a developer who plans to build a major resort, and it swapped 113 acres on Tellico Lake to another developer. While some environmental groups supported the land swap, both transactions stirred controversy."

- "In the meantime, the board, as directed by Congress, grew from three to nine members. Last May, after eight of the members were in place, the TVA board declared a moratorium on land transactions so it could develop a policy."

- "The notion of TVA selling off or trading land with private entities is a stab through the heart of much of East Tennessee. After its creation, TVA acquired 1.3 million acres of land. Much of that land was acquired in the 1940s through eminent domain.

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About 16,000 families were displaced. Even now, second and third generations of East Tennesseans have stories to tell about TVA 'stealing' family property."

- "While much of that land is now under water [470,000 acres] and some tracts have been transferred to other state or federal agencies [506,000 acres], TVA still manages 293,000 acres around its reservoirs. So the thought of the federal agency selling or trading valuable shoreline to the highest bidder for a private development is particularly galling. Moreover, some attorneys posit that TVA cannot engage in land transactions because it doesn't own the property in the first place. Development of some of the shoreline property may be warranted, but only if it is carefully developed by a public entity for public use. A land policy that embraces that philosophy will put TVA's new board where it needs to be." (*The Tennessean*, 08/26/06; *The Daily Times* [Maryville, TN], 08/17/06)

TVA named as one of the top utilities of the year

- Site Selection Magazine has named TVA to its 2006 list of "Top Utilities of the Year," which appears in its September issue. The magazine recognized TVA because of the agency's economic development efforts have generated more than $3.6 billion in capital investment and created 57,000 jobs in the utility's service area. (*Memphis Business Journal,* 09/06/06)

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