

The **GSE** REPORT™

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Major Events

Freddie Mac's profits declined 11% in FY2005—they think...

- Freddie Mac estimated that its “implied net income” for 2005 was \$2.5 billion, down 11% from the previous year, but warned that its net income may turn out to be “materially different” when it releases detailed results in late May. The company disclosed that it expects a further reduction in the implied net income of approximately \$200 million to reflect the net impact of adjustments and corrections identified in the course of closing its books, based on work to date. Freddie said its earnings were adversely impacted by margin compression on its existing portfolio and lower margins on floating-rate assets it has purchased recently, as well as “competitive pressures” on fees it charges for guaranteeing mortgage payments. As a result, the company fell short of its long-term goal of low to mid-teen returns on the fair value of net assets, before capital transactions. Freddie’s after-tax losses related to Hurricane Katrina are likely to be modestly less than its previous estimate of \$190 million and its losses on derivative contracts were smaller in FY2005 than the previous year. Freddie Mac’s mortgage portfolio grew 12% last year, while its share of GSE mortgage securitizations reached 45%, up from 41% in 2004. Adjustable-rate mortgages now comprise 38% of Freddie’s portfolio, up from 29% at the end of 2004. The company’s estimated regulatory capital was \$36.3 billion on December 31, up \$1.3 billion from the year-end 2004.
- Freddie Mac believes that it exceeded its 2005 affordable housing goals for moderate, low and very-low income families and those who live in underserved areas, but awaits a final determination by HUD later this year. The company also delayed again its plan to return to timely quarterly reporting and monthly filings of GAAP-complaint reports until 2007. “Simply, we’re going to have problems on the quarterlies because our control structure is not robust enough now to support a timely close,” said the company’s COO and interim CFO Eugene McQuade. “And while we’ve made substantial progress towards there, towards the end of last year we found a couple of control issues that surprised us,” he added, referring to a computer programming error which required the company to restate results for the first half of 2005. “We thought we had done the control remediations that would have found that,” McQuade said, adding that Freddie is now doing an “end-to-end” assessment of its internal controls. Following Freddie Mac’s release of its financial results in May, management indicated that the company hopes to execute a plan to use preferred stock issuance proceeds for a buy back of common stock.
- Based upon the company’s earnings estimate for FY2005, Freddie Mac’s EPS approximates \$3 per share, well below Wall Street’s expectations of more than \$5 a share, said Bank of America Securities analyst Robert Lacoursiere. Freddie Mac’s profit estimate prompted Freidman, Billings, Ramsey & Co. (FBR) to downgrade its rating of Freddie Mac from Outperform to Market Perform and lower their target

price from \$76 to \$65, representing 1.4x book value and 12X its FY2006 EPS estimate. (*Dow Jones Newswires*, Damian Paletta, 03/31/06; *Wall Street Journal*, James R. Hagerty, 04/01/06; *Washington Post*, Annys Shin, 04/01/06; *Bloomberg News*, James Tyson, 03/31/06; *American Banker*, Jody Shenn, 04/03/06; *JAGfn.com*, 04/03/06)

OFHEO classifies Fannie Mae and Freddie Mac adequately capitalized on December 31st

- Fannie Mae and Freddie Mac were adequately capitalized as of December 31, 2005, based upon the GSEs' best estimates of their financial condition, said OFHEO. The agency indicated that Fannie Mae's classification remains subject to revision during the company's re-auditing and restatement process and OFHEO's special examination of the GSE. As of December 31, 2005, Fannie Mae's total capital of \$39.204 billion exceeded its risk-based capital requirement of \$12.636 billion by \$26.568 billion, said OFHEO. The regulator said that Fannie Mae's core capital (\$38.135 billion) exceeded its minimum capital requirement (\$28.463 billion) by \$9.673 billion. As of December 31, 2005, Freddie Mac's total capital of \$36.781 billion exceeded its risk-based capital requirement of \$11.282 billion by \$25.499 billion, said OFHEO. The regulator said that Fannie Mae's core capital (\$36.328 billion) exceeded its minimum capital requirement (\$24.993 billion) by \$11.335 billion. (*Dow Jones Newswires*, John Connor, 03/31/06)

Fannie Mae and Freddie Mac

Restricting the size of the GSEs' portfolios is the most effective way to limit the GSEs' systemic risk, says new study by Federal Reserve Bank of Atlanta

- Limiting the size of Fannie Mae's and Freddie Mac's portfolios is the most effective way to minimize the systemic risk posed by the GSEs on the U.S. economy, concludes a new study by the Federal Reserve of Atlanta. "We conclude that there is reason to be seriously concerned about potential future social costs associated with the systemic risk emanating from Fannie Mae and Freddie Mac and that this risk largely arises from the institutions' highly-leveraged [\$1.4 trillion] investment portfolios," wrote economists Robert A. Eisenbeis, W. Scott Frame and Larry D. Wall. Portfolio limits would be much more effective in minimizing system risk than raising capital requirements or changing debt-issuance user fees, they argue. If capital requirements were raised, the GSEs would likely lobby Congress to lower capital requirements later. Charging debt issuance user fees would "almost surely further strengthen ...investors' perceptions of an implied federal guarantee of GSE obligations," said the economists. While Congress shouldn't create specific limits on the portfolio size, the authors recommend that Congress provide strong legislative direction to the new GSE regulator that would preclude Fannie and Freddie from lobbying the regulator to soften portfolio limits. "Relying on regulatory discretion would create an incentive for the politically powerful GSEs to continuously lobby the regulatory and influential members of congressional oversight committees to bring pressure to weaken portfolio constraints," said the study. Instead, Congress should "spell out the principles of the portfolio limits and require the regulator to promulgate specific regulations," said the economists.
- Representative Barney Frank (D-MA), the ranking Democrat on the House Financial Services Committee, said the Atlanta Fed's study actually conceded a point asserted by his party --that a new regulator would have strict control over both GSEs and their portfolios. This is a political judgment on the [Atlanta Fed's] part," said Frank. Fannie and Freddie's current regulator, OFHEO, "was anything but captive. There is no basis to that whatsoever," said Frank. "And in this [House GSE regulatory reform] bill, we strengthen the regulator, we toughen the regulator," he said.
- Freddie spokesman Douglas Duvall said, "We continue to believe that our portfolio is central to our mission and it helps us provide a balance between fulfilling our affordable-housing mission and attracting" international investments to "America's doorstep," he said, but refused to comment specifically on the Federal Reserve study. (*Dow Jones Newswires*, Damian Paletta, 04/03/06)

GSE portfolio issue also raises question of role of Fannie and Freddie in U.S. economy

- In a March 2006 *Networks Financial Institute Policy Brief*, AEI resident fellow Peter J. Wallison wrote “Whether the GSEs will be able to hold portfolios of mortgages and MBS goes well beyond the simple question of the scope of regulatory authority; a direction from Congress that requires the new regulator to limit or reduce the size of the GSEs’ portfolios would profoundly reshape the GSEs and their role in the economy. Because of its adverse effect on their profitability, some believe that limiting the size of the GSEs’ portfolios will cause them to abandon their government charters entirely and attempt to privatize. In a relatively few years, then, the debate over the role of the GSEs has moved ...to a consensus that improved regulation was necessary, and finally to whether they can be allowed to continue to pursue a business model that has brought them, their shareholders, and their managements enormous prosperity,” at the expense exposing the national economy to systemic risk. (*Networks Financial Institute Policy Brief*, Peter J. Wallison, March 2006)
- In a letter to the editor of the *Wall Street Journal*, Robert Burns with Pacific Investment Management Co., wrote, “The real question people should be asking is not, ‘do the investment portfolios contribute to their mission?’ What is important is their daily activity in providing demand for long-term, fixed-rate mortgages and liquidity to the capital markets. The agencies, in large part, have been completely absent from the flow of long-term mortgage financing for several years.” (*Wall Street Journal*, Robert Burns, 03/31/06)
- HUD Secretary Alphonso Jackson said, “[The GSEs’] charter mandate is to serve low- and moderate- income Americans and that is what I expect them to do, both on the rental side and on the homeownership side. The problem is they, in many cases, got more concerned -- and it’s been documented -- with making profits and serving bonuses rather than serving the people... HUD supports [GSE regulatory reform] legislation that allows the [GSE] regulator to limit the GSEs’ portfolio to those investments necessary to carry out its mission. We’re not trying to cripple it or put it out of business...” (*Bloomberg News*, James Tyson, 03/28/06; *Dow Jones Newswires*, Damian Paletta, 03/28/06)
- In the April 8-9 issue of *National Mortgage News Online*, Paul Muolo wrote, “A task force for the Mortgage Bankers Association has taken the forceful position of opposing arbitrary caps or forced reductions on Fannie Mae and Freddie Mac’s retained portfolios. Then how come the trade group hasn’t? That’s something Countrywide Home Loans -- MBA’s largest dues-paying member -- would like to know. In a recent letter to MBA chief Jonathan Kempner, Countrywide CEO Angelo Mozilo, made his displeasure known, saying the trade group is making a ‘significant omission’ by not taking a public position on the issue (even though its task force has).” (*National Mortgage News Online*, Paul Muolo, April 8-9, 2006)

Financial Services Roundtable calls for passage of S. 190

- Citing the findings of the Rudman Report and Fannie Mae's expansion of ADC lending as the latest examples of the need for GSE regulatory reform, John Dalton, President of the Financial Services Roundtable, circulated a March 23 letter to all members of the Senate, urging them to co-sponsor and support full Senate action on S. 190. (*Correspondence to members of the U.S. Senate*, John H. Dalton, 03/23/06)

More "rational heads" are weighing in on the GSE reform debate,
says Freddie Mac President/COO McQuade

- The mood for creating strict new limits on the GSEs has changed on Capitol Hill over the last few months, said Freddie Mac president and COO Eugene McQuade. "Our view is that more rational heads are now balancing the pros and cons," said McQuade. "We are very supportive of having a strong regulator. We think that's critical. We think that many other things that were added to the bills may have been tangential, and I think people are now realizing that now." For example, strict limits on the GSEs' retained portfolios would not be in the "best interest of the housing finance industry," he said. "Much of our growth was because there was a need in the market for a GSE to provide liquidity," McQuade added. "Fannie wasn't able to do that, so we stepped in and were the liquidity provider this year. That's exactly what Congress has asked us to do." (*Dow Jones Newswires*, Damian Paletta, 03/31/06)

With prospects for passage of a GSE regulatory reform legislation fading,
will Treasury restrict the GSEs' debt issuance?

- Some observers say that the Treasury Department is biding its time and will act to limit the GSEs' debt issuance, once it is clear Congress will not pass a bill to create a regulator with greater power over the portfolios. "There is a very real and significant chance that, should Congress not act, Treasury would view that as the congressional direction that it has been seeking," said Medley Global Advisor's analyst Josh Rosner. Others argue that such a move could prove too costly for the Treasury. "It would be a political risk to the administration," said Stanford Washington Research Group's analyst Jaret Seiberg. "If the housing market has a hiccup after the Treasury moved, the administration would be blamed."
- While some GSE allies question if Treasury really possesses legal authority to limit the GSEs' debt issuance, the agency has gotten support from the Justice Department and Congressional Research Service for its oversight assertion. Others argue that Treasury could act without upsetting the housing market, by offering plenty of warning so as not to surprise the market. "This is not rocket science," said GSE critic Bert Ely. "Treasury does not have to micromanage. They can simply say 'This is the ceiling. Your debt cannot exceed this much.'" Others argue that the administration is

bluffing. “Say Treasury second-guesses a debt management decision from Fannie and it turns out wrong,” said Jim Vogel, the head of market research at FTN Financial Capital Markets. “Does Treasury take responsibility?” (*American Banker*, Patrick Rucker, 03/27/06)

Daniel Bob, OFHEO’s senior advisor, joins Canonbury Advisors

- On April 3, Daniel Bob, senior advisor for OFEHO, announced he is leaving the agency to become a principal at Canonbury Advisors, LLC. (*Correspondence from Daniel Bob*, 04/03/06)

Fannie and Freddie unable to address changing market demands in a timely fashion

- At the Countrywide Financial Equity Investor Forum on March 30, the company’s president and COO Stan Kurland discussed the dramatic changes that have taken place in the mortgage market over the past five years. Kurland said, “[Over this period,] the industry matured ...[and] is more accepting of alternative products, private label securitization, [and] the growth of home equity lines of credit ...Part of this speaks to the GSEs and their inability to address in a timely fashion the changing demands of both consumers and investors. The ability to innovate a product is both dependent upon what the consumer is in need of and accepting of, as well as what investors desires in terms of yields.”
- According to Kurland’s loan origination chart, GSEs accounted for 72% of the \$2.2 trillion of loan originations in 2001, followed by jumbo/Alt-a loans (13%), nonprime loans (10%) and home equity loans (5%). In 2005, the GSEs’ accounted for only 37% of the \$3.1 trillion of loan originations, followed by jumbo/Alt-a loans (32%), nonprime loans (20%) and home equity loans (11%). (*FDWire*, 03/30/06; *Countrywide Equity Investor Forum Slides*, 03/30/06)

Subprime lending comprises roughly 40% of market

- According to MGIC’s chief executive Curt Culver, nonprime lending has grown more than nine-fold from 5% of the market in 2001 to almost 40% of the market today. Demographics factors, such as the growing number of household formations, the growing second home market, higher loan-to-value ratios, and price appreciation, are driving the growth of the subprime market. (*National Mortgage News Online*, Brad Finkelstein, 03/31/06)

- Thirteen advocacy groups asked HUD to make certain that the block grant funds paid to help Gulf Coast residents recover from hurricane damage are jointly paid to their lenders, as a safeguard against contractors with “predatory practices.” The groups, including Catholic Charities USA, the Consumer Federation of America, the Consumers Union, the NAACP, the National Community Reinvestment Coalition, the National Consumer Law Center, the National Fair Housing Alliance, the Mortgage Bankers Association, the Consumer Mortgage Coalition, and the Housing Policy Council of the Financial Services Roundtable, sought an escrow-based approach for grant distribution, rather than a direct payout to borrowers. When there are large volumes of flood or homeowners insurance payouts, servicers typically retain the funds in escrow and distribute the funds as contractors, provide lien waivers documenting that the work has been completed has been paid-in-full or that the borrower, who is doing the work himself, provides receipts for materials purchased. Using an escrow-base process, both the homeowner and the lender are protected from fraudulent and abusive contractor practices. “In effect, this is a case where the interests of the borrower and lender are uniquely aligned,” the groups told HUD. “This is particularly true when properties will need to be rebuilt to new, higher standards,” they wrote. In addition, several groups expressed concern that a failure to use grant funds to repair the properties may jeopardize recovery of the borrowers’ full insurance benefits. By making the lenders a critical part of the payment administration process, the interests of both the lenders and borrowers alike would be protected and speed the recovery of the Gulf Coast region, the groups argued.
- On April 4, HUD approved Mississippi’s plan to direct \$3.4 billion of the community development block grant money to homeowners whose homes were damaged by floods in areas where flood insurance was not required. The Mississippi Development Authority’s plan allows, but does not require, a lender to be a co-payee and provides the homeowner discretion over the “management and use” of the funds.
- On April 6, Louisiana released a plan for public comment for a \$4.7 billion block grant payout, providing for the payment of up to \$150,000 the owners of flooded homes outside of floodplains and to those of low and moderate incomes whose homes suffered sizable damage. According to the Louisiana Office of Community Development’s (LOCD) proposal, “owners will be encouraged and assisted, and may be required,” to open escrow accounts with financial institutions, with which the agency will create standards for managing escrows and payouts process. According to their letter, LOCD wants to ensure that homeowners with mortgages have the same “significant consumer protections” against unscrupulous contractors that are provided by lenders’ traditional joint control of insurance funds. Louisiana’s plan also offers payouts to homeowners who wish to relocate in the state or sell their home to the state for 60% of the home’s pre-storm value, minus insurance and other federal aid.
- Steve Bradshaw, the head of servicing for New Orleans-based Standard Mortgage Corp., said that if lenders have no role in escrowing the grant funds, “naturally there’s

a higher risk than of walk-aways,” where borrowers pocket the money instead of applying it toward rebuilding. “I just hope the process is set up to help people keep their promises” to repay their mortgage. (*American Banker*, Jody Shenn, 04/07/06; *Correspondence to the Honorable Alphonso Jackson*, Regian M. Lowrie, Chairman of the Mortgage Bankers Association, 03/22/06; *Correspondence to the Mississippi Development Authority*, Mortgage Bankers Association and Housing Policy Council of the Financial Services Roundtable, 03/17/06; *Correspondence to the Mississippi Development Authority*, Mortgage Bankers Association, Housing Policy Council of the Financial Services Roundtable and Consumer Mortgage Coalition, 03/27/06; *Correspondence to the Mississippi Development Authority*, Anne C. Canfield, Executive Director of the Consumer Mortgage Coalition, 03/17/06; *States News Service*, 03/04/06)

- A study sponsored by the Financial Services Roundtable concluded that 447,000 houses must be created by 2008 to restore 40% of the 190,000 jobs lost in the New Orleans metropolitan area. An economic study released by Louisiana State University concluded that housing is the key to New Orleans’ economic revitalization. In his study, LSU economist James Richardson determined that even with modest economic growth, New Orleans will have a housing shortage of more than 100,000 houses and apartments by 2008. (*American Banker*, Stacy Kaper, 03/28/06; *Times-Picayune*, Bill Walsh, 03/28/06)

Senate Appropriations Committee approves \$5.2 billion in additional block grant funds
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- The Senate Appropriations Committee has approved an additional \$5.2 billion in Community Development Block Grant Funds to support housing assistance programs in the hurricane stricken areas in the Gulf Coast. The panel approved \$1 billion more than the Bush administration requested, to ensure that Louisiana would receive the \$4.2 billion grant requested by President Bush. (*Times-Picayune*, Bill Walsh, 04/05/06)
- The bill that passed the committee did not include the Bush administration’s request for an additional \$6 billion that the Army Corps of Engineers recently told the Bush administration is needed to raise the levees in the New Orleans area to meet national flood insurance standards. The reason for the sudden increase in levee repair costs—from \$3.5 billion to \$9.5 billion—is rising sea levels in the area that require height adjustments of up to eight feet, said experts. Of the additional \$6 billion, 48% of that amount (\$2.9 billion) would be spent to raise the levees in Plaquemines Parish from two to eight feet, depending on the section of the levee. [Levee improvements in Plaquemines Parish (population 14,795) represent an expenditure of \$190,000 per person]. On April 4, Senator Mary Landrieu (D-LA) said she will block all of the Bush administration’s appointments until it makes a “national commitment” to comprehensive hurricane protection by requesting \$6 billion to raise the levees. Senator David Vitter (R-LA) chided Landrieu’s position, calling it counterproductive and warning that it could alienate “senators who are trying to help or already are

helping us.” (*Times-Picayune*, Bill Walsh, 04/05/06; *Times-Picayune*, Bob Marshall, 04/01/06; *Dow Jones Newswires*, 04/04/06; *Times-Picayune*, Bill Walsh, 04/07/06)

The (risk) beat goes on

- Noting that global regulators are concerned about potential systemic risks in the credit derivatives market, *The Securities Industry News* wrote, “The scale of the over-the-counter derivatives markets is very large. Although the notional total value of these contracts, now approaching \$300 trillion, is not a particularly useful measure of the underlying economic exposure at stake, the size of gross exposures and the extraordinarily large number of contracts suggest the scale of the unwinding challenge the market would confront in the event of the exit of a major counterparty. The process of closing out those positions and replacing them could add stress to markets and possibly intensify the direct damage caused by exposure to the exiting institution.”
- “Credit derivatives, where the gaps in the infrastructure and risk management systems are most conspicuous, are less than 10 percent, and perhaps less than 5 percent, of the total OTC derivatives universe but are growing much more rapidly. Large notional values are written on a much smaller base of underlying debt issuance. The same names show up in multiple types of positions--single-name, index and structured products such as collateralized debt obligations. These create the potential for squeezes in cash markets and greater volatility across instruments in the event of a default, magnifying the risk of adverse market dynamics.”
- “The net credit exposures in OTC derivatives, after accounting for collateral, are a small fraction of the gross notional values. The ten largest U.S. bank holding companies, for example, report about \$600 billion of potential credit exposure from their entire derivatives positions, the total gross notional values of which are about \$95 trillion. This “credit equivalent amount” is approximately 175 percent of tier-one capital, about 15 percent higher relative to capital than five years ago. This measure of the underlying credit exposure in OTC derivatives positions is roughly a fifth of the aggregate total credit exposure of the largest bank holding companies. This is a relatively conservative measure of the credit risk in total derivatives positions, but, for credit derivatives and some other instruments, it still may not adequately capture the scale of losses in the event of default in the underlying credits or the consequences of a prolonged disruption to market liquidity. The complexity of many new instruments and the relative immaturity of the various approaches used to measure the risks in those exposures magnify the uncertainty involved.” (*The Securities Industry News*, 03/13/06)

- At the Regional Conference of Mortgage Bankers Associations, Zack Oppenheimer, regional vice president of Fannie Mae, and Paul Mullings, Freddie Mac senior vice president of single-family sourcing, discussed how their companies planned to make selling loans in the secondary market easier. To counter worries about affordability and homeowners' use of risky mortgage products to obtain a loan, Oppenheimer said that Fannie Mae has introduced a 40-year fixed-rate mortgage product to its offering. The company is also now allowing an interest-only feature to be added to a fixed rate mortgage, protecting the consumer from exposure to rate changes. Oppenheimer encouraged the audience to market these products to borrowers with adjustable rate mortgages as a refinancing option. Fannie Mae has cut its mortgage insurance coverage requirements for loans originated under the My Communities program to charter levels. At the request of originators, Fannie Mae is also working on changes for borrowers without traditional income and credit.
- Mullings said, "Penetrating the purchase money market, that's become the focus [for Freddie Mac]." His company has worked hard to reduce the time it takes to fund and deliver loans in the marketplace. Sellers now go from contract to loan delivery in three weeks, instead of three months. Freddie Mac is developing tools for originators use in serving the emerging markets. "We've revamped our affordable products around a new line called Home Possible. Think of these loans for people who don't earn a lot of money, who can't bring a lot of money to the table and whose credit is not perfect. Many of these people can meet a mortgage obligation, and we want to provide financing for these loans." (*Origination News*, Brad Finkelstein, April 2006)
- In the rising interest rate environment, Fannie Mae and Freddie Mac appear poised to increase their bond issuance by 10% in 2006, as homeowners turn to fixed rate mortgages, according to Morgan Stanley. Fannie Mae is working with lenders to encourage homeowners to refinance from adjustable- to fixed-rate mortgages, said Rob Levin, the company's chief business officer. (*Bloomberg News*, Al Yoon, 04/05/06)
- As 40-year mortgages become more commonplace, industry professionals are already talking about extending amortization schedules for up to 50 years, particularly in high cost real estate markets. "It's a good idea for consumers," said John Marcell, president of the California Association of Mortgage Brokers, noting that 25% of the loans closed everyday in California have 40-year terms. "There's nothing wrong with a 50- or 60-year mortgage." Robert Kleinhenz, chief economist of the California Association of Realtors, said, "If we include the 50-year mortgage with alternative loan products, this collection of loan products that enables people to become home buyers when they otherwise could not would certainly work in favor of those households." To date, however, 50-year loans are only a gleam in a couple of securities issuers' eyes, said Mark Douglass, a senior director at the Fitch ratings agency. But the idea is currently a hot topic in the industry. (*Firstrung* [London, UK], 04/01/06)

The evolution of E-mortgages continues

- MISMO is in the process of updating the e-delivery standard. Ed Ransden, director of product management at Desert Document Services, said “MISMO’s secondary loan delivery dataset version 2 went into the 30-day review stage. It should be in final approval by March [or April]. The standardization was based on getting away from proprietary coding.” Ransden added, “Fannie and Freddie were driving this for the past two years. The goal was to get to one spec. However, there are certain nuances to the Fannie and Freddie specs, but for the most part it is standardized. There will be exceptions, but they will be minor. It used to be that all the correspondents had to write to Citi or Countrywide or Fannie or Wells or Freddie, etc. So, they wanted them to pick one spec, which is why MISMO has updated this standard.”
- But will the industry adopt the MISMO standard? “It’s hard to implement all of the e-delivery specs at once,” replied Layne Sapp, MILA’s CEO. “You’ll still have to deliver the recording docs to each county, which is difficult. We’re working on different technology to make e-signatures possible online. We’ll be able to authenticate and sign disclosures online in the end. It will happen as fast as the counties will move. It would be great if there was a clearing house to take in all the loans and have them work with the counties. I’d like to see us there over the next five years. We can electronically deliver the entire file now. In the next year everything but the closing docs will have e-signatures. You have to understand that notaries, title, etc., have to come together at closing. There are a lot of moving people involved at closing. The front end of the process on the other hand will move really fast.”
- While the march toward electronic mortgages continues, it will likely be years before paperless loans are generated in any significant volume said industry executives. Ed Albrigo, vice president of the enterprise office at Freddie Mac, said his company is buying small amounts of e-mortgages to test the process, but it will take a lot of work to navigate federal, state and local laws meant to protect consumers. “It will all come together,” he said. “The volume is going to be quite a ways” away. (*Mortgage Servicing News*, Anthony Garritano, April 2006, *Reuters*, Lynn Adler, 03/30/06)

Fannie Mae

The Rudman Report only scratches the surface

- In American Enterprise Institute’s (AEI) April *Financial Services Outlook*, the Rudman Report’s “skin deep” analysis raises troubling policy issues and more unanswered questions about Fannie Mae. AEI resident fellow Peter J. Wallison wrote, “First, despite doing everything required by the Sarbanes-Oxley Act, Fannie’s board and audit committee were still deceived by the company’s management, raising questions about the [Act’s] reliance on “gatekeepers” to prevent corporate fraud. ...Second, management pressure for specific earnings results at Fannie was strong and pervasive, raising questions about what else management might have done—in addition to manipulating the company’s accounts—to achieve its earnings objectives. ...Finally, had the management shakeup at Freddie Mac—the event that caused ...[OFHEO] to commission a forensic audit of Fannie—never occurred, it seems likely that the company’s management would still be deceiving the board, its regulator, and investors on its way to a cataclysmic default. This suggests that it is faulty policy to rely on regulation alone for protecting taxpayers and the economy against the systemic risks associated with the mortgage portfolios of these huge, complex enterprises.”
- “For those who believe that regulators and gatekeepers can save the economy from some future systemic disaster arising from a mistake or dishonesty on the part of either Fannie’s or Freddie’s management, the sequence of events here should be troubling. It begins with Freddie engaging a special counsel to review its accounting. ...Freddie’s special counsel then reported that it had found financial manipulation—earnings management—and a cover-up at the top of Freddie. This resulted in the dismissal of Freddie’s top officers. ...Embarrassed by Freddie’s disclosure, OFHEO began a forensic audit of Fannie, apparently believing that if Freddie had been engaging in financial deception that might also be true of Fannie, and in September 2004 published a highly critical report. Only then did the Fannie board request its own special counsel investigation, resulting in the Rudman Report seventeen months later. Thus, there is good reason to believe that had Freddie not begun its own internal investigation and dismissed its top officers, OFHEO would never have investigated either Fannie or Freddie, the Fannie board would never have been the wiser about the dishonesty of its own management, and the false accounting regime at Fannie would have continued—with untold results when it was finally revealed as a massive fraud many years later. This should be a sobering thought to lawmakers and other government officials who seem willing to place their faith in a ‘world class’ regulator to protect the taxpayers and the economy from the systemic risks associated with Fannie’s and Freddie’s massive mortgage portfolios.”
- “...[T]he dominant theme of the [Rudman Report] is the heavy pressure from top management at Fannie to avoid any accounting treatment that would add to the

appearance of earnings volatility or interrupt the upward trend of the company's earnings. The obvious importance attached to making the earnings numbers is what should worry lawmakers, regulators, and outside observers. What we know from the report is that a culture existed within the company that drove management to distort its accounting in order to achieve particular financial results. What we do not know from the report is what the company might or might not have done in its operations—as distinguished from its accounting—to achieve favorable earnings results. For example, if Fannie's officials were willing to falsify the accounting for certain transactions in order to cover up losses on real transactions, were they also willing to engage in real transactions that would have produced temporary earnings but resulted in losses over the longer term? This will probably be a key question in the investigation that is now being carried out by OFHEO and possibly the SEC."

- Important questions, which the Rudman Report failed to answer, include:
 - "To what extent did the errors in Fannie's accounting identified by the report have a material effect on the company's reported earnings or its financial condition, beyond the amounts already estimated by the company?"
 - "Was there a pattern in these errors that suggested they were induced by an effort to manage earnings rather than simply the result of mistakes?"
 - "To what extent were the company's risk management procedures—including particularly its hedging activities—affected by the management's determination to achieve certain earnings goals? Did the company, in other words, incur unnecessary exposure in order to reduce the cost associated with its hedging activities?"
 - "Did Fannie cherry-pick the portfolios it assembled, keeping those that were unlikely to prepay and selling to unsuspecting investors those that had a greater risk of prepayment?"
 - "Did Fannie collude with Freddie Mac to maintain high guarantee fees on securitized portfolios?"
 - "Did Fannie compromise its underwriting standards in order to reach for higher profits on its portfolios by taking greater risks—particularly by acquiring Alt A and lower-quality mortgages?"
 - "Did Fannie set its underwriting standards so as to exclude borrowers in minority and low-income areas whose mortgages might have been thought to pose greater credit risk than borrowers of equivalent credit standing in other areas?"
- "[I]f the upcoming OFHEO examination report on Fannie Mae is thorough, it should provide some answers [to these questions]." (American Enterprise Institute for Public Policy Research, *Financial Services Outlook*, Peter J. Wallison, April 2006)

Why Fannie Mae's board didn't want to kill the golden goose

- In the April issue of *American Banker-Bond Buyer*, Paul Muolo wrote, “Shortly before - and then after – [Fannie Mae’s chairman and CEO Franklin Raines and CFO Timothy Howard] got forced out (by the board), a handful of mortgage executives close to the GSE had told us on several occasions that the board had no plans to ax [the] two men, despite mounting evidence that they played a key role in bending accounting rules that resulted in what will be an \$11 billion downward statement of earnings. ... Now the big question: Why was the board not critical of Messrs. Raines and Howard? Why did it take a regulator holding a baseball bat to their heads to get them to act? ... The bottom line is this: The board didn’t act because Fannie and the [Fannie Mae Foundation] were a cash cow feeding causes the directors held near and dear. It might be argued that the board dismissed the mounting allegations being levied against Fannie/Raines because they didn’t want to kill the golden goose.” (*American Banker-Bond Buyer*, Paul Muolo, April 2006)

Reflecting on the Fannie Mae accounting scandal

- In a March 11 press release, Representative Emanuel Cleaver (D-MO) said, “When a quasi-government agency like Fannie Mae reports profits \$11 billion more than what is accurate, that is an accounting error in the same category as Enron.” (*GSe-news*, FM Policy Focus, VOL. III No. 7)
- At the March 30 Countrywide Financial Equity Investor Forum, chairman and CEO Angelo Mozilo said, “In terms of GSEs, we’re a fan and I personally am a fan of the GSEs and despite what they’ve been through. And what they’ve been through, really they created themselves. And you all are familiar with them; many of you have followed them. And that’s what happens when you’re arrogant, eventually in life it will catch up with you. Humility is the greatest asset you can have as a company and, in my opinion, as a leader of a company. And they suffered because of arrogance and that drove them to ignore rules and lack sensitivity to the world around them and they’ve...suffered the consequences of that.” (*FD Wire*, 03/30/06)

Fannie Mae adjusted dividend rates for non-cumulative preferred stock

- In accordance with the terms of the issues, Fannie Mae announced scheduled dividend rate change of 4.56% for its Variable Rate Non-Cumulative Preferred Stock Series F and 7.065% for Series O, effective March 31st. (*Fannie Mae Press Release*, 03/31/06)

Fannie Mae's director of single-family client services joins MeridianLink

- MeridianLink, Inc., a technology provider for the mortgage finance industry, announced today that Doug Glagola has joined the company as Vice President of Mortgage Industry Relations. An 11 year veteran of Fannie Mae, Glagola was formerly Director of Fannie's Single Family Client Services team, responsible for all of the GSE's eBusiness solution integration and implementation engagements. (*Business Wire*, 03/28/06)

Freddie Mac

Freddie Mac names Kirk Die SVP and general auditor

- Former MBNA executive Kirk Die will join Freddie Mac as senior vice president and general auditor. Die will supervise the company's internal auditing activities and coordinate audit practices and procedures as Freddie Mac' internal auditor, reporting directly to the Audit Committee of the board of directors and administratively to chairman and CEO Dick Syron. Prior to the Bank of America acquisition, Die served as executive vice president and corporate general auditor at MBNA. He later served as audit executive for a combined card services division post acquisition. Die replaces Stanley Martin, who served as Freddie Mac's auditor and senior vice president before retiring earlier this year. (*Freddie Mac Press Release*, 04/03/06; *American Banker*, Jody Shenn, 04/04/06)

Freddie Mac implements a "total [IT] overhaul"

- In the aftermath of its \$5 billion accounting scandal, Freddie Mac is undergoing "wrenching structural changes that are fundamentally altering how the company operates," reports Thomas Hoffman in *Computerworld*. "What we're talking about here is a total overhaul" of how Freddie Mac operates, including its IT organization, said Joseph A. Smialowski, executive vice president of Freddie's operations and technology, who is overseeing a major effort from building its own software applications to a buy-and-integrate model. The transition reflects the GSE's emphasis on speed to market being paramount, said Ed Albrigo, vice president of the enterprise program office at Freddie Mac. "[Our goal is] "to get products into the market faster to support our mission, in particular as we start looking at a broader diversity of loans that we want to potentially buy and securitize," said Albrigo.
- Freddie Mac will invest "in the nine figure range" in its buy-and-integrate IT program this year, said Smialowski. The transition represents a huge cultural shift within the GSE, whose 1,700-person IT department must transition from application

development to customizing and configuring commercial systems. Freddie Mac's organizational transformation has also resulted in the company expanding its IT workforce, where 95% of its staff has been based in Northern Virginia, to other geographic locations. Smialowski plans to establish regional development centers in major markets where Freddie Mac has offices, such as Chicago, New York and Atlanta, and hire staff with financial services and buy-and-integrate experience in the Washington, DC market. (*ComputerWorld*, Thomas Hoffman, 04/03/06; *Reuters*, Lynn Adler, 03/30/06)

Freddie Mac completes \$72 million Premier Lease-Up transaction with Wachovia Securities and Holliday Fenoglio Fowler

- Freddie Mac recently completed a \$72 million transaction with Wachovia Securities and Holliday Fenoglio Fowler (HFF) using Freddie Mac's Premier Lease-Up execution, which provides long-term financing at a competitive rate very early in the process and prior to completion of construction of Homecoming at Terra Vista, a 503-unit garden-style apartment complex in Rancho Cucamonga, CA. "The competitors were offering a staged funding with separate rate-locks. Freddie Mac offered to rate-lock the entire \$72 million and fund up front once the agreed-upon occupancy and rental collections were achieved. The Premier Lease-Up execution also eliminated the risk of interest rates increasing," said Steve Griffin, Freddie Mac's Western Region managing director. Freddie Mac's Premier Lease-Up execution is for qualifying loans on newly constructed or substantially renovated, market-rate properties in lease-up, and utilizes Freddie Mac's Extended Early Rate-Lock execution. Using this execution, the borrower can lock the interest rate well in advance of property stabilization prior to completion of construction and with occupancy as low as 40%. The execution may have up to an 18-month rate-lock period. (*Freddie Mac Press Release*, 03/30/06)

Freddie Mac's commitment to help end homelessness in Fairfax County [VA]

- In an April 7 speech to the Fairfax County Summit to End Homelessness, Freddie Mac President and COO Eugene McQuade said, "In addition to our business activities, we're bringing additional resources to bear [to help end homelessness]. Housing the homeless is now a much higher priority in our philanthropic efforts. Through the Freddie Mac Foundation, we're making grants to support transitional housing in our County. Last year, we donated more than \$700,000 for such properties and – just as important – the social services that help families get back on their feet. Also, this June we will hold our annual fundraiser called Hoops for the Homeless. It's our signature corporate event: a basketball tournament where money goes directly to non-profit organizations that help the homeless. Last year, we raised \$800,000 from corporate sponsors – and we'd like to do even better this year. All to benefit homeless organizations, including two here in our County: Shelter House and New Hope. Once again, Magic Johnson will be joining us at the Hoops event..."

- “Since Magic was a terrific basketball player, let me borrow a phrase from the legendary coach, John Wooden. He teaches us that star players don’t win games by themselves. Rather, as the Coach emphasizes: “It takes 10 hands to score a basket.” Likewise, ending homelessness in Fairfax requires a team effort. All of us have a hand to lend, and a role to play.” (*Prepared comments by Eugene McQuade, 07/07/06*)

Federal Home Loan Banks

FHLBs of San Francisco and Atlanta warn that dividend rates will be slashed to comply with the Finance Board’s proposed equity rule

- If the Federal Housing Finance Board’s proposal to require the FHLBs to retain more capital to build a larger cushion for potential losses is adopted, a number of the FHLBs are warning their members that they will have to slash their dividend rates in order to comply with the new regulation. According to the FHLB-San Francisco, the Bank will have to reduce its dividend rate by 56%, from \$4.44 to \$2.50 per share, for about 2.5 years (assuming profitability remains at FY2005 levels) to comply with the proposed regulation. The FLHB-Atlanta estimates that it would take two complete quarters to reach the new minimum level of retained earnings. “During such time, the Bank’s dividends would be significantly less than those historically paid by the Bank,” said the FHLB-Atlanta. Going forward, the Bank added, dividends may fall below historic levels to maintain regulatory capital compliance.
- The Finance Board’s proposed rule will force most, if not all, of the FHLBs to slash their dividends and discourage the Banks from purchasing mortgage loans made by their members, which may ultimately result in a smaller FHLB system. The Finance Board chairman Ronald Rosenfeld said that he isn’t trying to determine how large the FHLBs should be. “We’re not here to make a theological judgment,” Rosenfeld said. “We’re here to make sure the system is safe and sound.” (*Wall Street Journal, James R. Hagerty, 03/27/06; National Mortgage News Online, 03/27/06*)
- As the FHLBs face pressure to raise capital and register with the SEC, the Banks are tackling these challenges with a shortage, on average, of five board members, because the Finance Board has not made its statutorily mandated appointments. Today, about 70% of the 82 appointed positions are vacant. By year-end, more than 40% of the FHLBs’ 200 total board positions will be vacant. In December 2004, Finance Board chairman Ronald Rosenfeld attempted to extend the terms of appointed directors by six months, only to be reversed by the White House lawyers, who advised Rosenfeld that the Finance Board could not legally extend the appointments. While Congress addresses GSE regulatory reform legislation which would address the structure of the

FHLBs' board, officials at the FHLBs and their members are growing nervous that the boards are strained at a time when the system is under growing scrutiny and strain. (*American Banker*, Patrick Rucker, 04/04/06)

Management shake-up at FHLB-Des Moines continues

- Neil Fruechte, acting president and CEO of the FHLB-Des Moines announced the realignment of the Bank's financial functions and accepted the resignations of Amy Angle, COO, and Jamie Bishop, chief risk officer. Fruechte's announcement follows the sudden December resignation of the Bank's president, Patrick J. Conway, and the creation of the position of chief financial officer, currently held by interim CFO James Huston, in March. Fruechte, said, "The changes to our management structure will streamline our operations while we continue in our effort to complete the restatement of previous-years financial statements and our registration with the Securities and Exchange Commission." (*PrimeZone Media Network*, 04/06/06; *American Banker*, Jody Shenn, 04/07/06)

FHLB-Seattle files its Form 10 with SEC

- On March 31, the FHLB-Seattle filed its Form 10 Registration Statement with the SEC, including its audited financial statements for FY2005. The FHLB-Seattle also announced that the board has voted to reduce the amount of stock that members are required to hold to support their membership and new borrowing activity with the Bank. "By allowing our members to take greater advantage of their current stock holdings in the Seattle Bank, we are better able to meet their liquidity and funding needs as we increase our core advances business," said Seattle Bank President and CEO James E. Gilleran.
- In the FHLB-Seattle's assessment of risk, the Bank's filing said that "recent negative public policy views on the systemic risks presented by GSEs and accounting and other announcements by Fannie Mae, Freddie Mac and the FHLBanks have, at times, created pressure on debt pricing, as investors apparently perceive such obligations as bearing greater risk than some other debt products. Any additional similar announcements may contribute to further pressure on debt pricing. As a result of the perception of higher risk relating to GSE debt products, as well as GSE growth, the FHLBank System may have to pay higher interest rates on its consolidated obligations to make them attractive to investors." (*BusinessWire*, 03/31/06; *Dow Jones Newswires*, John Connor, 04/04/06)

FHLB-Chicago reports net income for FY2005 of \$244 million

- In its Form 10-K filing with the SEC, the FHLB-Chicago reported net income of \$244 million for a return on equity of 5.54%. On December 31, the Bank reported total assets of \$85.3 billion and regulatory capital of \$4.5 billion. The Bank's regulatory capital ratio of 5.3% was well above the FHLB minimum of 4% and the Bank's current regulatory minimum of 4.5%. "These results demonstrate that the Bank remains profitable and in solid financial condition," said Mike Thomas, President and CEO of the FHLB-Chicago. "We are pleased that more of our members are finding value in advances and other credit products, the Mortgage Partnership Finance® Program and our Community Investment products. We remain committed to developing new products and services to increase that value for our members." (*FHLB-Chicago Press Release, 03/30/06*)

FHLB-San Francisco announces annualized dividend rate of 4.97% for first quarter

- The FHLB-San Francisco's board of directors declared a projected first quarter dividend at an annualized rate of 4.97%, based upon information to date. The Bank expects to announce the dividend rate when it announces its financial results for the first quarter of 2006. (*Business Wire, 03/31/06*)

David Curtis rejoins FHLB-Pittsburgh's board of directors

- The FHLB-Pittsburgh announced that David W. Curtis, a nationally known advocate for and builder of affordable housing, has rejoined the Bank's Board of Directors, filling the term of David M. Applegate which expires December 31, 2007. Applegate, chairman of the board of GMAC Bank, resigned earlier this year in anticipation of the relocation of GMAC Bank's home office from Delaware to Pennsylvania. Curtis is a member of the board of directors of Citizens Bank Delaware and is executive vice president of Leon N. Weiner & Associates, Inc., a Wilmington, DE home builder, developer and property management firm. In January 1996, Curtis was appointed by the Federal Housing Finance Board to the FHLB-Pittsburgh's board of directors and served two terms which expired on December 2002. Curtis served as chairman of the board from July 1999 through 2001 and as vice chair in 2002. A respected leader in the fields of homebuilding and housing finance, Curtis currently serves as co-chairman of the Mortgage Roundtable and is a past chairman of the NAHB's Housing Finance Committee. (*Business Wire, 04/05/06*)

FBI investigates possible fraud in \$3 million grant from the FHLB-Dallas

- According to *The Dallas Morning News*, “The low-income housing builders [Brian and Cheryl Potashnick] at the heart of the FBI’s corruption investigation at City Hall created a nonprofit organization [Housing Services, Inc.], stocked it with friends and political allies and used it to obtain more than \$3 million in tax-free subsidies [from the FHLB-Dallas] that earned their companies millions more in profit.” The FBI and IRS are investigating Housing Services’ activities and benefits that the nonprofit’s board members received from the builder, as part of a larger inquiry into possible bribery and public corruption surrounding the city’s approval of real estate deals. (*Dallas Morning News*, Reese Dunklin, 03/26/06)

Ginnie Mae

HUD proposes to modernize FHA and revitalize Ginnie Mae

- In the FHA Modernization Act, HUD proposes legislation to revitalize the FHA’s lending program by allowing it to charge flexible rates based upon the credit profile of the borrowers. Under the proposal, first time homeowners can obtain an FHA insured loan with no down payment, and potentially reduce mortgage insurance premiums, said Assistant Secretary for Housing and FHA Commissioner Brian Montgomery in testimony before a Subcommittee of the House Committee on Financial Services. “The impact of this bill may be tremendous,” said Montgomery, adding that 43% of first-time homebuyers financed their homes with no down payment in 2005. “The dynamic mortgage market passed FHA by,” said Montgomery, leaving potential FHA borrowers to seek more costly mortgages. “A new, modern-era FHA would offer many hard-working Americans a variety of home ownership options that are safer and at a fair price,” he added. HUD’s plan also would increase loan limits to 100% of the \$417,000 maximum available to borrowers qualifying for conforming loan programs, up from 87% today. In low cost areas, the HUD proposal would increase the loan limit to 65% of the conforming rate from 48% percent and in mid-priced areas the cap would rise from 95% to 100% of the limit. The plan changes the rules to allow FHA to insure condominiums under its standard single-family insurance program and would eliminate the cap on federally-insured reverse mortgages. The FHA reforms would also revitalize Ginnie Mae, whose share of the mortgage bond market has fallen by half since 1999. In 2005, Ginnie Mae issued \$86 billion in mortgage bonds, while its share of agency debt fell to 8.7% from an average 11.7% the prior three years, according to Bloomberg. If the FHA bill were enacted, Ginnie Mae may increase sales to as much as \$95 billion in 2007, compared with the government’s forecast of \$63 billion this year, according to Bush’s budget proposal.

- Representative Bob Ney (R-OH), chairman of the House Financial Services subcommittee on housing, and Representative Maxine Waters (D-CA), ranking member on the panel, are co-sponsoring the FHA reform bill, along with Representatives Gary Miller (R-CA) and Patrick Tiberi (R-OH). Representative Barney Frank (D-MA) said he is in “overwhelming agreement” with the administration’s FHA reform package, except for charging lower-income subprime borrowers higher mortgage insurance premiums. Instead, Frank recommended that the premiums be cross-subsidized with other government funds. (*Wall Street Journal*, Benton Ives-Halperin, 04/06/06; *Reuters*, Kristin Roberts, 04/05/06; *Bloomberg News*, Al Yoon, 04/05/06; *Bureau of National Affairs*, Richard Cowden, 04/06/06; *National Mortgage News Online*, 04/07/06; *National Mortgage News Online*, Paul Muolo, April 8-9, 2006)

International Mortgage Market

International Mortgage Lenders Association is formed
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- International Mortgage Lenders Association has been formed to focus on developing a global market in Mexico. The association’s website, www.internationalmla.org, is under construction. (*National Mortgage News Online*, 04/06/06)

Farm Credit System / Farmer Mac

FCA “wants to have its cake and eat it too by expanding its taxpayer-advantage powers but not melding into the broader financial system”
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- In the March issue of *Farm Credit Watch*, Burt Ely wrote, “One would have thought, in the summer of 2004, that Western Civilization, as we have known it, would have come to an end had Farm Credit Services of America (FCSA), the second largest FCS association, been able to sell its loan portfolio to Rabobank and then exit the FCS. The furor from within the FCS was deafening -- don’t let FCSA escape the FCS -- a message repeated that fall in a House Agriculture Committee hearing.”
- “The Farm Credit Administration (FCA), friendly regulator that it is, responded to FCS concerns that some of its associations might want to flee the coop by issuing a proposed rule that would lock the jailhouse door so tightly that no institution would

ever consider leaving the FCS. This proposal, issued on January 11, drew 46 comments, with just eight from within the FCS -- one from the Farm Credit Council (FCC is the FCS trade association), three from FCS banks, and four from FCS associations. Most of the remaining comments came from trade associations and individual banks, including Rabobank.”

- “What is deafening this year is the silence within the FCS over the termination regulation, a silence which can only be interpreted as a desire of many associations to leave the door open to exiting the FCS, if a good enough deal comes along. Not only did two of the five FCS banks (which fund the FCS associations with monies raised in Wall Street) not comment on the proposed regulation, but there was not a peep from 92 of the 96 associations. Several years ago, the FCC ginned up letters from most of the associations in support of the FCA’s National Charters proposal. Clearly, most FCS associations do not feel too strongly about restricting the ability of associations to exit the FCS or else they would have written to support the proposed regulation. More importantly, a close reading of several FCS comment letters suggests some interesting divisions within the FCS over exiting the system.”
- “The harshest letter came from AgriBank, the largest FCS bank, which serves much of the Midwest. It asked the FCA to go beyond the proposed regulation to make it even harder for an FCS institution to leave the FCS and to give more favorable treatment to those members who oppose an association’s departure. The FCC’s shorter letter spoke favorably of the proposed regulation, but more importantly, reiterated its support for eliminating the statutory right of FCS associations to leave the FCS, once again demonstrating its opposition to shareholder rights within the FCS.”
- “CoBank’s letter was the most interesting given that CoBank has, according to reliable reports, itself considered leaving the FCS. While one intent of the proposed regulation is to drag out the exiting process by not mandating when the FCA must act at specific stages of the process, CoBank asked that the FCA ‘retain the flexibility to act earlier on a termination request if FCA has sufficient information.’ In other words, don’t slow the process down. CoBank’s letter further stated that the ‘FCA should not allow the form of the regulation to control the substance of the transaction, *while disadvantaging the petitioning institution* and/or the remaining institutions in the System’ [emphasis supplied]. One can envision CoBank as the petitioning institution, which may be why AgriBank made its pointed comments about a bank which wants to terminate its FCS status. Perhaps AgriBank’s comments were aimed at CoBank.”
- “The most extensive comments on the proposed termination regulation came from Rabobank, with many of its comments echoing concerns the ABA expressed about specific provisions in the proposed regulation. The clear intent of those provisions is to make it as difficult as possible for an association to leave the FCS, or for a prospective acquirer to make an attractive offer to acquire an FCS association. Rabobank’s comment letter additionally highlighted ‘the contradiction on the one hand between the FCA’s proposed [regulatory] changes, which are designed to

“tighten the locks” on the [FCS] and protect its ability to fulfill its original mission and, on the other hand, the [FCS’s] desire for broader powers in order to serve a large market well outside its historical mission, as expressed in the Horizons project.”

- “*FCW* could not have said it better. The real issue is that the FCS wants to have its cake and eat it, too, by expanding its taxpayer-advantage powers but not melding into the broader financial system. This, of course, is what the credit unions are seeking, aided and abetted by their regulator, the National Credit Union Administration (NCUA). One wonders if the NCUA and the FCA have taken pages from each other’s playbook as they seek to preserve the competitive advantages of those they regulate rather than being even-handed regulators. As Rabobank observed, ‘the Horizons project reflects the ambitions of many FCS institutions to operate as a commercial bank without relinquishing the competitive advantages provided under the [FCS’s] government mandate to finance U.S. farmers.’”
- Not only is the FCS’s proposed termination regulation not wildly popular within the FCS, given the paucity of comment letters, but there is division among those FCS institutions which commented. As Rabobank observed, there is a fundamental conflict between this lock-in proposal and the FCS’s credit-union-like ambitions. FCA needs to pull this proposed regulation off the table and fundamentally rethink the exit issue. (*Farm Credit Watch*, Bert Ely, March 2006)

Farmer Mac’s portfolio tops \$6 billion

- Farmer Mac has issued a long-term standby purchase commitment (LTSPC) to a FCS institution on a \$479 million pool of agricultural real estate mortgage loans, bringing its portfolio of loans, guarantees, and LTSPCs to a record \$6 billion, for an increase of 13% this year. “This transaction significantly advances Farmer Mac’s mission to improve the availability of long-term credit at stable interest rates to America’s farmers, ranchers and rural homeowners, businesses and communities by increasing the capacity of the FCS institution to make additional agricultural mortgage loans, said Farmer Mac President and CEO Henry D. Edelman. “The transaction is a product of Farmer Mac’s ongoing efforts to diversify its marketing focus to include large program transactions that emphasize high asset quality, with greater protection against adverse credit performance and commensurately lower compensation for the assumption of credit risk and administrative costs.”
- In March, Farmer Mac announced the closing of a \$500 million guaranteed of “AgVantage” securities, a form of corporate borrowings by farm lenders which require loans as collateral, similar to FHLB advances. According to Farmer Mac, a five-year mortgage-backed obligation of Metropolitan Life Insurance Co. backed by agricultural mortgages supports the AgVantage securities. In 2005, Farmer Mac bought only \$15.7 million of these securities.

- According to Farmer Mac's 10K, the agency's overall program volume slipped 3.6% to \$5.3 million in 2005. "Core" earnings for the year rose 4.7% to \$28.7 million, while GAAP earnings, including changes in derivatives' values, fell 3.2% to \$27.3 million. In its 10K disclosures, Farmer Mac said it faces "significant challenges in its efforts to regain its past growth rates," due to challenges caused by the agricultural lenders' high capital and liquidity levels; alternative sources of funding and credit enhancement; secondary market competition; lower growth prospects for the Farm Credit System, limiting LTSPC demand. (*Farmer Mac Press Release*, 07/03/06; *American Banker*, Jody Shenn and Erick Bergquist, 04/06/06)

Postal Service

The only way is up for postal rates

- According to Postmaster General John E. Potter, the Postal Service cannot continue to absorb high fuel costs, which "have risen more than a \$1 a gallon, costing the USPS over \$1 billion a year for gasoline we purchase directly." Unlike most businesses, Potter said, "...[T]he Postal Service still has CPI-based [cost of living adjustments] in our collective bargaining agreements, which in turn have driven our cost per work hour up 9 percent since 2002. That means this year's salaries and benefits are \$4.5 billion more than they were four years ago." Healthcare is another cost driver for the Postal Service. "Despite the reduction in employees, our annual health benefits costs have grown some \$2 billion -- or 36 percent -- since 2002," Potter added. As a result of these factors, the USPS plans to file its next rate case as soon as this month, followed by smaller, annual increases beginning in 2009, he said. (*DMNews.com*, Melissa Campanelli, 05/04/06)
- Attendees of the 2006 National Postal Forum speculated that the Postal Service would file the rate case with the Postal Rate Commission on April 17, the day after Easter, which would result in higher postal rates next spring. Many expect the rate request will be higher than the mid-single-digit estimate that USPS Board of Governors chairman James C. Miller predicted last year. (*DMNews.com*, Melissa Campanelli, 05/03/06)

Postmaster General says Postal Service's financial forecast is "very good"
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- In a speech at the National Postal Forum, Postmaster General Jack Potter said that the forecast for the Postal Service and the mailing industry is very good. The USPS's forecast assumes that a transformed Postal Service that will see a growth in Direct Mail and that technology advances will improve the Postal Service's performance and reduce costs. "I feel confident about the future," Potter said. "We have enormous

challenges. But we have the ideas to grow this business. I know that we can be more successful than ever.” (*USPS Newslink*, 04/03/06)

Rumblings on Mickey Barnett’s nomination as a governor of the USPS

- In a letter to Senator Susan Collins (R-ME), Earlene Roberts, the former [Republican] Minority Whip for the New Mexico House of Representatives, wrote in opposition to the confirmation of Mickey Barnett of New Mexico to the Postal Service Board of Governors. Roberts wrote, “I can tell you in no uncertain terms that Mr. Barnett does not hold the qualifications or the personal qualities that a Postal Governor should possess. Mr. Barnett is a paid special interest lobbyist. In his work...., he has practiced the politics of personal destruction and intimidation. ...To put this in Washington terms, Mr. Barnett has engaged in ‘Jack Abramoff’ style politics here in New Mexico.” (*Correspondence to Senator Susan Collins*, Earlene Roberts, 03/14/06)
- According to the *PostalNews Blog.com*, Ron Godbey, retired member of the New Mexico House of Representatives wrote a letter to the American Postal Workers and National Association of Letter Carriers urging the groups to oppose Barnett’s nomination to the USPS Board of Governors. Godbey wrote, “Barnett was [the National Right to Work Committee’s] chief mover in its attempt to make New Mexico a Right-to-Work state. Mr. Barnett’s efforts in opposing organized labor makes his service on the Postal Service Board very suspect and not helpful to harmonious relations between the letter carriers and management. Barnett is also the New Mexico lobbyist for the payday loan industry. In fact, while serving in the New Mexico Senate, Barnett introduced the legislation that led to New Mexico’s repeal of the interest rate caps on these lending institutions. ...Rates can reach 500 percent or more when calculated on an annual basis. Barnett ...recently filed suit against New Mexico Attorney General, Patricia Madrid who is trying to administratively regulate the industry. Given Mr. Barnett’s past record, and controversial department, I can’t believe he would or could be fair-minded with your initiatives, programs and ideas.” (*PostalNews Blog.com*, 04/04/06)

TVA

TVA's new board elects new chairman and names acting CEO

- On March 31, TVA's six new board members were sworn into office, joining the two remaining board members to constitute the agency's first part-time board in the utility's 73-year history. The newly constituted board then elected Knoxville businessman William B. Sansom as chairman and elevated TVA president Tom Kilgore as acting CEO. Bill Baxter, TVA's previous chairman, stepped down from that position to ensure a "clean break from the old governing structure," said Sansom, adding that the board will leave the management and operations of TVA to Kilgore and his staff. "This board will continue to listen to customers and to employees, but it will be much different because we are not involved in day-to-day operations," Sansom said. "This is a huge step to have a corporate board running TVA, making policy and determining strategy. It's important that boards not go into meddling with daily operations." Board member Don DePriest, a former chairman of TVA's distributor in Columbus, MS, was chosen to serve as chairman of a committee to write the corporate bylaws for the new board within the next 30 days.
- TVA's board will meet next month in Kentucky, where they've agreed to hear the concerns of many of TVA's 18 distributors who are upset that the agency's electric rates are higher than the wholesale rates in neighboring communities. Six distributors have served notice of their intent to cancel their TVA purchase contracts. Senators Mitch McConnell (R-KY) and Jim Bunning (R-KY) have introduced legislation that would provide TVA distributors in Kentucky with easier transmission access to less expensive power sources. TVA has objected to this legislation which opens up its service territory, unless the agency is allowed to sell its power outside its seven-state service area. (*Chattanooga Times/Free Press*, 04/04/06; *WVLT-Knoxville, Channel 8*, 04/03/06)

TVA issues \$1 billion in 50-year non-callable bonds

- On March 29, TVA issued \$1 billion in 50-year non-callable bonds with a yield of 5.408%, using Merrill Lynch and Morgan Stanley as joint lead managers of the offering. The bond proceeds will be used to refinance the agency's existing debt. "Demand for the bonds produced an order book that was more than twice the announced billion-dollar size," said TVA Treasurer John Hoskins, thanks in part to the bond's ratings of "Aaa" by Moody's and "AAA" by S&P's and Fitch Ratings. "The shortage of high-quality, ultra-long bonds in the market contributed to a very strong transaction," said TVA CFO Michael Rescoe. (*Reuters*, 03/29/06; *Associated Press*, 03/30/06)

- In a court filing, TVA lawyers have asked a federal court to dismiss a lawsuit filed by North Carolina over agency's pollution, arguing that TVA cannot be sued as a nuisance because it is carrying out a public service authorized by Congress. "We maintain that the lawsuit is not needed because TVA has already spent \$4.4 billion putting controls on our plants, and we plan to spend another approximately \$4 billion," said agency spokesman John Moulton. "[TVA] is using every trick in the book to avoid responsibility for cleaning up the air that it is polluting," said N.C. Attorney General spokesman William McKinney. "Attorney General [Roy] Cooper will keep fighting until TVA agrees to reduce pollution, like North Carolina plants have already agreed to do." (*News & Observer* [Raleigh, NC], Wade Rawlins, 04/04/06)

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