

# The **GSE** REPORT™

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## ***Major Events***

### **OFHEO finds “*extensive financial fraud*” at Fannie Mae from 1998 - 2004**

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- In its special examination of Fannie Mae, OFHEO found that company executives “deliberately and systematically” created earnings “illusions” to hit Fannie’s earnings per share targets from 1998 through 2004 through “extensive financial fraud,” leading Fannie to overstate its earnings by \$10.6 billion. “The image of Fannie Mae as one of the lowest-risk and ‘best in class’ institutions was a façade,” said OFHEO acting director James Lockhart. “Our examination found an environment where the ends justified the means. Senior management manipulated accounting, reaped maximum, undeserved bonuses, and prevented the rest of the world from knowing.” In a 340-page report summarizing the agency’s 27-month examination of nearly eight million pages of documents, OFHEO unleashed a scathing critique of Fannie Mae’s board of directors and management for an “arrogant and unethical corporate culture” that allowed managers to violate more than a dozen accounting standards when they got in order to achieve earnings targets. Of the \$90 million paid to former CEO Franklin Raines from 1998 to 2004, \$52 million was tied to EPS that the company hit. “You could argue that none of the [\$52 million] was deserved,” said Lockhart. The report documents a fact pattern, connecting Fannie Mae’s focus on earnings goals to the

company's executive compensation and the company's corresponding accounting maneuvers dating back to the early 1990s, using cookie jar reserves and deferred expenses to smooth earnings and profit targets. When earnings exceeded EPS goals, management utilized debt repurchases and recorded losses totaling \$3.5 billion from 2001 to 2003 to push profits to future periods to ensure that subsequent EPS goals were met. To further illustrate management's efforts to defer income, OFHEO highlighted two REIT transactions in 2001 and 2002 with Goldman Sachs that improperly pushed \$107 million of the GSE's earnings into future years. "Our examination found an environment where the ends justified the means," said Lockhart.

#### Fannie Mae enters into consent agreement and agrees to pay \$400 million penalty

- Fannie Mae entered into a consent agreement with OFHEO, agreeing to pay a \$350 million civil penalty to the SEC and \$50 million to the Treasury to settle accounting fraud charges against the company. The SEC's settlement, the second-largest fine ever assessed against a company in the agency's history, will compensate Fannie Mae's investors damaged by the alleged violations. SEC chairman Christopher Cox said, "Both Director Lockhart and I agree that a penalty of this size represents a meaningful sanction that is necessary to address the egregiousness of Fannie Mae's conduct. Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets, which is to allocate capital to its best uses. By interfering with the full and fair disclosure that underpins our markets, fraudulent financial reporting cheats investors of their savings." [Fannie Mae investors have lost approximately \$30 billion of market value since OFHEO disclosed accounting improprieties in 2004.]
- While the company neither admitted nor denied wrong-doing by entering into the settlement, Fannie Mae agreed to the entry of a final judgment that permanently enjoins it from violations of anti-fraud reporting, books and records and internal controls provisions of the federal securities laws. The consent agreement contains 56 stipulations, governing virtually every aspect of Fannie's operations and mandating a wide array of "top to bottom" changes in its corporate culture, internal controls, accounting procedures, and corporate governance improvements. The agreement also extends OFHEO's requirement that Fannie hold 30% surplus capital above its minimum level.
- The settlement contains a provision restricting the size of Fannie Mae's portfolio to \$727.1 billion, the level it held on December 31, 2005. Fannie Mae has 60 days to submit to OFHEO a plan, which can provide a "modest" increase in its mortgage portfolio for purposes of liquidity, its housing goals, and competitive considerations. Lockhart said his agency's control over Fannie Mae's mortgage portfolio would remain in place until the company has resolved its accounting problems and improved its internal controls and risk management. "We're talking years. This company was so messed up ... that it's going to take a very long time," said Lockhart. During a conference call with investors, Fannie Mae CEO Daniel Mudd was

“characteristically” upbeat about Fannie Mae’s ability to have the portfolio limits lifted by OFHEO, but gave little, if any, hint of how long it would take.

- The agreement requires Fannie Mae to review 29 current and former employees to determine if the individuals should remain with the GSE or be subject to remedial steps. Specifically, Fannie Mae will review Raines, and former CFO J. Timothy Howard, along with other former employees to determine if any should be retroactively fired “for cause” and be forced to repay the company “ill-gotten” pay. The consent agreement specifically bans Raines and Howard from ever working for Fannie Mae again. On May 23, Fannie Mae chairman Stephen B. Ashley said that the board had decided to keep Mudd as the company’s CEO and that he would lead the company’s investigation of its employees role in the accounting improprieties. On May 24, Ashley said that the board had “developed its thinking further on how the review ...should be handled” and that that four independent board members, who joined Fannie Mae in the past 18 months, would conduct the employee reviews. [The board committee consists of Dennis Beresford, former head of the FASB, Greg C. Smith, vice chairman of Ford Motor Co., Bridget A. Macaskill, principal of BAM Consulting LLC and John K. Wulff, chairman of Hercules, Inc.] Ashley also said that board’s decision to retain Mudd does not exempt him from a review of the bonuses he received and possible disgorgement.
- At a press conference, OFHEO acting director James Lockhart denounced Fannie Mae’s “arrogant and unethical culture” and directed the company to recover any unjustified compensation paid to management as a result of accounting misdeeds. SEC chairman Christopher Cox said that the people responsible at Fannie Mae for massaging the company’s financial results to maximize their bonuses “will be vigorously pursued.” He added, “...[T]oday we are in the midst of ongoing investigations of the other entities and individuals that are responsible for getting us to this pass. ...[A]nd you can expect further announcements from us on the investigative front.” The SEC’s settlement applies only to Fannie Mae, not to [current or former] executives of the company who may still face legal action, Cox added. While the SEC and OFHEO investigations of the company have been completed, a criminal investigation of Fannie Mae by the Department of Justice continues, along with numerous shareholder lawsuits.

#### OFHEO Report details breath of problems at Fannie Mae

- The OFHEO Report was highly critical of Fannie Mae’s current and former directors, who failed to be sufficiently informed; failed to act independently of management; failed to exercise appropriate management oversight; and failed to correct accounting and internal control problems after similar problems emerged at Freddie Mac in 2003. OFHEO found that the board failed to demand accountability from top executives and, instead, gave “management unbridled authority.” The board failed to launch an independent inquiry into allegations of accounting fraud by employee Roger Barnes. The audit committee failed to monitor the GSE’s financial statements and “exercised little, if any, meaningful or active oversight.” The compensation committee “allowed

management to script its meetings and rubber stamped executive compensation proposals by senior management.” The report suggested that chairman Ashley and director Ann Korologos should leave the board because their service as Fannie Mae directors exceeds the 10-year limit set by OFHEO and the company’s governance standards. [A director may serve longer than 10 years in “exceptional cases,” under OFHEO’s governance standards.]

- According to OFHEO, Fannie’s internal auditors [Office of Auditing] and external auditors [KPMG] failed to carry out their duties and provided “a cursory review, at best, of the allegations of fraud” raised by a company employee [Barnes] in 2003. OFHEO wrote, “The Office of Auditing contravened both OFHEO Standards and the responsibilities outlined in its board-approved charter.” Fannie’s internal auditors failed to ensure staffing proficiency; exercise due professional care; verify adequate internal controls; meet stated audit report objectives of assessing GAAP compliance; and carry out “truthful and complete communications with management, the external auditors, and the board of directors.” The report also said that KPMG “contravened OFHEO’s requirement for external audits in that those audits failed to review adequately Fannie Mae’s significant accounting policies for GAAP compliance.” OFHEO added, “KPMG also improperly provided unqualified opinions of financial statements that contained significant departures [from GAAP]. ... The failure of KPMG to detect and disclose the serious weaknesses in policies, procedures, systems and controls in Fannie Mae’s financial accounting and reporting, coupled with the failure of the board of directors to oversee the external auditors properly, contributed to the unsafe and unsound conditions at the enterprise.”
- “Senior management expected to be able to write the rules that applied to Fannie Mae and to thwart efforts to regulate [it],” said the Report. Under Raines, the company built one of the most potent lobbying machines in Washington by increasing lobbying expenditures by 25% during Raines’ tenure [according to *PoliticalMoneyLine*]. OFHEO documented repeated efforts of Fannie Mae using its political clout to undermine the agency’ efforts to more closely regulate the company’s business. Among other actions, Fannie Mae instructed its lobbyists to try to influence the congressional staff of Senator Kit Bond (R-MO) to request an inspector general investigation of OFHEO. Fannie Mae lobbyist Duane Duncan testified under oath that Bond launched the IG investigation at the company’s request, in hopes that the IG’s report would undercut OFHEO’s efforts and cast doubt on the agency’s findings. Following the release of the IG report, Bond said, “OFHEO officials have misused their agency and abused their public trust.” Fannie Mae also sought to insert a provision in an appropriations bill that would have reduced OFHEO’s budget until the agency’s director, Armando Falcon, was replaced.
- While former COO Daniel Mudd was not directly linked to the company’s accounting problems, OFHEO criticized Mudd for not taking more steps to address internal control problems of which he had knowledge. In September 2003, an employee told Mudd in an email that Fannie was conducting improper accounting similar to that of Freddie Mac. According to the report, Mudd “missed an opportunity to recognize

that perhaps there were similarities between Freddie Mac and Fannie Mae,” and did not adequately share the employee’s concern with the company’s audit committee. The OFHEO report concluded that an investigation by internal auditors validated the employee’s allegations, but the findings were not shared with the GSE’s audit committee. “I was disappointed to see the extent of [Mudd’s] involvement,” said former OFHEO director Armando Falcon Jr., who approved Mudd’s promotion to CEO in June 2005. “If I knew then what I know now from reading this report, I would have advised them to select someone from outside the company.” In a *Washington Post* interview, Mudd acknowledged he did “miss an opportunity” to address aspects of Fannie Mae’s accounting abuses in 2003, but said he never engaged in wrongdoing and did not attend “any meeting where there was any discussion of shifting or falsifying income.” Warren B. Rudman, who led a board-commissioned review of Fannie Mae, said, “Our conclusion was that [Mudd’s involvement] didn’t amount to wrongdoing. Though there may have been some missed opportunities, there’s a difference between missed opportunities and improper conduct.” Fannie Mae chairman Ashley, said, “The board met . . . and reviewed all references to Dan in this report. The board’s review of the OFHEO report and its consultation with counsel . . . gives us no reason to express anything other than complete confidence in Dan Mudd’s leadership of this company.”

- The OFHEO report said that Fannie Mae failed to disclose to shareholders or OFHEO a post-employment consulting agreement with former CEO James A. Johnson dated February 7, 2000, retroactive to January 1<sup>st</sup> [the effective date that Johnson stepped down from the company’s board]. Under the agreement, Johnson received a “consumer priced indexed-adjusted fee of \$390,500 a year,” two support-staff members, a car, and payment of the salary for a driver for up to 50% his time, in addition to Johnson’s annual pension of \$852,000. According to the Report, Johnson’s contract and related costs totaled \$547,109 in 2001 and \$411,788 for the first eight months in 2002. OFHEO expressed concerns about the terms of Johnson’s post-employment contract and stated that “during 2004, the possible use by Mr. Johnson of phone and fax lines for political activity in that election year appeared to cause concern.” According to the report, Fannie Mae developed ground rules for the appropriate use of Fannie Mae-provided transportation and support staff when Johnson was engaged in political activity [in the 2004 John Kerry presidential campaign], and that then COO Dan Mudd “spoke with . . . Johnson about the concerns of Fannie Mae in that area.” In a March 17, 2005 letter to Fannie Mae’s board of directors, Johnson offered to temporarily reduce his consulting fees to \$300,000 and to give up his support staff and car. “I should do my part to assist Fannie Mae’s efforts to reduce expenditures at this time,” Johnson wrote. OFHEO also noted that Fannie Mae continued to pay for an office and a secretary for former CEO David Maxwell after he turned 70 at an annual cost of \$190,000 in 2002. [Fannie Mae’s 1991 proxy statement indicated that Fannie would provide Maxwell these benefit “until he reached the age of 70.”] In correspondence to Fannie Mae board member Stephen Friedman, a company deputy general counsel said, “[T]here is no legal obligation [for Fannie Mae] to disclose that we are continuing this benefit [to Maxwell].”

- In contrast to the Rudman Report, OFHEO's findings were far more critical, painting a scenario of executives deliberately and intentionally manipulating earnings to increase their bonuses, while a frequently conflicted board largely stood by. Lockhart said, "We all agreed on the accounting issues. We really looked at the motivations and came to some different conclusions" relative to Rudman's findings. Among them, Lockhart said, was that Fannie's management was involved in earnings manipulations year in and year out, making certain that reported earnings resulted in the maximum for their bonus in every reported year from 1998 to 2004. [Rudman's report attributed many of the company's violations to Howard and controller Leanne Spencer, but stopped short of blaming Raines. Rudman also concluded that with the exception of 1998, there was no evidence that Fannie Mae's accounting problems "were motivated by a desire to maximize bonuses."] OFHEO's investigation concluded that Raines was at the center of the company's accounting problems and accused the CEO of fostering an arrogant and unethical tone at the top. Many on Capitol Hill and Wall Street viewed the \$60 million Rudman Report as a "whitewash," because it absolved Raines and Fannie Mae's board of directors of any serious blame for the company's accounting fraud. (*Dow Jones News Service*, Siobhan Hughes, 05/23/06; *Dow Jones International News*, Damian Paletta and Siobhan Hughes, 05/23/06; *Wall Street Journal Online*, 05/23/06; *TheStreet.com*, Matthew Goldstein, 05/23/06; *Chicago Tribune*, Robert Manor, 05/24/06; *CQ Today*, Michael R. Crittenden, 05/24/06; *New York Times*, Eric Dash and Michael J. de la Merced, 05/24/06; *The Hill*, Elana Schor, 05/24/06; *Bloomberg*, David Pauly, 05/25/06; *USA Today*, Elliot Blair Smith, 05/24/06; *USA Today*, Edward Iwata, 05/24/06; *USA Today*, Elliot Blair Smith, 05/24/06; *Washington Post*, Terence O'Hara, 05/24/06; *Washington Post*, Kathleen Day, 05/24/06; *Washington Post*, Terence O'Hara, Kathleen Day, and Annys Shin, 05/24/06; *Dow Jones Newswires*, John Connor, 05/23/06; *Wall Street Journal Asia*, James R. Hagerty, 05/25/06; *Wall Street Journal Online*, 05/23/06; *Remarks of SEC Chairman Christopher Cox*, 05/23/06; *Bureau of National Affairs*, Richard Cowden and Steve Burkholder, 05/24/06; *CFO.com*, Stephen Taub, 05/23/06; *Bloomberg*, James Tyson, 05/23/06; *Associated Press*, Marcy Gordon, 05/24/06; *Dow Jones International News*, Damian Paletta, 05/25/06; *Dow Jones Newswires*, John Connor, 05/23/06; *Bureau of National Affairs*, Richard Cowden and Steve Burkholder, 05/23/06; *Bureau of National Affairs*, Richard Cowden, 05/30/06; *Dow Jones International News*, 05/23/06; *Chicago Tribune*, Robert Manor, 05/24/06; *Wall Street Journal Online*, 05/23/06/)

#### Congressional reaction to the OFHEO Report

- Richard C. Shelby, (R-AL), chairman of the Senate Banking Committee, said "If OFHEO's report does not prove that Fannie Mae has lost focus on its housing mission, I can't imagine what would. It appears that their primary business mission was, in fact, to engage in earnings management in order to yield maximum possible executive compensation. In my mind, this constitutes fraudulent behavior, even if the company's agreement with OFHEO and the SEC does not constitute that admission-- which is standard practice in many of the recent high-profile settlements we have

seen.” Shelby added, “Aside from the corporate misdeeds, this report also makes clear that any regulator for the GSEs needs sufficient authority to keep them focused on their mission. Clearly, the report shows that left to their own devices, the GSEs, at best, are willing to neglect this mission and at worst, abuse their unique status to line their pockets.” (*Bureau of National Affairs*, Richard Cowden and Steve Burkholder, 05/24/06; *Dow Jones Newswires*, John Connor, 05/23/06)

- Senator Chuck Hagel (R-NE) said, “Fannie Mae has clearly violated its statutory housing mission. This report adds to the overwhelming amount of evidence that Fannie Mae is not appropriately regulated and it raises serious questions about its portfolio management and future liabilities for the American people. Fannie Mae’s agreement to limit the growth of its mortgage assets through its settlement reached with OFHEO is an important step toward protecting the American taxpayer. However, the failure to address the size and growth of Fannie Mae’s non-mission related assets represents serious potential liability for the American people and I will be asking OFHEO, Treasury and HUD what is being done to address this problem. Until Congress passes the GSE reform bill passed out of the Senate Banking Committee, we will be replaying these kinds of episodes. To protect the American taxpayer and investors, Congress must act this year.” (*US Fed News*, 05/23/06)
- Senator John Sununu (R-NH) said, “OFHEO’s report and announced settlement again confirms that Fannie Mae is not a low-risk financial institution. Even more, the report stipulates that the inadequacy of Fannie’s internal controls, risk management and accounting persist to this day. . . . I am very troubled by the fact that the negotiated settlement only addresses the growth of Fannie’s ‘mortgage portfolio assets’ and is completely silent on the GSE’s non-mortgage, or non-mission, assets that it purchases for its portfolio. . . . I think that it is irresponsible to expressly permit Fannie Mae to acquire and hold non-mission assets on its balance sheet. OFHEO and the SEC have essentially given Fannie a free pass to purchase securities that have nothing to do with housing, nothing to do with its statutory mission, and only stand to exacerbate the taxpayers’ exposure to a future bail-out. Unfortunately, this settlement ignores what we’ve learned thus far about the enormous risk that the GSEs’ portfolios pose to the housing market, the overall financial system, and the economy as a whole. Simply put, it demonstrates that OFHEO remains an ineffective regulator for these two huge financial institutions, and that Congress must act this year to create a new, independent regulator that can limit the GSEs portfolios by anchoring them to their statutory housing mission.” (*US Fed News*, 05/23/06)
- Senator Elizabeth Dole (R-NC) said, “The OFHEO report not only confirms my deep concerns about Fannie Mae - it demonstrates that the agency’s actions were even worse than I imagined. There is no doubt that Fannie Mae and Freddie Mac need a strong regulator to ensure that the manipulation and deception in Fannie and Freddie’s accounting practices has been forever banished from both institutions. No clearer argument can be made for the swift consideration and passage of legislation to create a strong regulator of these enterprises.” (Senator *Elizabeth Dole Press Release*, 05/23/06)

- Senator Wayne Allard (R-CO) said, “This report demonstrates that we need strong, fundamental reform, and we need it quickly. I would encourage the [SEC] and the Justice Department to closely examine the circumstances revealed by the oversight panel’s report to determine if it is appropriate to bring criminal charges against those involved.” (*Rocky Mountain News*, 05/24/06)
- Senator Jim Bunning (R-KY) said, “We need a GSE [regulatory reform] bill very badly. Unfortunately, it’s stalled. Maybe, [the OFHEO] report will get it going again. It is essential to strengthen our financial system. This is the most important issue we are dealing with this year in the financial area.” (*Market News International*, John Shaw, 05/24/06)
- Senator John McCain (R-AZ) said, “For years I have been concerned about the regulatory structure that governs Fannie Mae and Freddie Mac known as ...GSEs and the sheer magnitude of these companies and the role they play in the housing market. OFHEO’s report this week does nothing to ease these concerns. In fact, the report does quite the contrary. OFHEO’s report solidifies my view that the GSEs need to be reformed without delay. I join as a cosponsor of the Federal Housing Enterprise Regulatory Reform Act of 2005, S. 190, to underscore my support for quick passage of GSE regulatory reform legislation. If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall financial system, and the economy as a whole. I urge my colleagues to support swift action on this GSE reform legislation.” (*State News Service*, 05/30/06)
- House Financial Services Committee chairman Michael G. Oxley said, “Unfortunately, as [the OFHEO] report details, Fannie Mae sought to oversee OFHEO, instead of the other way around. ...Given the large failure of internal controls and the audit function at Fannie Mae, this episode reinforces the need for the Sarbanes-Oxley Act. ...With one of the largest penalties ever paid by an individual company, Fannie Mae is the Enron of the financial services industry. ...While I applaud today’s result of the two-year OFHEO examination, it shouldn’t be this difficult to conduct regulatory oversight. The solution is to create a stronger, world-class regulator for Fannie Mae and Freddie Mac, which the House-passed bill emphatically accomplishes. As I have stated before, we in the House await the report of the Senate Banking Committee that could lead to Senate floor consideration. Only after the Senate acts can we begin the conference committee that would combine and compromise the two products.”
- Oxley continued, “The House version of the bill would give the new regulator full power and discretion to adjust portfolio size, yet refrains from issuing a specific directional mandate. The House bill provides clear and strong authority on capital requirements and portfolio size, while strengthening the new regulator’s supervision and enforcement powers. While some are enamored with the Banking Committee’s portfolio limitation provision, all of the regulatory power in the world will do no good

if it is contained in legislation that cannot pass. Today's [consent] agreement, in my estimation, will control portfolio growth. The Treasury Department possesses power to limit debt issuance that Treasury officials apparently are unwilling to use." (*House Committee on Financial Services Press Release*, 05/23/06)

- Representative Richard Baker (R-LA) said, "While Fannie's accounting errors have been known for some time, OFHEO's report sheds new light on the despicable motivations and lack of controls behind these manipulations, as well as on other aspects of the company's egregious behavior." (*The Advocate*, 05/24/06)

#### Congress schedules hearings on the OFHEO Report

- Capital Markets Subcommittee chairman Richard H. Baker (R-LA) will convene his panel to review the Office of Federal Housing Enterprise Oversight's (OFHEO) recent report on accounting irregularities at Fannie Mae on Tuesday, June 6, at 2 p.m. and will receive testimony from James B. Lockhart, III, acting director of OFHEO. (*House Committee on Financial Services Press Release*, 05/31/06)
- On the *Wall Street Journal's* WashWire Blog, Michael Schroeder wrote, "The Senate Banking Committee is calling Fannie Mae's current chief executive officer, Daniel Mudd, and former chief Franklin Raines to testify as early as [the first week of June] on federal regulators' allegations that the giant mortgage company engaged in fraudulent accounting. Also being asked to discuss their investigations are James Lockhart, acting director of [OFHEO] ... and Christopher Cox, chairman of the [SEC]. ... Committee Chairman Richard Shelby (R-AL) is planning a wide-ranging hearing, including probing whether Mudd is the right person to lead the mortgage giant. While not accused of wrongdoing, he was a senior Fannie executive for a few years during which the books were cooked." (*Wall Street Journal WashWire Blog*, Michael Schroeder, 05/31/06)

#### Bush administration's reaction to the OFHEO Report

- U.S. Treasury Undersecretary for Domestic Finance Randal Quarles said the OFHEO Report underscores the need for stronger regulation over the GSEs, as well as a need for legislation to limit the substantial investment portfolios at Fannie Mae and Freddie Mac. "OFHEO's findings are a clear warning about the very real risk the improperly managed investment portfolios of the GSEs pose to the greater financial system. The Report demonstrates that a legislative mandate limiting these portfolios, as proposed in legislation pending before the Senate [is imperative]" said Quarles. "I think a legislative outcome is quite possible this year. The undeniable facts from this Report ought to give significant impetus to an outcome that provides the legislative mandate that we have sought and that is present in the Senate Banking Committee Bill." (*Bureau of National Affairs*, Margaret Chadbourn, 05/24/06; *Market News International*, Yali N'Diaye, 05/24/06)

- “Emil Henry, Assistant Secretary at the U.S. Treasury Department, said, “The [OFHEO] report ...makes clear that perfect hedging of such a portfolio is virtually impossible. Shame on us if we just sit idly and hope against hope that the portfolio will not produce a severe and wrenching dislocation for our capital markets.” Henry continued, “That report laid bear an important and disturbing fact. That is that the oversized portfolio has been created by Fannie solely for the purpose of compensation and earnings and disappointingly disconnected from mission. ...We are hoping to achieve [GSE] reform via the legislative process and in particular we are confident we will achieve reform in the form of the Senate bill.” (*Reuters*, Anna Willard and Ana Nicocolaci da Costa, 05/24/06)

### Nothing fazes the credit rating agencies

- After the issuance of the OFHEO Report, Moody’s reaffirmed its rating of Fannie Mae’s Bank Financial Strength Rating as B+ with a stable outlook; the company’s Aaa senior unsecured debt rating with a stable outlook; and its Prime-1 rating for short-term debt. (*Market News International*, 05/25/06)
- Fitch also affirmed with stable outlook Fannie Mae’s Long-term Default Rating of AAA; long-term senior debt of AAA; and short-term of ‘F-1.’ Fitch’s rating of Subordinated Debt AA- and Preferred Securities A+ remain on Rating Watch Negative. In a press release, the agency said, “Fitch believes the OFHEO Report may spur additional board and management board changes, litigation, and potentially lengthen the discovery phase of pending lawsuits. It also places additional pressure on capital due to the potential for higher settlements or judgments. The Report discusses an enterprise whose management was mired in earnings management and manipulation. While it also highlights some turnover at the senior management level, it may negatively impact management by increasing distractions and turnover. Both the board and management will need to demonstrate a material change in culture and improved transparency. Both the Board and management will also need to move beyond the correction of accounting systems and internal controls and address numerous other challenges. These include addressing earnings expectations and portfolio management issues as the growth rate in mortgages has materially slowed, managing the portfolio as the U.S. yield curve steepens, adapting to potential regulatory changes and competitive threats and differentiating itself from the culture currently depicted with an emphasis on improving safety and soundness.” (*Business Wire*, 05/23/06)
- To date, Standard & Poor’s has not updated its ratings for Fannie Mae. In 2003, S&P gave Fannie Mae a “gold star” for corporate governance, giving it a rating of “9,” based upon a 10-point scale. After Fannie Mae’s accounting scandal surfaced, the credit rating agency discontinued issuing corporate governance ratings. (*Dow Jones Newswire*, Phyllis Plitch, 02/24/03)

## Wall Street's reaction to the OFHEO Report

- Following the May 23<sup>rd</sup> release of the OFHEO report, Fannie Mae's stock closed at \$50.71, up \$0.45 a share for the day but down 28% from the date of Raines' departure as CEO in December 2004. "I think that people are actually taking this to mean that OFHEO's issues are behind them," said Josh Rosner, a Graham Fisher analyst. "I think that is the wrong answer, the wrong approach and the wrong interpretation. Really, what it means is that Fannie's fixing of their problems is going to take a lot more money and a lot more time than anyone had anticipated. And as they fix their problems, it will necessarily make it harder for them to execute going forward." (*New York Times*, Eric Dash and Michael J. de la Merced, 05/24/06)
- Paul Miller, an analyst with the Friedman, Billings, Ramsey Group Inc., said, "[The] regulators have a tight control of the company. This is a harsh piece of paper that is pretty much saying OFHEO is coming out swinging. This is much worse than Wall Street believes it is." (*American Banker*, Rob Blackwell, Patrick Rucker, Jody Shen and Joe Adler, 05/24/06)
- On *TheStreet.com*, Jim Cramer "pooh-poohed" the Fannie Mae-SEC settlement, saying, "[T]he execs who presided over the accounting missteps--led by ex-CEO Franklin Raines--haven't given back a dime of their multimillion-dollar bonuses. That's our own form of rapacious capitalism [referring to an earlier riff on various brands of communism across the globe]. Everyone loses but management." (*TheStreet.com*, Jim Cramer, 05/23/06)

## Editorial boards' reaction to the OFHEO Report

- In a May 26 editorial, the *Wall Street Journal* wrote, "...The larger story here is that Fannie Mae is less a corporate outrage than a political one. It is the tale of a company that has grown rich off an implicit taxpayer subsidy and then plowed those profits back into buying political protection in Congress and feckless regulation from the executive. OFHEO only rose to the occasion thanks to the prodding of a few souls in Congress and the press, and only after Freddie Mac's own accounting blew up. Even now, a bipartisan coalition in the House and Senate is protecting the companies from genuine supervision. *That's the real scandal.*" [Emphasis added.] (*Wall Street Journal*, 05/26/06)
- In a May 27 editorial, the *Los Angeles Times* wrote, "The settlement, along with the release of a scathing report by the [OFHEO], is welcome not just because it is a victory against shoddy corporate oversight. Bringing Fannie Mae to justice is important because of the company's unique ties to Washington. Like its smaller sibling Freddie Mac, Fannie Mae started life as a government entity, intended to keep mortgage markets liquid by buying loans from banks and reselling the debt to investors. ...It enjoyed tax breaks, loose capital restrictions and low borrowing costs that were unavailable to other publicly traded companies. It also received preferential treatment from investors, who assumed that its ties to the federal government meant it

could never go belly-up, and it faced less onerous regulation than other financial institutions. The settlement and the report are a good start — but only that — to bringing Fannie Mae in line. ...Fannie Mae's board should consider the next best thing to retroactively firing former Chief Executive Franklin Raines and former Chief Financial Officer Timothy Howard, who were allowed to take early retirement in 2004. It should force Raines and Howard — and any others who profited through the accounting tricks — to reimburse the company for the compensation they received by falsely achieving earnings targets. According to the report, \$52 million of Raines' \$90 million in compensation from 1998 to 2003 was linked to "achieving" earnings-per-share goals. The Securities and Exchange Commission and the Justice Department must continue their investigations, which will target individual executives. And, after years of dancing around the subject, Congress should follow the Bush administration's lead and make it clear that, despite the widespread belief on Wall Street, these publicly traded companies won't be bailed out by taxpayers should their riskier investments and hedging strategies backfire. (*Los Angeles Times*, 05/27/06)

- In a May 31 editorial, *USA Today* wrote, "In early 2004, Fannie Mae's then-CEO Franklin Raines came to *USA Today* to talk to editors and reporters. He was furious over an editorial that had run a few days earlier criticizing his company for, among other things, its 'questionable accounting practices.' With barely a 'good morning,' Raines launched into a criticism of the editorial and a defense of his company. He began his remarks by declaring that facts are important. We could not agree more."
- "And two and a half years later, the facts don't look very good for Raines and Fannie Mae. In releasing a 348-page report last week, government officials said the company engaged in 'extensive financial fraud' by doctoring earnings so Raines and other executives could earn 'unjustified levels of compensation.' Officials also said the company suffered from 'an arrogant and unethical corporate culture.' These are extraordinarily damning assertions. They show a company whose top executives were contemptuous of criticism and imbued with a sense of entitlement to enrich. According to the report, Raines pulled in more than \$90 million in his six years as CEO, \$52 million of which was performance pay triggered by bogus accounting."
- "Fannie Mae is no average company. ...The company, which pours money into the housing market by buying millions of mortgages from banks, is crucial to the functioning of the economy. For that reason, taxpayers would almost certainly be called on to bail it out if it ever got into serious financial trouble. That makes an honest accounting of its profits, assets and liabilities a vital public trust. That is not what the public got under Raines and his associates. The company overstated its earnings by \$10.6 billion over six years, according to last week's report. When people questioned the company's extraordinarily complex accounting, they were treated to angry rejoinders reminiscent of those delivered by Enron executives at their arrogant heights. When lawmakers or government officials argued that the company needed tighter oversight or fewer privileges, they were outgunned by Fannie's lobbying machine. The battle against corporate fraud did not end with the Enron

verdicts last week. The report on Fannie Mae was accompanied by a \$400 million settlement with the government. Federal agencies are still evaluating whether to bring civil or criminal charges against individuals. These are not pleasant things to contemplate. But they are the facts.” (*USA Today*, 05/31/06)

- In a May 30 editorial, *Knight Ridder/Tribune Business News* wrote, “Americans have become used to reading about corporate accounting scandals. But, when the company involved operates under a government charter that gives it special benefits, the question of how these types of schemes continue takes on added importance. The answer isn’t more regulations but tougher enforcement of those already on the books. ...[T]he government needs to take a stronger rule in regulating Fannie Mae and Freddie Mac. A bill passed by the Senate banking committee would help by establishing an independent regulator within the Department of Treasury to oversee the companies. They are now regulated by the Department of Housing and Urban Development while other banks are overseen by the treasury department. The bill is stalled in the Senate. The OFHEO report should prompt lawmakers to pass it.” (*Knight Ridder/Tribune Business News*, 05/30/06)
- In a May 26 editorial, *The Christian Science Monitor* wrote, “When a company chartered by Congress to help finance affordable housing for lower-income Americans cooks its books to line the pockets of its managers, one might hope Congress would seek quick reform. It’s worth asking why it hasn’t. ...The scandal puts in doubt the whole public mission of Fannie Mae and Freddie Mac to financially lubricate the home mortgage business. If conditions still exist that might allow further corrupt practices, arm-twisting lobbying, and extreme risk-taking, Congress should remove the federal credit nest that the two companies seem to enjoy in the eyes of Wall Street investors. In the meantime, a bill passed by the Senate Finance Committee to beef up the federal oversight and curb the two companies’ size and mission should be passed. (The House bill is a weaker measure.)”
- “...Manipulating financial accounts to fool investors and benefit top managers was at the root of many large, recent business scandals. Fannie Mae’s mistakes were particularly large and in the public realm, involving a lack of ‘the values of responsibility, accountability, and integrity,’ according to the regulator’s report. The scandal hasn’t generated as much outrage as, say, that over Enron’s misdeeds, largely because of Fannie’s past largess with politicians’ campaigns, its PR prowess, and the tapping of help from the housing industry. Scaling back Fannie, improving its oversight, altering its governing board, and other such steps are fine. But more root-and-branch reforms will be needed.” (*The Christian Science Monitor*, 05/26/06)
- In a May 29 editorial, the *Denver Post* wrote, “Add Fannie Mae executives to the long list of names who came to Washington, D.C., to do good - and stayed on to do well. Now that Fannie and her sibling Freddie Mac are joined under the harsh light of financial scandal, Congress needs to tighten regulation of both agencies. ...Recovering undeserved bonuses from [Fannie’s] executives may be the easy part. The hard part will be for Congress to ensure that in tightening financial reins over the

two companies it doesn't also cripple their vital role in enabling the American dream of home ownership. Punish the wrongdoers, not future home buyers." (*Denver Post*, 05/29/06)

- In a May 25 editorial, the *St. Petersburg Times* wrote, "The corporate sewer of financial deceit and greed, littered with the likes of Enron's rotting carcass, now has a new netherworld lord of moral putrescence - the once shining mortgage giant Fannie Mae. It's not easy to out-Enron Enron, but Fannie Mae did. Under a succession of politically wired executives, it used its clout to manipulate earnings while holding off scrutiny of its accounting practices to one end: outsized executive bonuses. The con is over... Throughout Fannie Mae's downfall, its top executives raked in obscene amounts. More than half of Raines' \$90-million in pay over five years was tied to earnings targets apparently reached through financial chicanery. Even after Johnson retired as chief executive, he was kept on as a paid consultant - adding \$390,000 a year to his \$852,000 pension, two staffers, a car and driver. How does such a lifestyle skew values? Last year, when the company was crumbling under the weight of its own excesses, Johnson offered to "sacrifice" - by reducing his fee to \$300,000 and giving up the company car. Former and current executives should be called to account for their behavior. Fannie Mae is a warning to us all, especially Congress. When it gives an advantage to a company but neglects the necessary oversight, it is a formula for disaster." (*St. Petersburg Times*, 05/25/06)
- In a May 25 editorial, *The Kansas City Star* wrote, "In a 300-page report made public this week, the regulator of mortgage giant Fannie Mae says the company's steady, double-digit earnings growth between 1998 and 2004 were mere "illusions" based on accounting tricks. It was a damning report. ... Those considered individually responsible face further investigation. Those cases should be pursued vigorously, but the larger issue of the risk to the financial system posed by Fannie and its cousin, Freddie Mac remains unresolved. Congress should either fully privatize these 'government-sponsored enterprises,' which issue debt implicitly backed by taxpayers, or agree on an appropriate, permanent mechanism for curbing their growth. (*The Kansas City Star*, 05/25/06)
- In *Slate*, Mickey Kaus wrote, "Fannie Mae, where the Dem's best and brightest went to get rich by violating generally-accepted accounting rules ... was a well-run scam!" (*Slate*, Mickey Kaus, 06/01/06)

#### Follow the money...

- In an article asking "What went wrong with Fannie Mae?" Jan Frel wrote, "Larry Makinson at the Sunlight Foundation pulls more out of the Fannie Mae accounting fraud scandal -- it wasn't just a case of the execs fudging the books for massive pay benefits -- it's that Fannie Mae ... has been conducting a massive bipartisan buyoff in Congress for years to keep pesky oversight investigators from taking a look at the books. A government-backed entity making political contributions? Yep."

- “Citing *Open Secrets*, Makinson says that Fannie Mae gave \$3.5 million to Congress from ‘97-’02, and he points out, ‘The money was split almost equally between the Democratic (47%) and Republican (53%) parties... The *Washington Post* reported that it will cost an estimated \$800 million just to review Fannie Mae’s records, find the phony accounting and come up with clean numbers. In that article, author Jerry Knight ...[concludes], ‘We’ve created a pair of mortgage monsters [Fannie and Freddie], and we can’t do anything about it.’”
- “I agree. But why? Why can’t we do anything about it? My take is that at this point is that many of the federal agencies have such colossal inertia and responsibilities that they are beyond the scope of political imagination in Washington. Partly because the legislative and executive bodies haven’t been updated much since they were first created, and partly because there’s been one long process of increasing centralized power in the federal branch -- deeply accelerated since the New Deal era -- the system of government is not accountable, even to itself. To try and deal with a massive agency problem like this, it’s good to look at the number of \$800 million to figure out what happened as litmus proof that the idea of what government is needs to be rethought: Someone needs to come out and say that even if we ‘get to the bottom’ of the Fannie Mae scandal, ban its abilities to make political contributions, etc. that perhaps the existence of centralized and government-backed mortgage company run by political appointees is itself a corruption of a democratic republic.”  
([www.alternet.org/bloggers](http://www.alternet.org/bloggers), Jan Frel, 05/26/06)
- In a May 31 editorial, the *Toledo Blade* [OH] wrote, “...Representative. Mike Oxley is on his way out of Congress at the end of the year, but the mercenary spirit with which he represented Ohio’s 4th District may live on forever in Washington. And it will unless the Federal Elections Commission comes up with a bigger fine than the record \$3.8 million civil penalty levied against [Freddie Mac] for violations of campaign finance law. The FEC found that most of nearly \$3 million raised by Freddie Mac’s chief lobbyist went - illegally - to Mr. Oxley when the Findlay lawmaker was chairman of the House Financial Services Committee and the federally chartered lender had legislation it either favored or opposed before the panel. This tidy quid pro quo arrangement was consummated from 2000 to 2003, when lobbyist R. Mitchell Delk held more than 75 fund-raising events for members of the financial services committee, 90 percent of which he said benefited ‘Chairman Oxley.’ The contributions were illegal because federal law prohibits corporations from contributing directly to members of Congress and Freddie Mac did not have a political action committee to make them legal. In a document presented to Freddie Mac’s board in 2000, Mr. Delk referred to the series of fund-raisers as ‘Political Risk Management,’ apparently because his efforts also rubbed off on a few Democratic congressmen. The next year, the lobbyist boasted, ‘We proposed to Chairman Oxley a political model that was unprecedented. We offered to use our fund-raising model to marry his interests as chairman with our interests in assisting committee members supportive of the continued strength of America’s housing finance system ...’ The cozy deal, uncovered by the advocacy group Public Citizen, was described in a series by *The Blade* on Mr. Oxley’s legerdemain with campaign cash published in 2003.

But it took until April of this year for the FEC to sort out the details and levy the fine, the largest ever for the agency. In the wink and nod shadowboxing that substitutes for federal regulation these days, Freddie Mac was able to pay the penalty without acknowledging that it or its bagman did anything wrong. As for Mr. Oxley, well, he wasn't even accused of wrongdoing. In Washington, apparently, it is better to receive than to give." (*Toledo Blade*, 05/31/06)

#### The next shoe to drop

- *National Mortgage News* wrote, "The Enron convictions were big news this past week and mortgage executives are starting to wonder if criminal charges might be brought in the Fannie Mae case. [OFHEO] and the [SEC] formally accused the company and its former top executives of fraud. Of primary interest to criminal investigators are the 1998 bonus payments. One industry veteran who has worked on fraud cases told us that breaking the rules to make money is a 'criminal act' and adding that 'people go to prison for that.' (Millions of dollars in bonuses were paid that year.) The obvious question in the Fannie case is who was responsible for bending the accounting rules and what did they do -- and when..." Former Fannie Mae chairman and CEO Franklin Raines and other current and former top Fannie officials are among those facing civil and possible criminal charges, said federal officials. (*National Mortgage News Online*, May 27-28, 2005; *Business Week*, Dawn Kopecki and Mara Der Hovanesian, 06/12/06)
- Raines' personal attorney, Robert Bennett said "Mr. Raines has repeatedly stated that he never authorized, encouraged, or was aware of violations of Generally Accepted Accounting Principles ("GAAP") at Fannie Mae for the purpose of smoothing earnings, reaching bonus targets, or for any other improper reason. The facts on the record and conclusions from previous reports support this statement." (*PR Newswire*, 05/23/06)
- If the recent Enron trial is a leading indicator, a jury may not accept Raines' argument that he wasn't aware that Fannie Mae's financial statements were not GAAP compliant, if he is charged with any crimes. A Houston jury recently found Enron former chairman Kenneth Lay guilty on all counts of conspiracy, wire fraud, and securities fraud; Lay will likely spend the remainder of life in jail. Enron's former president Jeffrey Skilling was found guilty of 18 counts of conspiracy and fraud. To date, about 30 people have been criminally charged with Enron-related crimes and more than a dozen have pleaded guilty to crimes. (*Wall Street Journal*, John R. Emshwiller and Gary McWilliams, 05/25/06)
- Many expect the SEC to mount a similar legal offense regarding crimes alleged by individuals and entities uncovered at Fannie Mae. Specifically, the SEC is looking into deals in which Goldman Sachs, among others, allegedly helped structure transactions to "rearrange" earnings to provide steady profit growth, according to sources familiar with the inquiries. The SEC is also examining deals designed by Lehman Brothers and executed by KPMG, that the IRS later determined improperly

deferred income taxes. According to sources, the SEC is scrutinizing KPMG, Fannie's external auditor, who approved financial statements that the agency is since deemed were misleading. "When a company has engaged in wrongful conduct, the inquiry [inevitably examines] who knew about it, who could have prevented it, who facilitated it," said former SEC Chairman Harvey Pitt. SEC chairman Christopher Cox told reporters that the individuals and "entities whose actions and inactions" contributed to Fannie Mae's fraudulent accounting will be "vigorously pursued." According to a knowledgeable federal official, the government is expected to stick to civil actions if it moves against businesses that advised Fannie, to avoid the collapse of an entire company, which occurred after its prosecution of Arthur Anderson in Enron-related matters. (*Business Week*, Dawn Kopecki and Mara Der Hovanesian, 06/12/06)

#### Contempt of Congress charges also possible for Raines and Howard?

- Representative Richard Baker (R-LA), chairman of the Capital Markets, Insurance, and Government-Sponsored Enterprises Subcommittee, said, "...[U]nder direct questioning by me and others during a committee hearing in October 2004, former Fannie executives Frank Raines and Tim Howard both denied under oath that the company had manipulated the calculation of earnings per share to targets that triggered the maximum bonuses paid to them and other executives. OFHEO's report demonstrates that those statements were inaccurate, and I believe consideration should be given to determining whether charges of contempt of Congress and lying under oath should be brought against them." (*Dow Jones International News*, Damian Paletta and Siobhan Hughes, 05/23/06)
- At an October 6, 2004 hearing of the subcommittee, Representative David Scott (D-GA) said, "Mr. Raines and Mr. Howard, your accuser, OFHEO, has spent the better part of four hours this morning making some extraordinary accusations. And I want to make sure that you have ample opportunity to refute those accusations, a fair amount of which is this: that essentially you all cooked your books so that you could meet certain earnings targets so that you could get bonuses. ... I think we owe you the opportunity to make sure that you have the opportunity to refute that charge first."
- Raines responded, "Well, thank you for that opportunity. This is a very serious allegation, and I deny that that occurred. We have looked for the facts. There were no facts in the OFHEO report. None. Other than their calculation that said, 'Oh, there seems to be if we subtract one number from another you get this result.' But we looked into the facts of what happened back six years ago, and we found no facts that would support the allegation..."
- Former CFO Timothy Howard testified, "...If I may take advantage of that opportunity [to respond] and just be very clear in what we are saying, there is no linkage, to my knowledge, of compensation to the determination of what the catch-up charge would be in 1998. We found no evidence of a linkage of that to compensation decisions for 1998."

- In his prepared statement, Raines also testified “...[W]hen I certify our financial statements, I certify that these documents fairly present, in all material respects, the financial condition, results of operations and cash flows of the company. That is a very serious statement, and I take it very seriously. We engage in a rigorous due-diligence process before I ever put pen to paper and make that certification. I only certify after receiving assurance that I can say with confidence that our financial statements fairly present, in all material respects, the financial condition, results of operation and cash flows of the company.” (*CQ Transcripts*, Capital Markets, Insurance, and Government-Sponsored Enterprises Subcommittee Hearing, 10/06/04)

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

### OFHEO proposes new record retention regulation

- On May 31, OFHEO proposed new record retention requirements for Fannie Mae and Freddie Mac, designed to make records readily available for its examiners as the agency enters its next phase of examining individuals' role in Fannie's accounting fraud. "Under the proposal, the enterprises will have an obligation to maintain and promptly produce records useful in regulatory examinations and other proceedings," said OFHEO's acting director James Lockhart. Among other things, the proposal would require any enterprise employee, who is aware of an OFHEO investigation or lawsuit, "to retain any records that may be relevant to such investigation, enforcement proceeding, or litigation." The GSEs would also have to retain its accounting firm's documents, conclusions, or opinions related to an audit or review. According to the rule, if a GSE fails to maintain adequate records, OFHEO could initiate cease-and-desist proceedings or impose civil money penalties. The rule would require Fannie Mae and Freddie Mac to submit its written record-retention program to OFHEO's examiner in charge within 120 days of the effective date, and annually thereafter. The public will have 60 days to comment on OFHEO's proposed rule. (*MarketWatch*, Robert Schroeder, 05/31/06; *Dow Jones Newswires*, Damian Paletta, 05/31/06; *Bureau of National Affairs*, 06/02/06; *US Fed News*, 05/31/06)

### OFHEO Report may energize GSE regulatory reform

- OFHEO's scathing report on Fannie Mae's accounting fraud and the company's agreement to pay a \$400 million fine may give Congress its best chance to pass GSE regulatory reform legislation, said lobbyists and lawmakers on Capitol Hill. "This could possibly be a major catalyst for movement by the Senate on the bill," said a Republican lobbyist. "Senators don't want to be seen as responsible in an election year for not addressing corporate fraud." Some also point to a confluence of events, including a newly energized Treasury Department that seeks to assert its executive authority over this issue; GOP Senators who realize the legislation must move forward soon due to the election-shortened legislative calendar; and a push by top House Republicans, who view passage as a personal highlight of their career. House Financial Services Committee chairman Michael Oxley wants to secure passage of a GSE reform bill, before he retires at the end of this congress. Capital Markets subcommittee chairman Richard Baker (R-LA) also would like to see legislation enacted because it might aid his chances in the race to take over Oxley's chairmanship.
- Former OFHEO director Armando Falcon said he believes that all parties with an interest in creating a new regulatory regime for Fannie and Freddie have an even greater stake in reaching a political accord. The clear evidence of financial fraud at

Fannie Mae that OFHEO documented probably puts pressure on both political parties in the Senate to make a deal, said Falcon. “If Shelby can get a bill through the Senate and work out some kind of compromise that pulls in a good, strong vote, then that will certainly be something the House has to consider,” he added.

- “A lot of it comes down to [Shelby] and which way he wants to go,” said Michael Williams, vice president of legislative affairs for the Bond Market Association. “The instructions are there to get a deal done; it’s just a matter of when the Senator feels it’s necessary to pull the trigger.” Another lobbyist, who asked not to be named, said, “My sense is that Senator Shelby is a deal-cutter. To see Senator Selby so hardened on his position on the GSE bill has been somewhat of a surprise to me.” Another lobbyist, sympathetic to Shelby’s position, said “I think there is growing view in the administration and now in Congress that now is the time to get this done. We’re sensing that everybody realizes that there is a window of opportunity here that they don’t want to lose.”
- A Senate Banking Committee spokesman said Shelby has approached Senate Majority Leader Bill Frist (R-TN) about bringing GSE regulatory reform legislation (S. 190) to the floor. Shelby is working on a manager’s amendment that would expedite floor consideration of S. 190. GOP leaders will wait for the packaged before making decisions, the aide added. The month of June is already “oversubscribed” and July now looks like the best bet for S. 190 to go to the Senate floor, according to a senior legislative aide. (*National Journal’s CongressDaily*, Bill Swindell, 05/24/06; *Reuters*, Kristin Roberts, 05/23/06; *Dow Jones Newswire*, John Connor, 05/31/06; *Bureau of National Affairs*, Richard Cowden, 05/30/06)

Will OFHEO’s caps on GSEs’ portfolios (adequately) reduce the enterprises’ systemic risk?
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- With Fannie Mae agreeing to a cap on its portfolio and Freddie Mac warning investors that they may face a similar restriction, some on Capitol Hill are arguing that such caps will achieve what the Bush administration has been demanding in GSE regulatory reform – restricted growth of the GSEs’ portfolios. In his March 23 statement, Michael Oxley, chairman of the House Committee on Financial Services, said, “[OFHEO’s] agreement, in my estimation, will control portfolio growth.” Senator Jack Reed (D-RI) said in an interview with *Dow Jones Newswires* that the OFHEO Report proved that the strict portfolio restrictions in S. 190 weren’t necessary. “I think what the OFHEO Report actually represented was a regulator doing a thorough investigation and then imposing through consent and regulation suitable steps on the company,” said Reed. “It argues for the approach that we suggest, giving the regulator power to do that rather than establish these arbitrary legislative limits. I was kind of hoping that in the wake of this, Shelby might be more responsive to us.” (*House Financial Services Press Release*, 05/23/06; *Dow Jones International Newswires*, Damian Paletta, 05/25/06)

- OFHEO acting director James Lockhart said his agency’s current authority over the GSEs’ portfolios was not sufficient. “We need to get better control on the growth of these companies [Fannie Mae and Freddie Mac].” He added that he hopes that a new GSE regulatory reform bill, granting the new GSE regulator more powers over the GSEs’ portfolios, would be passed by Congress soon. (*American Banker*, Rob Blackwell, Patrick Rucker, Jody Shenn and Joe Adler, 05/24/06)
- Senate Banking Committee chairman Richard Shelby (R-AL) contends that an OFHEO’s cap on the GSEs’ portfolios is not adequate to address the risk they pose. “Even the head of OFHEO, Mr. Lockhart, said they need more powers and that is what the legislation intends to do,” said Shelby. (*American Banker*, Patrick Rucker, 05/26/06)
- Treasury Undersecretary for Domestic Finance Randal Quarles said that OFHEO’s agreement to cap Fannie Mae’s portfolio was not sufficient because Treasury wants to shrink the GSEs’ portfolio, not just limit them. (*National Journal’s CongressDaily*, Bill Swindell, 05/24/06)
- The Council for Citizens Against Government concurs that restriction of the GSEs’ investment portfolios is a critical provision in GSE regulatory reform (S. 190), which would help protect taxpayers from risk of having to bail out a GSE in the event of failure. The group wrote, “CCAGW urges you to approve the right bill for taxpayers and the financial system as a whole by voting in favor of S. 190.” (*PR Newswires U.S.*, 05/22/06)
- GSE expert Thomas Stanton argued, “The portfolio limitation appears to be symbolic rather than an effective approach to limiting the company’s growth. Excessive growth was the source of many of [Fannie Mae’s] problems. The company grew so fast that [in addition to Fannie’s malfeasance and misfeasance] it outran its internal controls.” (*Dow Jones Newswires*, John Connor, 05/23/06)

Keating Five redux?
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- On *National Mortgage News Online*, Paul Muolo wrote, “Former OFHEO chief Armando Falcon Jr. said Fannie Mae officials pulled a ‘Keating Five’ [K5] in their attempt to discredit his investigation of the mortgage giant. In a speech last week, Mr. Falcon said the GSE’s behavior reminded him of the K5 scandal of the late 1980s when five U.S. senators pressured thrift regulators to go easy on [Keating’s] rogue S&L. In the Fannie saga, the K5 role was played by Senator Christopher Bond (R-MO). As the chairman of VA-HUD appropriations subcommittee, Senator Bond included language in OFHEO’s \$60 million budget that penalized the agency if Mr. Falcon remained at the helm. Why did Bond do this? Because Fannie executives asked him to. Did Senator Bond receive campaign donations from Fannie officials?”

Are the Mets in first place? One of Bond's donors was current Fannie CEO Daniel Mudd." (*National Mortgage News Online*, June 3-4, 2006)

- John Dalton, president of the Financial Services Roundtable's housing-policy council, said that Fannie's lobbying missteps were among the "most egregious" charges in the OFHEO report. "The contact by the GSE to the Hill to affect appropriations for OFHEO because [Fannie] didn't like how they were going about their job," said Dalton. "[OFHEO] currently [doesn't] have the independence they need ...for a regulator to be effective," he added. (*The Hill*, Elana Schor, 05/24/06)

#### Senators Hagel and Sununu hope to force review of GSEs' lobbying and foundations

- In the wake of the release of the OFHEO Report, Senators Chuck Hagel (R-NE) and John Sununu (R-NH) hope to add a provision to lobbying reform legislation which would provide closer scrutiny of the lobbying efforts and charitable foundations of Fannie Mae and Freddie Mac. Earlier this year, the Senators were forced to drop the amendment during Senate debate because of certain Senate parliamentary rules. Now that the OFHEO Report confirms lobbying abuses by Fannie Mae, the lawmakers hope House and Senate negotiators will consider adding the amendment to the final version of the lobbying bill. "It's difficult to ignore words like 'arrogant' and 'unethical', difficult to ignore that 60% of executives compensation [at Fannie] was obtained by the smoothing of earnings," said Sununu said, citing conclusions reached in OFHOE Report.
- The Hagel-Sununu amendment would require HUD to perform annual audits of the Fannie Mae Foundation and the Freddie Mac Foundation. It would also require a study by GAO of Fannie and Freddie's lobbying activities. Senator Trent Lott (R-MS), who will lead the lobbying reform talks for the Senate, said he is sympathetic to the lawmaker's goals. "Something must be done," said Lott, but added he didn't know whether the lobbying reform bill was the appropriate place for the Hagel-Sununu amendment. (*Dow Jones Newswires*, John Godfrey, 05/26/06)

#### President Bush nominates Goldman Sachs chairman Henry Paulson as Treasury Secretary

- On May 30, President Bush announced that Treasury Secretary John Snow had submitted his resignation and that he was nominating Goldman Sachs chairman Henry M. Paulson to replace him. Paulson, 60, has been the sole chief executive of Goldman Sachs since May 1999, and is currently chairman of the Financial Services Forum. Senator Chuck Hagel (R-NE) praised Bush's nomination of Paulson to head the Treasury Department. Hagel said, "We are ...at a critical juncture in the debate over reforming government-sponsored enterprises like Fannie Mae and Freddie Mac. The fraud and corruption at Fannie Mae outlined last week in the [OFHEO Report] on Fannie Mae's \$11 billion accounting scandal needs to be addressed. Strong

leadership will be needed at the Treasury Department to ensure that the GSEs do not continue to pose an irresponsible risk to our financial system or the American taxpayer.” (*Reuters*, 05/30/06; *Dow Jones International News*, Damian Paletta, 05/30/06; *Congressional Press Releases*, 05/30/06)

Senate Banking Committee schedules hearing on Bush administration nominees

- On June 8, the Senate Banking Committee will conduct a hearing on the following Bush nominees: Donald Kohn to be vice chair of the Federal Reserve; James B. Lockhart, III to serve as director of OFHEO; Kathleen Casey to serve as a member of the SEC; and Sheila Blair to head the FDIC. (*Reuters*, 06/01/06)

Housing prices up 12.54% in first quarter of 2006, but show signs of moderating

- OFHEO reported that housing prices were 12.54% higher during the first quarter of 2006 than the first quarter of 2005. Appreciation during the first quarter was 2.03% higher or 8.12% on an annualized basis. “These data show average housing prices still growing stronger than might be expected,” said OFHEO acting director James Lockhart. “They do indicate, however, that price growth is moderating in some parts of the country, particularly in areas where prices have been rising the most.” OFHEO noted, however, that the recent popularity of cash-out refinancings may be making the level of price appreciation appear higher than actual sales prices of homes warrant.
- Arizona continues to exhibit the highest appreciation rate, although price growth has dropped significantly from earlier periods. Rapid increases continue to be widespread in Florida, which accounted for ten of the 20 MSAs with the largest percentage house price gains in the past year. Iowa and South Dakota experienced small price declines between the fourth quarter of 2005 and first quarter of 2006. (OFHEO *Press Release*, 06/01/06; *Bureau of National Affairs*, Richard Cowden, 06/02/06)

Louisiana Recovery Authority is “in discussions”  
concerning role of lender participation in grant distributions

- In Louisiana, the state legislature has approved the Louisiana Recovery Authority’s (LRA) housing assistance plan and Governor Kathleen Blanco has sent the plan to HUD for approval. Meanwhile, the LRA said discussions are underway concerning lender participation in the Road Home plan. “[LRA has] not yet established the details of their plan,” said Paul Leonard, vice president of housing policy for the Financial Services Roundtable. “Encouraging an escrow account would be ideal,” said Leonard. “[Lenders hope to] see language in the grant that said the purpose of the funding is to repair and rebuild the property whenever possible.” (*Mortgage Servicing News*, Brian Collins, June 2006)

## Troubling news as hurricane season opens

- In a \$19.7 million sweeping study of the flooding of New Orleans last year, the Army Corps of Engineers concluded that the levees it built were an incomplete patchwork of protection, which contained flaws in design and construction and were not built to handle a storm anywhere near the strength of Hurricane Katrina. The 6,113 page, nine-volume study details the engineering and design failures that allowed the catastrophic flooding of New Orleans on August 29. (*Associated Press*, Cain Burdeau, 06/02/06; *New York Times*, John Schwartz, 06/02/06)
- New research suggests that parts of New Orleans are sinking faster than many scientists imagined – more than an inch a year—which may explain some of the levee failures that occurred during Hurricane Katrina. The research, based upon new satellite radar from 2002 to 2005, showed that some areas are sinking four or five times faster than the rest of the city, which experts say can be deadly. “My concern is the very low-lying areas,” said author Tim Dixon, a University of Miami geophysicist. “I think those areas are death traps. I don’t think those areas should be rebuilt.” (*Associated Press*, 05/31/06)
- Absent legislative changes, the national flood insurance program will be unable to cover claims arising from the 2005 hurricane season or costs of the program, concluded CBO. In a letter to Senators Judd Gregg (R-NH) and Richard Shelby (R-AL), CBO said the [national flood insurance program’s] current financial situation is unsustainable.” The program will need an additional \$3 billion to pay claims arising from the 2005 hurricane season, which cannot be paid in a timely fashion without legislative action providing additional budgetary resources, said the CBO. By a vote of 20-0, the Senate Banking Committee approved a flood insurance reform bill that phases-out subsidized premiums for second homes, commercial properties, and properties that repeatedly suffer major flood damage. Without these reforms, “the federal government will assuredly find itself bailing out the program, and exposing the American taxpayer to never-ending losses,” said Shelby at the bill’s mark-up. (*Bureau of National Affairs*, Karen L. Werner, 06/02/06; *National Mortgage News Online*, 05/26/06)

## The outlook for e-mortgages

- Gabe Minton, executive vice president of MISMO, said it might take ten years for e-mortgages to capture 50% of the market, a pace replicating earlier successful technologies such as automated underwriting engines, and the clock is running. “Mark my words, this is all going to happen,” said Minton. “[E-mortgages aren’t] onesie-twosie any more,” now that thousands of e-mortgages have been sold to Fannie Mae. The biggest remaining challenge for e-mortgages comes at the county courthouses, where titles are transferred. MISMO has targeted the top 300 courthouses, which control 80% of all mortgage volume in 3,600 counties in the U.S.

Industry consultant Dave Williamson warned mortgage lenders that they have two to three years to get their houses in order for e-mortgages, which will soon have full-scale industry acceptance. (*National Mortgage News*, 05/22/06)

Super-sizing the mortgage loan
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- Just as the GSEs incorporate 40-year mortgages in their product line, a number of California lenders have begun marketing 50-year fixed-rate [with a balloon feature in 30 years] and adjustable-rate mortgages as a means of making home-ownership affordable in high-cost markets. “A lot of brokers are suggesting [the 50-year mortgage] is a better avenue than interest-only [mortgages] and the monthly payments are about the same,” said John Marcell, president of the California Association of Mortgage Brokers. (*Press Enterprise* [Riverside, CA], Leslie Berkman, 05/30/06)

## ***Fannie Mae***

### Fannie Mae reports portfolio growth in April, but contraction “looms”

- Fannie Mae reported growth in its mortgage portfolio in April, but warned that contraction “looms” now the OFHEO has capped its mortgage holdings to \$727 billion. In April, Fannie Mae’s mortgage portfolio grew at an annualized rate of 15.7%, following a 0.6% growth in March. The company’s retained mortgage holdings totaled \$730.4 billion on April 30, bringing year-to-date growth to an annualized 1.2%. “It was not a surprise, but this will be the last time we will see an expansion for quite some time,” said Arthur Frank, director of MBS research at Nomura Securities International. “Prepayments on mortgage bonds have been running at about \$11 to \$12 billion a month, so it is not as if they cannot buy anything, it just says they have to buy less than their prepayments. Fannie Mae is out of the equation in terms of growth.”
- Fannie’s investment portfolio and mortgage backed securities it guarantees grew by a compound annual rate of 7.3% in April after rising 7.5% in March. Total business volume increased to \$52.1 billion in April from \$47.3 billion in March. Fannie Mae’s duration gap averaged plus one month in April, compared to zero months in March. (*Reuters*, Kristin Roberts, 05/31/06; *Dow Jones Newswires*, Damian Paletta, 06/01/06; *Reuters*, 05/31/06)

### “The rotten Enron culture reincarnated in a federal agency”

- In the *Financial Times*, John Plender wrote, “When Mr. Raines set a goal to double earnings per share within five years from \$3.23 in 1998 to \$6.46 in 2003, says the OFHEO Report, the man in charge of internal audit, Sampath Rajappa, harangued the in-house watchdogs as follows: ‘By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe and dream 6.46, you must be obsessed on 6.46... Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, employee stock purchase plans, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100 percent...’ That is the rotten Enron culture reincarnated in a federal agency.” (*Financial Times*, John Plender, 05/29/06)

### The SEC gold standard

- In a November 2004 memo to former CEO Franklin Raines, COO Daniel Mudd wrote, “The old political reality was that we always won, we took no prisoners, and

we faced little organized political opposition. We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us. We now operate in a world where we will have to be ‘normal.’ The SEC is our standard for disclosure and our arbiter for the rules, not our own proofreaders.” (*Wall Street Journal*, James R. Hagerty, 05/24/06)

Did Fannie Mae retaliate against whistle-blower Roger Barnes?

- “Sometimes whistle-blowers don’t fully appreciate what an awesome thing it is to have the full power of the corporation come crashing down upon you,” said James E. Fisher, director of the Emerson Center for Business Ethics at St. Louis University. Roger L. Barnes, the whistle blower who alerted former chairman and CEO Franklin Raines about the company’s accounting irregularities, discovered first hand the power of Fannie Mae. In an interview with the *Baltimore Sun*, Barnes showed the reporter a bullet hole in the window, that came after two disemboweled deer appeared mysteriously on his lawn, but before someone painted curse words in animal feces on his black Chevrolet Camero. One year, someone destroyed his outdoor Christmas decorations, said Barnes. He also recounted how a man in a dark sedan followed him everywhere he went. Following the release of the OFHEO Report, Barnes, a husband and father of three, said he feels “tremendously vindicated,” but still worries about his safety and vandalism, as he tries to find a new management job 2.5 years after leaving Fannie Mae. Barnes left the company in 2003, when Fannie settled with him for \$1 million and stock valued at \$500,000. At the company’s insistence, the settlement claimed that Barnes believed that Fannie Mae was discriminating against him because of his race. Instead, he said that the settlement had everything to do with the uncomfortable questions that Barnes had been asking about the company’s accounting practices. When OFHEO called Barnes in early 2004 to discuss his concerns, he showed up not with his lawyer –but with his pastor, Reverend John L. Wright of First Baptist Church of Guilford. Wright, who met with Howard County’s police chief to alert him about the harassment that Barnes was experiencing, said he continues to worry about Barnes’ security. “It’s not over,” said Wright. “You’re dealing with a giant, and you never know which way it’s going to fall.” (*Baltimore Sun*, Jamie Smith Hopkins, 05/25/06)

“Can’t we all just get along?”

- *National Mortgage News* wrote, “[A]t least one veteran Fannie supporter is sticking with the GSE. National Association of Home Builders chief Jerry Howard said of the [Fannie Mae] scandal, ‘What is past is done. I am only concerned about the organization’s ability to do its job and move forward. And I don’t think anything in this [OFHEO] report impedes that.’” (*National Mortgage News Online*, May 27-28, 2005)

## ***Freddie Mac***

Freddie Mac reports 27.6% decline in net income for FY2005

- Freddie Mac reported net income for fiscal year 2005 of \$2.1 billion, down 27.6% from \$2.9 billion in 2004. The decline in Freddie's earnings was steeper than expected by Wall Street, due to \$220 million in costs related to the settlement of a securities class action lawsuit and shareholder derivative litigation, \$265 million related to the net impact of accounting changes, and \$133 million for losses related to Hurricane Katrina. The company said its losses from derivatives fell to \$1.36 billion from \$4.48 billion in 2004. The fair market value of net assets attributable to Freddie Mac common shareholders was \$26.7 billion on December 31, 2005, down 0.4% from \$26.8 billion at year-end 2004. Before capital transactions, Freddie Mac's fair value was up \$900 million.
- While the company expects that most of its accounting problems will be behind it in 2007, Freddie Mac CEO Richard Syron said that OFHEO could impose new growth restrictions as the GSE fixes its financial controls. "[OFHEO acting] director [James] Lockhart has indicated that he intends to consider whether additional remedial actions may be appropriately applied to Freddie Mac while we continue to fix our control environment, and this could include consideration of portfolio growth limitations for some period of time," said Syron in a conference call with investors. "Getting our house in order is essential to completing our return to timely reporting and meeting the requirements that OFHEO established for us under our 30% capital surplus framework," Syron added.
- In 2005, "[Freddie Mac] continued [its] investment in the business capabilities, infrastructure and management team" said Eugene McQuade, the company's president, COO and acting CFO. "These investments position our company to achieve our long-term growth and return objectives, and to deliver long-term value to the market and our stockholders." McQuade disclosed plans for Freddie Mac to buy back \$2 billion in common shares and sell \$2 billion in new preferred stock.
- During 2005, Freddie Mac's share of mortgage securitization climbed to 45% from 41% in 2004. The company's mortgage portfolio grew 8.7% in 2005 to \$710 billion. Regulatory core capital totaled \$36.0 billion on December 31, 2005, \$3.5 billion in excess of the 30% surplus requirement by OFHEO. Freddie Mac said it would limit "new [lending] initiatives" and steer additional financial resources into the overhaul of accounting a financial reporting policies. Such limits may make it more difficult for Freddie Mac to expand its presence in the non-traditional loan market, a growing segment of the market in which the company has made little headway. In 2005, Freddie Mac said its guarantees covered 18% "other than traditional fixed-rate mortgages," up from 16% in 2004. "We were expecting more [growth in non-

traditional mortgage market],” said Morgan Stanley equity analyst Kenneth Posner. “It’s a legitimate profit opportunity for the GSEs. Politically, they’ve been encouraged to do more, and we’ve listened to executives talk about the opportunity.”

- Freddie Mac said it would provide quarterly updates beginning this year and will resume quarterly financial reports when it releases its full-year 2006 results. The company has not reported timely financial results since accounting problems surfaced in 2003, which led to a \$5 billion financial restatement.
- According to the company’s disclosures, HUD determined that certain Freddie Mac “mixed-pool investments are not authorized under our charter.” A Freddie Mac spokeswoman said that the reference was to bond tranches that received cash flows from both residential and nonresidential loan pools. OFHEO has concurred with HUD’s ruling and has asked the company to submit a plan to sell the assets, apparently by year end. The spokeswoman did not know how large the prohibited investment is, but said that the effect on us should really be zero to negligible” because several years ago Freddie had begun buying multifamily-focused tranches of CMBS made expressly for GSEs. (*American Banker*, Jody Shenn, 06/01/06; *Reuters*, Al Yoon, 05/31/06; *Market News International*, Margaret Chadbourn, 05/31/06; *Wall Street Journal*, James R. Hagerty, 05/31/06; *Associated Press*, Marcy Gordon, 05/30/06; *Reuters*, Kristin Roberts, 05/30/06)

#### Freddie Mac sets annual shareholders meeting date and sets dividend rate

- Freddie Mac’s board of directors has set September 8, 2006 as the date for the company’s next annual stockholders meeting. Holders of record of Freddie Mac’s common stock as of June 30 will be electing 13 members of the company’s 18-member board of directors. Proxy material and the company’s 2005 annual report will be mailed to shareholders in accordance to Freddie Mac’s bylaws and NYSE requirements. (*Freddie Mac Press Release*, 06/01/06)
- Freddie Mac’s board of directors declared a quarterly dividend on the company’s voting common stock of \$0.47 per share, payable on June 30 to stockholders of record as of June 12. The board also declared quarterly dividends on the corporation’s preferred stock in accordance with the terms of the terms of the issues. (*Freddie Mac Press Release*, 06/01/06)

#### Freddie Mac’s retained portfolio jumps in April

- Freddie Mac’s robust growth in its mortgage portfolio has put the company’s holdings in a position to surpass its long-time competitor Fannie Mae for the first time in history. Freddie Mac’s retained portfolio grew at an annualized 14.0% in April to \$723.8 billion, bringing year-to-date growth to an annualized 5.8%. “Freddie

Mac's growth in April put the company a couple billion ahead of where Fannie Mae's portfolio was in March," said Arthur Frank, director of MBS research at Nomura Securities International. "But now that [Fannie's] growth is frozen, Freddie Mac's portfolio should be significantly bigger than Fannie Mae's over the next several months." In April, Freddie Mac entered into \$19.7 billion of net mortgage purchase agreements, down from \$32.1 billion in March. Freddie Mac's duration gap remained at zero months, unchanged from the previous month. (*Reuters*, 05/24/06)

"Neither the GSEs or the housing finance system...  
[can] achieve housing affordability in this country," says Syron

- In a May 22 speech at affordable housing conference sponsored by the Federal Reserve Bank of Boston, Freddie Mac CEO Richard F. Syron said, "...[L]et's not pretend the GSEs or the housing finance system as a whole can by themselves achieve housing affordability in this country. For example, the answer cannot lie in simply ratcheting up the GSEs' affordable housing goals. First, there is a very real upper limit here before we're forced into behavior that would encourage predatory lending. Second, the GSEs' share of even the conventional conforming market has fallen. We lack the ability to influence enough of the market – all the more so in high-cost areas like Boston where the problem is most acute. So we can't even help most potential homeowners in the state of California – where the median home price of more than \$560,000 is well above the conforming loan limit. The GSEs are the largest but only one of many programs on the housing finance side. And the power of the financing programs – even collectively – is limited."
- Syron argues that the discussion about how to achieve housing affordability needs to be enlarged to address "greater educational opportunities, comprehensive health policy, and improved public transportation connecting jobs to where people live." He added, "We need to attack housing affordability with a full-court press of this kind. For we know that home ownership is the most democratic means we have as a nation for building wealth and building up a strong middle class."
- Syron concluded, "The housing finance system and the GSEs, working on the demand side, cannot make up for all the heavy lifting that's yet to be done on the supply side. We clearly can't – not by a long shot – and we ought to have a little humility. For the more hung up the Washington debate gets on radical fixes to the GSEs, the more energy gets diverted from where we as a nation can really make the longest strides towards housing affordability." (*Prepared remarks for Richard F. Syron*, 05/22/06)

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

### **FHLB-Dallas' assets drop 12% during the first quarter results**

- The FHLB-Dallas reported net income of \$27.6 million for the first quarter of 2006, an increase of \$1.6 million or 6.2% from the same period in 2005. Assets declined 12.3% from \$64.9 billion on December 31, 2005 to \$56.9 billion on March 31, 2006. The Banks' decline in assets during the quarter was due primarily to a reduction in advances and short-term investments during the period. On March 31, the Bank total capital was \$2.5 billion, including retained earnings of \$181.3 million. (*FHLB-Dallas Press Release, 05/26/06*)

### **FHLB-Seattle announces SEC registration is effective**

- The FHLB-Seattle announced that its registration with the SEC became effective May 31. As part of the registration process, the Bank amended Form 10 to include its first quarter financial results. According to the filing, the Bank's assets grew 11% to \$53.4 billion on March 31 from March 31, 2005, while the Bank's advances grew 32% to \$21.9 billion and its investments in mortgage loans held for portfolio declined 30.5% to \$7.0 billion over the corresponding period. The Bank reported net income of \$8 million for the first quarter of 2006, down 33% from the first quarter of 2005. On March 31, 2006, the Bank reported total capital of \$2.2 billion, representing 4.26% of total assets. (*FHLB-Seattle Press Release, 05/30/06; FHLB-Seattle Amended Form 10, 05/26/06*)

### **FHLB-Des Moines elects Richard S. Swanson as CEO**

- The FHLB-Des Moines board of directors elected Richard S. Swanson as the Bank's president and CEO effective June 1, 2006. Swanson is an attorney, veteran bank CEO and former director of the FHLB-Seattle. Previously, he served as chairman and CEO of HomeStreet Bank in Seattle, WA. After leaving HomeStreet, Swanson became a principal of Hillis, Clark, Martin and Peterson, a Seattle law firm, where he counseled in the areas of finance, banking law and SEC regulation. Swanson replaces Neil Fruechte, who has served as acting president and CEO since December 2005. (*FHLB-Des Moines, 05/19/06*)

## Treasury turns deaf ear to America's Community Bankers's plea for FHLB directors

- In a letter to the Treasury Department, America's Community Bankers argued that the Federal Housing Finance Board should fill appointed seats on the 12 FHLB boards of directors, as mandated by law. ACB asked the agency to intervene on their behalf with Finance Board Chairman Ronald Rosenfeld, who has said he does not plan to make the appointments to the FHLBs board of directors while Congress debates bills to create a new regulator for the GSEs.
- Treasury declined ACB's request. In a May 10 letter, Emil Henry, Treasury's assistant secretary for financial institutions, said a stall in the GSE legislation "is a key reason why public interest directors have not been appointed" by the Finance Board. Henry added that Rosenfeld had the situation under control and is ensuring that the FHLBs have "the necessary resources and personnel to fulfill their missions." (*American Banker*, Stacy Kaper and Patrick Rucker, 05/22/06)

## *Ginnie Mae*

### House Financial Services Committee approves FHA reform

- On May 24, the House Financial Services Committee approved FHA reform bill (H.R. 5121), which increases the limit for FHA-insured mortgages in high-cost areas; grants FHA flexibility to establish zero or reduced payment requirements for single-family mortgage programs; allows the agency to establish a risk-based mortgage insurance premium pricing structure; and permits the FHA to extend mortgage terms to 40 years. As approved, H.R. 5121 contains all of the FHA reforms proposed by the Bush Administration. Committee leaders plan to push for a House vote on H.R. 5121 in June. In addition, the Committee approved H.R. 3043, the Zero Downpayment Pilot Program Act, which would eliminate the downpayment requirements for families and individuals who buy houses with FHA-insured mortgages. (*Nation's Building News Online*, National Association of Homebuilders, 05/29/06; *National Mortgage News Online*, 05/25/06)

### Ginnie Mae adds rural MF loans to REMIC transactions

- Effective in May, multi-family loans backed by the Rural Housing Service Guaranteed Rental Housing Program are eligible for inclusion in Ginnie Mae's multi-family securitization pools. Previously, only Ginnie Mae pools backed by FHA multifamily loans were eligible as collateral for the agency's multifamily REMIC transactions. (*National Mortgage News*, 05/22/06)

## *Farm Credit System / Farmer Mac*

The ugly truth about FCS's loan program to YBS farmers
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- In the May issue of *Farm Credit Watch*, Bert Ely wrote, “[The Young Beginning and Small farmers] loan data the FCA publishes ...not only paints a misleading picture of the FCS's YBS lending, but a close analysis of the data reveals ugly truths about who the FCS really lends to -- large, creditworthy borrowers who least need the substantial interest-rate subsidy the FCS delivers to its favored borrowers. FCS's YBS loan data is highly misleading, in three regards. First, it counts loans, not borrowers. For example, if a farmer has a FCS real-estate loan, a seasonal operating loan, and a five-year installment note on a combine, that one borrower is triple-counted. Hence, the FCS's 744,088 loans and loan commitments outstanding at the end of 2005 were extended to far fewer borrowers. There is no excuse for this double, triple, and quadruple counting since the FCS's internal loan accounting system has to accumulate loans by borrower (just as banks do) so that FCS personnel can monitor the FCS's total credit exposure to a borrower.”
- “Second, the FCS double and triple-counts loans to YBS farmers. The FCA defines a young farmer as ‘35 years old or less,’ a beginning farmer as having ‘10 years or less of farming or ranching experience,’ and a small farmer as having ‘less than \$250,000 annual gross [farm] sales.’ A 31-year-old individual who has been farming for eight years and who reaped \$223,000 of gross farm sales in 2005 will get triple-counted in the FCA's YBS data. The FCA readily admits to this data shortcoming, stating that it is “not meaningful to add two or three YBS categories together since the categories are mutually exclusive.” What the FCA should do is aggregate its loan data by borrower (which of course will lower its loan numbers) and then publish this data in seven categories: (1) young, beginning, and small; (2) young and beginning; (3) young and small; (4) beginning and small; (5) young; (6) beginning; and (7) small. From a public-policy perspective, the first two categories are the most important because these individuals are the most likely candidates to become full-time, commercially successful farmers, which is the intent of the YBS program.”
- “The third problem with the FCS data is the definition of ‘farmer’ and ‘rancher.’ As has become increasingly evident in recent years, many FCS loans are made to people who in fact are not farmers. These include loans on country estates, weekend getaways, hunting preserves and the like. Most of these properties generate little, if any, sales of farm crops or livestock; keep in mind that the definition of small – ‘less than \$250,000 of annual gross sales’ -- encompasses zero. A loan to someone who generates no farm sales is hardly a small farmer.”
- “One problem in publishing data is that it often reveals truths that the publisher would rather keep hidden. That certainly is true with the YBS data... Subtracting YBS loan data from data on all FCS loans provides interesting insights into the FCS's non-YBS

borrowers, the folks the FCS does not like to talk about. Comparable data is available on-line back to 2001. The most interesting data relate to the FCS's largest loan category, loans over \$250,000:

- Over the four-year period, 2002 to 2005, FCS loans and loan commitments over \$250,000 increased by 81.3%, or \$33.4 billion, rising to \$74.4 billion.
- Loans and loan commitments over \$250,000 accounted for 66.0% of all FCS lending at the end of last year, up from 56.6% at the end of 2001. The average size of these loans rose from \$808,336 at the end of 2001 to \$974,408 today.
- The total amount lent to “small” farmers (annual farm sales under \$250,000) in loans over \$250,000, more than doubled in the 2002-2005 period, to \$10.86 billion, 9.6% of all FCS lending.
- Loans over \$250,000 to “small” farmers rose to 21,647 by the end of 2005 from 11,224 at year-end 2001, with the average loan size rising to \$501,543, up from \$462,439 four years earlier. Many of the country estate and hunting preserve loans fall in this size category.
- As one can clearly deduce from the YBS report, the heart of FCS lending continues to be in large loans to big borrowers -- these 54,755 loans at the end of 2005 totaled \$63.59 billion (up 77.3% in four years) and accounted for 56.4% of all loans and loan commitments.
- The average size of \$250,000+ loans to big borrowers rose to \$1,161,351 at the end of last year from \$906,427 four years earlier.”
- “[T]he FCS is pushing for broader off-farm lending powers through its HORIZONS Project, a goal it already is advancing through Rural American Bonds... The numbers revealed in the latest YBS lending report show the extent to which FCS already is rapidly increasing its focus on large borrowers.” (*Farm Credit Watch*, Bert Ely, May 2006)

## ***Postal Service***

“We’re close” to approving postal reform legislation, says Representative Davis

- House Government Reform Chairman Tom Davis (R-VA) said “we’re close” to naming House conferees and approving the first Postal Service overhaul bill in three decades, which he expects to happen by the July 4 recess. Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins (R-ME) said she felt “confident that we’ve reached a solution” on the escrow fund, an issue that has stalled final approval of the sweeping bill. Collins said language in the Senate bill allowing the Postal Service partial access to the fund to pay for future employee health benefits and operating costs probably will be included in the conference report. Talks continue between White House chief of staff Joshua Bolten, Collins and Davis, seeking to reconcile the pension provision, which would shift the costs of postal workers’ military pensions to the Treasury Department. (*CongressDaily*, Jessica Brady, 06/01/06)

Postal rate increases unjustified

- In a May 31 editorial, *The Democrat* wrote, “Earlier this month, the United States Postal Service quietly announced plans for rate increases. ... Beyond the 3-cent increase proposed for first-class stamps, the boys in blue have taken aim on another, small-town staple — small newspapers. Although the ruling is a miniscule part of most daily newspapers’ delivery system, the in-county mail rates are critical to small, weekly hometown newspapers. The postal service may increase those rates by as much as 30 percent. Amazing. Although rate increases are run through an “independent” postal rate commission, Congress needs to get involved. Besides adding pressure to make the agency more streamlined, Congress could quickly stop some of the bleeding that is costing the agency big money. For example, currently overpayments to the postal service’s pension system roll into the federal budget instead of being returned to the agency. Better management is needed to get this bad-tasting problem licked once and for all.” (*The Democrat* [Natchez, MS], 05/31/06)
- In a June 1 editorial appearing in the *Baltimore Sun*, Lexington Institute senior fellow Sam Ryan wrote, “The Postal Service says the reason behind this new rate request is rising gas prices. On the surface, that seems reasonable. The price of gasoline has a major effect on the Postal Service’s bottom line. But this excuse completely ignores the elephant in the room - the Postal Service’s massive labor costs. ... [M]odest streamlining effort[s] won’t be enough to stop stamp prices from substantially outstripping inflation in the coming years. Until the Postal Service can bring its labor costs under control, we can expect rates to keep going up. And if prices get too high, customers will stop using the Postal Service. That would be a disaster. What would

we do with our forever stamps if the Postal Service went out of business?"  
(*Baltimore Sun*, Sam Ryan, 06/01/06)

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