

# The **GSE** REPORT™

[www.gsereport.com](http://www.gsereport.com)

## **Contents of GSE Report™**

### ***Major Events***

- [Fannie Mae reports NEW accounting problems, but cannot provide an estimate of the impact of these issues on the company's earnings \(p. 3\)](#)
- [Former Fannie Mae chairman Raines "tainted" company's board, suit alleges \(p. 4\)](#)
- [Senators Hagel and Sununu file amendment requiring annual audits of the Fannie Mae and Freddie Mac Foundations \(p. 5\)](#)
- [House Financial Services Committee plans March 14 hearing on Rudman Report \(p. 5\)](#)
- [Freddie Mac delays release of its FY2005 results \(p. 5\)](#)

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

- [Congress needs to "create an aggressive and empowered" GSE regulator \(p. 6\)](#)
- [Rumblings on GSE regulatory reform on Capitol Hill \(p. 7\)](#)
- [The taxpayers' \\$1.5 trillion bet on GSEs \(p. 10\)](#)
- [Time to recast Fannie Mae? \(p. 11\)](#)
- [Higher conforming loan limits subsidize the wealthiest in our society – and hurt those who need help \(p.12\)](#)
- [Lessons learned from Fannie Mae and Freddie Mac \(p. 14\)](#)
- [Support voiced for Fannie Mae's AD&C loan purchase program \(p. 15\)](#)
- [A tip of the hat to Dawn Kopecki \(p. 16\)](#)
- [Hurricane recovery notes \(p.17\)](#)
- [Making the case for \\$4.2 billion in housing aid for LA \(p. 17\)](#)
- [Spur of crisis fades for LA \(p. 19\)](#)
- [Will the good times ever roll again in the Big Easy? \(p. 20\)](#)
- [Credit rating agencies come under "heavy fire" in Senate hearing \(p. 21\)](#)
- [Home prices appreciated 12.95% in 2005 \(p. 22\)](#)
- [BIS reports record year on exchanged-traded derivatives \(p. 23\)](#)

### ***Fannie Mae***

- [Fannie Mae's "attitude of arrogance" \(p. 24\)](#)
- [Follow the bouncing hard drives \(p. 26\)](#)
- [Buffett's words of wisdom \(p. 26\)](#)
- [FASB 133's contribution to the Fannie Mae "train wreck" \(p. 26\)](#)
- [Fannie Mae's portfolio shrinks in January \(p. 27\)](#)
- [Fannie Mae promotes Linda Knight to EVP for Capital Markets \(p. 27\)](#)

### ***Freddie Mac***

- [Freddie Mac declares dividends for first quarter \(p. 29\)](#)
- [Terms of Freddie Mac-OFHEO settlement won't augment OFHEO's appropriations \(p. 29\)](#)
- [Freddie appoints James R. Egan as SVP, Comptroller \(p. 29\)](#)
- [Freddie Mac chairman and CEO Syron elected to Genzyme's board of directors \(p. 29\)](#)
- [Freddie announces multi-family mod rehab project \(p. 30\)](#)
- [Freddie Mac Foundation donates \\$1.5 million to Boys & Girls Clubs of Greater Washington \(p. 30\)](#)

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

- [FHFB approves proposed rule to strengthen FHLB's capital \(p. 31\)](#)
- [FHLB-Seattle reports \\$9.1 million loss in 4<sup>th</sup> Quarter 2005 \(p. 32\)](#)
- [FHLB-Cincinnati sponsors the New Neighbors programs \(p. 33\)](#)

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

- [FCA board approves the Agency's Unified Agenda and revised Performance Plan for FY2006 \(p. 33\)](#)
- [FCA system is vital to the nation's agricultural economy, says AgriBank president \(p. 34\)](#)

### ***Postal Service***

- [Postal reform legislation likely to emerge from conference by April \(p. 34\)](#)
- [White House announces two nominations to the Postal Board of Governors \(p. 35\)](#)
- [USPS is expected to file a rate case soon \(p. 35\)](#)
- [Financial outlook bleak for USPS in FY2006 \(p. 36\)](#)
- [E-delivery battles heat up on several fronts \(p. 36\)](#)
- ["Do Not Mail List" movement growing \(p. 37\)](#)

### ***TVA***

- [TVA board nominees finally clear the Senate \(p. 37\)](#)
- [TVA will continue paying down its debt in an effort to rein in future rate increases \(p. 38\)](#)
- [TVA may have a partner, a first, in building reactor \(p. 38\)](#)
- [TVA wins \\$34.9 million judgment against the Department of Energy \(p. 39\)](#)

## ***Major Events***

Fannie Mae reports ***NEW*** accounting problems,  
but cannot provide an estimate of the impact of these issues on the company's earnings

- In its March 13 Form 12b-25 filing with the SEC, Fannie Mae disclosed *new* accounting problems which were not identified in the Rudman Report or in the company's previous SEC filings. While the company did not provide an estimate of the financial impact of these issues, Fannie Mae said it believes it still meets its minimum capital requirements based on its current "view" of its accounting errors. According to the disclosure, Fannie Mae's new accounting problems include improper accounting for certain investment securities and for some of the fees and obligations that arise from Fannie's guarantees of payments on mortgages bundled into securities and sold to investors world-wide. Additionally, Fannie Mae disclosed problems related to accounting for the costs of dealing with houses acquired through foreclosures, for debt restructurings and for interest on delinquent loans, among other things.
- While the company it does not expect to complete its financial restatement until the second half of 2006, Fannie Mae president Daniel Mudd said, "Although our review of accounting policies and practices is not complete, we have made significant progress in completing our analysis and determination with respect to the accounting issues we have identified."
- Fannie disclosed that its administrative expenses increased 44% to \$2.18 billion last year, reflecting the company's efforts to clean up its accounting problems and deal with investigations and shareholder suits. In a conference call to investors, Fannie executives said the company is spending about \$50 million a month to more than 2,000 consultants and other outside experts, who are helping with the restatement and related accounting and corporate-governance projects. Fannie also lowered its initial estimate of \$550 million in after-tax losses from last year's hurricanes to a range of \$250 million to \$400 million. The company also said that it expects a required management report to show that internal controls over financial reporting were ineffective as of the end of 2005.
- Fannie Mae also reported that its share of the mortgage market declined to 24% in 2005, down from 29% in 2004 and 45% in 2003. The company said it hopes to regain market share as rising interest rates prompt more people to refinance from adjustable-rate mortgages to fixed-rate loans. As the company works on cleaning up the books and dealing with investigations and shareholder suits is proving costly. (*Wall Street Journal*, James R. Hagerty, 03/14/06; *Dow Jones Business News*, Robert Schroeder, 03/13/06; *Dow Jones Capital Markets Report*, 03/13/06)

Former Fannie Mae chairman Raines “tainted” company’s board, suit alleges

- Former Fannie Mae chairman and CEO Franklin D. Raines is accused of compromising the company’s independent directors by giving them \$12 million in charitable donations to prevent the directors from challenging his activities in a mounting \$10.8 billion scandal at the GSE. The suit, filed by plaintiffs Wayne County Employees’ Retirement System, Pirelli Armstrong Tire Corp and 11 other shareholders in the Washington U.S. District Court, said Raines improperly used the Fannie Mae Foundation’s dollars “to dominate his fellow board members” and compromise the judgment of six directors. Raines, who was chairman of both the corporate board and its charitable foundation, directed money to charities on which the company’s outside directors served as trustees or supporters, providing them more personal stature as philanthropists, according to the suit. “In more than 78 board meetings, 48 audit committee meetings and 38 compensation committee meetings, defendants never raised any opposition to Raines, enabling and fostering the perpetuations of his schemes,” the suit alleges. The charitable donations also influenced directors to allow Raines and former CFO Timothy Howard to walk away from the accounting scandal with \$135 million in golden parachutes, said the suit.
- Specifically, the suit alleges that Raines “directed” \$3.9 million to the Brookings Institution, \$2.9 million John F. Kennedy Center, \$1 million to the National Alliance to End Homelessness, and \$240,000 to John Hopkins University – all organizations in which Fannie Mae director Kenneth Duberstein serves as a board member or trustee. According to the filing, Raines also channeled \$127,500 from the Foundation to Federal City Council, a non-profit where Fannie Mae director H. Patrick Swygert served as a trustee. Swygert, President of Howard University (HU), “managed to get his son a job” at Fannie Mae and secured an \$800,000 line of credit for HU from the GSE. Swygert also “gained” \$450,000 in grants for HU while serving on the Foundation’s board. Raines also awarded \$2.75 million of Foundation grants to the Urban Institute, where Fannie Director Ann Korologos was a visiting fellow, and \$280,000 in grants to Aspen Institute, where Korologos was board chair, according to the filing. Raines also approved \$40,000 of foundation grants to the Center for the Study of the Presidency, where Fannie Mae director Donald Marron served as chairman. The suit also cited other grants to charities involving directors Daniel Mudd and Thomas Gerrity [chairman of Fannie’s audit committee]. Nine of the 13 directors named as defendants in the suit continue to serve on Fannie’s board of directors. The lawsuit, called the Fannie Mae Derivative Litigation, 1:04cv01783, U.S. District Court, Washington, D.C., names nine of Fannie’s 13 current board members, including the GSE’s president, Daniel Mudd, and chairman Stephen Ashley. Fannie Mae and most of the other defendants have filed motions to have the lawsuit dismissed to no avail. (*New York Post*, Paul Tharp, 03/02/06; *Bloomberg News*, James Tyson, 03/01/06; *Associated Press*, Bruce Meyerson, 03/04/06; *National Mortgage News*, Paul Muolo, 03/06/06)

Senators Hagel and Sununu file amendment requiring annual audits  
of the Fannie Mae and Freddie Mac Foundations

- On March 9, Senators Chuck Hagel (R-NE) and John E. Sununu (R-NH) filed an amendment to a lobbying reform bill which would require HUD to perform annual audits of the Fannie Mae and Freddie Mac Foundations and require GAO to examine whether the lobbying activities of Fannie Mae, Freddie Mac and the FHLBs “further each of their congressional chartered missions.” (*S. 2349*, 03/09/06; *American Banker*, Damian Paletta, 03/10/06)

House Financial Services Committee plans March 14<sup>th</sup> hearing on Rudman Report

- The House Financial Services Committee scheduled a hearing on March 14 at 10:00 a.m. entitled “Review of the Rudman Report on Fannie Mae.” Former Senator Warren Rudman, who led the internal investigation of Fannie Mae’s accounting scandal, is set to testify before the committee, along with others who helped write the report. No Fannie Mae employees or former employees mentioned in the report are expected to appear before the Committee. (*Dow Jones Newswires*, John Godfrey, 03/06/06; *Market News International*, Margaret Chadbourn, 03/08/06)

Freddie Mac delays release of its FY2005 results

- Freddie Mac has delayed the release of its 2005 financial results until May to implement an accounting change, but said the change would not affect prior results. Previously, the company had planned to report FY2005 results by the end of March. Freddie Mac recently decided to make greater use of third-party market information in its valuation methodology and is implementing this change in its 2005 financial statements. According to the company, this new methodology will be reflected as a change in estimate and will improve the reliability and transparency in the valuation of these instruments. Freddie Mac said it hopes to return to regular financial reporting by the end of the year. The company also announced that it will hold its quarterly market update conference call with investors on March 30, 2006.
- Freddie Mac CFO Martin F. Baumann said the company has made “substantial progress in fixing our financial reporting infrastructure, but our work is not done.” He added, “Getting this infrastructure to the point where it can support timely, reliable quarterly reporting continues to be an enormously complex task.” (*Reuters*, 03/10/06; *Freddie Mac Press Release*, 03/10/06; *Dow Jones Newswires*, John Connor, 03/10/06)

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

Congress needs to “create an aggressive and empowered” GSE regulator

- In a March 1 editorial, the *Washington Post* wrote, “The company’s accounting systems were ‘grossly inadequate.’ Its practices weren’t consistent with accounting principles -- and, ‘in many instances, management was aware of the departure.’ Employees in critical financial jobs ‘were either unqualified for their positions, did not understand their roles, or failed to carry out their roles properly.’ The information given to the board about all this ‘was incomplete and, at times, misleading.’ Sound like some two-bit, fly-by-night company? Yes, but the company in question is Fannie Mae... And this unsparing assessment isn’t from an irate whistle-blower or even an unhappy bureaucrat -- it’s from an outside review commissioned by Fannie Mae’s own board and headed by former senator Warren B. Rudman (R-N.H.)”
- “[T]he report also underscores the importance of having an aggressive and empowered regulator to keep an eye on Fannie Mae -- and the degree to which the current regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), is not up to that job. True, OFHEO eventually found serious deficiencies in the company’s operations. But it was inert for a long time while the company’s accounting systems were, as the Rudman report found, ‘grossly inadequate.’ Instead, as the report described it, Fannie Mae’s improper method of accounting for its huge derivatives portfolio was well known to its regulators, who didn’t see the problem: ‘As late as June 2002, ...OFHEO reported that the company’s implementation of [the derivatives accounting rule] had a sound basis.’”
- “Fannie Mae and ...Freddie Mac may be too big to fail, but they’re also too big to be regulated this laxly. The continuing congressional failure to fix this situation is intolerable. It is ‘strong but good medicine,’ Fannie Mae chief executive Daniel H. Mudd said in a statement responding to the report. That’s fine, but a tough new regulator is needed to make sure the patient keeps taking the medicine after Dr. Rudman has moved on.” (*Washington Post*, 03/01/06)
- In a March 6 editorial, the *Kansas City Star* also voiced its support for a stronger GSE regulator by writing, “Former Federal Reserve Chairman Alan Greenspan often warned Congress about the ‘systemic’ financial risk posed by the mortgage giants Fannie Mae and Freddie Mac. If they run into trouble, in other words, there’s no telling how bad the resulting chaos could be for the entire economy. Yet lawmakers have done little to ensure that these two ‘government-sponsored enterprises’ are more closely regulated. A recent report on Fannie Mae’s accounting problems is only the latest reminder that this problem remains unsolved.”
- “... [M]ore must be done. ...Fannie Mae and Freddie Mac are publicly traded and privately owned. Yet they’re sponsored by the federal government, so they borrow at

below-market interest rates. Studies have shown that only a tiny increment of this implicit subsidy shows up in lower mortgage rates for home buyers. Most of the benefits flow to shareholders and executives. Together, Fannie Mae and Freddie Mac retain portfolios of around \$2 trillion in mortgage-backed securities, which they attempt to hedge with complicated derivative-based schemes. The accounting for these derivatives has been way off the mark. If a financial panic were to unravel these hedging mechanisms, the weakness could spread rapidly to banks since many hold debt instruments issued by Fannie Mae and Freddie Mac. Meanwhile, taxpayers would be on the hook, since Fannie Mae and Freddie Mac are deemed 'too big to fail.' Fannie Mae's accounting has been obscure even to its regulator, the Office of Federal Housing Enterprise Oversight. Congress should step up and deal with this problem before it's too late." (*Kansas City Star*, 03/06/06)

- John Berthoud joined the chorus, writing on *Government Bytes*, the National Taxpayers Union blog, "What happens when government grants selected entities special privileges and those privileges are maintained over the years based on political clout? Economic theory would suggest that while the privileged entities benefit, there are a range of adverse economic consequences elsewhere. And this has certainly come to pass with Fannie Mae and Freddie Mac, two [GSEs]. Last week, a report on the accounting scandals at Fannie Mae was released, outlining the substantial systemic risk posed by Fannie. The report also outlined how Fannie's culture led to the accounting abuses. One might think that Congress would want to take the lead to fix things (ending the special status and consequent enormous size - and market risks - of Fannie Mae and Freddie Mac), but Fannie's and Freddie's ceaseless lobbying and extensive political contributing have successfully stopped such action for many years." (*Government Bytes*, John Berthoud, 02/27/06)

Rumblings on GSE regulatory reform on Capitol Hill
--

- Following the announcement of the House Financial Services Committee's hearing set for March 14 on the Rudman Report, Chairman Michael Oxley (R-OH) said, "It's important that Congress act soon to send the President bipartisan legislation that would create a stronger regulator. The House has approved H.R. 1461 to do just that, and I hope my colleagues in the Senate will act soon." Representative Richard Baker (R-LA), chairman of the House Financial Services Committee's subcommittee with jurisdiction over GSEs, said the Rudman Report "confirms many of the concerns expressed by committee members about the dangers posed by the combination of the size, implicit government guarantee, and inadequate oversight of the housing government-sponsored enterprises, and provides further evidence of the urgent need to address these concerns by passing GSE reform legislation." Representative Barney Frank, minority leader of the House Financial Services Committee, said "The passage of [GSE regulatory reform] legislation would be very helpful. It is not a healthy thing for the market to have this uncertainty." (*Market Watch*, John Connor, 03/09/06; *Bloomberg News*, James Tyson, 03/09/06; *Bloomberg News*, James Tyson, 03/06/09)

- Senate Banking Committee Chairman Richard Shelby (R-AL) has voiced confidence a GSE regulatory reform bill will be enacted into law this year, but indicated that he's in no rush. Downplaying the significance of the Rudman Report, which he pointed out was commissioned by Fannie Mae; Shelby said he's more interested in the results of the investigations by OFHEO and the SEC. While he doesn't know when these reports will be released, Shelby said that there's plenty of time to complete action on GSE regulatory reform legislation. "We've got all year," he added. According to a Senate leadership aide, Shelby is working with Senate Majority Leader Bill Frist (R-TN) to decide how and when to bring the bill to the Senate floor. (*Market Watch*, John Connor, 03/09/06; *Dow Jones Newswires*, John Godfrey, 03/01/06)
- Senators John Sununu (R-NH), Tom Carper (D-DE) and Jack Reed (D-RI) have been discussing a compromise over the proposed fund for low-income homebuyers. "We're ...trying to be constructive [in having these talks] and I think that's a very positive sign," said Reed. Since passing GSE regulatory reform legislation along party lines last July, the bill has not gone to a full vote in the Senate because Democrats want to add a provision, creating a \$900 million affordable-housing fund proposed by Reed. In addition, Democrats oppose a provision requiring cuts to the GSEs' mortgage portfolios. Under one alternative AH proposal being considered by Sununu, Fannie Mae and Freddie Mac would channel money for AH to the fund run by the FHLBs. "This is a much better approach," said Sununu, who liked having locally-owned FHLBs disperse the fund. This approach would deter Fannie and Freddie from using the allocation of the AH fund to influence lawmakers. "There's a lot more work that needs to be done [on the proposed AH fund,]" said Sununu. Reed also said he is refining his GSE amendment so that Fannie's and Freddie's contribution toward an AH fund would be based upon the size of the companies' mortgage portfolios rather than their earnings. (*Bloomberg News*, James Tyson, 03/03/06; *National Mortgage News Online*, 03/01/06)
- The Treasury Department has not seen any acceptable legislative proposals to reduce the size of the GSE portfolios – other than the proposal contained in the Senate bill which is viewed by many as too strict, said Treasury Undersecretary Randall Quarles. While there is "relatively little wiggle room" for a compromise on the portfolio provision, Quarles said Treasury is focused on the "principle" of tying portfolios to the GSEs' congressionally mandated mission of boosting home ownership, leaving open the door for alternative language on this issue. "What I'd say at this point is that we're focused on the principle... of tying the portfolios to the entities' mission," Quarles told *Reuters* in an interview. "I think the Shelby language does that. I haven't seen other language that does that. But ultimately, what we are focused on is the principal." Quarles reiterated the Bush administration's call for a legislative mandate for portfolio cuts, saying, "In the absence of a legislative mandate, history has shown us that the regulator of these entities is just not likely to strictly limit the portfolios. There has to be a pretty clear mandate to do that and as to how to do that." While Treasury is focused on the passage of GSE regulatory reform legislation, it will consider the tools that are available to deal with the systemic risk of the GSEs' portfolios if legislation is not passed by Congress. "If that were to happen, we'd have

to look at the tools that are available to address what we clearly see to be an issue,” Quarles said. Those tools include limiting Fannie’s and Freddie’s debt issuance, he added. (*Reuters*, Kristin Roberts, 03/09/06)

- In a March 8 statement, HUD Secretary Alphonso Jackson said, “HUD’s position on a strong GSE regulator remains unchanged. I believe strongly in the need for a world-class regulator to ensure the soundness of the GSEs. We look forward to working with Congress to develop a regulator that will provide strengthened oversight. Legislation to mandate a reduction in the retained portfolios to reduce systemic risk is also a critical part of this equation.” HUD issued this statement in the aftermath of a conversation between Jackson and *Bloomberg News*’ reporter James Tyson to make it “unambiguously clear” that HUD’s position on GSE regulatory reform and support of portfolio reduction has not changed. (*Dow Jones Newswire*, John Connor, 03/08/06)
- *National Mortgage News Online* reports that OFHEO general counsel Alfred Pollard said his agency is “not taking a position” on portfolio caps for Fannie Mae and Freddie Mac. While he would not discuss portfolio caps, Pollard said he favors other pieces of the House and Senate bills, including taking the GSE regulator out of the appropriations process and merging the agency with the Federal Housing Finance Board. (*National Mortgage News Online*, 03/08/06)
- In an interview with *American Banker*, Freddie Mac’s president and COO Eugene McQuade said that his company “supported [GSE regulatory reform] legislation that would create a strong regulatory environment,” but added that the reform effort has “take[n] on extraneous issues,” such as portfolio limits. Freddie Mac has been frustrated to see “new issues get added that are not part of strengthening the regulatory environment, he said. (*American Banker*, Damian Paletta, Joe Adler, and Patrick Rucker, 03/06/06)
- New York City Mayor Michael R. Bloomberg voiced his support for H.R. 1461’s provision for an affordable housing fund in a speech before the National Low-Income Housing Coalition on February 28. Bloomberg said, “Using a tiny fraction of profits from Fannie Mae and Freddie Mac to create a \$1 billion National Housing Trust Fund [is] an idea that I join all of you in enthusiastically supporting.” (*States News Service*, New York City Mayor Michael R. Bloomberg, 02/28/06)
- A provision in the House-passed GSE regulatory reform GSE bill (H.R. 1461) that restricts nonprofit groups from receiving affordable housing grants due to their political activities raises serious First Amendment concerns, according to a Congressional Research Service analysis prepared by CRS legislative attorney Jack Maskell. The report points out that while Congress can restrict the use of government-provided funds, it cannot prohibit an organization from using its own funds for lobbying and political speech. “[T]he Supreme Court has in the past ruled that the government may not deny a benefit to a person because he exercises a

constitutional right,” wrote Maskell, in the analysis requested by Senator Carl Levin (D-MI). (*National Mortgage News Online*, March 11-12, 2006)

The taxpayers’ \$1.5 trillion bet on GSEs
---

- In the *Wall Street Journal*, AEI resident fellow Peter J. Wallison wrote, “The Rudman Report on Fannie Mae recites facts eerily similar to what we now know about Enron. According to the report, the CFO of Fannie misled the board (and possibly the CEO) about the financial position of the company. The CEO, head of the corporate governance committee of the powerful Business Roundtable, regularly misled Wall Street and the board, but may not have understood the accounting. The auditors (this time not Arthur Andersen) failed to stand up to the management or didn’t understand what was happening. The board, primarily made up of independent directors, and the audit committee, made up entirely of independent directors, were unable to penetrate the scam and remained clueless as earnings were manipulated. In Fannie’s case there was also a regulator, but the regulator did not begin to look into any problems until it had been surprised by similar wrongdoing at Fannie’s smaller sibling, Freddie Mac.”
- “What we should learn from this -- much of which occurred after the adoption of Sarbanes-Oxley [SOX] -- is that a board made up primarily of independent directors, an audit committee made up entirely of independent directors, a Big Four accounting firm alerted to the dangers of accounting fraud, and a regulator that claimed to be fully on top of what was happening, could not prevent senior management from fudging the accounting and misleading the board and investors. No surprise there. Many observers were saying, both before and after the enactment of SOX, that a management determined to defraud or mislead could evade the scrutiny of all the gatekeepers.”
- “This has important implications for the legislation now before Congress to reform the regulation of Fannie and Freddie and limit the size of their portfolios. Since dishonesty and incompetence are an unavoidable fact of life, and gatekeepers are unreliable, investors must protect themselves by diversifying their investments. But there is good reason to believe that diversification would not be available if dishonesty or incompetence at Fannie or Freddie in the future resulted in the collapse or financial incapacity of either. Fannie and Freddie are not ordinary companies. They have almost \$1.5 trillion of debt outstanding, which they borrowed to buy and carry portfolios of mortgages and mortgage-backed securities; these portfolios expose both companies to enormous interest-rate and prepayment risk. To hedge this risk, Fannie and Freddie are parties to derivatives transactions with notional values in the trillions, in which the counterparties are some of the largest financial institutions; any failure of Fannie or Freddie to meet its obligations would expose these institutions to substantial losses. Fannie and Freddie debt is also held widely by banks and other financial institutions, in some cases accounting for more than 100% of their capital; a decline in the value of that debt would seriously weaken these organizations and reduce their capacity to lend. Finally, both companies are central to the real-estate

financing market. If either of them could not function normally, that market -- amounting to almost a third of the economy -- would freeze up. As Alan Greenspan has pointed out for years, the risks inherent in the portfolios carried by Fannie and Freddie add up to huge systemic risk -- the danger that a failure at either company will spread to the economy as a whole.”

- “So here is the key difference between Enron and either Fannie or Freddie. Dishonesty or incompetence in Enron’s management hurt shareholders and employees, both of whom could have protected themselves through diversification of investments. Dishonesty or incompetence in Fannie’s or Freddie’s managements could throw the economy into chaos, and from that catastrophe diversification provides no shelter. Faith in boards, audit committees, auditors and even regulators has been shown to be misplaced. Sure, Congress would likely come in and bail them out -- but immediately, without extended debate, and with trillions of taxpayer dollars potentially at risk? Not a chance. And the damage in the meantime would be devastating.”
- “As reform legislation languishes in the Senate, Congress should consider the lessons of Enron, Fannie and Freddie: Despite our best efforts, error and fraud will occur. That’s why it’s important to make sure -- by reducing the size of Fannie and Freddie’s portfolios -- that no future management failure at either company will threaten the stability of the economy.” (*Wall Street Journal*, Peter J. Wallison, 03/07/06)
- Under cross-examination in the trial of former Enron chairman Ken Lay and former president Jeffrey Skilling, former CFO Andrew Fastow said, “Within the culture of corruption Enron had, a culture that rewarded financial reporting, rather than economic value, I believed I was being a hero.” [From the Rudman Report, it appears that the Fannie Mae’s culture rewarded hitting EPS numbers and smoothing its earnings, rather than rewarding economic value through accurate reporting. Perhaps former Fannie CFO Timothy Howard and former controller Leanne Spencer believed at the time that they too were “heroes.”] (*Wall Street Journal*, Gary McWilliams and John R. Emshwiller, 03/08/06)

Time to recast Fannie Mae?
----------------------------

- In the *Realty Times*, Peter G. Miller wrote, “You knew it was coming. A just-issued 2,652-page report by former New Hampshire Senator Warren Rudman details the world inside Fannie Mae and the drive to produce financial results that would satisfy stock analysts. The report will get a lot of media attention, but the central issue will remain untouched: How to change the quasi-government status that Fannie Mae enjoys[?]”
- “...The core issue now facing Fannie Mae and ...Freddie Mac is not bookkeeping. We know they have had past instances of woeful accounting and we hope the future

will be better, but what really needs to be addressed is the coming role of these two [GSEs]: Do they continue as mutant public/private behemoths? Do they get de-tangled from the federal government to become entirely private? Or, are they swept completely into the arms of the national government?

- “...In practice, investors believe that because of their size and history, if Fannie Mae or Freddie Mac have financial troubles the federal government will step in and bail them out. That means there is little down-side risk for investors. Meanwhile, profits generated by Fannie Mae and Freddie Mac go to shareholders, not government vaults. If you’re an investor, you win in either case. The problem is that Fannie Mae and Freddie Mac were not established to further the interests of either shareholders or executive bonus plans. The idea was to assure low mortgage rates across the country so that opportunities for homeownership would be expanded. But under the current system, every dollar in profit paid to shareholders and every cent in multi-million dollar bonuses pools means fewer dollars available to reduce mortgage costs.”
- “The time has come to change the ties between the huge GSEs and the federal government -- either make them private companies that will be subject to the same rules and regulations as competing secondary lenders or convert them back to government status. The first option, going public, means the companies would get no special tax or regulatory breaks. There would be no competitive advantage leading to lower borrowing costs as the result of a perceived special status. Reports to the SEC would not be voluntary. The second option, going federal, would end massive payouts to shareholders and executives, money better spent reducing loan costs and filling empty government coffers.”
- “Either option would be better than the blurred positions now held by Fannie Mae and Freddie Mac. But what to do with these companies is not just a financial matter, it also has a political dimension. It would require strong leadership in Washington to take on the two huge companies and their fee-earning backers on Wall Street -- leadership which is just not there.” (*Realty Times*, Peter G. Miller, 02/28/06)

Higher conforming loan limits subsidize the wealthiest in our society – and hurt those who need help
---

- Peter Wallison, former general counsel of Treasury in the Reagan Administration and now resident fellow at AEI, and John J. Lafalce, former ranking Democratic member on the House Financial Services Committee and now professor at Canisius College agree on *one* thing: “[W]e are in complete agreement that the government should not be subsidizing housing for the wealthiest in our society. Writing in the *American Banker*, they continue, “Yet that would be the result of a provision in the GSE reform bill passed by the House this past fall. It would raise the ‘conforming loan’ limit for Fannie Mae and Freddie Mac by a whopping 50% and thereby increase the access of wealthy homebuyers to a government subsidy that Congress intended to benefit

families with low and moderate incomes. So far, the Senate has rightly balked at including this provision in its own bill.”

- “To help ensure that the subsidy accorded Fannie and Freddie was used only for those who need it, Congress established limits -- called ‘conforming loan limits’ -- on the amount of a mortgage that Fannie or Freddie could deal in. Under existing law, the limit has risen to \$417,000. This is already too high. To qualify for a \$417,000 mortgage, a family would have to earn at least \$130,000 -- more than twice the median family income in this country, and hardly a low or moderate income.”
- “The House bill, however, would increase the conforming loan limit by 50%, to \$625,500, for higher-cost areas across the entire United States. To qualify for a mortgage of that size, a family’s income would have to be \$190,000, almost three times the national median, and in the top 5% of all family incomes. And such an increase would probably mean, assuming a standard down payment, that the actual cost of the home would be about \$800,000.”
- “Let’s be clear about what this means. To the extent that Fannie and Freddie make loans to these wealthy families for high-cost homes, they are not making loans to the families of low and moderate income that Congress intended to benefit. The GSEs and some special interests that benefit from government subsidies for housing are now trying to convince the Senate to adopt the House-passed provision. This would be very bad public policy -- not just extending a subsidy to those who don’t need it, but depriving those who do need help of whatever benefits the GSEs confer.”
- “In any event, the GSEs’ record in providing assistance for homebuyers of low and moderate income has not been good. The Department of Housing and Urban Development has long had regulations intended to focus Fannie and Freddie on low-income or affordable housing. HUD secretaries have set goals, but these have had little effect in helping ensure the GSEs meet the housing needs of the underserved. In an April 2002 report, HUD found that the GSEs ‘continued to underperform the conventional conforming market in funding affordable home purchase loans for borrowers and neighborhoods targeted by the housing goals.’ It also found that ‘their market share for each of the affordable lending categories is less than their share of the overall market; and they account for a very small share of the market for important groups such as minority first-time homebuyers.’”
- “In other words, despite their significant subsidy -- about \$20 billion, according to a 2004 Congressional Budget Office study -- the GSEs were doing less than conventional lenders in helping the underserved. The HUD data was striking: GSE purchases were about 46% to 48% of all home loans originated in metro areas, but only 24% to 29% of loans for African-American and Hispanic borrowers, and about 35% to 37% for low-income borrowers and properties in underserved areas. Further, a Federal Reserve Board staff study had earlier found that the GSEs, despite their large and growing portfolios and dominance of the conforming market, provided only about 4% of the credit support going to minority borrowers.”

- “Even more troubling, the GSEs have been more interested in looking good than doing good. Recently, both Fannie and Freddie were found to have engaged in ‘roundtrip’ transactions purely to ‘appear’ to meet goals rather than actually funding goal-related loans. They did this by purchasing mortgages from major financial institutions but with agreements containing dissolution options that allowed the seller to take the mortgages back within a very short time.”
- “So, one must ask: Why should the GSEs be allowed to underwrite mortgages of up to \$625,500 for homes costing about \$800,000? There are many lenders aggressively competing to make the higher-amount loans, and the GSEs are not doing the job they should for low-income homebuyers.”
- “Fannie and Freddie should do a much better job of providing affordable home financing to a neglected portion of the mortgage market. And this certainly doesn’t include someone applying for a \$625,500 loan.” (*American Banker*, Peter J. Wallison and John J. Lafalce, 03/03/06)

Lessons learned from Fannie Mae and Freddie Mac
---

- In the March 3 issue of *FRBSF Economic Letter* published by the Federal Reserve Bank of San Francisco, Professor Thomas F. Cargill from the University of Nevada [Reno] and Harvard Law School Professor Hal S. Scott outline the lessons learned from the privatization of Fannie Mae and Freddie Mac in the context of Japan’s ongoing privatization of its postal savings and life insurance system [PSS, now called Japan Post] to identify issues that might arise in the future. Cargill and Scott wrote, “Like the PSS, Fannie and Freddie are large institutions—they hold assets worth nearly \$4 trillion, representing about 30% of U.S. GDP and they either hold or assume the credit risk of about three-quarters of U.S. residential mortgages. Like the PSS, Fannie and Freddie enjoy competitive advantages over private sector competitors by borrowing with implicit government guarantees. As a result they increase systemic risk by assuming significant interest rate risk, and they misallocate resources by directing most of their subsidy to shareholders rather than homeowners. Like the PSS, these institutions have strong grass roots support among homeowners and the home industry.”
- “Also like the PSS, Fannie and Freddie have arguably played an important positive role in the U.S. financial system. Their original function was to create a secondary market in residential mortgages, and in this regard they were highly successful. The secondary market allowed depository institutions, especially savings and loans, to reduce interest rate and prepayment risk. Fannie and Freddie purchased these mortgages with funds raised by selling mortgaged-back securities (MBS) to those better able to manage the interest rate and prepayment risks. Fannie and Freddie assumed the credit risk of the mortgages because they guaranteed only that interest

and principal would be paid. Even though now privately owned, Fannie and Freddie have a special relationship with the government that in turn was part of a social contract with the public dating back to the Homestead Act of 1863 to support residential housing.”

- “Like the PSS, the original rationale of Fannie and Freddie is increasingly difficult to support in light of the potential problems they generate. Securitization is now a major part of the private market, and, in the absence of Fannie and Freddie, private market securitization providers would surely emerge. Furthermore, in an effort to generate higher earnings, Fannie and Freddie have significantly increased borrowing from the markets to finance purchases of mortgages held in their own portfolios as well as MBS that they previously issued. This portfolio activity generates interest rate and payment risk in addition to credit risk for Fannie and Freddie. Those institutions have been able to borrow at rates only slightly above government security rates, because their debt is perceived as implicitly guaranteed by the government, even though it is only their assets that are so guaranteed. Given this perception, the public is likely correct that the government would go to great lengths, including using taxpayer funds, to ‘save’ the mortgage market and support the American dream of homeownership.”
- “Japan has started a process to privatize the largest and longest-lived element of its old financial regime. ...There is broad public support for modernizing Japan’s economic institutions. At the same time, even a privatized PSS with a special relationship to government will continue to generate issues—one need only consider the issues that have arisen in the U.S. regarding its own government-sponsored enterprises, Fannie Mae and Freddie Mac.” (*FRBSF Economic Letter*, Thomas F. Cargill and Hal S. Scott, 03/03/06)

Support voiced for Fannie Mae’s AD&C loan purchase program
--

- In a February 27 editorial, *Mortgage Line* wrote, “Is Fannie Mae’s decision to make acquisition, development and construction lending a permanent part of its business a legitimate move into a complementary area or a blatant example of mission creep, as some analysts have argued? It’s legitimate, it says here. Although to hedge our bets, we also urge the Department of Housing and Urban Development to set limits to direct the secondary giant’s ADC efforts towards the affordable housing sector.”
- “...The commercial banks and thrifts that dominate ADC lending are right to fear as formidable a competitor as Fannie Mae moving in on their turf. But if the end result of a secondary market for construction lending is less expensive houses (read: more affordable) then this is a reasonable justification for doing it.”
- “Fannie’s new product line also comes at a time when the Hurricane Katrina disaster means that thousands of destroyed homes in the affected areas will need to be razed and rebuilt. We have argued before that this creates opportunities for products like

the one-close construction and permanent mortgage, and expanded ADC authority makes sense in this context of expanded need.”

- “...NAHB has estimated that hundreds of thousands more buyers would qualify for homes if a secondary market for ADC loans is sustained, shaving \$3,000 off a home that could be built today for \$200,000. And since you generally can’t buy a home without a mortgage at these kinds of affordable levels, the benefit to lenders should be quite tangible.”
- “That also would be quite salutary for the kind of borrower affected by the terrible disaster of Hurricane Katrina, as well as the kind of emerging markets borrower seen as key to the mortgage market’s continued health as we retreat, in the words of Freddie Mac’s Richard Syron, from the mortgage Everest the business has climbed in recent years.” (*Mortgage Line*, 02/27/06)
- On March 1, the National Association of Realtors wrote HUD Secretary Alphonso Jackson to support the Agency’s decision to grant permanent status to Fannie Mae’s 10-year pilot of ADC loan purchases. NAR president Thomas M. Stevens wrote, “The AD&C loan purchase program provides funds to construct single-family housing, priced below the conforming loan limits, in areas where affordable housing is desirable. The program provides a secondary market support for affordable housing initiatives that actually assist Fannie Mae meet their affordable housing goals... and help fulfill housing needs in underserved areas...” (*Correspondence to HUD Secretary Alphonso Jackson*, Thomas M. Stevens, 03/01/06)

A tip of the hat to Dawn Kopecki
----------------------------------

- The *National Journal* reports, “After 11 years in journalism -- the past seven at the *Dow Jones Newswire* -- Dawn Kopecki has landed a reporting position with the Washington bureau of *BusinessWeek*. “It’s fun covering breaking news,” says Kopecki, who has reported on accounting scandals at Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system during her time with *Dow Jones*. Kopecki, 34, has seen many of her articles appear in *The Wall Street Journal*. She’s had several career highlights, including a three-month stint as the business editor of the *Aspen Daily News* in Colorado, where she covered both business news and the skiing industry. Kopecki also spent three years as the business reporter for *The Washington Times*. There, she enjoyed being the underdog “competing against *The Post*.” One of her most memorable moments occurred on September 11, 2001, when she was “ducking behind a tree with Senator [Robert] Byrd,” who was the president pro tempore at the time. While a student at Pennsylvania State University, Kopecki interned with several publications. One was *Kiplinger’s Personal Finance* magazine, which eventually hired her. Kopecki says she has “broken good stories” but is looking forward to a slightly less hectic schedule in the magazine world, with fewer postponed lunches, dinners, and hair appointments. She starts at *BusinessWeek* on

March 13. [You will be missed on the GSE beat, Dawn.] (*National Journal*, Jessica Sperlongano, 03/04/06)

Hurricane recovery notes:

Making the case for \$4.2 billion in housing aid for LA

Spur of crisis fades for LA

Will the good times ever roll again in the Big Easy?

Making the case for \$4.2 billion in housing aid for LA

- In a March 12 editorial, the *Times-Picayune* wrote, “The ruined streets of New Orleans made a persuasive backdrop [March 8] for President Bush to argue for the additional \$4.2 billion in housing aid he wants Congress to send to South Louisiana. The money is essential to carry out the state’s recovery plan, he said, noting that it is a well-thought-out strategy that has been vetted by federal officials. ‘We’ve all been working together to figure out how to come up with a housing plan that will restore the confidence of the people of this important part of our country,’ he said. The president’s support is a comfort. No one around here needs to be convinced of the importance of this appropriation to the recovery of greater New Orleans. But some members of Congress clearly do.”
- “Last week the House Appropriations Committee defied President Bush’s wishes to target the money to Louisiana and instead made it susceptible to a money grab by other Gulf Coast states. So far Texas is the only state to make an overt attempt to get a share, but the money is still vulnerable. Rep. Jerry Lewis, a California Republican, claimed that it would be improper to designate disaster aid for a single state. Set aside the fact that lawmakers routinely funnel money to specific causes. Congress should consider the immensity of the damage here, as President Bush has done in requesting additional housing aid for Louisiana.”
- “The government’s own accounting of the damage done by hurricanes Katrina, Rita and Wilma shows that Louisiana suffered far more than its neighbors. This state had 204,737 houses with major or severe damage. Alabama, Mississippi, Florida and Texas combined had fewer than half as many homes with that level of damage. In fact, Orleans Parish alone had more houses with major and severe damage than all four of those states. A single neighborhood in New Orleans -- Gentilly -- had more housing damage than the state of Texas. The degree of damage should be considered as well. More than half of the seriously damaged houses in Louisiana were in the severe/destroyed category. As so many people in greater New Orleans have discovered since Katrina struck, it is a monumental task to rebuild with that sort of damage.”

- “Congress also should keep in mind that the federal government bears responsibility for much of the flood damage in New Orleans. Blunders by the U.S. Army Corps of Engineers led to the collapse of the 17th Street and London Avenue canals. Those breaches inundated the city and left upwards of 8 feet of water in some homes, many of which had never flooded before.”
- “The logic of the extra \$4.2 billion appropriation is so simple for those of us here to understand that it is frustrating to watch Congress and leaders from other states question the need for it. In the initial allocation of Community Development Block Grant money, Mississippi got almost as much as Louisiana despite the greater damage here. That left this state facing an untenable situation: tens of thousands of ruined homes and not nearly enough money to help residents rebuild.”
- “From Washington, it might seem as though Louisiana has been given a tremendous amount of federal help since Katrina struck. But a visit here shows just how little of that money has reached those who are suffering. Programs run by the Federal Emergency Management Agency and the corps are rife with waste. The government has spent too much on trailers and blue roofing tarps. And many of the trailers still have not materialized for residents desperate for a place to live while they rebuild their lives.”
- “Although his administration was slow to understand the depth of need here, President Bush gets it now. That seemed clear during his visit last week. ‘I fully understand, and I hope your country understands, the pain and agony that the people of New Orleans and Louisiana and the parishes surrounding New Orleans went through,’ he told a 9th Ward business owner who has reopened her restaurant. Many Americans do understand. Their generosity and support have been overwhelming. It’s some members of Congress who seem out of it.” (*Times-Picayune*, 03/12/06)
- In a March 1 letter to Representatives Jerry Lewis (R-CA) and David Obey (D-WI), chairman and ranking member, respectively, of the House Appropriations Committee, the House Texas delegation requested \$2 billion to meet the hurricane recovery needs left outstanding for their state from the upcoming supplemental appropriations packages. The members wrote, “We implore you to help us insure Texas an equal opportunity to secure its fair share of critical hurricane recovery funding.” (*Correspondence to Chairman Jerry Lewis and Ranking Member David Obey*, 03/01/06)
- Donald Powell, the president’s coordinator for Gulf Coast recovery, testified before a congressional panel that he is telling lenders that Community Development Block Grant funds (CDBG) will be available to homeowners in disaster areas in a “very short period of time,” which will enable homeowners “to satisfy some mortgage obligations that they might not otherwise do.” According to *National Mortgage News*, Mississippi plans to begin taking housing assistance applications by April 1 and anticipate that homeowners will receive the funds in another three months. (*National Mortgage News Online*, 03/09/06)

## Spur of crisis fades for LA

- In a March 12 editorial, *The Advocate* [Baton Rouge] focuses on the failure of the Louisiana state legislature to enact reforms to cope with the aftermath of Hurricanes Katrina and Rita and how this failure will impair the State's recovery effort. *The Advocate* wrote, "The vast devastation of hurricanes Katrina and Rita would seem to be enough to concentrate the attention of even members of the Louisiana Legislature. But the reality that we live with in Louisiana is that there remains a reluctance to change, and a comfort level in the State Capitol with business as usual. Just look at the fate of reforms proposed to reduce the number of elected officials in malgoverned Orleans Parish. Those bills went nowhere. And they weren't really that far-reaching. After all, every parish in Louisiana is over-governed in terms of political baronies; Orleans is just much more so. The governor, to her credit, proposed that Orleans operate on the same basis as other parishes. But those bills went nowhere.
- We're fooling ourselves if we think that the nation does not notice. We're also fooling ourselves if we think that we can blame everything on FEMA and its ilk. Here is a recent editorial in *The New York Times*: 'Struck once by an unforgiving hurricane, the victims now face a perfect storm of poor response: a federal government of terrible administrators and a locality that is legendary for political dysfunction.' FEMA takes its lumps, but Louisiana isn't immune from criticism. *The Times* noted that 'watching the outbreaks of pettiness among lawmakers in the Louisiana Legislature is enough to turn one's stomach.'"
- "Are things going to get better? Hard to say, although the president's visit — despite so many disappointments before — gives us some hope that the federal government will eventually better organize itself to serve the suffering citizens of the entire Gulf Coast. But in Louisiana, the spur to reform may be further enervated by the reports of an improved revenue forecast for the 2007 fiscal year, which begins July 1. That budget may be illusory for a lot of reasons that have fiscal conservatives very worried. But even if it doesn't last much beyond the upcoming session, a good budget forecast virtually eliminates chances that this Legislature will vote for tough reforms. That's just the political reality. 'When you take the budget pressure off, you take away the pressure to make structural changes,' said Dan Juneau, president of the Louisiana Association of Business and Industry. ...Alas, the political moment may be lost for that kind of landmark reform." (*The Advocate*, 03/12/06)
- Thanks to higher tax collections and federal hurricane aid, Governor Kathleen Blanco submitted a \$20.3 billion budget proposal that spares most state agencies from major slashing and pours new dollars into colleges and teachers pay. Blanco's 2006-2007 spending plan represents an 8.6% increase over the budget plan approved by the state legislature last year. The governor's budget sets aside the state's first \$156 million bill due to the federal government for disaster response efforts, but state officials plan to review documents regarding how recovery money was spent before actually making the payment. In the budget, Blanco proposes to use \$105 million to give \$1,500 pay raises to school teachers and \$103 million to the state's public colleges to

cover rising health care and retirement costs, increase professors' pay by 5%, and help schools who lost students after the hurricanes. Commissioner of Administration, Jerry Lukce LeBlanc, the governor's chief financial architect, said that the budget is an attempt to balance the state's hurricane recovery needs against its pre-Katrina priorities. "Our challenge was: How do we budget for recovery and rebuilding while at the same time moving the state forward in those other priorities?" LeBlanc said. The sheer size of the budget and the absence of any major program cuts or reductions surprised longtime fiscal watchdogs, who fear that the state is postponing an inevitable day of reckoning. "The question remains: Are we overextending ourselves based on the amount of one-time, nonrecurring revenue in the budget?" asked Jim Brandt, president of the nonpartisan Public Affairs Research Council. Having hoped that the budget would have included plans for redesigning the state's health care and higher education infrastructure, Brandt said, "It looks as though it's back to business as usual in many of these departments."

- Blanco stepped up her campaign to push for a \$1,500 raise for public school teachers through the launch of a 60-second statewide radio ad that criticizes those who will try to use her \$20.3 billion proposed budget to rebuild big government rather than focus on education and other needs. "My radio ads are aimed to just make a positive statement about Louisiana and the priorities of our government," Blanco said. One political consultant called the ad campaign to be "a little bit odd," while another analyst said the campaign is more a move to shore up the governor's storm-tarnished image. Blanco, a 63-year-old Democrat who plans to seek a second term in 2007, has watched her approval rating sink to 32% in a February Survey USA, compared with 50% before Katrina hit. The governor's apparent weakness has triggered an effort to draft former Senator John B. Breaux, 62 years old, to challenge her in a Democratic primary. While Breaux has remained silent on whether he wants the job, some influential Democrats are backing his return. In 2007, Republicans hope to take control of one of the last Southern states that leans toward the Democratic column. One of the party's leading prospects for this race is Representative Piyush "Bobby" Jindal (R-LA), a 34-year-old conservative who represents some New Orleans suburbs and a sliver of the city. (*Wall Street Journal*, Corey Dade and Ann Carrns, 03/08/06; *The Advocate*, Michelle Millhollon, 03/09/06; *The Advocate*, Will Sentell, 03/11/06; *Times Picayune*, Jan Moller, 03/07/06; *Associated Press*, Melinda Deslatte, 03/06/06)

### Will the good times ever roll again in the Big Easy?

- In a March 5 article in the *New York Times*, John Schwartz writes, "Despite scattered signs of progress, New Orleans seems mired in its destroyed neighborhoods and political squabbling. It is a place where no decision is so small that it cannot be second guessed and one of the most common complaints—after gripes about FEMA—is the dearth of leadership." Against this back drop, 24 candidates now battle for the mantle of Mayor of the Crescent City in what's viewed by many as a "free-for-all" in the April 22 election. With only half of the city's residents having returned home, tens of thousands of evacuees still scattered across the country will be eligible to vote by mail or at satellite polling places in the state, transforming the

mayoral race into a far-flung affair with candidates planning stops in Atlanta, Houston, Dallas, Memphis and Jackson, MS. Lt. Governor Mitch Landrieu, a 45 year old descendant of a legendary New Orleans political family, and Ron Forman, the 58 year old CEO of the Audubon Nature Institute, are considered to be the leading challengers to Mayor C. Ray Nagin. If no one takes more than 50% of the vote, the mayoral race will be decided in a May 20 runoff. (*Wall Street Journal*, Corey Dade and Ann Carrns, 03/08/06; *Washington Post*, Peter Whoriskey, 03/06/06; *New York Times*, John Schwartz, 03/05/06)

- Writing in the *Weekly Standard* Matt Labash captures the frustration of the people in New Orleans, through a long-time resident nicknamed “Kingfish.” Labash wrote, “One of the last Uptowners with a generator and the bad sense to stay in New Orleans, Kingfish was fighting to keep his house and his businesses and his life from washing away with the rest of the city... A native son with civic pride, he is tired of Louisiana being a national punch line. He’s tired of Orleans Parish public school officials literally stealing millions of dollars as the system fails; he’s tired of idiot-brothers-in-law littering corrupt levee boards; he’s tired of episodes such as the one currently playing out in the April mayoral race, in which a fringe candidate (and the state’s chief election official) is campaigning from her jail cell. If [former governor Huey P.] Long said, ‘The time has come for all good men to rise above principle,’ then *this* Kingfish has no use for good men.” (*Weekly Standard*, Matt Labash, 03/20/06)

Credit rating agencies come under “heavy fire” in Senate hearing
--

- Amid charges of duopoly and conflicts of interest, credit rating agencies (CRAs) were subjected to harsh criticism in an April 7 hearing before the Senate Banking Committee. As a top S&P official defended his company against attacks, Senate Banking Committee Chairman Richard Shelby (R-AL) said lawmakers have “a decision to make” on the oversight of the \$2.5 billion credit rating agency industry, in which CRAs “wield extraordinary power in their role as gatekeepers to the bond markets.” Shelby continued, “It is quite clear that the U.S. Congress has a decision to make regarding this essentially self-regulated yet noncompetitive industry with duopoly profits.” The hearing marked the latest chapter in a four-year battle over regulation of an industry that is highly concentrated, hugely profitable and, long overdue for a shake-up, according to critics.
- Moody’s Investors Service and S&P dominate the business, accounting for 80% of the industry’s revenues, according to a 2005 American Enterprise Institute study. Operating profit margin at Moody’s approaches 55%, fifth on the S&P500. Since Moody’s went public in 2000 at \$12.50 a share, its stock has risen five-fold to \$67.11 a share at its close on March 7. The Fitch Ratings, a unit of France’s Fimalac SA, runs a distant third to Moody’s and S&P, followed by smaller rivals such as Dominion Bond Rating Service, of Canada, and A.M. Best Co., a specialist in the insurance business. These five agencies are the only ones dubbed by the SEC as

NRSROs, or “Nationally Recognized Statistical Rating Organizations,” a status providing them major advantages over their competitors. “It is almost impossible for a rating firm to compete in this industry without the [NRSRO] designation,” said Shelby.

- Critics argue that the NRSRO designation creates a barrier to competition, making the top CRAs complacent. Moreover, the agencies’ standard business model, in which debt issuers pay the agencies for ratings, poses an inherent conflict of interest, claim critics. Investment Company Institute President Paul Schott Stevens, AFL-CIO Associate General Counsel Damon A. Silvers, and Financial Executives International President and Chief Executive Officer Colleen S. Cunningham argued that Congress should enact legislation that would establish a registration system for CRAs and would provide the SEC the authority to inspect them to ensure credible and reliable credit ratings. CFA Institute President and CEO Jeffrey J. Diermeier urged Congress either to expand the SEC’s oversight powers over CRAs and/or to mandate rating agencies to submit to either involuntary regulation or voluntary self-regulation.
- Calls for reforming the industry emerged in 2002 after the ratings agencies failed to detect balance sheet issues at Enron Corp. ahead of the 2001 collapse of the former energy trading group. Under pressure to reform the industry, in 2005 the SEC voted unanimously in favor of a modest proposal to better explain its NRSRO system, but the Commission has taken no further action.
- S&P Credit Market Services Executive Vice President Vickie Tillman told the Senate Banking Committee that her firm favors NRSRO reform. “We urge Congress to press the SEC to move forward,” Tillman said. She warned, however, that abandoning the NRSRO system, as some in Congress favor, would leave “a regulatory vacuum.” Tillman argued that legislation “is unnecessary at this time” and contended that there is “no evidence” that the issuer-pays business model compromises impartiality. After the hearing, Tillman said that credit rating agencies have First Amendment rights that shield them from government regulation. A credit agency reform bill in the House would run afoul of these protections, she added. (*Reuters*, Kevin Drawbaugh, 03/07/06; *Bureau of National Affairs*, Rachael McTague, 03/08/06)

Home prices appreciated 12.95% in 2005
--

- In 2005, home prices rose 12.95%, up slightly from the prior year, according to OFHEO. “Despite recent indications that a slowdown may be forthcoming, house price appreciation during 2005 continued to hover at near record levels,” said OFHEO chief economist Patrick Lawler. The strongest rates of housing price growth in 2005 were centered in areas that are popular with retirees, including Arizona (where home prices rose 34.9%) and Florida (26.8%). (*Bureau of National Affairs*, 03/02/06)

- Meanwhile, the outlook for the U.S. housing market remains strong in 2006, and there is no national real-estate bubble that's about to burst, said St. Louis Fed President William Poole, in a speech before the Regional Chamber and Growth Association in St. Louis, MO. "My hunch ... is that housing activity will stabilize and remain at a high level this year," he added. Poole said his forecast was based on the expectation that the Federal Reserve "will keep underlying inflation low and stable." Real household income "will recover nicely due to the waning influence" of last year's spike in energy prices, he said. "Continued healthy job growth will also help keep housing at a high level."
- Poole dismissed fears of a nationwide housing bubble, based upon research from the St. Louis Fed, which suggested that U.S. house prices "are not particularly unreasonable" based on fundamentals. "The conventional view, which I subscribe to, is that a housing-price bubble does not exist on a national average basis, but there may be pockets of the country where prices have risen beyond levels that can be justified by economic fundamentals," said Poole. (*MarketWatch*, Greg Robb, 03/085/06)

BIS reports record year on exchanged-traded derivatives
---

- According to the 2005 data released by the Bank for International Settlements (BIS), demand for exchange-traded futures and options contracts reached an all time high with annual turnover up 22% over 2004. Trading reached \$1,408 trillion on the world's derivatives exchanges, up more than 22% from 2004's turnover of \$1,152 trillion. Approximately 90% of trades were linked to interest rates, 9% to equity and 1% to currency, while each of the asset classes grew by 22%, 26% and 68%, respectively.
- Notional amounts in the fourth quarter were down 3.6% compared to the third quarter, with \$344 trillion traded versus \$357 trillion. According to the BIS, "The fourth quarter decline in derivatives activity may be related to an increase in investors' need for liquidity to meet year-end cash flow obligations or to reduce position-taking in order to 'lock in' previous returns. In both cases, traders may reduce positions in derivatives." Particularly low demand for interest rate-linked derivatives in the US and Japan during the fourth quarter of 2005 was partly offset by demand for euro interest rate-linked derivatives ahead of the European Central Bank's rate hike on December 1, according to BIS. (*Risk News*, Gore Gareth, 03/07/06)

## *Fannie Mae*

Fannie Mae's "attitude of arrogance"
--------------------------------------

- In the weeks following the release of the Rudman Report, reporters continue to dig through the 2,652-page report, which took more than 17 months to prepare at a cost of more than \$60 million. As Steven Pearlstein noted in the *Washington Post*, "... [A]s the definitive word on what went wrong at Fannie Mae, the [Rudman] Report ... is surprisingly unsatisfying. You get the whos, what, wheres, and whens. But it's annoyingly short of the whys..." While Rudman and his investigators summarized what they discovered through hundreds of interviews and the review of millions of documents, the reader isn't provided much, if any, context in which events occurred. Missing from the Rudman Report is "the frenzy of Wall Street, the ridiculous escalation in executive pay, the widespread deterioration of accounting standards, and the relentless political assault against [Fannie Mae] by competitors and ideological foes," wrote Pearlstein. He continued, "And even after wading through hundreds of pages, you still can't figure out why so many smart, hardworking and basically decent people could get it so wrong" –to the tune of \$10.8 billion.
- Actually, the Rudman does address "why." According to the Rudman Report, "[A]lthough [Fannie Mae's] management paid lip service to a culture of openness, intellectual honesty and transparency, the actual corporate culture suffered from an attitude of arrogance ...and discouraged dissenting views, criticisms, and bad news." The Report specifically points to Fannie's arrogance which over the years soured its relationship with OFHEO. "Many members of management believed that OFHEO had no right to question Fannie Mae's policies in light of the company's years of sustained success," said Dan Mudd. The Report also highlighted the GSE's lobbying arm's use of "aggressive" tactics against OFHEO. In a 2003 e-mail, senior advisor William Maloni suggested to the company's chief lobbyist that he contact lawmakers and "have a Democrat nail" [OFHEO deputy director] Steve Blumenthal and accuse him of "setting up the company in the coming [special examination]."
- In a September 2003 memo, Raines told employees that "our openness and intellectual honesty with each other helps to make us the quick, creative, fast, agile and successful company we are." Raines added, "We need to be transparent and address the tough questions internally as well." Clearly, Fannie's culture was apparently out of sync with Raines's vision. According to employee surveys taken during Raines's tenure as CEO, Fannie's culture was one in which lines of authority were jealously guarded and the flow of information was far from free. "Many folks are not willing/comfortable to tell senior management what they don't want to hear," said one employee in the legal department. Roger L. Barnes, a former accounting manager who raised concerns with Fannie officials about accounting irregularities, found management was unwilling to listen to his concerns. Barnes told investigators, "They said, 'Intellectually, you don't know what you're talking about... You're

intellectually inferior or out to destroy the mission.” Later, Barnes’ allegations were largely borne out by OFHEO and the Rudman Report.

- The Report also illustrated how information flow was closely guarded by management and not disclosed to Fannie’s board members. When director Tom Gerrity, head of Fannie Mae’s audit committee called Sam Rajappa, Fannie’s head of internal auditing in the spring of 2004, CFO Howard informed Rajappa that such contact was strictly forbidden. Howard, who tightly controlled what information and how information was presented to the board, viewed such “end runs” as a threat to his authority. In a March 3, 2004 email to controller Spencer, Howard wrote, “I just got off the phone with Sam [Rajappa]. I made it ‘blisteringly clear’ to him that on any future calls he gets from the chairman of the audit committee on accounting-related issues he must run the question or issue by you before he or anyone else gets back to Gerrity. ...He said he got the message and [said he] would do so in the future.” When investigators told Gerrity of Howard’s e-mail last year, he said he was “shocked.”
- According to the Report, Fannie Mae’s management also controlled (and restricted) information flow to its external accountants as well. Memos included in the Rudman Report demonstrated that Howard and his staff intentionally withheld loss analyses from KPMG’s new team of auditors in 1998, fearing that they would find the process violated GAAP, according to an unsigned memo to Howard. “The accounting team [KPMG] currently have on the audit is more technically proficient, and if they stumble across these packages, may not be as easily convinced of the current accounting treatment. We have made every effort to keep our analysis confidential,” said the memo.
- In November 2004, Raines conceded in talking points for a speech to Fannie Mae’s executives that the company’s culture had not served it well. “We need to be candid about the fact that we are not perfect. We may have believed our own PR a little too much. We allowed ourselves to be arrogant. We thought we had a lot to teach and little to learn from others.” By then, Raines’ concessions were much too late – the damage had been done to Fannie Mae.
- The Rudman Report concluded, “We did find ...that Raines contributed to the culture that improperly stressed stable earnings growth and that ...he was ultimately responsible for the failures that occurred on his watch.” (*Washington Post*, Steven Pearlstein, 03/03/06; *Washington Post*, Terence O’Hara, 02/24/06; *Bloomberg News*, Mike Weiss, 02/24/06; *Washington Post*, Annys Shin, 02/24/06; *Washington Post*, 02/27/06; *American Banker*, Rob Blackwell, Patrick Rucker, and Joseph Adler, 02/27/06; *Dow Jones Capital Markets*, John Connor, 03/06/06; *USA Today*, Paul Davidson, 02/24/06; *Associated Press*, March Gordon, 02/23/06)

### Follow the bouncing hard drives

- As noted in the February 27 GSE Report, Fannie Mae general counsel Beth Wilkinson “flagged [Rudman] investigators” about the discovery of 22 laptop computers used by senior accounting officials and other executives during business travel. According to reports, these laptops were recently found in a warehouse and have been turned over to Rudman. In a March 6 article on Rudman’s electronic document investigation, *eWeek* wrote, “In the investigation, 127 hard drives were imaged, providing a snapshot of company data. However, some hard drives got away, or in Fannie Mae’s case, were donated to charity. Hard drives from [computers of] key executives were donated to the Children’s Health Project and Vanessa Ali Ministries.” (*Bloomberg News*, James Tyson, 03/24/06; *eWeek*, Larry Digan, 03/06/06)

### Buffett’s words of wisdom

- In his February 28 letter to Berkshire Hathaway shareholders, chairman Warren Buffett analyzed executive compensation in the U.S., which he views to be “ridiculously out of line with [corporate] performance.” Buffett wrote, “...Getting fired can produce a particularly bountiful payday for a CEO. Indeed, he can ‘earn’ more in that single day, while cleaning out his desk, than an American worker earns in a lifetime of cleaning toilets. Forget the old maxim about nothing succeeding like success: Today, in the executive suite, the all too-prevalent rule is that nothing succeeds like *failure*.” (*Letter to the Shareholders of Berkshire Hathaway, Inc.*, Warren E. Buffett, 02/28/06)
- Buffett’s words of wisdom certainly apply to severance packages for former Fannie Mae chairman and CEO Franklin Raines and former CFO Timothy Howard. When Raines “accepted early retirement “ from Fannie Mae in December 2004, he left the company with a minimum \$24.2 million severance package, which *excluded* his \$1.4 million annual salary for life; another \$21 million in accelerated stock, potential future stock payouts valued at up to \$34.6 million, and an undisclosed amount in 401(k) benefits. Howard, who was forced to resign from Fannie Mae, left the company with a minimum severance package valued at approximately \$12 million, which *excluded* a \$433,000 annual salary, another \$15.3 million in accelerated stock payout that he had already earned, potential future stock payouts valued up to \$6.4 million and an undisclosed amount in 401(k) benefits. (*Dow Jones Business News*, Dawn Kopecki, 02/27/04)

### FASB 133’s contribution to the Fannie Mae “train wreck”

- In the *American Banker*, AEI resident fellow Alex J. Pollock focused on the utter failure of FAS 133, and the impact it has had on at least 40 companies which have

had to restate financials “because they could not cope with this Byzantine accounting rule.” Pollock continued, “It took the FASB a decade to create this failure... [And] [i]t has taken the FASB half a decade to recognize this failure. Better late than never. But the real need is not just an alternative but to scrap FAS 133 and start over.”

- “A notable case to ponder is Fannie Mae’s disastrous meeting with FAS 133. The Rudman Report has now concluded that Fannie’s implementation of FAS 133 ‘deviated from the standard’s clear requirements in numerous and important respects.’ Of course Fannie should have followed the GAAP standard, however silly and flawed it may be to the best of its ability; that is the requirement for being a public company. But from an economic welfare and public policy perspective, consider the expense to shareholders (which is also a wealth transfer to accounting firms) of having 2,000 consultants at Fannie costing hundreds of millions of dollars redoing the books largely to implement with precision an accounting rule that is conceptual nonsense. New financial statements will be produced at immense cost -- but what will they be worth? Since FAS 133 distorts the real economics, not much. How ironic to spend a fortune to produce misleading and opaque ‘corrected’ statements.” (*American Banker*, Alex J. Pollock, 03/10/06)

#### Fannie Mae’s portfolio shrinks in January

- Fannie Mae’s mortgage portfolio fell at an annualized rate of 3.1% in January due to higher costs and strong competition. “The portfolio results for January really just reflect diminished investment opportunities, along with continued strong competition for mortgage assets,” said company spokeswoman Janis Smith. Fannie Mae’s book of business [the sum of its investment portfolio and the MBS that it guarantees] grew at a compound annualized rate of 6.9%, driven by an annualized compound growth of 11.8% in MBS. Total business volume was \$51.1 billion in January, down more than 10% from December’s volume of \$57.9 billion. Portfolio purchases of \$12.2 billion in January were offset by \$12.4 billion of liquidations and \$1.8 billion of sales. Fannie Mae’s average duration gap was unchanged at zero months in January. (*Reuters*, Lynn Adler, 02/27/06; *Fannie Mae Monthly Volume*, January 2006)

#### Fannie Mae promotes Linda Knight to EVP for Capital Markets

- Fannie Mae announced that Linda Knight, senior vice president and treasurer, has been promoted to executive vice president for Capital Markets, where she will manage the operation of Fannie Mae’s Capital Markets Group under the leadership of Peter Niculescu, EVP for Capital Markets. Knight will have responsibility for the day-to-day operations of the group, direct responsibility for all middle office and back office functions and interactions with Fannie Mae’s systems and operations teams. She also will continue to be responsible for overseeing fixed-income marketing and corporate finance and will manage the processes related to balance sheet assets the company maintains to fulfill its mission to expand affordable housing for low-

moderate- and middle income Americans by bringing global capital to local communities. Knight, who joined Fannie Mae as a senior market analyst in 1982, served as the company's senior vice president and treasurer since 1993.

- Niculescu also announced a new Capital Markets leadership team comprised of four senior vice presidents. David Benson has been promoted to senior vice president and treasurer, Capital Markets and will have a dual reporting line to Niculescu and Knight. Benson will be responsible for the company's debt issuance, liability management, and liquidity management activities, including responsibility for the execution of derivatives utilized for the interest rate risk management of the company's balance sheet. Benson joined Fannie Mae in 2002 as vice president and assistant treasurer. Prior to joining Fannie Mae, he was managing director and head of e-Commerce for the fixed income division at Merrill Lynch.
- Ramon de Castro was promoted to senior vice president, Capital Markets-Mortgages, and will focus on identifying and executing mortgage transactions consistent with Fannie Mae's strategy and liquidity mission. He will be responsible for the trading of all mortgage products for the company's mortgage portfolio, as well as oversight of the company's structured asset transactions group. He began his career at Fannie Mae in 1991. Prior to joining Fannie Mae, de Castro worked in the corporate treasury of US Airways.
- Andrew Bon Salle was promoted to senior vice president, Capital Markets-Lender Channel. He will act as the primary liaison with mortgage lenders for mortgage transactions and for new business initiatives and will be responsible for providing market execution and liquidity to Fannie Mae's lender customers through retained portfolio and off-balance sheet transactions. In his most recent position with Fannie Mae, Bon Salle has been responsible for trading, marketing, product development, and sales of customer-targeted mortgage backed securities trading services. Prior to joining Fannie Mae in 1993, Bon Salle was vice president at Hamilton, Carter, Smith & Co., Inc., where he coordinated the marketing and sale of mortgage loan servicing, whole loan transactions, and portfolio evaluations.
- William Quinn, senior vice president, Capital Markets Strategy, will continue to focus on asset/liability management and total return management subject to risk and capital constraints. Quinn and his team will focus on credit risk management, application requirements, development, and testing. He also will assume responsibility as the Capital Markets Group's second business unit risk officer, responsible for interest rate risk management, and for management of non-Fannie Mae mortgage credit risk and model risk. Quinn joined the company in 2000 as vice president for risk management strategies where he was responsible for developing an asset-liability structure to manage portfolio risk. (*Fannie Mae Press Release*, 03/10/06)

## ***Freddie Mac***

### Freddie Mac declares dividends for first quarter

- Freddie Mac's board of directors declared a quarterly dividend of \$0.47 per share on the corporation's voting common stock. The company's first quarter dividends will be payable on March 31, 2006 to stockholders of record as of March 10, 2006. The GSE also declared dividends on its preferred stock, pursuant to the terms of each issue. (*PRNewswire-Firstcall*, 03/03/06)

### Terms of Freddie Mac-OFHEO Settlement won't augment OFHEO's appropriations

- The GAO has determined that the terms of a settlement between Freddie Mac and OFHEO, under which the GSE agreed to pay a vendor to electronically format certain documents for the regulator, won't augment the agency's appropriations. "Under the terms of the settlement agreement, Freddie Mac's payment of formatting costs does not constitute a de facto augmentation of OFHEO's appropriation," said the GAO. "Despite the language of the settlement agreement ('Freddie Mac shall pay a vendor or vendors hired by OFHEO'), the costs of formatting, up to \$1 million, are Freddie Mac's costs, not OFHEO's costs." GAO added, "No augmentation of OFHEO's appropriations will occur as the settlement satisfies a prosecutorial objective, and no contractual relationship between OFHEO and the vendor exists with respect to formatting of Fannie Mae's documents." The GSE isn't defraying an obligation of OFHEO, but is fulfilling Freddie Mac's obligation as agreed to in settling the charges brought against it by OFHEO, said GAO. (*Dow Jones Newswires*, John Connor, 03/06/06)

### Freddie Mac appoints James R. Egan as SVP, Controller

- Effective April 3, James R. Egan will join Freddie Mac as senior vice president, controller and principal accounting officer. Previously, Egan was executive vice president and controller for MBNA America Bank. Egan, 53, will be responsible for accounting policy, external reporting and financial disclosures, corporate accounting and analysis, internal controls and regulatory reporting. He will report directly to Martin F. Baumann, EVP-Finance and chief financial officer. (*Freddie Mac Press Release*, 03/07/06)

### Freddie Mac chairman and CEO Syron elected to Genzyme's board of directors

- Genzyme Corp., one of the world's leading biotechnology companies, announced the election of Richard F. Syron, chairman and CEO of Freddie Mac to its board. Founded in 1981, Genzyme has grown into a diversified enterprise with more than

8,000 employees and revenues of \$2.7 billion in fiscal year 2005. (*PR Newswire US*, 02/28/06)

Freddie Mac announces multi-family mod rehab product

- Freddie Mac has announced the Low-Income Housing Tax Credit Moderate Rehabilitation (LIHTC Mod Rehab), as an enhancement to its Multifamily Affordable Forward Commitment product for borrowers acquiring properties with affordable units and seeking to finance moderate rehabilitation while keeping their tenants in place. In the LIHTC Mod Rehab, Freddie Mac provides up-front financing to accomplish moderate rehab for properties funded entirely, or in part, with low-income housing tax credits. This execution is available to approved Seller/Service providers for properties that have received either a 4% tax credit tax-exempt bond execution or a 9% tax credit cash execution. (*Freddie Mac Press Release*, 02/28/06)

Freddie Mac Foundation donates \$1.5 million to Boys & Girls Clubs of Greater Washington

- The Freddie Mac Foundation has awarded a \$1.5 million grant to the Boys & Girls Club of Greater Washington, the largest grant ever received in the 120-year history of the organization. BGC GW will use the funds to build and expand its Education Initiative, a program providing skill-building and learning activities to over 1,000 DC youth; its overnight summer camp; and its Come on Home Alumni Campaign. (*PR Newswire*, 03/07/06)

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

Finance Board approves proposed rule to strengthen FHLBs' capital
---

- The Federal Housing Finance Board unanimously approved a proposed rule intended to strengthen the FHLBs' capital structure by requiring a minimum level of retained earnings and restricting the amount of excess stock that a Bank can accumulate. Under the proposal, the FHLBs would have to hold approximately \$4.4 billion in retained earnings, a 76% increase from current capital requirements at year-end. The proposal most dramatically impacts the FHLBs which have large holdings of mortgage assets and other non-advance investments, such as mortgage-backed securities. Under the rule, the Finance Board would also restrict the amount of dividends that a FHLB could pay when it is not in compliance with the minimum retained earnings requirements and would prohibit the Banks from issuing dividends in the form of stock. The proposal requires the FHLBs to cut their cash dividends in half until the Banks reach the required capital level, a process which agency officials estimate would take two years or more. "The [FHLBs] have grown in size, complexity, and inherent risk. My goal is to ensure that the Banks remain safe and sound, appropriately capitalized, and able to raise funds in the capital markets," said Chairman Ronald Rosenfeld. "The proposal today is an important step towards fulfilling that goal." The proposed rule will be published in the Federal Register and will be open for public comment for 120 days following publication.
- Industry officials are critical of the Finance Board's proposal, arguing that it would be a reversal from the capital standards created under the Gramm-Leach-Bliley Act of 1999. "Gramm-Leach-Bliley established a capital framework and put a system in place," said Diane Casey-Landry, president of America's Community Bankers. "They are rewriting what the banks spent years doing. They are causing unnecessary hardships in the system. We do believe there is a mission purpose for dividends." Another industry observer, who asked not to be identified, said, "This will be a war of the worlds—the members will not stand for this."
- Steve Cross, the Finance Board's director of supervision, said that the Board issued this proposal because some of the FHLBs "fell short" in their response to the guidance issued by the agency in 2003, encouraging them to increase their retained earnings. "We needed...to push harder against the Banks that have been slow to respond to the advisory bulletin," Cross added.
- Jaret Seiberg, a policy analyst for Standard Washington Research Group, said "This proposal will make it harder for the Home Loan banks to be active in the mortgage purchase business." In an interview, Rosenfeld said that wasn't the intent of this proposal. "If we wanted to end it, we could end it. That was never discussed," he added.

- “There is no question that this is the Finance Board sending a message to the 8,000 or so members of the [FHLB] System that you will always be able to get the par value of your stock back,” said Alfred DelliBovi, the president of the FHLB-New York. “I believe their intention is to make sure there is enough retained earnings available to deal with any kind of routine hit and to use the equity capital only in the event of a catastrophe.” Rosenfeld and Cross agreed that the Finance Board had such intent when the proposal was crafted. Cross pointed to the \$190 million loss on manufactured housing bonds in 2003 suffered by the FHLB-NY, a loss that nearly exhausted the Bank’s retained earnings. “How many [FHLBs] have retained earnings that could absorb that kind of loss without dipping into the capital stock?” Cross asked. “How many banks in that situation are bigger than the New York Bank and probably have more asset-backed securities and other investments, to say nothing of mortgages?”
- However, industry representatives argue Congress did not have such a system in mind when lawmakers mandated a risk-based capital structure under Gramm-Leach-Bliley. “We do believe that [equity capital] is real capital,” said Casey-Landry. “You don’t get to throw out a framework Congress established.”
- DelliBovi acknowledged that the Finance Board’s proposal “is going to create some pain. He added, “That’s what regulators do. Their job is not to give out candy.” (*Federal Housing Finance Board Press Release*, 03/08/06; *American Banker*, Rob Blackwell, 03/10/06; *American Banker*, Rob Blackwell, 03/10/06)

FHLB-Seattle reports \$9.1 million loss in 4 <sup>th</sup> Quarter 2005
---

- During the fourth quarter of 2005, the FHLB-Seattle lost \$9.1 million, as the Bank realized losses of \$6.4 million due to the retirement of \$236 million of long-term, high-cost debt and \$5.4 million relating to the abandonment of leased properties. For the twelve months ended December 31, 2005, the Bank reported net income of \$1.7 million. Noting that these results reflect the Bank’s transition to an advances-focused business, Seattle Bank president and CEO James E. Gilleran said, “We’ve significantly grown our advances volumes, and ...reduced our risk profile, even though we incurred some costs in the process. Now, we believe we have positioned ourselves to strengthen our earnings growth and our profitability.” During FY2005, the Bank’s advances increase 21% to \$21.4 billion. The Bank also sold \$1.4 billion of mortgages in its Mortgage Purchase Program portfolio, reducing the MPP balances outstanding to \$7.2 billion as of December 31, 2005. Earlier, the FHLB-Seattle had projected that it would not return to profitability until 2007. Based upon its 2005 results, the FHLB-Seattle said it is “currently tracking ahead of its original plan and no longer expects losses in 2006.” (*FHLB-Seattle Press Release*, 03/03/06)

FHLB-Cincinnati sponsors the New Neighbors Programs

- In response to the devastating effects of the hurricanes Katrina and Rita, the FHLB-Cincinnati is offering financial assistance through the New Neighbors Program to help evacuees establish permanent residences. The Bank is making \$15 million of grants available for the acquisition of owner-occupied housing or to provide housing in small rental (1-8 units) housing. Members of the FHLB-Cincinnati will deliver the New Neighbor Program funds on a first-come, first serve basis. For rental projects, New Neighbor funds will be made available in monthly competitive offerings until all funds are committed. The maximum New Neighbors grant is limited to \$20,000 per owner-occupied unit or \$12,500 per rental. The maximum purchase price for an owner-occupied unit may not exceed \$175,000. Additional information about the New Neighbors Program is available at [http://www.fhlbcin.com/05\\_NewNei\\_Des.asp](http://www.fhlbcin.com/05_NewNei_Des.asp) . ([www.fhlbcin.com](http://www.fhlbcin.com))

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

FCA board approves the Agency's Unified Agenda  
and revised Regulatory Performance Plan for FY2006

- The Farm Credit Administration board of directors has approved the Agency's Spring 2006 Unified Agenda of Federal Regulatory and Deregulatory Actions and the revised Regulatory Performance Plan for Fiscal Year 2006. The Unified Agenda, published semiannually in the *Federal Register*, describes all rulemaking items that the FCA expects to conduct or review in the next 12 months. Items on the Agenda include an advance notice of proposed rulemaking on the assessment on FCS institutions, a re-proposed rule on investments in Farmers' Notes, and a review of lending program requirements. Final rules on the Agenda include regulatory burden, disclosure and reporting requirements, risk-based capital standards for the Federal Agricultural Mortgage Corporation (Farmer Mac), and termination requirements for FCS institutions. The revised Regulatory Performance Plan includes rulemaking actions that have occurred or are projected to occur during fiscal year 2006.
- At its March 9 meeting, FCA's board also authorized Northwest Farm Credit Services, ACA to make investments in agriculture and rural community (ARC) bonds under a pilot program designed to help meet the changing financing needs of young, beginning, and small farmers and ranchers, agricultural businesses, and rural communities. The board also approved guidance on the rules that the FCS banks and associations and the Federal Farm Credit Banks Funding Corporation could apply to prepare their annual reports for the fiscal year ending December 31, 2005. (*FCA Press Release, 03/09/06*)

FCA System is vital to the nation's agricultural economy, says Agribank president

- The largest bank based in St. Paul, MN is AgriBank, a \$40 billion farm lender with a 15-state "empire" reaching from North Dakota to Tennessee. Bill York, AgriBank's new chief executive officer, said he's not concerned that AgriBank is a mystery to most city-dwellers. "As long as our associations know and respect what we're doing, that's what we're about," York said. "It's not our intention to be a household name." In an interview with the *St. Paul Pioneer Press*, York argued that the FSA System is vital for farmers, saying, "This is a cyclical business. There will be times when there is a flight to quality, when many lenders want to come to agriculture. And there are also times, frankly, that credit will go out of agriculture. We as a culture cannot let that happen. ... Farmers and ranchers need to know there is a provider out there who is not going to exit the marketplace." He continued, "While the farm economy is healthy and doing well, that does not necessarily translate to the rural economy being healthy and doing well, and it may mean we have some opportunities. ...I think the performance of the system is absolutely critical to agriculture in the United States, being the biggest player. With the scale of this district, our impact on the agricultural marketplace is huge. And the agricultural economy has a big impact on the U.S. economy, and the world's." (*St. Paul Pioneer Press*, Tom Webb, 03/05/06)

## ***Postal Service***

Postal reform legislation likely to emerge from conference by April

- In a March 7 *Postal Legislative Update*, the National Association of Postal Supervisors stated, "Since February 9 nearly a month ago, when the Senate passed its postal reform measure, the pace of action on postal reform has slowed once again. The next major step will involve conference negotiations between representatives of the Senate and House to bridge the differences between the House and Senate-passed bills. Those conference talks will determine the ultimate face of postal reform. The conference measure, once negotiated, must return to each chamber for its final approval before going to the President for signature and becoming law. Last month, Senate Majority Leader Bill Frist (R-TN) appointed the Senate's eight conferees: Senators Susan Collins (R-ME), Ted Stevens (R-AR), George Voinovich (R-OH), Norm Coleman (R-MN), Robert Bennett (R-UT), Joseph Lieberman (D-CT), Daniel Akaka (D-AK), and Tom Carper (D-DE). House Speaker Dennis Hastert (R-IL) has not yet announced the delegation of House conferees." According to the *e-NAPUS Legislative and Political Bulletin*, "The [House] delay does not appear to be related to any political mischief or substantive controversy about the bill. Rather, the delay is attributed to the House of Representatives' unique procedural bureaucracy and the variety of rules under which the House operates in appointing conferees. Those rules differ from Senate rules governing Conference appointments." (*Postal Legislative*

*Update*, the National Association of Postal Supervisors, 03/07/06; NAPUS; *e-NAPUS Legislative and Political Bulletin*, 03/24/06)

- In an article on *DMNews.com*, Cary Baer wrote, “Washington insiders have told me that the earliest any [postal reform] bill will emerge from conference is late March or early April. It should be noted that the conferees could add items to the bill that were in neither original version. As of this writing, the House has not selected its representatives to the conference. The Senate has chosen its representatives...Of the eight members, five come from states having what some might consider special postal needs. These states are Alaska, Hawaii, Utah, Maine and Minnesota. Therefore, my concern is that the conferees from these relatively rural or distant states will enter into the legislation various restrictions on the U.S. Postal Service that harm its ability to change its mail processing network as volumes or processing technologies change.” (*DMNews.com*, Cary H. Baer, 03/02/06)

White House announces two nominations to the Postal Board of Governors
--

- The White House has nominated to the Postal Board of Governors Mickey D. Barnett of New Mexico, for the remainder of a nine-year term expiring December 8, 2013 and Katherine C. Tobin of New York, for the remainder of a nine-year term expiring December 8, 2012. (*White House Press Release*, 03/03/06)

USPS is expected to file a rate case soon
---

- The *Business Mailers Review* reported, “With the Postal Service expected to file a rate case within the next few months, mailers are obviously wondering whether the Postal Service will propose an increase in the mid-single digits, as postal officials had been saying publicly, or something much higher. When considering the amount of revenue it will need to raise through a rate increase, the Postal Service will have to take into account the impact of that increase on mail volume, revenue and costs. When the rates go up, the volume declines and the degree to which that occurs is called the elasticity of demand.” (*PostalWatch.com*, 03/10/06)
- In a recent commentary, Association for Postal Commerce Vice President Kate Muth said, “It’s not clear exactly when the Postal Service will file the [next rate] case and no one is sure how big the rate request will be. But one thing is crystal clear to the mailing community. The Postal Service should not ask for a contingency fee in this upcoming case. The Postal Service is debt-free for the first time in its history. The Postal Service asks for a contingency in rate requests to cover the expenses of unforeseen or unforeseeable events. Given the USPS’ debt-free status, the contingency should not be requested in this case. Borrowing is a better option than a contingency, which just gets baked into the rate base. If the contingency funds aren’t needed, the money isn’t refunded to ratepayers. This puts a burden on mailers

because they have to pay this cost up front, with no opportunity for a refund.”  
(*PostalWatch.com*, 03/08/06)

#### Financial outlook bleak for USPS in FY2006

- The Postal Service expects to lose \$1.8 billion by the end of its fourth quarter, in part due to weak Standard mail volume. “We see very little growth in Standard Mail volume [right now], [but] we are hoping to get it back up to the 3% growth level that it did last year,” said Richard J. Strasser, the USPS chief financial officer. (*DMNews.com*, Melissa, Campanelli, 03/23/06)
- In January, the Postal Service reported a net gain of \$244.5 million, after escrow allocations on \$6.4 billion of revenues. Total revenues increased 10.3%, while total expenses increased 4.3%, compared to the same period last year. (*USPS Financial Operating Statements*, 03/01/06)

#### E-delivery battles heat up on several fronts

- In a complaint, filed in Docket No. MC2004-2, DigiStamp, Inc. contends that the Postal Service is providing a document delivery service called Electronic Postmark in violation of the Postal Reorganization Act. DigiStamp requests, among other things, an order from the Commission finding that the ‘Postal Service’s document delivery service called “Electronic Postmark (EPM)” is a “postal service” subject to the [Commission’s] jurisdiction [.]’ The Postal Service moves to dismiss DigiStamp’s complaint by contending that the Commission lacks authority to resolve a complaint over the nature of the service provided; and by arguing that, even assuming the Commission’s jurisdiction, the complaint should be dismissed since electronic postmark is not a postal service.
- A diverse coalition of groups has launched a campaign to pressure America Online into halting plans for a pay-to-send email system. The coalition of 50 groups, including political action committee MoveOn.org, Gun Owners of America, the Electronic Frontier Foundation, the Association of Cancer Online Resources, the Humane Society, the AFL-CIO, and the media reform group Free Press, denounced the pay-to-send systems which inevitably will establish a two-tier system in which only people and organizations willing to pay Internet service providers could be certain their messages would be delivered. The coalition argued that certified email is counter to the open system that has led to the wide adoption of email, which can be received and sent by anyone with a computer. To pressure AOL, the coalition has launched an effort among its memberships to gather online signatures to an open-letter against the pay-to-send system. (*Information Week*, Antone Gonsalves, 02/28/06)

## “Do Not Mail List” movement growing

- In yet another “threat” to the USPS’ prospects for future mail volume, five states have initiated “Do Not Mail List” or restricting mailing list-related legislation, including Illinois, Massachusetts, Missouri, New Jersey and New York. (*Postcom.org*, 03/08/06)

## **TVA**

### TVA board nominees finally clear the Senate

- The Bush administration’s six nominees for the TVA’s board of directors overcame Congressional hurdles on March 3 to win unanimous confirmation in the Senate. Senator Johnny Isakson (R-GA) removed his hold on the nominees’ confirmation after receiving written assurances from the nominees that they would pay attention to Georgia’s interests. Then, Democratic Leader Harry Reid (D-NV) blocked confirmation because none of the nominees were Democrats. Senate Majority Leader Bill Frist (R-TN) negotiated with Reid over a two week period, before confirming the nominees on March 3.
- President Bush must still appoint one more nominee to the TVA board, but has made no promises about that candidate, according to a congressional source. There has been a broad push for the Administration to nominate a black candidate from Memphis for the remaining opening on the board. No black has ever served on the TVA board and none of the directors have been from Memphis. According to sources, the Bush administration is considering William Graves, a black bishop at the Christian Methodist Episcopal Church in Memphis as a possible nominee to the TVA board. Democrats, including Representative Harold Ford, Jr. (D-TN), have encouraged the administration to nominate Herman Morris, the former head of Memphis Light, Gas & Water, TVA’s largest customer. (*Associated Press*, Nancy Zuckerbrod, 02/03/06)
- In a February 27 editorial, the *Jackson Sun* [Jackson, TN] wrote, “For an administration that has long prided itself on the diversity in its Cabinet, President George W. Bush’s recent picks for the newly expanded [TVA] board leave something to be desired. Board members Bill Baxter and Skila Harris continue to serve, and with the six new picks, Bush has one more to make. He should use that pick to begin to increase the board’s diversity. ...The original idea behind expanding the [TVA] board to nine members was to increase the chance for diversity, both in terms of geography, in terms of experience and in terms of race and gender. Yet, look at these picks. They are all Republicans. And they are all white. What’s worse, none have

experience in environmental issues - an often overlooked part of TVA's mission - and only one has any experience in the electric power industry.'

- "Let's be clear. Race and gender should never trump qualifications or experience when it comes to making picks. But neither should these things be ignored. If the idea in expanding the board was to increase diversity, then the administration has failed miserably. Why increase diversity? Because TVA represents seven states across the Southeast made up of a racially and ethnically diverse population, and the board should reflect that diversity. And because members from various racial or ethnic backgrounds come with different life experiences and a distinct point of view. Increasing diversity also means including people from across the business spectrum. TVA has a broad mission that goes beyond simply generating electrical power. TVA also deals with issues like land use and air pollution. It would just make sense, then, that at least one member of the board should be versed in at least some of these issues."
- "With TVA facing some tough challenges in the future, Bush should have done more to create a more diverse and deeply experienced board. With one pick left, he has a chance to take a step in that direction." (*Jackson Sun*, Jackson, TN, 02/27/06)

TVA will continue paying down its debt in an effort to rein in future rate increases

- In testimony before Congress, TVA Chairman Bill Baxter said that TVA is trying to rein in future rate increases by paying down its debt and exploring more flexible pricing options. For FY2007, TVA plans to cut \$529 million more in its debt of \$25.6 billion with a goal reducing debt by \$7.8 billion by 2016, said Baxter. In the near future, TVA plans to test fuel-cost adjustment billing that would vary rates for its 158 distributors, based upon the utility's changing cost for fuel and purchased power, he added. The TVA's newly expanded board of directors will review the adjustment billing proposal, as well as the need for future rate increases, Baxter said. He also told the panel that TVA plans to bring the Browns Ferry Unit 1 nuclear reactor in Athens, AL on-line in 2007 to meet growing power needs, which are expected to increase 2% annually over the next decade. (*Associated Press*, 03/09/06)

TVA may have partner, a first, in building reactor

- For the first time, TVA has agreed to jointly pursue the building a major power plant with a partner utility, according to an agency spokesman. TVA and Southern Co. agreed in a memorandum of intent to jointly pursue building a nuclear reactor at the Bellefonte plant site in northern Alabama, creating up to 2,000 jobs during the construction phase. TVA Senior Vice President Jack Bailey told *The Chattanooga Times Free Press*, "We are looking at a different design and licensing approach and different partnerships to help pay for such a plant. It's a new way of thinking for us." Sandi Robinson, a spokeswoman for the Southern Nuclear Operating Co., in

Birmingham, AL, said, “It’s still very preliminary and we’ve made no commitments,” said (*Associated Press*, 03/07/06)

TVA wins \$34.9 million judgment against the Department of Energy

- Judge Charles Lettow in the U.S. Court of Federal Claims has ordered the Department of Energy to pay \$34.9 million to TVA after the agency failed to meet a 1998 deadline to dispose of nuclear waste at the Browns Ferry nuclear plant in Limestone, AL and Sequoyah facility in Hamilton County, TN . The favorable ruling for TVA is the first one in which DOE has been told to pay specific damages to a utility that is keeping highly radioactive spent fuel stored onsite while delays continue to hamper plans for a repository at Yucca Mountain in Nye County. According to government officials, damage awards are paid through special judgment accounts overseen by the Department of Treasury that are “essentially fueled” by taxpayers. Lettow’s ruling underscores the need for Congress to “fix” Yucca Mountain or at least relocate spent fuel away from power plants, said Steve Kraft, nuclear waste director at the Nuclear Energy Institute. Utilities, which run most of the nation’s 103 nuclear plants, have filed 61 lawsuits seeking similar damages. (*Pahrump Valley Times*, Pahrump, NV, Steve Tetreault, 02/03/06)

**Canfield & Associates, Inc.**

1401 H St., NW, Suite 560

Washington, DC 20005

Phone: (202) 661-2100

Fax: (202) 403-3924

[www.canfieldassoc.com](http://www.canfieldassoc.com)