

The **GSE** REPORT™

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Major Events

The Rudman Report:

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The fundamental question: Do we need the GSEs?

Fannie Mae's "earnings-at-any-cost" culture exposed in the Rudman Report

- An internal review of Fannie Mae's accounting conducted by former Senator Warren Rudman concluded that ***management's accounting practices in virtually all of the areas reviewed were not consistent with GAAP***. According to the Rudman Report, in many instances management was aware of the departures from GAAP, but justified or excused such departures based upon materiality assessments, the need to accommodate for system inadequacies, the unique nature of Fannie Mae's business, or "substance over form" arguments. While investigators did not find any evidence – with one exception supporting the conclusion that management's departures were motivated by a desire to maximize bonuses in a given period, overwhelming evidence demonstrated that management's adoption of certain policies and financial reporting procedures was motivated by a desire to show stable earnings growth, achieve forecasted earnings, and avoid income volatility. The Report provided extensive and detailed evidence that executives deliberately and frequently manipulated Fannie Mae's earnings, setting aside a "non-recurring earnings piggybank" and a loan loss reserve "war chest" to utilize when profits fell short of EPS targets.
- The Report concluded that Fannie's employees who occupied critical accounting, financial reporting and audit functions were either unqualified for their positions, did not understand their roles, or failed to carry out their roles properly. This deficiency was specifically noted in the employees occupying the senior positions in the Office of the Comptroller and Office of Auditing. Further, the financial resources devoted to

accounting, financial reporting, and audit functions were insufficient to meet the needs of a company the size and complexity of Fannie Mae.

- The Report said that the information management provided to the Board of Directors regarding accounting, financial reporting, and internal audit issues “generally was incomplete and, at times, misleading.” Information to the Board was tightly controlled and filtered by management, particularly CFO Timothy Howard.
- Rudman concluded that Fannie Mae’s accounting systems were grossly inadequate, as clearly demonstrated in the investigators’ review of accounting for premium and discount amortization under FAS 91 and FAS 149, as well as the company’s accounting for investments in affordable housing partnerships.
- Lastly, the Rudman Report concluded that former CFO Howard and former controller, Leanne Spencer were primarily responsible for implementing accounting practices that departed from GAAP, in which they put an “undue emphasis on avoiding earnings volatility and meeting EPS targets and growth expectations.” The report added, “[W]e did not find that [former CEO Franklin Raines] knew that the Company’s accounting practices departed from GAAP in significant ways. We did find, however, that Raines contributed to a culture that improperly stressed stable earnings growth and, that as Chairman and CEO of the Company from 1999 through 2004, he was ultimately responsible for the failures that occurred on his watch.”
- The Report noted that Fannie Mae has “gone through an extensive transformation in both personnel and structure since September 2004. ... [T]here has been a dramatic shift in both the ‘tone at the top’ and the Company’s internal organization. As the Report was compiled, Rudman made periodic reports to the management and board of directors, which took steps to address necessary changes as circumstances warranted. “As a result, (1) the Company has disclosed the principal problematic accounting issues that are the subject of this report, and (2) no member of management who we found knowingly participated in improper conduct continues to be an employee of the company, and (3) ...our suggestions for changes in corporate governance either have been implemented or are underway,” said the Report.
- The Report expanded on accounting issues previously raised by OFHEO, without providing a new estimate of Fannie Mae’s restatement for FY2001-FY2004 currently pegged at approximately \$11 billion. The 2,652 page report was compiled over an 18-month period by Rudman and Paul, Weiss, Rifkind, Wharton & Garrison LLP with the assistance of Huron Consulting Group, which provided forensic accounting services. Collectively, the investigators reviewed more than four million pages of hardcopy and electronic documents and conducted more than 240 interviews. According to management estimates, the cost of the Rudman Report is roughly \$60 to \$70 million. Rudman relied upon and received good (voluntary) cooperation from current and former management in obtaining documents and interviews with the exception of CFO Howard, who declined repeated requests for interviews. Six other non-senior managers under Howard also refused to talk to investigators. Controller

Spencer cooperated with the investigation in its early stages, but declined further interviews after investigators became aware of a critical document in her files, which she had failed to produce in a Paul, Weiss document request.

- In an interview with *The New York Times*, Rudman said that the document that Spencer failed to produce was the closest thing to a smoking gun, which his investigators found when they raided Spencer's office last spring while she was not present. This document, prepared by Spencer, set out different earnings projections with expense deferrals that described a plan, subsequently adopted by management, to improperly defer \$200 million in expenses in an effort to meet management's earnings per share (EPS) goals in 1998. In early 1999, Raines met with Spencer and Howard to discuss this plan, which resulted in an EPS slightly below the target of \$3.23. [Raines, who signed-off on the expense deferral, promoted Howard to the number two position in the company and Spencer to Senior Vice President and Controller in 1999. Howard, who joined the company in 1982 as chief economist, held a master's and bachelor's degree in economics from the University of California, Los Angeles. Spencer, a ten year veteran with the company, was *not* a certified public accountant.] To achieve a higher EPS, management decided to take two additional steps to reach its targeted EPS goal: (1) change accounting of low-income housing tax credits and (2) make an "unsupported" reversal of approximately \$3.9 million from an account for unreconciled items into miscellaneous income. The \$3.9 million adjustment, the Report said, "can be explained only by a motive to increase EPS results..." By making these three adjustments, Fannie Mae's EPS reached \$3.2309, which exceeded their targeted \$3.23 maximum and triggered payment of \$27.1 million in cash bonuses to the company's executives.
- Rudman said that the investigation will continue until his investigators have completed their review of materials submitted by Fannie Mae this month. On February 24, *Bloomberg's Money & Politics* reported, "Fannie Mae turned in 22 computers it found in a warehouse to investigators tracing accounting errors at the finance company. Former Senator Warren Rudman, heading the investigation, says the laptops were used by senior executives. ...A footnote in the [Rudman] Report says that Fannie notified Rudman only this month of the existence of those laptop computers."
- Fannie Mae chairman Stephen B. Ashley said, "[The Rudman Report's] findings are disturbing, disappointing and very serious. But big problems brought to light can teach big lessons. The Board accepts and embraces the report, its findings, and recommendations, including those regarding the company's structure, functions, financial system, compensation, and policies to ensure adherence to proper accounting practices and new internal controls. We acknowledge we have a lot of work to do to restore faith in Fannie Mae, and we are committed to doing that. We will continue to implement the improvements and move the company forward."
- Fannie Mae CEO Daniel H. Mudd said, "The Paul, Weiss report is strong but good medicine. We will work closely with the Fannie Mae Board of Directors, the Office

of Federal Housing Enterprise Oversight, the U.S. Securities and Exchange Commission, and others as we continue to move forward with remedial measures, carry out the terms of our regulatory agreements with OFHEO, make progress toward completing our restatements, cooperate with federal investigators and regulators, and build a better company. We have to get things right, get back on track, and continue serving the nation's housing needs.” (*A Report to the Special Review Committee of the Board of Directors of Fannie Mae*, Paul, Weiss, Rifkind, Wharton & Garrison LLP, 02/23/06; *The Main Wire*, Margaret Chadbourn, 02/23/06; *The New York Times*, Stephen Labaton and Eric Dash, 02/24/06; *The Main Wire*, Margaret Chadbourn, 02/23/06; *Bloomberg News*, James Tyson and Al Yoon, 02/23/06; *Bloomberg News*, Miles Weiss, 02/24/06; *USA Today*, Edward Iwata, 02/24/06; *Dow Jones Newswires*, Dawn Kopecki, 02/23/06; *Washington Post*, Annys Shin, 02/24/06; *Correspondence to the Honorable Warren B. Rudman*, David S. Krakoff, 01/05/06; *Washington Post*, Terence O’Hara, 02/24/06; *Bloomberg Money & Politics*, 02/24/06; *Fannie Mae Press Release*, Statement by Stephen B. Ashley, 02/23/06; *Fannie Mae Press Release*, Statement by Daniel H. Mudd, 02/23/06)

Reactions from Treasury Department and Senator Richard Shelby

- Treasury Undersecretary Randal Quarles said, “The Rudman Report lays bare the earnings-at-any-cost culture that had developed over many years at Fannie Mae, and the substantial abuses that resulted. A principal vehicle for generating these earnings was the enormous growth in the portfolio of retained mortgages, and that remains the principal legacy of this decade of abuse. While Senator Rudman’s report indicates that a number of the specific accounting violations and corporate governance problems are in the process of repair, the broad systemic risks inherent in the retained portfolio that was at the heart of the process remain unchanged. In addition, the retained portfolio provides little added value to achieving the GSE’s mission. That is why we need legislative reform. Treasury remains committed to seeing the presence of a world class regulator for the GSEs and ensuring a legislative mandate for reduction of the retained portfolios to reduce systemic risk.” (*U.S. Treasury Department Press Release*, 02/23/06)
- Chairman of the Senate Banking Committee Richard Shelby (R-AL) said, “...[T]he [Rudman] Report focuses on the failure of accounting and management controls that occurred at the company, indicating that many employees with accounting, financial-reporting and auditing responsibilities were unqualified or unfit for their positions. It describes a corporate culture at Fannie Mae that put earnings ahead of any other consideration. Many of these issues arose because of the large retained portfolio held by Fannie Mae. While a portfolio of this size is not a critical component in achieving their housing mission, it did serve as a mechanism to allow Fannie Mae to ensure earnings growth. The Rudman Report was tasked with examining and rectifying substandard accounting and management practices at Fannie Mae, it was not asked to address the nature of portfolios or the potential for systemic risk. I remain committed to passing a strong GSE regulatory reform bill this year. While a report of this nature

may soothe investors, the GSEs' portfolios remain a systemic risk for the U.S. economy." (*Press Release from Senator Richard Shelby, 02/23/06*)

Is the Rudman Report a "whitewash?"

- Former OFHEO director Armando Falcon, Jr. said the Rudman Report, which pinned most of the blame for the accounting errors on former CFO Timothy Howard and former controller Leanne Spencer, appeared "very generous in absolving almost anybody who had any role with what went wrong" at Fannie Mae. "They find so much improper accounting, but almost no misconduct?" asked Falcon. "It does not make a whole lot of sense." Falcon said he expects OFHEO will be "much more skeptical of the rationalizations that seemed to satisfy Rudman." In response, former Senator Warren Rudman said his report was "extremely critical" and has "very serious findings." Rudman added, "If that's a whitewash, I'd hate to see a blackwash." (*American Banker, Rob Blackwell and Patrick Rucker, 02/24/06*)
- In *National Mortgage News* online, Paul Muolo wrote, "It's finally out -- the long-awaited 'Rudman Report' which (from my reading) absolves Fannie Mae's board of all wrongdoing and pins the \$11 billion accounting scandal (we, of course, don't know the real size yet) on former executives Franklin Raines, Timothy Howard and Leanne Spencer. Sen. Rudman's investigators appear to have bought the argument from the directors that they were in the dark about the mess because they were being led astray by the alleged wrongdoers. (Question: Who hired Raines? Answer: The board.) It's too bad that Sen. Rudman didn't analyze the cozy relationship that some of the directors had with Mr. Raines. (Perhaps OFHEO will set the record straight?) One area Rudman looked into was the interference that Fannie's legal counsel (inside and outside) ran for management against OFHEO. (Remember how cocky Mr. Raines was in the fall of 2004, a few months before OFHEO forced the board to can him?) This was what Mr. Rudman (a lawyer) and his authors had to say about Fannie's lawyers: 'We have not seen any evidence that would call into question the good faith of the company's lawyers.' The report does note, however, that 'management and the lawyers were wrong.' As FM Policy Focus executive director Mike House put it: "It is inconceivable that a fraud of this magnitude, so amply documented in this 2,700-page report, went completely undetected" by the GSE's regulator, and its board..." (*National Mortgage News Online, Paul Muolo, February 25-26, 2006*)
- Collin Barr wrote on *TheStreet.com*, "The Report's wishy-washy take on Raines is hard to square with the CEO's chest-thumping testimony in October 2004, when he was so eloquent in describing Fannie's supposedly formidable internal controls. 'I receive reports about the financial statements, accounting policy developments, key disclosures, and any internal control considerations,' Raines told Congress. 'The CFO and I ensure that any questions raised during this session are answered prior to finalizing the report. ...Then the Board's Audit Committee reviews the draft report, and holds a conference call with senior management, and attended by KPMG, to discuss the report and results of our due diligence session.' Only then would he sign

off on the financials, he claimed. ‘These findings are disturbing, disappointing and very serious,’ Fannie’s chairman, Stephen Ashley, said of the Rudman Report. ‘But big problems brought to light can teach big lessons.’ Like don’t hire Frank Raines as your CEO.” (*The Street.com*, Colin Barr, 02/24/06)

Other Reactions to Rudman Report

- Peter Wallison, resident fellow at American Enterprise Institute, said, “The Paul Weiss report is not comforting. Fannie Mae and Freddie Mac are using enormously complex hedging strategies to manage the interest rate risk in their portfolios. The report covers only the accounting for these activities, and shows that some of Fannie’s senior officials were apparently able to manipulate the accounting in order to deceive the board and achieve their own ends. This is troublingly reminiscent of what happened in Enron and WorldCom. However, the accounting for hedging is only a way of describing reality. What we don’t know is whether the hedging itself was done properly. If the hedging was also done in such a way as to manipulate the financial reports, the problem could be far more serious. Unlike Enron and WorldCom, the financial troubles or failure of either of these two companies could--as Alan Greenspan has pointed out--create systemic risk. Under these circumstances, the stability of our economy, in effect, may rest on whether Fannie and Freddie continue to have both honest and competent staffs managing the risks inherent in their portfolios. Congress was concerned enough about Enron and WorldCom to pass the Sarbanes-Oxley Act in the hope of preventing a recurrence of similar events, and now has the chance to act before a crisis occurs. The only way to prevent dishonesty or incompetence from creating a systemic crisis in the future is to reduce the size of their portfolios. Fortunately, because they can continue to perform their functions through securitization, their portfolios can be reduced without in any way sacrificing whatever benefits they provide to the mortgage market.” (*Peter Wallison Press Release*, 02/23/06)
- John Dalton, president of The Housing Policy Council, said, “The most important conclusion that should be drawn from this [Rudman] Report is that it reaffirms the critical need for a strong, independent regulator for Fannie Mae and Freddie Mac.” (*Bureau of National Affairs*, 02/24/06)
- Mike House, Executive Director of FM Policy Focus, said, “It is inconceivable that a fraud of this magnitude, so amply documented in this 2,700 page report, went completely undetected by Fannie Mae’s regulator the Office of Federal Housing Enterprise (OFHEO) and Fannie’s Board for years. The fact that Fannie Mae was systematically cooking its books, while OFHEO continued, year in and year out, to give the company the highest safety and soundness ratings, is outrageous. Fannie Mae operated with impunity because it had nothing to fear from its regulator. And that is why Fannie Mae and the American taxpayer remain embroiled in an accounting scandal that is 19 times bigger than Enron’s. ...What is most important to remember today is that the same regulatory structure that continuously gave Fannie Mae the highest ratings possible and the same Board that allowed Fannie Mae to

represent itself as ‘Best in Class’ while the GSE was manipulating its earnings, remain in place. In fact, Fannie Mae is currently engaging in new high-risk business like construction finance even though no one yet knows the scope of their internal control problems. There is only one effective solution to this problem: Congress must act to create a tough independent regulator with adequate authority to prevent these abuses and protect the taxpayers.” (*FM Policy Focus Press Release*, 02/23/06)

- Jerry Howard, CEO of the National Association of Home Builders, said, “The Rudman report confirms our long-held belief that the current Fannie Mae management team is taking the necessary steps to put the company back on the right course. ...The Rudman report’s findings underscore the need to pass H.R. 1461..., which was introduced by Representatives Richard Baker (R-LA) and Michael Oxley (R-OH) and adopted by the House last year by a wide margin. Furthermore, the Rudman findings do not support taking any draconian action as some policymakers have suggested. H.R. 1461 provides the appropriate regulatory structure that allows the Government Sponsored Enterprises (GSEs) to fulfill their housing mission and to deliver the necessary credit to the housing market while, at the same time, guaranteeing that the GSEs operate in a safe and sound manner.” (*PR Newswire*, 02/23/06)

Wall Street’s reaction to the Rudman Report

- Wall Street breathed a sigh of relief after reading the Rudman Report, noting that no new accounting items were identified which could impair the company’s capital. The Street viewed the Report’s “exoneration” of the company’s existing management and board favorably and concluded it would add little, if any, momentum to Congress’s push to pass GSE regulatory reform. “The concern was that if they found additional accounting problems that there would be capital issues to deal with, leaving Fannie Mae in a shrinking rather than growing mode,” said Arthur Frank, Nomura Securities’ director of mortgage bond research. “It’s a pretty positive report for Fannie Mae.” Jaret Seiberg, a policy analyst for Stanford Washington Research Group, wrote, “This Report reinforces our view that the worst of the GSE scandals is past.” Citigroup mortgage analyst Bradley Ball wrote, “We believe the [Rudman] Report is unlikely to boost hard-line government-sponsored-entity reform. Political reactions should largely be verbal as views in Congress and at the Treasury Department shouldn’t change in the near term.” (*Marketwatch*, Leslie Wines, 02/23/06; *American Banker*, Rob Blackwell and Patrick Rucker, 02/24/06; *Bloomberg News*, Michael Schneider, 02/23/06)
- Jim Vogel, an agencies strategist at FTN Financial Capital Markets, said, “What’s particularly striking in the report is that it’s in direct contrast to the way the company presented itself, with its accounting being basically above reproach.” Piper Jaffray analyst Robert Napoli said, “It’s just mind-boggling. Fannie Mae has this trillion-dollar mortgage portfolio and relatively small amount of overhead. A company like that could invest hundreds of millions to have the best systems and controls.” [Why didn’t they?] (*Bloomberg News*, Miles Weiss, 02/24/06)

- In a more critical assessment, Bank of America Equity Research analyst Robert Lacoursiere wrote, “[The Rudman Report] should serve as a catalyst to the political process of the GSE reform.” The Report confirmed problems associated with Fannie Mae’s “oversized portfolio,” and “shows the company did not have proper accounting systems and professionals to adequately handle the accounting issues associated with the large retained non-mission supportive portfolios.” Lacoursiere continued, “This increases our concerns that the portfolio issues must be addressed in order to ensure solid accounting and reduce the market-disruptive impact of associated concentrated portfolio risk. ...The systematic problems indicated by the [R]eport call into question the ability of the GSEs to properly handle their large, risk-concentrated retained portfolios and, in our view, make constraining the size of the portfolios even more pressing and an important, necessary component of the final GSE reform resolution.” (*Dow Jones International News*, John Connor, 02/23/06)

Former Fannie employee’s reaction to Rudman Report speaks volumes

- During an on line chat held on February 25 by *Washington Post* reporters Annys Shin and Kathleen Day, an anonymous poster wrote, “I used to work for Fannie Mae and I can offer the following commentary: After the Freddie Mac scandal, Fannie Mae had their yearly open meeting where anyone in the company could ask Frank [Raines], Tim [Howard], or anyone in senior management anything. Frank showed honest anger at the Freddie Mac execs. If you’ve ever seen him, you know he’s quite mild-tempered so this really made an impression on me. That said ...and this is why I’m posting anonymously ... I know some DBAs [database administrators] who were asked to re-run older scripts against the database to see ‘what the numbers would look like’ under prior year’s regulations. In hindsight, it seems very, very obvious what was happening. But you really have to appreciate the change in corporate culture from the late ‘90s to early 2000s.”
- “When I joined [Fannie Mae], there was a proactive culture where people would go out of their way to help you. When I left, everything was (and according to my former co-workers still is) very passive aggressive. If you see someone about to fall off a cliff, you don’t help them. You wait for them to fall and tell management about it. I chuckled when I read the line in Annys Shin’s article today: ‘Many folks are not willing/comfortable to tell senior management what they don’t want to hear.’ HA! If I saw a problem, I wouldn’t have told LOWER management about it. There’s always a chance the problem could correct itself and if you can’t blame someone else for a problem, the messenger gets put up against a firing wall and shot. But then I don’t work there anymore and I’m clearly bitter. So take this with all the appropriate salt required.” (*Washington Post Online: Fannie Mae Accounting Report*, Annys Shin and Kathleen Day, 02/24/06, 12:00 PM)

Editorial boards react to “internal rot” found at Fannie Mae

- In a February 25 editorial, the *St. Petersburg Times* wrote, “Internal rot has been found in the house that Fannie Mae built. A new report details how top managers at the home mortgage finance giant manipulated the books so they could secure generous bonuses for themselves. The tale is almost cliché at this point, with so many corporate accounting scandals erupting in recent years with the same script. But it is still disgusting to see how easily corporate leaders let avarice get the better of them, and how willing they are to cheat their companies and shareholders.”
- “After an 18-month investigation, a team of lawyers and investigators including former Sen. Warren Rudman found that Fannie Mae’s top executives cooked the books so it appeared that they had met earnings projections. That enabled them to qualify for more than \$27-million in bonus payments. When a thief steals a few hundred dollars from a bodega cash register, he is considered a menace to society. So too are those involved in a plan that results in the siphoning off of millions in undeserved compensation.”
- “This investigation should not end with the executives simply being asked to repay the excess bonuses. It is expected that later this year, Fannie Mae will have to restate \$11-billion of claimed earnings. That’s not chicken feed. The company’s executives were not giving the board or shareholders an accurate financial picture. The Department of Justice and the Securities and Exchange Commission are independently looking into the executives’ machinations. If a criminal case can be made, it should.” (*St. Petersburg Times*, 02/25/06)
- In a February 24 editorial, the *Wall Street Journal* wrote, “The stock market seemed relieved yesterday when Warren Rudman’s 2,652-page report into Fannie Mae’s accounting troubles didn’t report major new discrepancies in the mortgage giant’s books. That news was enough to put the stock up about 2% on the day after a nearly 4% rise Wednesday ahead of the report’s release. And we suppose it is good news of a sort that Fannie Mae’s accounting restatement, for which the world has been waiting for more than a year, won’t grow from the \$10.8 billion figure already estimated. But \$10.8 billion is big enough as it is; WorldCom’s fraud came to ‘only’ \$11 billion. The report’s main findings paint the picture of a company that routinely flouted both the rules and law.”
- “...If Fannie Mae were a normal private company, it would be tarred and feathered faster than you can say ‘Enron.’ But Fannie Mae is not just another private company. It has a federal charter and an implicit guarantee from the government (read: taxpayers) of its debt. Which makes it all the more vital that Congress reduce the risk that Fannie Mae and Freddie Mac pose to our financial system...”
- “One of the Rudman report’s more worrisome findings was that Fannie’s derivatives accounting was wrong because Fannie claimed that its hedges exactly matched its risk exposure when it did not. Fannie has long claimed it is capable of perfectly hedging

the interest-rate and prepayment risks in its \$800 billion portfolio of mortgage-backed securities. The Rudman report found that that often was not true. But the report only looked at the accounting issues posed by derivatives and hedging, so the public still knows precious little [if anything] about the extent of the portfolio risk.”

- “The report lets former CEO Franklin Raines off lightly, blaming him mainly for a ‘culture’ that tolerated the accounting abuses. But the core of that culture was a belief that critics -- including us -- could be dismissed and assailed because the company knew it had Congress bought and paid for. And judging by the laughably weak reform that Financial Services Chairman Mike Oxley passed through the House, it still does. If Republicans on Capitol Hill want to know why voters think they’ve gone native, the failure to rein in Fannie even after a \$10.8 billion accounting scandal is Exhibit A.” (*Wall Street Journal*, 02/24/06)

The fundamental question: Do we need the GSEs?

- In a February 23 report on National Public Radio’s *Marketplace*, reporter Amy Scott said, “[T]he main [GSE] issues that Congress is looking at have more to do with whether we need Fannie Mae and Freddie Mac, and whether their size, their relative sizes are so great that they pose much more of a financial risk than the economy can take. And so I think ...the accounting errors may be put behind Fannie Mae, but what’s left to come are some serious questions about how they should be regulated, how they should be structured and whether we need these government-backed agencies at all.” (*National Public Radio’s Marketplace*, Kai Ryssdal and Amy Scott, 02/23/06)

Federal Reserve Chairman Bernanke renews call to limit the size of Fannie and Freddie

- In his maiden voyage appearing before Congress, Federal Reserve chairman Ben Bernanke voiced his concern that the size and risk profile of Fannie Mae’s and Freddie Mac’s investment portfolios threaten the stability of financial markets. “The portfolios of the GSEs are much larger than can be justified in terms of their fundamental housing mission, and these large portfolios represent a risk to financial stability.”
- In response to a question at a House Financial Services Committee hearing, Bernanke said that the House GSE regulatory reform bill (H.R. 1461) has a number of shortfalls, including weak authority for a new regulator to set capital levels at the GSEs and insufficient restrictions on the companies’ enormous investment portfolios. “I understand the good intentions underlying the House bill, but I feel it does not solve the problems and therefore if we were to go with that bill, we would be missing the last opportunity we will have in many years to really address these problems,” said Bernanke. “I want to just reiterate that I agree the GSEs do perform a very important service in securitizing mortgages. So I have no vendetta against the GSEs by any means. But I am concerned about size of their portfolios and the risks

inherent in trying to hedge them.” When asked to comment on the House bill provision that creates an affordable housing fund, Bernanke declined to comment, saying the proposed fund is “outside my purview.”

- After Bernanke appeared before the House Financial Services Committee, Chairman Michael Oxley (R-OH) told *Bloomberg News*, “We’re willing to entertain everything on the table,” including portfolio limits for GSEs. (*Washington Post*, Annys Shin, 02/16/06; *Congressional Quarterly*, Michael R. Crittenden, 02/15/06; *Reuters*, Kristin Roberts, 02/15/06; *Bloomberg News*, James Tyson, 02/15/06; *Marketwatch*, Rex Nutting, 02/15/06)
- In the annual report prepared by the White House Council of Economic Advisors (CEA), the economists echoed Bernanke’s calls for Fannie Mae and Freddie Mac to have a stricter regulator that would reduce the size of their combined \$1.4 trillion mortgage portfolios. A failure by the GSEs to control the risks in their massive portfolios “could severely diminish the liquidity of the mortgage market and create severe financial stress for holders of the companies’ securities,” the report said. Countering the GSEs’ arguments that massive reductions in their portfolios could raise interest rates or disrupt the housing market in other ways, the report noted that Fannie Mae reduced its portfolio by \$75 billion in the first half of 2005 with “no noticeable effects” on the MBS or home mortgage market. (*Bloomberg News*, Brendan Murray, Andrew Ward and Ryan J. Donmoyer, 02/13/06; *Dow Jones Newswires*, Henry J. Pulizzi, 02/17/06)

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac spent \$23 million lobbying Congress in 2005

- In 2005, Fannie Mae and Freddie Mac spent nearly \$23 million on lobbying Congress, as Congress considered GSE regulatory reform legislation in response to the GSEs' multibillion accounting scandals. During the year, Freddie Mac spent \$12.6 million on lobbying, down from \$15.44 million in 2004, while Fannie Mae spent \$10.1 million, up from \$8.78 million in 2004. While Fannie Mae reduced its spending on outside lobbyists by 24% to 3.7 million, the company's in-house lobbying cost rose 64% to \$7 million. Fannie Mae officials attributed the growth in lobbying expense to the rapid increase in its administrative costs last year, part of which are apportioned to its in-house lobbying operations under the company's internal accounting rules. Fannie Mae officials "look at our internal lobbying hours divided by our total employee hours, so you come up with a fraction, and then you multiply the administrative costs of the whole company by that fraction" to determine lobbying expenses, said Fannie's spokesman Brian Faith. "Fannie Mae remains committed to its overall objective of cutting external lobbying expenses by one-third from previous levels," Faith added. Campaign experts were puzzled by the Fannie's increased lobbying expenditures, particularly in light of the company's pledge to cut back its extensive lobbying network. (*Bloomberg News*, James Tyson, 02/18/06; *Dow Jones Newswires*, John Connor, 02/21/06; *Washington Post*, Annys Shin, 02/20/06)

Senator John Sununu reiterates the need for GSE regulatory reform

- Senator John Sununu (R-NH), a co-sponsor of GSE regulatory reform legislation, said "Many people in the financial services community, across a wide range of disciplines, wide range of areas, they have seen problems of moral hazard, they have seen problems of systemic risk and they have seen how important it is to have a regulator with real power. ...There is a lot of history that underscores the need for a credible, effective [GSE] regulator with real supervisory powers."
- Sununu continued, "The Senate language reflects a very good approach [to requiring reductions in the GSEs' portfolios]. It doesn't set a specific level, but requires that the portfolio be consistent with the charter and the mission of Fannie Mae and Freddie Mac. That is exactly what a credible, effective regulator should be doing: Make sure that these institutions remain focused on their mission of liquidity in the secondary mortgage market."
- "I think it's very possible [to reach consensus with Democrats on restricting the GSEs' portfolios]. There really aren't many areas of the bill where there are differences in opinion, even across the entire political spectrum. We're talking about

a few areas of the bill where people want to take a closer look. The possibility is there to build consensus. I think more and more people are recognizing the need for regulatory powers on the part of the overseer to establish guidelines and limits on the portfolios. They cannot continue to allow them to expand unrestricted in a way that has nothing to do with the mission of Fannie Mae and Freddie Mac. (*Bloomberg News*, James Tyson, 02/16/06)

Federal Reserve Vice Chairman Ferguson resigns

- Federal Reserve Vice Chairman Roger W. Ferguson, Jr. announced his resignation, effective April 28. Ferguson, whose term was not set to expire until January 31, 2014, joined the central bank in November 1997. He was the last Democratic appointee on the seven-member Board; the six other members are all Bush appointees. In a separate statement, the Fed said Ferguson would not attend the March 27-28 meeting of the policy-setting Federal Open Market Committee.
- As Ferguson leaves to “pursue other professional opportunities,” some expressed surprise that he was leaving so soon after Ben Bernanke replaced Alan Greenspan as the Fed chairman. “I think his departure is more a sign of stability and consensus at the Fed than a reflection of disagreement,” said former Fed governor Edward M. Gramlich. Donald L. Kohn, who now sits on the board after years as a top Fed staff economist, is widely considered to be the leading candidate to replace Ferguson as vice chairman. (*New York Times*, Louis Uchitelle, 02/23/06; *Federal Reserve Press Release*, 02/22/06; *Reuters*, 02/22/06)
- Ferguson’s resignation was announced after the Senate approved the nominations of University of Chicago economist Randall S. Kroszner and White House aide Kevin M. Warch to be members of the Federal Reserve Board. The Senate confirmed the nominees without debate. The Senate also confirmed Edward P. Lazear, the President’s choice to succeed Ben Bernanke as chairman of the Council of Economic Advisors. (*CQ Today*, Michael R. Crittenden, 02/17/06; *Reuters*, Tim Ahmann, 02/17/06)

FAS 133 accounting rules may change

- Following years of companies complaining that FAS 133 distorted their earnings and confused investors, the Financial Accounting Board has proposed a rule to provide a simpler way for companies to account for derivatives and the securities and other instruments they often hedge on their balance sheet. The rule would let companies use current market prices (or “fair values”) for a wider variety of instruments than is now allowed, similar to the International Accounting Standards Board’s rules. Under current rules, companies value some instruments at their market price and others at their historical cost, resulting in a balance-sheet mishmash. “We believe this will

create an enormous opportunity for companies to simplify their accounting,” said Edward Trott, a FASB member.

- Jim Vogel, an analyst at FTN Financial Capital Markets, Memphis, said the effects of the rule change probably would be mixed for Fannie Mae and Freddie Mac. While the proposed rule might simplify their accounting and make earnings easier for investors to understand, by offering a way to hedge interest-rate risks without distorting earnings, the rule also could make it more attractive for banks to retain fixed-rate mortgages on their books rather than selling them to the mortgage giants. Even if the fair-value option is adopted, analysts and investors could still be confused if companies in the same industry don’t employ it uniformly. “Consider the comparability issues if [General Motors Acceptance Corp.] decided to carry their loan and lease receivables at fair value but Ford Motor Credit continued with [historical] cost accounting,” said Moody’s Investors Service in a recent report. While this issue has prompted some dissent within the FASB board, it is more likely that “where you have many companies in the same line of business, they may end up making about the same choices,” said Trott. (*Wall Street Journal*, James R. Hagerty and David Reilly, 02/23/06)

Hurricane recovery notes:

Fannie and Freddie extend their foreclosure moratorium in 21 Gulf Coast counties

Uninsured Katrina losses in New Orleans expected to total \$3 to \$6 billion

Finally – a chance for New Orleans

The Louisiana Legislature’s special session yields little for Governor Blanco

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Is Representative “Dollar Bill” Jackson’s political empire crumbling?

Fannie and Freddie extend their foreclosure moratorium in 21 Gulf Coast counties

- Fannie Mae and Freddie Mac have taken steps to extend their moratoriums on mortgage payments in the areas of Alabama, Louisiana, Mississippi and Texas hit hardest by Hurricanes Katrina and Rita. Fannie Mae has barred until May 31 any foreclosures on loans that it guarantees in the 21 counties and parishes in the three-state region declared a disaster area. According to a company spokeswoman, Fannie Mae will not allow foreclosures against “anyone who is late in their payments” as a result of the hurricanes. In other areas affected by the storms, Fannie said servicers should follow its normal foreclosure policies on properties that have no “significant

damage,” assuming that they have notified the borrowers. They also must obtain Fannie Mae’s approval to foreclose on other loans in these areas. (*American Banker*, Jody Shenn, 02/16/06)

- In place of its “one-size-fits all” approach to working with area borrowers, Freddie Mac has broken down the 119 Gulf Coast counties into three zones, defined by the degree of storm damage. The company has extended its foreclosure suspension until May 31 in Zone 3, which consists of the 21 counties and parishes hardest hit by the hurricanes. In Zone 2, consisting of the 34 counties and parishes with less severe damage, Freddie Mac is requiring servicers to obtain the GSE’s permission before initiating foreclosure on loans it guarantees. Freddie Mac is lifting its blanket foreclosure moratorium in Zone 1, the remaining 64 counties where there was no or minimal storm damage. (*Freddie Mac Press Release*, 02/13/06)

Uninsured Katrina losses in New Orleans expected to total \$3 to \$6 billion

- According to a Mortgage Bankers Association study, the cost of repairing the 95,000 properties damaged in New Orleans by Hurricane Katrina’s flooding will total between \$8 and \$10 billion. With flood insurance expected to cover \$4 billion to \$5 billion, uninsured losses are estimated to total between \$3 billion and \$6 billion. (*National Mortgage News Online*, 02/16/06)
- According to new estimates by the U.S. Bureau of Economic Analysis, Hurricanes Katrina and Rita wiped out approximately \$67 billion of residential housing stock in the Gulf Coast region. (*National Mortgage News Online*, 02/14/06)

Finally – a chance for New Orleans

- In a February 18 editorial, the *Washington Post* wrote, “Sometimes, more is achieved by quiet negotiation than by public finger-pointing. That seems to be the lesson of the Bush administration’s turbulent New Orleans policymaking over the past several weeks. The latest round started last month, when the administration loudly announced that it would not support legislation to set up a federal development corporation to buy back destroyed property in the city. After doing so, a clutch of public officials, including President Bush, infuriated Louisianans by accusing them of having ‘no plan’ for reconstruction. In fact, the development corporation had been the plan.”
- “But although some of the public comments were ugly, the main participants quickly concluded that the fuss was helping nobody. Quietly, the Department of Housing and Urban Development, the Louisiana Recovery Authority and the White House’s Hurricane Katrina point man, Donald E. Powell -- together with some hired consultants from McKinsey & Co. -- decided to work out how much money was needed to put into a place a buyout program of the kind the rejected legislation had envisioned. The formula they came up with provides a sum of money to owners of

flood-damaged properties, taking into account pre-Katrina values and the extent of damage. The compensation is intended to work in concert with a zoning plan: Put simply, it will encourage people who lived in unsafe areas to take the money, sell their land back to the city and move to higher ground.”

- “The formula is not extravagant, covering only residential property, not businesses (which are theoretically supposed to receive help from the glacially slow Small Business Administration). It is designed to cover the gap between the real cost of reconstruction and what hurricane victims have already received from their insurance companies and the Federal Emergency Management Agency. No homeowner can receive more than \$150,000. The White House and the Louisiana Recovery Authority now agree that the whole program can be paid for with the \$6.2 billion Louisiana has received in reconstruction funds, plus an additional \$4.2 billion that the president has requested that Congress put into a supplemental spending bill.”
- “This is not a done deal. New Orleans politicians have to encourage city residents to participate. Congress has to approve the final chunk of money and not siphon it off for other purposes. But if the country ever wants this city to be revived, this is the best remaining solution.” (*Washington Post*, 02/18/06)

The Louisiana Legislature’s special session yields little for Governor Blanco

- The Louisiana State House killed Governor Kathleen Blanco’s housing trust legislation in the waning hours of the final day of its 12-day session, refusing to consider a stripped-down bill that supporters said was necessary to begin the process of figuring out how to get rebuilding and buyout money to homeowners. The Governor has instructed her staff to “figure out” a new mechanism that the state can use to distribute billions of dollars in federal aid without involving the legislature, which reconvenes on March 27 for its regularly-scheduled three-month session. Of the \$6.2 billion in federal Community Development Block Grants and \$1.7 billion in hazard mitigation money, Blanco has said she wants the Legislature to allocate \$4.6 billion to individual homeowners and \$1 billion to affordable housing. Some lawmakers refused to support the Governor’s housing trust legislation, because the administration was trying to rush the creation of a state agency that could control as much money as the state’s operating budget. One sticking point in the proposed bill was whether there should be only one state entity to distribute assistance or whether the City of New Orleans should have its own vehicle. Blanco was successful in getting more permanent legal standing for the Louisiana Recovery Authority, an agency she had created in October through Executive Order to oversee rebuilding efforts. (*Times-Picayune*, Laura Maggi, 02/18/06)
- Blanco was also unable to marshal support for a single unified levee board or for the consolidation of the seven New Orleans assessors into a single office, as well as sheriffs, clerks of court, and other New Orleans municipal offices. As the session progressed, the “mood ... veered from rebellion to outright hostility,” according to the *Times-Picayune*. In a “major turnaround,” the legislature approved a final levee

board consolidation plan, creating create two boards for the east and west banks, whose appointees are experts like engineers and hydrologists and that don't oversee non-levee items like marinas and a police force. Voters must approve the constitutional change needed to enact this legislation in a September statewide election. (*Associated Press*, 02/18/06; *Times-Picayune*, Jan Moller, 02/14/06)

- In a February 26 editorial, the *Times Picayune* wrote, "...The debate over levee board reform was partly symbolic. For business groups and good-government activists, replacing local levee boards with a single, more professional agency was the least our state could do to show that it's willing to help itself. If we can't do this, the argument went, then how can we attract wary employers back? If, after a disastrous flood, we can't change the culture of indifference, sloth and political intrigue that pervades our local flood-protection agencies -- then how can we claim to be responsible stewards of federal aid? When hostile lawmakers killed Sen. Boasso's reform bill last fall, concerned residents banded together to demand action on the issue. Newly formed groups such as Citizens for 1 Greater New Orleans treated the levee debate as a battle for the soul of Louisiana government. And it was. But the future of greater New Orleans' levee boards isn't just a symbolic matter. The behavior of the new agencies will affect the health and safety of everyone in greater New Orleans. For that reason, groups that will nominate people need to start thinking about [levee] board members [who] are up to the job. And average citizens need to remain vigilant." (*Times-Picayune*, 02/25/06)
- In a February 24 editorial, *The Advocate* [Baton Rouge, LA] wrote, "Louisiana needs less happy talk. We're all for being upbeat, but let's face it. Gov. Kathleen Blanco is just flat delusional if she believes that the special session of the Legislature was a success. Again and again, measures for progress were defeated or watered down. The administration was almost helpless, with dozens of its floor leaders and committee chairmen voting against Blanco's key recommendations.
- "...What happens this year? Open rebellion, with no apparent consequences. In purely political terms, it's ironic. Blanco's wishes aren't the be-all and end-all of legislation, obviously, but she at least formally recommended significant measures to the Legislature. When there was any serious political pushback, her recommendations failed. The governor compromised a lot, perhaps too much. Was she wrong to push tough proposals? We don't think so. Was she wrong to compromise? Maybe so, although the levee board bill is arguably a measurable improvement. And compromise is part of the legislative process."
- "But at the end of the session, she was lauding its result as though it were a gold medal in the Olympics. Perhaps it's in the governor's political interest to appear to be winning. We long for the governor to come out before the people and ignore her politics. She ought to be willing to say how disappointed she is in the Legislature's blindness to the new realities of Louisiana. That the Legislature in the special session did about 10 percent of what it needs to do. That Louisiana has to change in ways

that nobody's going to like politically and that require sacrifice across the board.”
(*The Advocate*, 02/24/06)

New Orleans race attracts twelve candidates for Mayor

- Hoping to win the post his father held in the late 1970's, Louisiana Lt. Governor Mitch Landrieu has announced his candidacy for Mayor of New Orleans to “restore our creditability and internationality.” The crowded field of Mayoral candidates includes incumbent Ray Nagin and the Reverend Tom Watson, the only two black candidates (to date) in the race. Other candidates include Ron Forman, chief executive officer of the Audubon Institute; City Councilwoman Peggy Wilson; local public radio host James Arey; lawyer Virginia Boulet; former minor league baseball owner Rob Couhig; Orleans Parish School board member Jimmy Fahrenholtz; investment banker Mike Hammer; community activist and financial planner Carola Hornbrook; community activist and former state Representative Leo Watermeier and lawyer Bill Wessel. The sign up period for the race ends the week of February 27 for the April 22 election. (*Times-Picayune*, Gordon Russell, 02/25/06; *Associated Press*, Jessica Bujol, 02/22/06)
- U.S. District Court Judge Ivan Lemelle refused to postpone the April 22 mayoral elections in New Orleans, rejecting argument that not enough has been done to ensure participation by the city's evacuees. “We're extremely disappointed,” said attorney Tracie Washington, who represented hurricane victim advocates who argued that state should set up out-of-state “satellite” voting operations or that the election must be delayed. Lemelle rejected both arguments out-of-hand. Secretary of State Al Ater said the State has done everything possible to ensure that displaced New Orleans residents can vote, including a \$1.5 million information campaign to inform and educate voters. Provisions have been made to loosen absentee restrictions and voting places in ten locations around the state will be set up to allow displaced New Orleans residents to vote. Leaders of the National Association for the Advancement of Colored People have threatened to file a lawsuit seeking to block the April 22 elections, if it is not delayed. “The effect of this adverse ruling means that more than 100,000 people, predominately people of color, will have to use absentee ballots, when historically less than 5 percent of Louisiana's registered voters used them under the best of conditions,” said the NAACP. (*Houston Chronicle*, Kevin McGill, 02/24/06; *Times-Picayune*, Bruce Egglar, 02/25/06)

Rumblings on the 2007 LA Governor's race

- In a letter to supporters, Senator David Vitter (R-LA) said, “I'm flattered by the talk [that I might consider running for in 2007 for the governorship]. But I am completely focused on, and challenged and fulfilled by my work in the U.S. Senate. Even in these pressure packed times, it is my dream job.” Vitter assured his supporters that he has “personally spoken to another well known conservative reformer who has assured me that he will now definitely make the race, no matter who else does or doesn't

run.” Although no names are named, it’s “not a far leap to assume that the candidate in question is Representative Bobby Jindal (R-LA), who ran a near-miss gubernatorial bid in 2003 before being easily elected to Vitter’s old House seat in 2004,” wrote the *Washingtonpost.com’s Political Blog*.

- Meanwhile, Governor Kathleen Blanco (D), who has pledged to seek re-election, reported \$2.4 million in her campaign account on December 31, 2005. Some Democrats, concerned about Blanco’s political baggage, are trying to recruit former Senator John Breaux to challenge the Governor in the primary. (*Washingtonpost.com’s Political Blog*, 02/21/06)
- As a result of an unexpected surge in state tax revenues which created a windfall of \$400 million more in revenue than previously forecast [and an *additional* \$101 million for the upcoming budget year], Blanco said she plans to include a pay raise for public school teachers in the budget that she presents to the Legislature next month. She refused to comment on how big a raise she will seek or how it would be structured. The Governor rejected the notion that the State would send a poor message by using its surplus dollars for something other than recovery and reconstruction. “This is Louisiana money. This is our tax base,” said Blanco. “When we talk about recovery, sometimes we only think about the coastal regions, but we have to recognize that the rest of Louisiana has picked up the burden and education is the universal equalizer.” State Senator Craig Romero (R-New Iberia) argued that the state should reserve any excess tax revenues for emergency spending. “We still have a ...bill from the [federal] government that’s hanging over our head that we have pay,” said Romero, referring to estimated \$1 billion that the state will owe FEMA for its share of hurricane relief spending. Blanco responded that the budget “will likely include” money for the first installment payment of \$156 million due to FEMA by March 31.
- Is the Governor’s proposal to raise teachers’ pay another example of “L’etat c’est moi” governance in Louisiana? *The Advocate* [Baton Rouge, LA] wrote, “The French monarch Louis XIV, the man for whom Louisiana is named, is famous for the assertion, ‘L’etat c’est moi,’ which translates as “I am the state.” It was the king’s view, in other words, that his personal interest and the public interest were always one and the same. ...In the wake of Hurricane Katrina, the worst natural disaster in American history, the tax base of New Orleans is decimated, and its local government is living hand-to-mouth. We’ve gone to Washington with tin cup in hand to make the case that the Crescent City and Louisiana can’t afford to rebuild without federal help.” So, the Governor proposes to raise teachers pay rather than use the tax base for hurricane recovery? (*Times-Picayune*, Jan Moller, 02/25/06; *The Advocate*, 02/21/06)

Is Representative “Dollar Bill” Jackson’s political empire crumbling?

- Representative William J. Jefferson (D-LA) legal woes are mounting, as federal investigators target the 58-year old Congressman for allegedly demanding cash and

other favors for himself and other relatives in exchange for using his Congressional clout to arrange African business deals. The *Washington Post* wrote, “Jefferson’s world is toppling. ...Depending on Jefferson’s fate, his central New Orleans district - - badly damaged by Hurricane Katrina and in need of effective representation in Washington -- could face a rowdy special election. The political scene is so chaotic that Republicans believe they could win the gerrymandered Democratic seat.”

- “...Jefferson has attracted controversy over the years. Nicknamed ‘Dollar Bill’ in New Orleans, he is known as a formidable fundraiser with designs on his own political empire. Daughter Jalila Jefferson-Bullock is a state legislator. In helping her get elected, Jefferson was heard on an FBI wiretap soliciting improper fundraising help from his brother-in-law, Jefferson Parish Judge Alan Green, who was sentenced last week to more than four years in federal prison in an unrelated bail-bond corruption case. Jefferson said in a statement last May that he recalled the conversation with Green but added that his request for help was familial. ‘To my knowledge, nothing resulted from the conversation -- the campaign did not receive any money from Judge Green or anyone who may have been prompted by him to contribute -- and there were no further conversations on the matter,’ Jefferson said. Jefferson also generated controversy when, in the midst of post-Katrina rescue efforts, he used National Guard troops to help him get belongings from his house in New Orleans.”
- “...With only about one-fifth of the district’s 500,000 residents believed to be living in New Orleans, it is possible that a white Democrat or even a Republican could take the seat, which was drawn as a black district and which Jefferson had hoped to hand off eventually to his chosen successor. That now looks less likely. ‘He’s strong, but not that strong that he could withstand an indictment,’ said John Maginnis, publisher of a weekly Louisiana political newsletter.” (*Washington Post*, Shailagh Murray and Allan Lengel, 02/16/06)

Hearings on credit-rating agencies will likely be held this spring in Congress
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- Senate Banking Committee Chairman Richard Shelby (R-AL) has tentatively scheduled a March 7 hearing on credit rating agencies, said committee spokesman Andrew Gray. Shelby is undecided about the best way to address concerns about conflicts of interest in the credit rating process and the lack of competition in the industry, said Gray. The Senator has not had an opportunity to review the proposed 2005 Credit Rating Agency Duopoly Relief Act [H.R. 2990], proposed by Representative Michael Fitzpatrick (R-PA), he added. “I wouldn’t rule out legislation at our end. We have a deliberative process in place through the Committee, which is the way we operate all legislative matters,” said Gray. (*Bureau of National Affairs*, Rachel McTague, 02/15/06)
- Representative Richard Baker (R-LA), chairman of the House Capital Markets Subcommittee, has tentatively scheduled an April hearing with SEC Chairman

Christopher Cox to address his concerns related to credit rating agencies. Baker has complained that only a handful of rating agencies are designated as “nationally recognized” by the SEC, leaving the industry to be dominated by Moody’s and Standard & Poor’s. While the SEC has floated a proposal to clarify the designation process, legislation may be needed to make broader changes to the industry. Baker has not yet discussed the subcommittee’s agenda with House Financial Services Committee Chairman Michael Oxley (R-OH) or Cox, who recently had surgery to remove a tumor. “[Cox’s] recovery appears to be going fine. There is no bad news [regarding Cox’s health],” said Baker. (*Dow Jones Newswires*, Judith Burns, 02/16/06)

Fannie Mae

Fannie Mae falls short of some 2005 housing goals

- Fannie Mae “fell slightly short” of two subgoals HUD created last year, said company spokesman Chuck Greener. A preliminary analysis of 2005 results show that Fannie met HUD’s three basic goals, requiring certain percentages of its financing go to people of low or moderate incomes, to very low-income people, and to areas deemed underserved by lenders. Within HUD’s subgoals that set targets for home-purchase mortgages and exclude refinancing loans, Fannie met the subgoal for very low income people, but fell less than 1% short of the subgoals for low and moderate income and for underserved areas, according to the GSE’s analysis. “We are fully committed to working with HUD in an effort to meet these goals,” said Greener. The GSEs are required to submit data on their mortgage financing, which demonstrates their compliance with HUD’s goals and subgoals to the agency by March 16. (*Wall Street Journal*, James R. Hagerty, 02/13/06; *Associated Press*, Marcy Gordon, 02/13/06; Bloomberg News, James Tyson, 02/13/06)

The “welcome mat” is out at Fannie Mae,

- On the eve of the issuance of the Rudman Report, *The New York Times* reported that Fannie Mae has instituted some new house rules: “Demonstrate humility. Communicate openly. Make the company a no-spin zone. Respect the view of others. Minimize internal politics. Apologize and quickly and fix mistakes.” [Clearly, former CEO Franklin Raines has left the building.]
- Fannie Mae CEO Daniel H. Mudd, who is trying to change the company’s old ways, acknowledges that it will take far more than a new mission statement to prepare the company for the political and business challenges ahead, starting with the issuance of the Rudman Report, which Mudd doesn’t expect to be “a flattering piece of prose.” He added, “We have a long way to go. Of all the things, the one with the longest tail is the culture.”
- For all the talk of a gentler, humbler Fannie Mae, critics claim that little has changed. “All the talk of a new Fannie Mae—we are warm and fuzzy now, everybody loves us—means nothing unless you put the proper structure in place,” said Mike House, executive director of FM Policy Focus. “The only reason that Fannie Mae changed the way of doing business is because they were caught,” House added. (*New York Times*, Eric Dash and Stephen Labaton, 02/18/06)

Minority Whip Steny Hoyer loses his chief of staff to Fannie Mae

- Cory Alexander, chief of staff for Minority Whip Steny Hoyer (D-MD), will leave his post on February 28 to become vice president for government and industry affairs for Fannie Mae, where he will focus on outreach to House and Senate Democrats. A Maryland native, Alexander, 33, has been one of Hoyer's most loyal aides for more than a decade and is viewed as his closest confidant. Alexander began his career with Hoyer as a student intern in 1994 and ascended through the years from legislative assistant to legislative director to chief of staff in 1999. (*Roll Call*, Erin P. Billings and Steve Kornacki, 02/14/06)

Fannie Mae decides not to be a technology company

- In its January/February issue, *Mortgage Technology* wrote, "Fannie Mae's first e-mortgage guide did not include industry standards and was very proprietary. They launched an electronic quality control solution that would put them in competition with vendors like Mavent, ComplianceEase and others. They launched Custom Desktop Underwriter to private label their AU system for their users, making them competitors with the likes of ARC Systems, Commerce Velocity and GMAC-RFC. No wonder many industry pundits have long criticized Fannie for competitive encroachment into the technology space."
- "Finally, in 2005 - due in part to their accounting woes - Fannie Mae the vendor took a step back and is now starting to look more like Fannie Mae the GSE. To this end, Fannie Mae has updated its e-mortgage guide to include MISMO and MERS. Initially, the GSE did not include MISMO in their standards because, many say, Fannie was in a rush to deliver them in the hopes that they would be able to gobble up market share. However, the mass migration to e-mortgages hasn't happened so Fannie will now endorse both MISMO and MERS to help things along."
- "...The GSE has sold off its closing collaborative technology - which included its electronic quality control technology - to First American for an undisclosed price. 'We bought software components that Fannie developed to further e-mortgages in house,' said Roger S. Hull, executive vice president at First American, Santa Ana, Calif. 'They're still a buyer of e-mortgages and intend to remain active in that area,' he pointed out. ...'Fannie tried to be this technology company but decided in the end that they really didn't want to be there,' said Joe Dahleen, director of internal sales at MILA, Mountlake Terrace, Wash. 'They also wanted to recapture some of the cost that they lost in developing this technology that never went mainstream,' he concluded. 'Competition is good. Fannie will stick to being the end provider like they should and leave technology to vendors.'" (*Mortgage Technology*, January/February 2005)

Fannie Mae and Thomson TradeWeb announce
online trading of FNM's Discount Notes

- Thomson TradeWeb and Fannie Mae have announced new technology that will enable institutional investors for the first time to directly access and trade Fannie Mae's Discount Notes online through authorized dealers. This enhancement broadens the range of functionality on the TradeWeb Agency Discount Note platform by adding primary offerings of Fannie Mae short-term securities to the existing universe of fixed income offerings online. (*PR Newswire*, 02/13/06)

Freddie Mac

IRS audits municipal housing bonds

- The IRS is auditing at least six municipal bond issues totaling more than \$200 million for possible tax-exempt financing abuses. In the probe, the IRS is examining bonds in which Freddie Mac helped state authorities in Louisiana, California and other states set up programs that sold bonds to buy homes that were later leased to future buyers. Freddie Mac later bought the mortgages, said company spokeswoman Patti Boerger. "We were not involved in structuring the bonds," said Boerger. "Typically lenders involved would sell the loans to us."
- Charles Anderson, the Baltimore-based manager of the IRS's tax-exempt bond office, said the agency is examining the bonds because the lease-purchase program may constitute private loans to individuals, which would be an illegal use of private activity bonds. Issuers in the municipal-bond market must use tax-exempt debt for public purposes, according to U.S. tax law. "It's a technical matter," said Anderson. Further, repayment of mortgages used to back the bonds also may generate profits that are illegal under tax law, he added. In November 2005, the IRS made an initial finding that \$60.8 million of California Cities Home Ownership Authority bonds are taxable. In late January, the IRS notified the Louisiana Public Facilities Authority that it is auditing \$59 million of the bonds the Authority sold in 2003. Other state agencies participating in Freddie Mac's lease-to-own program include the Pulaski County Public Facilities Board in Arkansas; the Mississippi Home Corp., the New Mexico Region III Housing Authority; the Pima IDA Lease Purchase Program in Tucson, AZ; and Riverside-San Lease Program in Fullerton, CA. (*Bloomberg News*, 02/15/06)

Freddie Mac's portfolio shrinks for first time in three months

- Freddie Mac's retained portfolio shrank in January for the first time in three months, contracting at an annualized rate of 9.9% to \$704.2 billion versus a 29.9% gain in December. In January, the company bought \$12.4 billion for its retained portfolio in January, down more than 65% from December's \$36.2 billion. Freddie Mac spokesman Michael Cosgrove said, "The portfolio decline was mainly a product of our desire to be opportunistic, and the spreads between mortgage-backed securities and agency debt were not conducive for growth. The company's total mortgage portfolio, including its investments and mortgage securities held by outside investors, grew at an annualized rate of 13.2% percent to \$1.703 trillion on January 31. The tightness of spreads gave us fewer opportunities to grow." Freddie Mac's duration gap was zero months in January, unchanged from December. (*Reuters*, Julie Haviv, 02/24/06)

Freddie Mac commits to purchase \$100 million of Islamic home loans

- Freddie Mac has agreed to back \$100 million worth of Islamic home loans originated by University Bank's Islamic banking subsidiary in Michigan over the next 12 months. The two institutions have entered into a master purchase agreement to create a secondary market for the loans, which are structured to be interest-free. Since paying and receiving interest violates the beliefs of devout Muslims, University Bank's Islamic home loans are structured as murabaha transactions, in which the bank buys the house and sells it at a markup to the customer, who then pays for the home in installments over 30 years. (*Ann Arbor News*, 02/22/06)

Jim Park, former Freddie Mac executive, named AREA A COO

- Jim Park, the former vice president of industry relations and housing outreach at Freddie Mac, has been named the chief operating officer of the Asian Real Estate Association of American, based in San Diego, CA. (*Rismedia*, Beth Bresnahan, 02/16/06)

Freddie Mac announces new Internet-based tools to streamline data management

- Freddie Mac has introduced Default Reporting Manager™ and Incentive Manager™, two new Internet-based servicing tools designed to help servicers cut costs by streamlining a number of data management and default reporting operations. Designed to give servicers easier access and more up-to-date information for managing delinquent portfolios, Default Reporting Manager enables users to view, analyze and download EDR reports from their desktops, as well as monitor, validate and update foreclosure sale reporting processes, with error correction feedback.

Incentive Manager provides daily status reports and immediate access to loss mitigation and foreclosure timeline incentive reports. A third tool, Remedy Manager™, is scheduled for a full roll-out this spring. This tool will provide servicers fast access to Freddie Mac data for monitoring open and pending repurchase requests, track and analyze closed repurchase requests, and avoid unwanted interest fees for lost or misplaced requests. (*Freddie Mac Press Release, 02/14/06*)

Freddie Mac Foundation sponsors 2,500 Valentine's Day "care packages" to orphans

- More than 325 Freddie Mac volunteers prepared Valentine's Day "care packages" for 2,500 college students who have aged out of foster care. The event, hosted by Freddie Mac at its headquarters and underwritten by the Freddie Mac Foundation, was designed by the Orphan Foundation of America to meet the needs of thousands of young people who leave foster care without any emotional or financial support. The Freddie Mac Foundation is the founding partner of the Care Package Program, which involves three packaging events every year. (*Freddie Mac Foundation Press Release, 02/15/06*)

Federal Home Loan Banks

FHLBs earnings increase 25% in 2005

- The FHLBs' combined earnings were \$2.4 billion in 2005, up 25% from 2004, according to preliminary report by the FHLBanks Office of Finance. FHLB advances increased 7% to \$620 billion and investments grew by 18% to \$259 billion in 2005, while the System's holdings of single-family loans purchased from FHLB members declined 8% to \$105 billion. Total capital rose to \$44 billion on December 31, 2005, a 6% increase over the prior year.
- As of February 22, the FHLBs of Boston, Chicago, Cincinnati, New York, and San Francisco have completed the registration process with the SEC. Registration statements for the FHLBs of Dallas and Indianapolis are expected to become effective in the near future. The remaining FHLBs are working diligently to complete the registration process. (*FHLBanks Office of Finance, 02/22/06*)

FHLB-San Francisco reports fourth quarter results

- The FHLB-San Francisco announced that its net income for the fourth quarter of 2005 was \$110 million, compared to \$82 million in the fourth quarter of 2004. For the fiscal year ended December 31, 2005, the Bank's net income was \$369 million, compared to \$293 million for fiscal year 2004. Total assets grew \$38.6 billion or 21% during 2005. Based upon operating results for FY2005, the Bank expects to pay

a dividend for the fourth quarter at an annualized rate of 4.67%, up from 3.97% for the fourth quarter of 2004. The Bank's dividend rate for 2005 is expected to be 4.44%, compared to 4.07% for the year ended December 31, 2004. The Bank's duration gap was one month for FY2005, unchanged from FY2004. (*Business Wire*, 02/16/06)

FHLB-Chicago announces registration of its stock with SEC

- The FHLB-Chicago announced that it has registered its stock with the SEC, effective February 12, 2006. On February 10, the Bank filed an amendment to its Form 10 restating financial information for the nine months ended September 30, 2005, after the Bank determined that its accounting for certain hedging transactions related to mortgage loan delivery commitments was inconsistent with FASB 133. The impact was determined to be immaterial for all prior periods. Net income for the nine months ended September 30, 2005, decreased by \$8.7 million to \$188.8 million, while total capital on September 30 increased \$3.1 million. The Bank will submit its 10-K, with year-end 2005 financial statements, by the end of March, as required. (*FHLB-Chicago Press Release*, 02/13/06)

FHLBs of Dallas and Indianapolis file Form 10 with the SEC

- The FHLB-Dallas has re-filed its Form 10 Registration Statement with the SEC, which reflects its restatement of earnings for the years 2001 through 2004 and for quarters from January 1, 2003 through the first quarter of 2005 to correct errors related to the application of FAS 133. The cumulative net effect of the restatement for the specified periods, combined with the sale of investment securities announced on August 22, 2005, the sale of an additional \$2.9 billion of investment securities in September 2005, and the results of operations for the period from April 1, 2005 to September 30, 2005, was to increase the Bank's retained earnings from \$145 million as originally reported on March 31, 2005 to \$174 million as of September 30, 2005. (*PR Newswire*, 02/15/06)
- The FHLB-Indianapolis filed its Form 10 Registration Statement, including its financial restatements, with the SEC on February 14. The filing sets in motion the FHLB-Indianapolis' ultimate registration with the SEC. (*FHLB-Indianapolis Press Release*, 02/14/06)

FHLB-Des Moines names James E. Huston as interim CFO

- The FHLB-Des Moines has created the new position of chief financial officer and has named James E. Huston as the Bank's interim CFO. Huston will assume responsibility for the accounting, financial reporting, and financial planning for the

Bank and will assist the Bank in reaching its goal of SEC registration. He has more than 25 years of financial management experience, serving First Consumers National Bank in Portland, OR, Ames Financial Corporation, and Bank One Consumer Financial Services. (*PrimeZone Media Network*, 02/13/06)

FHLB-Atlanta's CFO resigns

- The FHLB-Atlanta announced that Lee Puschaver, the Bank's Executive Vice President and CFO, has resigned to pursue other interest. "[The FHLB-Atlanta] is appreciative of Lee's leadership and numerous contributions to the Bank, in particular its registration efforts with the Securities and Exchange Commission," said Ray Christman, President and CEO. "Lee has led the Bank through its restatement and the process that will soon result in our Form 10 filing with the SEC. We wish him the best in his future endeavors." The Bank expects to file its Form 10 registration statement with the SEC during the first quarter of 2006, following the completion of its 2005 audit, said Christman. (*PR Newswires*, 02/16/06)

International Mortgage Markets

Study concludes that "the implicit subsidization" of the GSEs has been the key to the growth of the US secondary mortgage market

- Marietta E.A. Haffner, with Delft University of Technology's OTB Research Institute for Housing, Urban and Mobility Studies, conducted a study of the secondary mortgage markets in the U.S. and the Netherlands. In the white paper, Haffner wrote, "The debate in the USA ...revolves around how far the implicit (guarantee) and explicit (soft conditions) subsidies [for the GSEs] are creating unfair competition on the secondary mortgage market. It is also the question whether hybrid organizations [publicly-owned government sponsored entities] should continue to implement securitization once the original objective has been achieved, namely: to generate enough capital for the mortgage market in order to avoid a re-enactment of the huge shortages in the 1930s and 1970s. The American owner-occupier market, which had a market share of almost 68% in 2002, has, indeed, grown spectacularly. Hence, now that securitization has outlived its original purpose, all that is left is a complex system to provide home-buyers with a small reduction in the mortgage interest; and the question whether the most effective and efficient way of realizing this is through hybrid organizations. As Fannie Mae and Freddie Mac are powerful lobbyists, the outcome of these debates is far from certain."
- "...It seems, therefore, that the 'best housing finance system in the world' was not born through a typically American market miracle. The real driver behind the success is the hybrid status of Fannie Mae and Freddie Mac – which brings cost savings in the

form of implicit and explicit subsidies, some of which are passed on to the buyers, but the shareholders also benefit. This observation is supported by the fact that the markets for CMBSs and for RMBSs that are nonconforming have been less successful than the one that Fannie Mae and Freddie Mac are operating on. This raises the question whether securitization in residential mortgage funding in other countries would meet with the same resounding success as in the USA if it did not get extra support from the government.”

- In an analysis of Netherlands’ mortgage securitization market, Haffner concludes that the country’s financial institutions use MBS as a tool to control growth and manage risk in their mortgage portfolios. In Netherlands and other EU countries, Haffner wrote “securitization brings no special benefits in the costs or otherwise compared with other ways of raising capital... Nor does securitization appear to offer (at present) any special benefits for the housing consumer. In fact, in the USA securitization demands a considerable degree of standardization in the mortgage credit process and the mortgage products. To boost securitization of mortgage loans in the Netherlands, the current mortgage market would have to become less heterogeneous with less consumer choice and, hence, less flexibility. More standardization could lower costs, however, which would make securitization more attractive to both the consumer and the financial institution. ...The securitization of residential mortgage loan portfolios probably has got out of the starting blocks but, even so, it does not look as if the secondary mortgage market in the Netherlands is gearing up to match the success of the secondary mortgage market in America.” (*Secondary Mortgage Markets in the United States and the Netherlands*, Marietta E. A. Haffner, OTB Research Institute for Housing, Urban and Mobility Studies, Delft University of Technology, 06/29/05)

Farm Credit System / Farmer Mac

Farm Credit System reports \$2.096 billion net income for 2005
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- The Farm Credit System reported net income of \$2.096 billion for fiscal year 2005, 14.8% above the System’s adjusted net income of \$1.826 [adjusted for one-time reversals of the allowance of loan losses] for fiscal year 2004. The System’s net interest income increased \$252 million to \$3.246 billion for 2005, as a result of continued growth in the System’s loan volume and investment securities. Net interest margin increased two basis points to 2.58% for 2005 from the prior year. The System’s net interest spread decreased 16 basis points to 2.01% for 2005, primarily due to competitive loan pricing pressures in a rising short-term interest rate environment.

- The System's gross loans increased \$9.905 billion or 10.3% to \$106.272 billion at December 31, 2005, due primarily from increased loan demand and continued marketing efforts. Cash and investments increased \$4.263 billion or 17.6% to \$28.427 billion at December 31, 2005, increasing the System's liquidity position from 161 days at December 31, 2004 to 187 days at December 31, 2005. The System's total capital increased \$1.385 billion during fiscal year 2005 to \$22.774 billion. Capital as a percentage of total assets was 16.3% at December 31, 2005. The System's nonperforming loans decreased \$143 million during the year to \$600 million at December 31, 2005. These loans represented 0.56% of the System's loans at December 31, 2005, a decrease from 0.77% at December 31, 2004. (*Business Wire*, 02/14/06)

FCA publishes its Regulatory Performance Plan for 2006
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- The Farm Credit Administration has published its Regulatory Performance Plan for 2006, which outlines the agency's projected schedule for regulatory development for the year. FCA regulations under development this year will address the assessment of FCA Expenses; financially and farm related services; lending program requirements; termination of FCA membership; regulatory burden; investments in Farmers' Notes; disclosure and reporting requirements, capital adequacy under the Basel Accord; Farmer Mac's risk-based capital standards; and the scope of lending for the FCA System. Details regarding the purpose for each regulatory project and the agency's calendar for action is provided on the Farm Credit website. (<http://www.fca.gov/FCA-Regulatory%20Performance%20Plan.htm>, 02/23/06)

Rural American Bonds: Lending disguised as investments
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- In the February issue of *Farm Credit Watch (FCW)*, Bert Ely wrote, "Complementing the FCS's audacious attempt to increase its off-farm lending powers through the 'HORIZONS Project,' the Farm Credit Administration (FCA), FCS's friendly regulator, has authorized a 'pilot investment program' called 'Rural America Bonds' (RABs). The FCA Board approved RABs with a 'notational' vote; that is, this pilot program was not discussed in a public meeting of the FCA Board. Instead, it was approved behind closed doors so as to keep it as quiet as possible. *FCW* has filed a Freedom of Information Act request with the FCA asking for all materials related to this program.
- "Although the FCA has disclosed next to nothing about RABs, beyond the fact that AgFirst and the Texas Farm Credit Banks and their 45 member associations can issue RABs, *FCW* has learned some troubling details about this program, specifically that RABs are to be classified as investments, not loans. In fact RABs will be loans in all but name and will be used to finance a wide variety of activities, including 'agribusiness, rural housing, rural infrastructure, essential community facilities and other aspects of rural economic development' that are not legal FCS loans. As one

FCS insider put it, “these bonds are just a proxy for loans.” Of course, thousands of rural and not-so-rural banks have financed these activities for decades.”

- “Some within the FCS are concerned that its auditor, PricewaterhouseCoopers, will demand that RABs be treated as loans. If RABs are loans in all but name, then the FCA should force the associations holding RABs to divest them because they are illegal loans. Bankers in the states served by AgFirst and the Texas Farm Credit Bank should alert FCW to any instance where a questionable FCS loan is clothed as a Rural America Bond. AgFirst funds 23 associations while Texas funds 22 associations.” (*Farm Credit Watch*, Bert Ely, February 2006)

Postal Service

Contentious conference awaits postal reform bills

- While aides in both chambers of Congress say it will be relatively easy to reconcile House and Senate differences, issues dealing with the White House’s threat are another matter. The Bush administration opposes language which transfers the USPS’s \$27 billion military pensions obligation from the Postal Service to the Treasury and provides the agency access to money slated for an escrow account. While the Postal Service has historically opposed the administration’s position on those issues, lobbyists and aides say the USPS relinquished a good portion of its negotiating posture when it came out against the bill last month. After the Senate passed S. 662, Senate Majority Leader Bill Frist (R-TN) issued a statement saying that the Senate would not consider the conference report unless it met budget targets.
- In a February 7 letter to Senate and House leadership, seven members of the President’s Commission on the U.S. Postal Service outlined two concerns with the current postal reform legislation, stating, “First, the bills call for a rate ceiling tied to the CPI, or similar economic indicator, but do not give the Postal Service any additional flexibility or authority to reduce costs...Our [other] concern is that the proposed legislation goes too far in transforming the regulator by giving it powers that will limit even further...the ability of the postal service to operate like a business.” (*Correspondence to Senators Bill Frist (R-TN), Harry Reid (D-NE), Susan Collins (R-ME), Joseph Lieberman (D-CT), and Representatives John Boehner (R-OH), Thomas Davis (D-VA), Dennis Hastert (R-IL), Nancy Pelosi (D-CA) and Henry Waxman (D-CA), 02/07/06*)
- In a February 13 press release, the Direct Marketing Association urged quick action by the joint House-Senate Conference Committee to resolve differences between the two postal reform bills and quickly finalize postal reform legislation. DMA said, “As passed by the House and Senate, postal reform legislation would give the USPS the flexibility to respond to both changing market conditions and ongoing evolution of

communication technology, while maintaining the USPS's cornerstone mission of providing universal service.” (*Direct Marketing Association Press Release*, 02/13/06)

CRS updates its side-by-side analysis of H.R. 22 and S. 662

- On February 15, Congressional Research Service updated its side-by-side analysis of H.R. 22 and S. 662. CRS analyst Kevin R. Kosar wrote, “Like these previous bills, H.R. 22 and S. 662 would define the categories of postal services and products as ‘competitive’ or ‘market-dominant’ and prohibit the Postal Service from subsidizing competitive products with revenues from market-dominant products. USPS could set rates for market-dominant products but increases would be capped at the rate of inflation. Although H.R. 22 and S. 662 are closer together than their counterparts in the 108th Congress, the two bills have significant differences, [including] the definition of “market-dominant” postal products and services; the components and goals of the new ratemaking system for market-dominant products and services; disability payments and retirement; retiree health benefits funding schedule; the establishment of “modern service standards”; and the make-up of the Board of Governors of the Postal Service.” CRS’s full analysis of the postal reform bills can be found at <http://www.fas.org/sgp/crs/misc/RL32903.pdf>. (*CRS Report for Congress Postal Reform Bills: A Side-by-Side Comparison of H.R. 22 and S. 662*, Kevin R. Kosar, 02/15/06)

USPS reveals the Evolutionary Network Development Program

- The USPS revealed details about the agency’s review and realignment of its mail processing and transportation networks, expected to occur in phases starting within a year. The Evolutionary Network Development program aims realign the Postal Service’s networks suited to current and future postal operational needs, reducing redundancy, making operations flexible and cutting costs. Paul Vogel, USPS vice president of network operations, said that new mailing patterns demand these changes. For example, said Vogel, “single-piece First-Class mail is eroding. Over the past six or seven years, it’s gone down almost 20 percent.” The USPS network currently consists of 675 processing facilities. The revamped network should consist of no more than 400. (*DMNews.com*, Melissa Campanelli, 02/17/06)

Mail delivery should get “nearer to normal” in New Orleans soon

- Postal officials have assured the New Orleans City Council that mail delivery should get “nearer to normal” before long. Even though the city’s main post office will resume partial service the week of February 20, tens of thousands of local addresses

are not likely to get mail delivery for many months, and there is no projection on when delivery of magazines and catalogs will resume. (*Times- Picayune*, 02/18/06)

TVA

TVA board approves first midyear rate increase in 25 years

- Channel 24 in Memphis, TN, reported, “TVA shocked everyone by raising rates [on February 13]” by 9.95% effective April 1. This current rate increase comes just four months after TVA raised rates 7.5%. TVA said it has cut staffing and maintenance, but is still in a deficit because of increased costs over the past two years. The rate increase will generate \$276 million in additional revenue, which won’t be enough to balance TVA’s budget. Agency officials said that they’ve already reduced operations, maintenance and capital spending by \$213 million and still must cut expenses by \$129 million by September 30 to avoid an operating deficit. TVA chairman Bill Baxter said costs of fuel and purchased power are up an estimated \$1 billion since 2004, representing a 52% increase over two years. (*WPTY Memphis* [Channel 24], 02/13/06; *Associated Press*, 02/14/06)
- While the agency was working to reduce its operating expenses, TVA paid \$50 million in bonuses to employees and \$12.9 million in bonuses and other compensation to 146 executives for fiscal year 2005. In a December 12 editorial, *The Tennessean* wrote, “The [TVA’s] generosity to its employees takes a big chunk out of the agency’s budget and its credibility...” (*Associated Press*, Elizabeth A. Davis, 12/24/05; *Commercial Appeal* [Memphis, TN], 12/05/05; *The Tennessean* [Nashville, TN], 12/12/05)
- In a February 22 Letter to the Editor of the *Huntsville Times*, Thomas J. Gildea wrote “I can’t see how the TVA can give bonuses to their people when they are getting charged with embezzlement, giving bad loans and paying fraudulent bills. Bonuses to employees in two years total \$119 million, not counting any other money lost by other means.” (*Huntsville Times*, Thomas J. Gildea, 02/22/06)

Some say diversity is needed on the TVA board

- In a February 22 editorial, the *Commercial Appeal* [Memphis, TN] wrote, “Despite some partisan bickering, U.S. senators are oh-so-close to a compromise that could give Memphis its first-ever representative on the Tennessee Valley Authority board of directors. ...Senate Democrats used a procedural move to block a confirmation vote on six of President Bush’s nominees for the board. All six have Republican Party ties. ‘All we’re asking for is a guarantee of one Democratic nominee, and to

date they [Republicans] have been unwilling to provide those assurances,' said Jim Manley, a spokesman for Senate Democratic Leader Harry Reid of Nevada.”

- “Our two Republican senators from Tennessee, Bill Frist and Lamar Alexander, took the Democrats to task for stalling. But while Frist sharply criticized the Democrats, he had comparatively little to say about the disturbing fact that not one of the nominees is from Memphis. ‘As the President considers his final nomination to the modernized TVA board, I am hopeful he will remain mindful of the Valley’s diversity and the importance of West Tennessee to TVA’s operations,’ Frist said... Frist’s tepid response leads us to believe our region’s lack of representation on the board isn’t a high priority for him. However, Alexander suggested something that hints at a compromise that could make both sides happy. Or happier, at least. Assuming the six current nominees are confirmed, there will still be one vacancy left to fill on the nine-member board. Alexander expressed hope the final slot would be filled by a minority from Memphis.”
- “In the interest of breaking the senatorial logjam, we pose this question: How hard would it be to find a candidate who meets all the criteria of Alexander and the Democrats? Memphis has plenty of black Democrats, including some with significant experience in the utility business. No minority has served on the board, which is unfortunate, considering that TVA has been around since 1933. Nor has anyone from Memphis ever served, even though one-fifth of the electricity supplier’s revenue comes from West Tennessee.”
- “The Memphis Light, Gas and Water Division is TVA’s single largest customer, which makes the lack of geographical representation all the more unfair. It may take some diplomacy to end this stalemate. The President might have to nominate a final compromise candidate satisfactory to Democrats to get the confirmation process moving again. The Democrats probably wouldn’t be totally satisfied with the scenario we’re suggesting, since they would undoubtedly like to see more than one person of their own party affiliation among the seven nominees. And Memphians should want to have more than one representative on this important board that has so much to say about how high our electric bills will be. Politics sometimes requires compromises, though. And getting one Memphian at the TVA board table would represent some progress.” (*Commercial Appeal*, Memphis, TN, 02/22/06)
- *The Tennessean* also agrees that the TVA board needs more diversity. In a February 23 editorial, the paper wrote, “Yet a more valid complaint about the six [TVA board] nominees is that, as a group, they bring little to TVA’s table in terms of experience and diversity. ...Individually, all of the White House picks are good people. The three Tennessee nominees — Dennis Bottorff of Nashville, Bill Sansom and Susan Richardson Williams, both of Knoxville — are well known in civic and government circles. Yet as a group, the six would bring to the TVA board not only a similar political affiliation but similar professional experience. Given the issues facing TVA, including deregulation, land use, air pollution and nuclear power, the White House should have looked beyond its own Rolodex.” (*The Tennessean*, 02/23/06)

“Dry” counties in Alabama should pay their own way

- In 2005, TVA paid Alabama \$89.2 million in lieu of taxes. Through a “weird” distribution formula, the state kept 20% of TVA’s remittance and 75% (or \$66.9 million) was distributed to 16 counties served by TVA and the remaining 5% (\$4.5 million) was given to “dry counties” outside the TVA service area. A bill in the state legislature proposes to phase out these payments to dry counties over a five year period and redistribute the money to cities and counties actually served by TVA. According to Representative Bill Dukes (D-Decatur), TVA customers shouldn’t have to subsidize dry counties. (*The Birmingham News*, 02/20/06)

TVA chairman responds to the NC Attorney General

- In a February 23 editorial appearing in *the Charlotte Observer*, TVA chairman Bill Baxter wrote, “There is at least one thing we can agree with in [N.C.] Attorney General Roy Cooper’s recent [opinion] column, and that is ‘cutting pollution from TVA makes good business sense.’ TVA has been steadily reducing emissions and ‘cutting pollution’ from its coal plants for decades. As a result of our efforts, the air is cleaner now in the Tennessee Valley, including Western North Carolina, than it has been at any other time in our lives, and it will continue to get better throughout this decade and beyond.”
- “We would like to set the record straight on some of the misstatements in Mr. Cooper’s column. We will try to separate fact from fiction in his column and in his lawsuit filed against TVA’s 11 coal-fired power plants in Alabama, Kentucky and Tennessee. In fact, a thorough analysis will show that the largest contributors to air pollution in North Carolina are its own utilities, other plants and motor vehicles, not TVA. Mr. Cooper’s finger pointing cannot change this fact. It is fully documented by emissions data reported to and published by the U.S. Environmental Protection Agency. North Carolina utilities now emit more sulfur dioxide than every other state in the southeast except for Georgia, where TVA has no plants. They emit more SO₂ than utilities in Alabama and Kentucky, where TVA and other utilities have plants, and twice as much as Tennessee, where seven of TVA’s plants are located.”
- “TVA has spent \$4.4 billion to put emission controls on its three-state system and is in the process of spending another \$1.3 billion on still more controls. From 2002, the year North Carolina adopted its Clean Smokestacks Act, through 2004, TVA spent six times more on controls than North Carolina utilities spent altogether -- \$1.3 billion to \$232 million. TVA has reduced its SO₂ emissions since 1977 by 80 percent and has reduced its NO_x emissions during the ozone season by 80 percent since 1995. Those aren’t promises. They are actual reductions achieved at a great cost to TVA and the public it serves.”

- “North Carolina’s Department of Environment and Natural Resources reported to EPA in 2004 that air quality is improving in North Carolina, but this was in ‘considerable part’ due to emission reductions in other states. We think appreciation for what TVA has done thus far is a more appropriate response than a lawsuit. North Carolina utilities are good companies, but the fact is they have work[ed] to do to catch up with TVA.”
- “TVA has tried to meet with Mr. Cooper to discuss his concerns, twice. He refused to meet and instead chose litigation over discussion. Now matters will run their course. North Carolina taxpayers and TVA ratepayers will foot the legal bills. Be assured, however, our commitment to clean air continues, and we will continue to reduce emissions even more than we already have.”
- “The most effective way to improve regional air quality is through regional solutions, such as EPA’s 2005 Clean Air Interstate Rule, which requires utilities to reduce both SO₂ and NO_x emissions beyond levels required by North Carolina’s Smokestacks Act. TVA is now planning a new emission reduction effort that will cost TVA and its ratepayers, including those in Western North Carolina, \$3 billion to \$3.5 billion on top of the \$5.7 billion we are already spending.”
- “Filing a unilateral lawsuit against one utility will not make the air cleaner. The actions TVA has taken thus far are what make the air cleaner, and TVA is committed to further reduce those emissions while providing reliable, affordable electricity to the 8.6 million consumers we serve.” (*Charlotte Observer*, Bill Baxter, 02/23/06)

Canfield & Associates, Inc.
1401 H St., NW, Suite 560
Washington, DC 20005
Phone: (202) 661-2100
Fax: (202) 403-3924
www.canfieldassoc.com