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The GSE REPORT ™

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Contents of GSE Report ™

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Major Events

The GSEs are specifically *exempt* from earmark reform provisions
in the House's Lobby and Accountability and Transparency Act (H.R. 4975)

- According to the Republican Study Committee May 3 *Legislative Bulletin*, government-sponsored enterprises are excluded form the definition of earmark. (*Republican Study Committee Legislative Bulletin*, 05/03/06)

- Representative E. Scott Garrett (R-NJ), who attempted to expand House earmark reform by amendment, issued a statement questioning the House's decision to exclude GSEs for earmarking purposes. Garrett said, "I [am] concerned that government-sponsored entities, such as Fannie Mae and Freddie Mac, have been defined as a federal entity and thus exempted from the new earmark reforms. I can find no evidence that GSEs have ever received an earmark, which begs the question of why would they need to be mentioned in the bill at all. I am concerned that this sets a bad precedent and that such an exemption could very well attract earmarks. …[M]y amendment on this was not made in order, but I will continue to press for this commonsense reform. (*US Fed News*, 05/03/06; *The Hill*, Elana Schor, 05/11/06)

- In a May 19 editorial, the *Wall Street Journal* wrote, "When the House passed its lobbyist-reform bill last month, we praised the earmark transparency provision as a rare bright spot. Maybe we spoke too soon. Outsiders have now had a chance to inspect the fine print, and if Sarbanes-Oxley were this full of loopholes, few businesses would complain."

- "Under the House bill, all earmarks inserted into appropriations during the conference committee stage must identify the earmarker -- unless, we now discover, the earmark goes to a federal agency, as nearly half of them do. Another notable earmark exception has been carved out for Fannie Mae and Freddie Mac, the mortgage giants that are political honey pots for the Members. As far as we know, the two companies have never received an earmark before -- which raises the question of whether they are about to become a new earmark shelter for the Members to disguise their pork-barrel habits."

- "Oh, and earmarks directed to state and local governments are also exempt from the requirement under some circumstances. How big a loophole is that? 'It could be as big as the appropriators are clever,' Representative Jeff Flake (R., Ariz.) told us. 'And they're pretty clever.' Congressman Flake has been fighting the earmark tide since long before it became a cause celebre, and he's hoping the loopholes can be narrowed when the House and Senate sit down to agree on a common version of the bill."

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- "Perhaps with the House's Appropriator-in-Chief, Californian Jerry Lewis, now under investigation for allegedly steering millions in appropriations to a lobbyist via earmarks, reform will take on added urgency. But GOP leaders should understand that this kind of cynical loophole-writing won't make voters feel any better about them come November." (*Wall Street Journal*, 05/19/06)

Fannie Mae's D-Day: OFHEO special exam report to be issued May 23

- OFHEO has asked Fannie Mae to review the agency's draft report on its special examination of the company. Fannie Mae is prohibited by law from discussing the report's content, until OFHEO publicly releases the report on May 23 at 10:00 a.m. [Eastern Standard Time]. On May 15, Fannie May said it has temporarily suspended its public offering of Benchmark and medium-term debt securities until May 23. Fannie Mae also cancelled previously scheduled presentations to investor conferences ahead of the release of the OFHEO report, including Fannie Mae CEO Daniel Mudd's keynote luncheon speech at the UBS Global Financial Services Conference scheduled for May 16. The company remains under investigation by the SEC, Justice Department and IRS. (*Fannie Mae Press Release*, 05/15/06; *Washington Post*, 05/16/06; *Reuters*, 05/16/06; *Dow Jones Capital Markets Report*, Damian Paletta, 05/16/06)

- House Financial Services Committee Chairman Michael Oxley (R-OH) has asked OFHEO's acting director James B. Lockhart to appear before his panel on June 6 to discuss his agency's special examination report on Fannie Mae, said a source close to the committee. (*Dow Jones Capital Markets* Report, Damian Paletta, 05/17/06)

Federal Reserve study finds that GSEs help lower mortgage rates by only *two* basis points

- A team of five economists with the Federal Reserve Board concluded that Fannie Mae and Freddie Mac helped lower U.S. mortgage rates by only two basis points from April 1997 through September 2005, below their previous estimate of 15 basis points to 18 basis points in 2003. "Current estimates of mortgage rate reduction are not statistically different than zero," stated the study, authored by Wayne Passmore, Gillian Burgess, Diana Hancock, Andreas Lehnert, and Shane M. Sherlund. The study's findings boost arguments that the GSEs fall short of their primary task of promoting home ownership, as Congress considers passage of GSE regulatory reform legislation.

- The Fed economists also said the $1.4 trillion in combined portfolios held by Fannie Mae and Freddie Mac did not aid their affordable housing mission. "Any expansion or contraction of GSE portfolios does not affect the level of total home mortgage debt outstanding," the economists said in a summary of their research. "Whether the

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GSEs subsequently purchase the securities for their portfolios or let them trade freely in public markets, liquidity is not affected." The researchers went on to say that the "only" purpose of the large portfolios was to boost "GSE shareholders' profitability, with no obvious public benefit."

- Freddie Mac SVP Edward L. Golding told reporters that the Fed research was wrong. "The number has been amazingly close to 25-basis points, on average," Golding. Fannie Mae had no comment. (*Dow Jones International News*, Damian Paletta, 05/18/06; *Reuters*, 05/18/06; *Reuters*, Kristin Roberts, 05/18/06)

Fannie Mae discloses *new* accounting errors forcing a **$28.5 billion restatement**

- Fannie Mae disclosed in its May 9 Form 12b-25 filing with the SEC that it has discovered that it did not properly account for certain trusts used for securitization transactions, which will require it to consolidate an additional $28.5 billion onto its balance sheet. (This was a direct violation of GAAP.) While the company isn't able to measure the mistakes' impact on its regulatory capital until it completes its restatement, Fannie Mae does not expect the mistakes to push capital levels below regulatory minimums [including the 30% capital surplus requirement placed on the company by OFHEO]. In addition, Fannie Mae also recognized mistakes in how it recorded some guaranty fee income and must reclassify a "pro rata portion" of its recorded guaranty-fee income as interest income.

- "Costs associated with the restatement process and related regulatory examinations, investigations and litigation significantly increased administrative expenses in the first quarter of 2006," said Fannie in its Form 12b-25 filing. "These costs totaled approximately $287 million for the first quarter of 2006. Based on our current projections, we estimate restatement and related regulatory costs, including the costs associated with technology investments, our litigation defense, regulatory investigations and our agreement with OFHEO, will total over $800 million for full year 2006," Fannie added. In a *Wall Street Journal* article, John Connor added, "This over $800 million estimate comes on top of the beaucoup bucks that were expended on clean-up efforts last year, some $569 million if we recall correctly." Thus, Fannie Mae will have spent more than $*1.369 billion* on its financial restatement in 2005 and 2006. "[The scale of the restatement] underscores how massive a portfolio they had built up and how unprepared they were from an accounting infrastructure perspective," said Banc of America Securities' analyst Robert Lacoursiere.

- Fannie Mae also reduced its expected after-tax losses related to Hurricanes Katrina and Rita to between $170 million to $280 million. Previously, the company had estimated losses to range from $250 million to $400 million.

- Fannie Mae also disclosed that the board has authorized a limited employee stock repurchase program in which the company could repurchase up to $100 million of securities from staff. Since April 2005, Fannie employees have not been allowed to

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purchase or sell company securities except in special circumstances. "Management is concerned that the prolonged nature of this trading blackout has adversely affected employee morale and created an employee retention issue at a time when management believes that retaining our employees is particularly important," according to the Fannie Mae filing. OFHEO approved the repurchase program, which excludes employees above the level of vice president.

- In a conference call with investors, Fannie Mae CEO Daniel Mudd said that the company "was substantially complete" in its review of its accounting. "We're making significant progress on the remediation of our accounting issues and building our business." Mudd refused to say, however, if these accounting errors would be the last disclosed by the company. He added, "I'm not going to make any commitments that 'It's done,' and 'I don't have anything else to do or review,' until we're truly done." Mudd said that the company continues to work diligently on the financial restatement, but is unlikely to have the report before the second half of 2006. Mudd also told investors that an internal team of advisors, along with outside experts, are examining ways of returning capital to shareholders. Any management recommendations regarding return of capital are subject to approval by Fannie's board of directors and OFHEO, Mudd added.

- Analysts downplayed the significance of Fannie Mae's new accounting errors and other disclosures, while the company's stock rose 1.3% following release of the news. "None of [the errors] were a big deal; it's small potatoes," said Fox-Pitt, Kelton analyst Edwin Groshans. "They already have a balance sheet of $721 billion, so adding $28.5 billion is not a big deal." (*Financial Time*s, Richard Beales, 05/10/06; *American Banker*, Erick Bergquist, 05/10/06; *Marketwatch*, 05/09/06;*Market News International*, Margaret Chadbourn, 05/09/06; *Dow Jones Newswire*, Damian Paletta, 05/09/06; *Wall Street Journal*, James R. Hagerty, 05/10/06; *Dow Jones Capital Markets*, John Connor, 05/09/06)

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Fannie Mae and Freddie Mac

24 Republican Senators urge Republican leadership to
move GSE regulatory reform to the Senate floor for debate

- In a May 5 letter to Senate Majority William H. Frist (R-TN) and Chairman of the Senate Banking Committee Richard C. Shelby (R-TN), 24 Republican Senators offered their support in bringing GSE regulatory reform legislation (S. 190) to the Senate floor for debate. Among the signatories were Senators Chuck Hagel (R-NE), John Sununu (R-NH), Elizabeth Dole (R-NC), Jim Bunning (R-KY), Michael Crapo (R-ID), Rick Santorum (R-PA), and Mel Martinez (R-FL), who are members of the Senate Banking Committee. The Senators wrote, "We are concerned that if effective regulatory reform legislation for the housing-finance government sponsored entities (GSEs) is not enacted this year, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall finance system, and the economy as a whole." A spokesman for Shelby said that the chairman welcomed the letter. "From Shelby's perspective, he is encouraged that the letter appears to show a growing consensus among conservatives about risks the GSEs present to the financial system, particularly the risks related to portfolios," said the spokesman. When asked by the media if Shelby has made any progress in reaching a consensus on the GSE reform bill, the Senator's spokesman responded, "I wouldn't say they've made meaningful progress." (*Bureau of National Affairs*, Richard Cowden, 05/12/06)

- In an interview with *Market News International*, Senator John Sununu said, "I think it's essential we take up the GSE bill because if there is a financial crisis, we risk leaving the tax payers holding the bag," Sununu said he was alarmed by Fannie's recent announcement that it had discovered two additional accounting errors and that its release of the company's financials is pushed back indefinitely. "That kind of uncertainty makes it even more important that we have a strong, credible regulator in place," he said. (*Market News International*, Margaret Chadbourn, 05/11/06)

- In a May 10 editorial, the *Wall Street Journal* wrote, "So what happens when a company that hasn't filed a financial statement in a year and a half announces … yet more accounting problems and puts off reporting any results until sometime in 2007? Its stock goes up 3% and its bonds rally too. At least, that's what happens if the company is Fannie Mae and everyone believes it is Uncle Sam that will be left holding the bag if the mortgage giant blows up. Not only has Fannie's stock remained remarkably buoyant through its epic accounting fiascoes, but earlier this year the New York Stock Exchange amended its rules on delisting, effectively giving Fannie Mae a get-out-of-jail-free card. The NYSE's Web site says that 'based on certain unique circumstances,' it will continue to allow Fannie Mae's stock to trade indefinitely. This, despite now being over a year late with its 2004 annual report -- and Fannie's having declared that all of its financial statements since 2001 'should no

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longer be relied upon.' In other words, there is no reliable financial data for Fannie going back six years."

- "Yesterday, we received a copy of letter dated May 5 and signed by [24] Senators, urging the GOP leadership to schedule floor time for Senator Richard Shelby's reform bill, which would require Fannie and Freddie Mac to reduce the size of their nearly $1.5 trillion mortgage portfolios, the chief source of risk to the economy from the government sponsored entities. The House has already passed a bill, albeit a far weaker one than Senator Shelby's. No one doubts any longer that Fannie retains its privileged access to financial markets solely because of its privileged position in Washington. Will Congress wait until it is too late to take action and avert a crisis?" (*Wall Street Journal*, 05/10/06)

House Banking Committee Chairman Oxley fights back

- According to *the American Banker*, House Banking Committee Chairman Michael Oxley is "done" being the *Wall Street Journal*'s punching bag and is striking back. Oxley wrote in a May 11 Letter to the Editor in the *Wall Street Journal*, "I don't even recognize the legislative process described by your April 27 editorial 'Freddie's Friends on the Hill,' and it surely is not the one outlined in the Constitution and practiced in the Capitol. Your editorial board is under the mistaken impression that the passage of a bill in the House has stalled the legislation. The House has spoken with a strong, bipartisan bill that passed last October by a vote of 331 to 90! Last May, the House Financial Services Committee overwhelmingly voted to approve the bill, 65 to 5. The House bill succeeds in its mission to create a stronger regulator for Fannie Mae and Freddie Mac. This is a remedy that is sorely needed in order to keep regulatory pace with the explosive growth and financial influence of the housing market giants. The proposed new [GSE regulator] Federal Housing Finance Agency would have a far greater degree of independence, assured funding that does not rely on the congressional appropriations process, and new operational and enforcement powers that are modeled after those currently held by most banking regulators."

- "The Senate Banking Committee has passed a bill, but has yet to report it to the floor. The Senate is free to act at any time, and I urge that body to work its will. Action by the full Senate is the only way to move the process forward and get to a conference committee, where the final details of a House-Senate compromise could be hammered out. All the editorial vitriol directed at me by the *Journal* has not and will not change the realities of the legislative process. Nor will it alter the House position, which is held by all 331 members who voted for the bill. The holdup in the legislative process is the full Senate, and your admonishments would be more properly and perhaps more effectively directed there."

- "However, you are backing a portfolio limitation policy that lacks widespread support and cannot pass either the House or the Senate. Yet the *Journal* damns the body that acted for stalling and praises the body that cannot act. If the Senate Banking

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Committee's portfolio provision is so popular, why are the senators not clamoring for a floor vote? Supporters of the provision know that it will fail on the Senate floor, which would doom both the portfolio limitation idea, as well as GSE regulatory reform, for the remainder of this Congress. On the portfolio issue, I have repeatedly signaled my willingness to discuss the options before us, provided the Senate can act in order to move us to conference."

- "It is completely inaccurate to say that the House legislation does not address the size of the portfolios held by the GSEs. The Federal Housing Finance Reform Act, H.R. 1461, would give the new regulator broad, discretionary power to act on portfolios. The House authors believe that a specific directional mandate or numeric limits would be a mistake. A world-class regulator is a regulator who is given the necessary tools and the authority to use them. If properly crafted, the law should give regulators the necessary flexibility to respond to changing market conditions for the time during which the law will be on the books, most likely for decades. If this Congress does not send a bill to the president, it will not be because of a lack of responsible action by the House. It will be because short-sighted proponents of portfolio limitation decided that this provision is paramount."

- "I applaud the *Journa*l's point about the current administration potentially exercising authority to limit Fannie and Freddie's debt issuance. I concur that the administration possesses the full authority necessary to move forward. There is no need for congressional approval. If administration officials believe that the systemic risk is so great that the Treasury should limit debt issuance and therefore portfolio size, I see nothing that prevents them from doing so. If that is their firm belief, then it is also their responsibility to protect the taxpayers and the housing finance system."

- "The House acted first. It has spoken with strong, bipartisan legislation to create a more effective regulator. We in the House urge the Senate to move and stand ready to complete the legislative process. The administration has the ability to act at any time. Readers may judge for themselves who is stopping progress and why." (*Wall Street Journal*, Representative Michael Oxley, 05/11/06; *American Banker*, 05/15/06)

Treasury Department reiterates the need to restrict the size of GSEs' portfolios

- Treasury Secretary John Snow said that appropriate portfolio limits are the key to any potential compromise on GSE regulatory reform legislation. "We need to find a way to give the [GSE] regulators authority to ultimately make a decision on the size of the portfolios," said Snow. It is important that the GSEs maintain portfolios which are sufficient to allow them to carry out their statutory mission of providing liquidity to the mortgage markets, but not more than what was needed for that purpose, Snow added. "As long as that test is in there, where the burden of proof lies is probably secondary." (*Dow Jones International News*, 05/18/06; *Reuters*, 05/18/06)

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- Undersecretary of Treasury for Domestic Finance Randal Quarles reiterated Treasury's concerns about the systemic risk of the GSE portfolios at a May 10 speech to the Money Marketeers at New York University. Quarles said, "One very significant risk that I have addressed previously is the question of the housing GSEs, Fannie Mae and Freddie Mac. It is now widely recognized that the GSEs have relied upon their funding advantage to expand the size of their retained portfolios far beyond levels necessary to achieve their mission. The concentration of risk inherent in these portfolios along with the GSEs' thin capital structure are an important policy concern and a high priority for the Treasury, and we are continuing to urge Congress to take action soon to address these issues." After the speech, Quarles told reporters, "We're focused right now on the [GSE reform] legislation. A positive outcome is achievable. We're working with Congress to get that legislation resolved, urging them to act on the two bills." (*Remarks by Randal Quarles, Undersecretary of Treasury for Domestic Finance*, 05/10/06)

Fannie Mae and Freddie Mac executives call for action on GSE regulatory reform legislation

- In an interview with *American Banker*, Fannie Mae CEO Daniel Mudd said his company supports the passage of legislation creating a strong GSE regulator, but opposes a provision that would restrict the size of the GSEs' portfolios. "The portfolio limits, to me, move beyond a strong, bank-like regulatory regime and say 'We're going to dictate the size and shape and lines of business that the company is in,'" said Mudd. "That is an entirely different discussion." He noted that Fannie has reduced the portfolio in recent years, largely to meet OFHEO's requirement that the company hold 130% of its minimum capital requirement, while it restates its financial results. "We have liquidated the equivalent of the 10th-, maybe 11th-largest bank in America in response to a capital requirement from the regulator," Mudd said. "Whether there is a systemic risk or not a systemic risk goes to the effectiveness of the risk management of the companies." Mudd rejects arguments that Fannie Mae's portfolio is not consistent with its mission, arguing that the portfolio helps the company provide liquidity to the mortgage market. "We do have an affordable housing mission, and we also have a liquidity mission," he said. "The liquidity mission requires us to be in the mortgage market providing liquidity, 24 by 7 by 365. That is written down, and I take that very seriously."

- Critics also argue that the portfolio exists only to boost GSE profits, while the taxpayers bear its associated risk. Mudd argues that there is nothing wrong with using the portfolio to make money. "When the company was established, they said it was OK to make money along the way, [and] they said 'One way that you can make money - in fact, the first way that you can make money - is by running a mortgage liquidity portfolio,'" Mudd said. "In order to provide liquidity to the largest capital market in the country, you know, you are going to have to be relatively big to do that." He adds that the vast majority of the portfolio is mission-related. "Every single asset that is in the portfolio - except for a 5% short-term liquidity portfolio - is

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a mortgage in the conforming loan space," Mudd said. "It's not third-world junk bonds. It's not hedge fund investments. I mean, it's mortgages." (*American Banker*, Patrick Rucker and Rob Blackwell, 05/09/06)

- At a May 8 secondary market conference held by the Mortgage Bankers Association, Thomas Lund, EVP of Fannie Mae's single-family mortgage division, said, "We want a super strong safety and soundness regulator. It is good for the housing market, it gets rid of a lot of uncertainty in the market, and we believe that we would be better off [if] it was to occur. …There remain a number of open issues that people are grappling with and we hope that ultimately those issues can come to resolution." Paul Mullings, Freddie Mac's senior vice president of single family sourcing, said, "We strongly support a bill that would give us a strong regulator." Both said that they oppose the Senate's provision for restrictions on the GSEs' portfolios, calling the bill "shortsighted" and warned of "unintended consequences" which would affect the liquidity of the mortgage market. (*Bureau of National Affairs*, Michael Bologna, 05/09/06)

- At the secondary mortgage market conference, the MBA's lobbyist Kurt Pfotenhauer told attendees that time was running out in Congress to pass GSE regulatory reform this year. "We believe that this session of Congress represents the best and perhaps last opportunity to pass meaningful GSE regulatory reform," Pfotenhauer said. He urged leaders in the Senate to push for a "workable compromise" on the portfolio restriction provision. Even if a compromise can not be reached on this issue, Pfotenhauer encouraged the Senate to move the bill to the floor for debate before the political momentum wanes. With regard to the release of OFHEO's special examination report on May 23, Pfotenhauer said, "Most watchers would be surprised if the OFHEO report created a lot of new political momentum to move the bill. It will deepen our understanding of what happened. It should sharpen the case for reform. But in and of itself, we don't anticipate at this point that it will provide new political impetus to pass a bill." (*Reuters*, Kristin Roberts, 05/08/06)

"We're stuck with the mortgage monsters"

- In the May 15 issue of the *Washington Post*, Jerry Knight wrote, "After too many years tilting at Washington's windmills, there are few subjects left that can trigger my feelings of outrage. Fannie Mae is one of them. The fall of mortgage giant Fannie Mae -- and its counterpart Freddie Mac -- is the greatest financial tragedy I've witnessed in almost three decades of writing about Washington business.

- "…We still don't know the truth about their finances, but last week we found out how much it is costing Fannie Mae to find out. Would you believe $800 million? Not $800 million in mistakes, $800 million just to review the records, find the phony accounting and come up with clean numbers. That's $800 million this year alone, and it's only an estimate. It includes about $250 million spent in the first quarter and Fannie's best guess of spending for the rest of the year. Roughly half that, Fannie

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officials say, is being used to hire outside accountants and attorneys, along with all the paralegal squires and computer handmaidens needed to support them. The other half covers a huge investment in new computer systems, the thousand employees doing temporary duty on the cleanup and countless miscellaneous costs. The outside-contractor budget comes to $7.7 million a week, enough to hire an army. It's an army recruited by the accounting firm of Deloitte & Touche LLP, which is getting the biggest share of the work. There are 2,500 employees of outside contractors working on Fannie's books, officials say. The legal team, hired by the board of directors to investigate Fannie's foul-ups, is led by lawyers from Paul, Weiss, Rifkind, Wharton & Garrison LLP. But Fannie has hired several other firms, some just to defend the company against the lawsuits filed by shareholders who lost money on Fannie's stock."

- "The cleanup crew is so huge that it's taken over the dining room in the company cafeteria, leaving employees to pick up their lunches and eat at their desks. They've taken over every available room in Fannie's headquarters at 3900 Wisconsin Ave. NW, in the office building next door and in the one across the street. The accountants and lawyers are even camped out in the executive suite, including the palatial acreage formerly occupied by chairman Franklin D. Raines, who left after overseeing the scandal. The reason so many accountants are needed is that an independent investigation found almost two dozen violations of accounting principles, said Warren B. Rudman, the former New Hampshire senator who ran the inquiry. Because the rules were so routinely ignored, the accountants -- who have to swear by the accuracy of their work -- have to go through millions of documents to make sure the bookkeeping is proper now."

- "The Fannie Mae mess is so huge, it may be the biggest single source of new jobs in the District of Columbia this year. Some of that $400 million will no doubt trickle down to do some good. It's putting gas in the tank, food on the table and BMWs in the driveways of the Deloitte & Touche partners, for example. But fundamentally, it's wasted money, a dead-weight loss. It's thousands of jobs and millions of dollars being wasted on work that is no more productive than raking leaves. It's money that could have gone not only to shareholders, but also to support low-income housing and to the Fannie Mae Foundation, the company's charitable arm, which is struggling through cutbacks."

- "What's most outrageous about the costly Fannie Mae cleanup is that no one seems outraged about it. When the $800 million number was disclosed last week, not a whimper was heard from Congress, which for months has been dithering about what to do about regulating Fannie and Freddie. Yet the number shows how badly the government needs to do something. Contrast the $800 million cleanup cost with the $62 million annual budget of the Office of Federal Housing Enterprise Oversight, the agency in charge of 'regulating' Fannie and Freddie. That office, which plans to issue its final report on Fannie Mae by the end of the month, has a staff of 225 people, not one-tenth the number Fannie has hired for the cleanup."

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- "Congress dares not complain because it is culpable. Fannie Mae's and Freddie Mac's lobbyists have so totally ingratiated themselves with lawmakers that they've been able to fend off regulatory initiatives for the past two decades. The White House is hardly in a position to provide leadership since presidents Bush and Clinton have significant responsibility for what went wrong. They appointed board members at Fannie and Freddie, reflecting their unique status."

- "The failure of that system is obvious. The White House traditionally treated appointments to the boards as political plums: not as cushy as, say, being named ambassador to the Vatican but as nice a job as you can get without having to leave town or do much real work. The presidential appointees reflect Fannie and Freddie's origins as offspring of the government. They were set up to raise money for home mortgages, which Congress concluded could be done better and more cheaply by a government-chartered entity. But their eventual privatization created the housing equivalent of the military-industrial complex, a Washington-Wall Street axis of money. Wall Street has made billions of dollars buying, selling and trading the bonds that the mortgage twins use to raise money. Wall Street has eagerly helped them sell stock -- collecting the usual investment banking fees along the way. And Wall Street has just as eagerly bought Fannie's and Freddie's shares and bonds, parking them in their mutual funds and other accounts they manage."

- "The conflicts run so deep when it comes to Fannie Mae that last week's announcement of the $800 million cleanup cost did not produce a peep from Wall Street. Analysts instead proclaimed that it was good news. It showed a light at the end of the tunnel, another reason to buy Fannie's stock. Wall Street, like Washington, has no choice but to support Fannie Mae and Freddie Mac, no matter what. If they failed, they could take down the stock market, the bond market, the housing market and perhaps the entire U.S. economy because their stocks and bonds are so widely held and they are so essential to the mortgage market. No one can afford to let that happen. That's why Congress is so afraid of grabbing the regulatory reins and why Wall Street keeps touting Fannie and Freddie as good investments. Today there are nine Wall Street analysts telling their clients to buy Fannie Mae stock and just two recommending they sell. The opinion on Freddie Mac is unanimous: 11 "buy" recommendations."

- "Reluctant as I am to admit the possibility, those recommendations may be right. Fannie and Freddie aren't going to fail. Wall Street and the government won't let them. That's the real tragedy. We've created a pair of mortgage monsters, and we can't do anything about it." (*Washington Post*, Jerry Knight, 05/15/06)

A global view of GSE reform

- In a May 2006 issue of *Mortgage Banking*, American Enterprise Institute resident scholar Alex J. Pollock wrote, "Consider this situation: A U.S. president who is popular in the South and West, while much resented on the East Coast, particularly in

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"elite" circles, leading his administration against a large, elite, government-sponsored financial power. This could be Andrew Jackson in the 1830s rejecting the rechartering of the Second Bank of the United States--the GSE of its day. Or it could be George W. Bush and the humbling of Fannie Mae and Freddie Mac. It strikes me there's an intriguing parallel there.

- Jackson wrote, as he vetoed the rechartering bill in 1832: 'Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government. It is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power.' Jackson's thoughts apply to the problems posed by GSEs in 2006. We have the same problems of government-sponsored profits for shareholders, concentration of power and special grants of privileges, as Jackson opposed."

- "…[T]the achievements [of the GSEs have come] at the price of creating what many economists believe is an implicitly colluding duopoly that concentrated both economic and political power. Fannie and Freddie amassed a dominating market and political role, reaped duopoly profits (economic rents) and created market distortions. The financing advantages derived from their government support allowed all… the GSEs to grow huge in unintended ways."

- Pollock suggests four structural changes which need to be made by Congress to the housing GSEs. "In the first place, as a minimum requirement, no GSE should continue to have a perpetual charter. The clear lesson of financial history is that GSEs should be given only limited-life charters: With GSE reform legislation now being considered by Congress, it is not too late to apply this lesson. The existing perpetual charters of all three should be revoked, and Congress should switch Fannie Mae, Freddie Mac and the FHLBs to limited-life charters. Twenty years is the American tradition for such charters, beginning with Alexander Hamilton and the First Bank of the United States in 1791. This would set the charter expirations for Fannie, Freddie and the FHLBs in 2026."

- "[Second,] GSE reform legislation needs to become clearly pro-competitive, consistent with the fundamental principles of market economies. The deregulatory experience since the 1970s shows that greater productivity and consumer benefits have been created in many industries by forcing competition on hitherto comfortable oligopolies. A notable contrast to this trend has been the secondary mortgage market. In order to achieve a competitive outcome, GSE reform legislation, in my view, should include the following:

  [1] It should clearly state that the intent of Congress, in addition to safety and soundness, is also to enhance competition. No one can disagree with this as a fundamental principle.

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[2] It should instruct the new combined GSE regulator that the development of its regulations must include the goal of promoting competition in the GSE sector.

[3] It should add mortgage securitization to the explicit legal powers of the FHLBs. This provision would directly attack the duopoly power and economically excessive guaranty fees of Fannie and Freddie, give mortgage lenders more competitive pricing, and add choice to the secondary mortgage market.

[4] It should give the new regulator the authority to issue as many new Fannie Mae and Freddie Mac-type charters as there are qualified and willing applicants, so that these charters are administered like those for national banks or federal savings and loans. This will ensure that the economic rents created by the charters are competed away to the benefit of the mortgage lenders and consumers. One or more of the FHLBs might spin off part of its operations into such a new charter."

- Third, Pollock suggests that the GSEs' relationship with the government should incorporate a joint-venture approach. Pollock wrote, "Former congressman J.J. Pickle, who had a lively interest in GSE issues, observed that for Fannie and Freddie, the risk is 99 percent public and the profit is 100 percent private. From the government's point of view, what kind of a deal is that? …[E]very GSE is a deal between the government and the GSE's shareholders, appropriately thought of as a joint venture. As with every joint venture, the question must be asked: How are we going to divide the net profits? Certainly not zero-100. If the FHLBs' 10 percent of profits affordable-housing contribution can be thought of as the government's share of the profits, that would suggest 10-90. In the current House bill, the corresponding 5 percent affordable-housing contribution for Fannie Mae and Freddie Mac would suggest 5-95. But I suggest the government should be asking, 'Why not 50-50?' The right split should reflect what each partner brings to the profitability of the joint venture. How much of the net profit of Fannie, Freddie and the FHLBs is due to the credit support and special privileges granted by the government? That should define the joint-venture profit split."

- And fourth, Pollock suggests the privatization of the GSEs. Pollock wrote, "As part of its now-implemented privatization proposal, Sallie Mae put forward the concept of a 'life cycle for GSEs.' The idea is that GSEs are formed to address some specific problem of the market of a given time… If they are successful, they lead the market to address the problem. Then they should cease to exist as GSEs and move on to a new life as a competitive private company without any special government-granted advantages. This is a very sensible approach. I think it should be applied to the housing GSEs."

- "…[A]lthough it is unlikely in the near term, privatization of the GSEs is an idea whose time should ultimately arrive. The triggering event will probably be that, like Sallie Mae, one or more of the GSEs will decide that the economic advantages of

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their special charters are no longer worth the regulatory restrictions and burdens they entail. Or they may find that there are greater economic opportunities from competing freely in the private market, or both. If the government demanded a greater share of the joint-venture profits, the ideas of the GSEs would probably move in this direction." (*Mortgage Banking*, Alex J. Pollock, 05/09/06)

OFHEO reaches agreement with FinCen to share mortgage fraud information

- OFHEO and the Financial Crimes Enforcement Network (FinCen) have reached an agreement, which facilitates the GSE regulator's ability to share information with FinCen regarding mortgage fraud. FinCen will include OFHEO's information in its database of Bank Secrecy Act information which can be queried by law enforcement officials. *(US Fed News*, 05/15/06)

Bush administration announces appointments

- President Bush has nominated longtime Federal Reserve Board insider Donald Kohn to be Fed vice chairman. Kohn, 63 years old, joined the Federal Reserve Bank of Kansas City as a staff economist in 1970 and moved to the Federal Reserve Board in Washington in 1975, where he was head of monetary affairs and became an adviser to former Chairman Alan Greenspan. In 2002, the President appointed Kohn and Ben Bernanke to the Fed board. "[Kohn has] been a crucial part of many of the major decisions in his 30 years at the board, he knows the system quite well and is respected by his colleagues," said Roger Ferguson, who retired as vice chairman in April.

- Separately, the President nominated Kathleen L. Casey, the staff director and Republican counsel to the Senate Banking Committee, to be an SEC commissioner to replace Cynthia Glassman, who announced that she wouldn't seek another term. (*Wall Street Journal*, Greg Ip, 05/19/06)

HUD Secretary Jackson's "dust up"

- Recent off-the-cuff remarks made by HUD secretary Alphonso Jackson to a Dallas business group sparked a political and media firestorm, resulting in a letter from 28 House Democrats to the President demanding a "public statement of repudiation for the unfortunate comments" made by Jackson. While addressing a group of minority real estate executives in Dallas at the end of April, Jackson said he had blocked a contract for someone who said he did not like President Bush. "Why should I reward someone who doesn't like the President, so they can use funds to try to campaign against the President?" the *Dallas Business Journal* reported Jackson as saying. "Logic says they don't get the contract. That's the way I believe."

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- Since it is illegal to punish a prospective federal contractor because of political views, Jackson's comments were called into question. Initially, the Secretary's spokeswoman, Dustee Tucker, appeared to confirm the story, but later acknowledged that the incident had never happened, but the tale was an "anecdotal" one meant to "explain to the audience how people in D.C. will say critical things about the secretary, will unfairly characterize the President, and then turn around and ask you for money." Moreover, Jackson is too far removed from the contracting process for the story to be true, Tucker added. Subsequently, Jackson has issued a statement of "regret" for his remarks and assured everyone that "all HUD contracts are awarded solely on a stringent merit-based process." (*American Banker*, Rob Blackwell, Patrick Rucker, and Stacy Kaper, 05/15/06;*Correspondence to the President*, 05/1/06; *Chicago Sun-Times*, Stephen Ohlemacher, 05/10/06)

Louisiana Recovery Authority's grant program wins final approval by state Senate

- The Louisiana Recovery Authority's proposed grant program won final approval from the state Senate, paving the way for HUD to begin its review of the state's plan to help rebuild 123,000 houses ruined during Hurricanes Katrina and Rita. The multibillion-dollar plan to rebuild south Louisiana's housing stock depends on $4.2 billion in a supplemental budget bill under consideration in Congress, which state officials hope will be approved by the end of May. Assuming Congress provides the additional funding, it will be August before the LRA begins distribution grant checks to homeowners, said LRA spokeswoman Catherine Heitman, noting that the group's consultants have indicated the August date is "extremely ambitious." (*Times-Picayune*, Laura Maggi, 05/11/06)

Nagin re-elected as New Orleans' mayor

- Nine months after Hurricanes Katrina and Rita swamped New Orleans, Ray Nagin was re-elected mayor, by a vote margin of 52% to 48%. With his re-election, Nagin will remain at the helm of a daunting recovery effort through 2010, removing an air of uncertainty that has slowed the rebuilding process.

MERS announces eDelivery for document delivery

- At the Mortgage Bankers Association's National Secondary Market Conference and Expo, MERS announced the launch of eDelivery, a new service to transport electronic documents from one party to the next and to help aggregators integrate their electronic mortgage technologies with those of their partners. (*National Mortgage News Online*, 05/11/06)

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Fannie Mae

In advance of the release of OFHEO report,
Fannie replaces chairman of the board's audit committee and hires risk officers

- On May 19, Fannie Mae announced that the board had named accounting professor Dennis Beresford to replace audit committee chairman Thomas Gerrity, who has elected to relinquish the position which he has held since 1999. "Over the past two years, Tom has indicated that, ... following the board's corporate governance policies, this is the right moment to step down and allow the board to bring on new leadership talent and energy to guide the audit committee forward," said Fannie Mae Chairman Stephen Ashley. "We accept his choice and decision." Beresford, a former chairman of the Financial Accounting Standards Board, teaches accounting at the University of Georgia at Athens and serves as chairman of the audit committees at Kimberly-Clark Corp. and Legg Mason, Inc. (*Associated Press*, Marcy Gordon, 05/19/06)

- On May 18, Fannie Mae announced the appointment of Enrico Dallavecchia as executive vice president and chief risk officer; Michael Shaw as senior vice president for credit risk oversight; Angela Hardy Isaac as senior vice president for operational risk oversight and Mark Winer as senior vice president for business analytics and decisions. Dallavecchia, who managed market risk for retail, mortgage and small business lending at J.P. Morgan Chase, replaces acting chief risk officer Winer. Issac, who will be in charge of the company's operational risk oversight, was formerly with Protivi, where she was responsible for building a new operation risk advisory practice. (*Fannie Mae Press Release*, 05/18/06; *Washington Post*, 05/19/06)

Fannie CEO Mudd "re-defines" Fannie Mae's mission

- In an interview with the *American Banker*, Fannie Mae CEO Daniel Mudd discussed how his predecessor [Franklin Raines] used the company's mission of providing homeownership to shield the company from criticism and how that hurt the GSE. "Mission became a little bit of a shield against criticism, and that is not what it should have been," said Mudd. "Maybe we have gotten ourselves a little boxed in here on the thought that the mission is only lending money to people that nobody else is going to lend any money to. That's an important part of it, but it's an incomplete picture of what the overall mission really is." Raines's claims that critics were hurting homeownership also cost Fannie credibility with Congress and others, said Mudd. "It turns out that if an assertion is not really true and people don't really accept it, then it's not sustainable," he said. "In some ways, it kind of debases your own message … We're on good standards if we drop back to what we know we're supposed to be doing and know to be true, and we're willing to … look at the reality."

- Mudd discussed at length the strides he is taking to change how Fannie Mae relates to

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lawmakers, customers, and its own employees. During the 2004 debate on GSE regulatory reform, Fannie Mae was accused of publicly supporting a bill, while quietly working to derail it. On the eve of the Senate Committee vote on the bill, Fannie aired television commercials, showing a family worried that they would not be able to buy a home because of the pending GSE regulatory reform bill. Mudd said he has worked to prevent those types of actions occurring at Fannie Mae. "We have not done any … kind of stuff to increase the temperature," said Mudd. "We have been trying to decrease the temperature. And we have insisted in every single meeting that the tone and the manner with which we approach it be constructive and respectful of both sides of the issue." He added, "Our voice has been discredited through this whole process, so we have to be careful about not getting up on the high hog on this. We'd like to have a [GSE regulatory reform] bill. We've said that, and we've tried to make the music and the words and the dancing … everything go together." When asked by *American Banker*'s reporters how he has changed the perception that Fannie's lobbying team is too aggressive, Mudd responded, "You reverse the reality before you reverse the perception." (*American Banker*, Patrick Rucker and Rob Blackwell, 05/09/06)

Mudd plans to increase the GSE's direct purchase of subprime mortgages

- Fannie Mae CEO Daniel Mudd said that not only does he oppose Congress's proposal to reduce the size of Fannie Mae's portfolio, he also wants to expand its holdings to include more higher-risk loans. In a March 13 conference call to investors, Mudd said, "It would be counterproductive not to be working on the development and future of the business and just to be in a holding pattern." In an interview with *Bloomberg News*, Mudd added, "I don't think we have served the market as well as we might have in some of the other products that aren't our bread and butter." In 2005, Mudd increased Fannie Mae's holding of adjustable rate mortgage and other non-fixed rate home loans to 19% of its portfolio. He also plans to increase the company's purchases of loans secured by multifamily properties and for home construction. [*Real Estate* reports that Fannie Mae's multifamily volume is up 150% from this time last year—a clear indication that the company has ramped up its MF lending.] While his company holds some subprime loan MBS, Mudd also is exploring the idea of increasing Fannie Mae's direct purchase of subprime mortgages. He emphasized that he doesn't plan any abrupt changes to the company's business mode. "Instead of a wholehearted jump into these areas, we're really building them out concentrically," Mudd added.

- At a recent Mortgage Bankers Association conference, Thomas Lund, Fannie Mae's EVP of single-family mortgage business, told the bankers that his company plans to pursue the nontraditional mortgage business more aggressively. "[Last year,] we wanted to take a stand against the outer edges [of nontraditional mortgages], said Lund. "We feel very, very confident now that the right [underwriting] steps are being taken," said Lund. Thus, Fannie plans to be "more of a player" in the market. "We feel good about how the market is evolving," he added. Fannie is ready to offer

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"more products and competitive pricing to win back your business," said Lund.

- Some investors appear to be skeptical of Fannie's expansion into the subprime market. David Dreman, the chairman of Dreman Value Management, said Mudd's shift to riskier loans was premature at best. "The company should first complete the restatement and rejuvenate their current businesses as much as they can," he said. David Brownlee, a bond fund manager for N.L. Capital Management in Montpelier, Vermont: "On the surface, it would seem to me that it's laden with risk," "If you lie down with dogs, you'll wake up with fleas." (*Bloomberg News*, James L. Tyson, 05/08/06; *Real Estate*, Brian Andrews, 05/09/06)

Fannie is concerned that foreclosures will rise, when adjustable rate mortgages reset

- Fannie Mae CEO Daniel Mudd said that he is concerned that mortgage foreclosures will spike over the next two years, as adjustable rate mortgages reset in a rising interest rate environment. Fannie Mae models suggest a couple of reset "spike periods" in the next two years, based on past originations of mortgages with adjustable rates and other features such as low initial "teaser rate" periods. It is still unclear what will happen to the housing market when these mortgages reset, especially given some of the weakening in certain housing markets, such as vacation areas with a lot of investment buyers. (*Reuters*, 05/10/06)

Fannie Mae extends its moratorium on foreclosures in Gulf Coast region

- On May 11, Fannie Mae informed servicers that the company would continue its moratorium on foreclosures through August 31 for counties and parishes in Alabama (one county), Louisiana (seven parishes), Mississippi (six counties) and Texas (four counties) which suffered severe damage from Hurricanes Katrina and Rita. (*LL03-06 Hurricane-Related Special Relief Measures*, Fannie Mae, 05/11/06)

Is Fannie Mae Foundation running out of money?

- Fannie Mae's accounting restatement has shaken the company's foundation "to the core," casting doubt on whether one of the region's most generous corporate philanthropies will remain a major source of funds for area charities. Over the past decade, Fannie Mae has pumped into the foundation roughly $764 million of the company's stock, which has lost about 33% of its value since the announcement of its accounting problems in 2004. Over the past two years, Fannie has given only $276,000 to the foundation, whose funds are rapidly dwindling. At year end 2004, the Fannie Mae Foundation had $51.1 million of company stock, which is worth roughly $37 million today. Fiscal year 2005 figures will not be available until November, when the foundation files its tax return. Despite the financial hardships,

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the Fannie Mae Foundation actually increased it local giving from $18.8 million in 2004 to $18.9 million in 2005, during a period in which its staffs were downsized and operating budget was slashed.

- "There is no doubt that this has introduced some uncertainty," says Andrew Schulz, deputy general counsel of the Council on Foundations, headquartered in Washington, DC. "It may be that they restructure for six months and get their bearing ... and then fire it up again. Or it could be the beginning of a trend that they are downsized. There is no way to guess now." With the Fannie Mae Foundation accounting for 16% of total local giving among the 50 largest Washington area philanthropists in 2005, the question is, who will pick up the slack if Fannie Mae's fortunes continue to fade? (*Washington Business Journal*, Sean Nadigan and Josh Drobnyk, 05/12/06)

Fannie Mae Foundation announces three finalists for its Affordable Housing Innovations Award

- The Fannie Mae Foundation has named the three finalists for its prestigious Innovations Award in Affordable Housing. The award, now in its second year, is collaboration between the Fannie Mae Foundation and the Ash Institute for Democratic Governance and Innovation at Harvard University's Kennedy School of Government, and is administered in partnership with the Council for Excellence in Government as part of the Innovations in American Government Awards, founded in 1986. The programs are eligible to receive a $100,000 grant to foster replication of their particular innovation to other jurisdictions. This year's finalists include the City of San Jose's [CA] Five-Year Affordable Housing Production Program; The Genesee County's [MI] Land Bank Program; and the State of Connecticut's Supportive Housing Pilots Program. (*US Newswires*, 05/09/06)

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Freddie Mac

Freddie Mac announces expansions in its mortgage products

- In July, Freddie Mac will begin offering a new array of 40-year fixed rate mortgages, 20 more adjustable rate products, and federally insured rural housing mortgage products through its Loan Prospector® automated underwriting service and its online Selling System. The GSE's 40-year products will include a 40-year fixed-rate mortgage product, a 40-year version of the Freddie 100 no-downpayment mortgage product and a 40-year Alta 97 mortgage. Freddie Mac is also beefing up the company's suite of Home PossibleSM affordable mortgage products by adding a 40-year fixed-rate option and providing lenders with more competitive selling options. The company also said it is revising its property insurance requirements to facilitate mortgage purchases in coastal markets, where insurers are raising their deductibles. Scheduled to take effect in July, Freddie Mac's maximum deductible will increase from 2% to 5% for fire, water (not caused by flooding) or wind damage coverage for 1- to 4-unit properties, condominiums, and Planned Unit Developments (PUDs). After these changes are implemented this summer, the enhancements will make it possible for lenders use Loan Prospector and the online platform to assess price, and deliver on a flow basis virtually every mortgage product offered in Freddie Mac's seller/servicer guide. (*Freddie Mac Press Release*, 05/08/06)

- Freddie Mac's EVP of operations and technology Joseph Smialowski said over the past year his company has succeeded in increasing adoption of its new Web-based selling system from 10% to 80% of its customers and expects to have 95% of its customers using the system by year end. "This is better than we anticipated in terms of the adoption rate by our customers," said Smialowski. "Part of that is because it is rules-based. We can respond to customer needs faster." Freddie's goal is to integrate all the rules management between the company's various platforms "to improve our day-to-day accounting" and to enable having a single platform for coming to market with new loan programs, he added. (*National Mortgage News*, Scott Kersnar, 05/15/06)

Freddie Mac is comfortable with the "legal and credit risks"
of mortgage loans to illegal immigrants

- After studying loans to immigrants who use individual taxpayer identification numbers to verify their identities, Freddie Mac is comfortable with the loans' "legal and credit risks," said Patricia McClung, the company's vice president of single-family offerings development. Given the country's recent anti-immigration sentiment, McClung said the "political risks" make it unlikely that Freddie Mac will start buying such loans soon. (*American Banker*, 05/11/06)

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Freddie Mac contributes to foreclosure avoidance program

- Freddie Mac has joined 14 other major financial organizations to create a multi-faceted foreclosure avoidance program, administered by NeighborWorks® Center for Foreclosure Solutions. A company spokesman said that Freddie Mac has contributed $1 million to fund the program. Other sponsors of the program include Bank of America, Chase, Citigroup, Countrywide Home Loans, Wells Fargo, and HSBC. Freddie Mac's vice president of default asset management Ingrid Beckles said, "We are delighted to join NeighborWorks and other co-sponsors to launch this promising new effort to show borrowers how to avoid unnecessary foreclosures." (*Freddie Mac Press Release*, 05/08/06)

Freddie Mac renews and expands its alliance with NAPMW

- Freddie Mac announced the renewal and expansion of its alliance with the National Association of Professional Mortgage Women (NAPMW), designed to strengthen NAPMW members' mortgage origination and secondary market knowledge, and enhance individual professional development for women in the mortgage finance industry. With the renewal of the alliance, Freddie Mac will be a Double Diamond Partner, becoming NAPMW's top sponsor for fiscal years 2006 and throughout 2007. (*Freddie Mac Press Release*, 05/17/06)

Freddie Mac ranks #38 on the "Top 100 Corporate Citizens"

- According to *Business Ethics*, Freddie Mac ranked #38 on its "Top 100 Corporate Citizens in 2006." [Where was Fannie Mae?] (*Freddie Mac Press Release*, 05/17/06)

- Also, the *Washington Business Journal* ranked Freddie Mac first among Washington, DC area corporations in contributions to the community. In 2005, philanthropic giving by Freddie Mac and Freddie Mac Foundation totaled $34.8 million with $22.1 million "[making] a difference in the Washington, DC area." Over the past 16 years, Freddie Mac has contributed more than $280 million around the D.C. metropolitan region. *WBJ* also cited Freddie Mac's response to helping hurricane victims in the Gulf Coast region as a proud moment for the company. (*Freddie Mac Press Release*, 05/12/06)

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Federal Home Loan Banks

The Shadow Financial Regulatory Committee urges the Finance Board to thoroughly overhaul the FHLB System's capital structure

- In a May 8 statement, the Shadow Financial Regulatory Committee (SFRC) examined the Federal Housing Finance Board's proposal to increase the FHLBs' capital. The SFRC wrote, "Federal Home Loan Banks (FHLBs) are member-owned government sponsored enterprises (GSEs) whose mission of encouraging home ownership resembles that of Fannie Mae and Freddie Mac. Their traditional and still principal business is to make "advances" (i.e., loans) to member institutions against the collateral of mortgage-related assets. Federal sponsorship means that FHLBs can fund any assets they hold with liabilities whose interest costs are reduced by implicit government guarantees. The interest-rate reduction that federal sponsorship generates allows FHLBs to act as a source of subsidized funding to housing lenders. To constrain FHLB member institutions' access to these subsidies and to control the FHLBs' ability to shift risk to taxpayers, the Federal Housing Finance Board (FHFB or "Board") is charged with assuring that each FHLB maintains an appropriate level and structure of stockholder capital."

- "In recent years, FHLB activities have outgrown their bureaucratic design. Their membership and balance sheets have expanded markedly in size, scope, and complexity. FHLBs have enlarged their span of owner-members from savings institutions and insurance companies to include commercial banks and credit unions. The FHLB System as a whole -- and especially a few individual FHLBs-- have substantially increased their holdings of mortgages and mortgage-backed securities."

- "Using two separate definitions of capital, each FHLB is required to hold total capital equal to 4 and 5 percent of its total assets. In March of this year, the Board proposed a rule that focuses on how FHLB capital must be defined in determining these leverage tests. The proposed rule restricts the amount of so-called "excess stock" each FHLB may have outstanding and sets targets for retained earnings. Excess stock is stock owned by a member institution beyond the minimum amount that is required for it to become an owner-member or to transact business with its FHLB. Unlike ordinary stock shares, holdings of excess stock can be redeemed at par after appropriate notice as long as the issuing FHLB's permanent-capital ratio is above 4 percent. Although labeled as "stock," these instruments are a hybrid form of debt. These positions are, in effect, member-optionable stock and are vulnerable to a run if and when the imputed market value of the stock is perceived to slide below par."

- "Historically, excess stock has been redeemed at par at the owner's request with minimal delay and has proved especially attractive to large institutions. Holders of excess stock earn subsidized returns—especially when market interest rates are low—and can plan to redeem their investment at par if adverse events occur or better

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investment opportunities emerge. For this reason, optionable funds cannot be relied upon to absorb losses that exceed the non-optionable capital of an FHLB and should not count as capital for regulatory purposes. Nevertheless, at year end 2005, excess stock equaled about 16 percent of the FHLBs' combined total capital of $46 billion."

- "The Board's proposed rule aims at reducing the role of optionable excess stock and building up the FHLB stock of retained earnings instead. The rule prohibits FHLBs from selling stock to institutions that would constitute excess (i.e., optionable) stock at the time of sale. It also caps the aggregate amount of excess stock for each FHLB at one percent of its total assets. At year end 2005, four FHLBs (Chicago, Cincinnati, Indianapolis, and Seattle) exceeded this level. To assure a prompt replacement of member-optionable capital, the rule imposes a minimum retained-earnings requirement on each FHLB (at least $50 million plus 1% of nonadvance assets) and restricts the amount of dividends that a FHLB could pay when retained earnings fall short of the minimum level. The rule also prohibits the FHLBs from paying dividends in the form of FHLB stock. As proposed, it is estimated that across the System the FHLBs would have to increase retained earnings by about $3 billion, or about 75% above current levels. As the FHLBs build retained earnings, dividend levels are expected to be cut significantly, perhaps by 50% for 18 to 36 months. Irrespective of the proposed restrictions on excess stock issuance, the reduced dividends would make the cap on excess stock easier to obtain by decreasing demand for these instruments, especially at very large member institutions."

- "To member institutions and the real-estate industry, the proposed constraints are unwelcome news. Consequently, they are already lobbying for mitigating adjustments. It is important that the public understand what is at stake. The danger is that, because of accounting lags, members can withdraw excess stock before unbooked losses from FHLB activities are explicitly recognized and can formally make excess-stock positions non-withdrawable. Such an instrument does not provide taxpayers with the protection that capital requirements on GSEs are designed to generate. The Committee applauds the Federal Housing Finance Board for calling attention to this problem. However, the Committee urges the Federal Housing Finance Board to add to the rule a requirement that FHLB accounting statements recategorize excess stock as a form of debt. Moreover, studying this issue has convinced the Committee that a piecemeal approach to restructuring capital requirements for the FHLBs is inadequate. The entire structure of capital management across the FHLB system needs a thorough overhaul." (*Statement of the Shadow Financial Regulatory Committee on Strengthening the Capital Structure of Federal Home Loan Bank*s, Statement No. 232, 05/08/06)

FHLBs debate possible use of non-consolidated debt

- The FHLB-Chicago's recent issuance of non-consolidated debt has sparked a debate among the FHLBs about whether other Banks should be allowed to issue such debt. While the Federal Housing Finance Board argues that the FHLB-Chicago's issuance

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was unique and that it cannot allow the other Banks to offer such debt, many observers claim the regulator could change its mind. Other FHLBs are considering the issuance of non-consolidated debt as a vehicle to reduce their excess capital and fund their mortgage purchase programs. "We believe that sub-debt funding options merit future consideration by both our bank and the Finance Board," said Barbara Hembree, a FHLB-Indianapolis spokeswoman.

- Since only capital "from sources available to absorb losses" would count as capital for a FHLB under the Gramm-Leach-Bliley Act, Finance Board employees argue that subordinated debt would absorb losses only during the liquidation of a FHLB and does not count as capital under the law. Neil Crowley, the deputy general counsel for the Finance Board said, "If someone could argue that subordinated debt absorbs losses during normal business, we might approve it. But frankly, I don't see how sub debt meets that test." (*American Banker*, Patrick Rucker, 05/18/06)

Will Wachovia's acquisition of Golden West spur consolidation of the FHLB system?

- Wachovia's proposed acquisition of Golden West Financial will likely hurt the FHLBs of Dallas and San Francisco and may push the FHLB System toward consolidation, said observers. Golden West's thrift, World Savings Bank, is the largest borrower at the FHLB-Dallas, holding $24 billion or 24% of the Bank's outstanding advances, and is the third largest customer of the FHLB-San Francisco, with $27.7 billion or 17% of the Bank's outstanding advances. If Wachovia chooses to consolidate the Golden West charters into its own, as it has in other acquisitions, Wachovia would have to sever its relationships with the FHLBs, which would damage the Banks' business.

- Wachovia's decision could be particularly critical for the FHLB-Dallas, which is still absorbing the loss of its previous top advance customer, Bank United Corp. of Houston, by Washington Mutual (Wamu) in 2001. In 2001, Bank United accounted for 25% of the FHLB-Dallas' advances. As advances come to term, Wamu has liquidated Bank United's advances. Today, Wamu is the second largest customer of the FHLB-Dallas, holding $7.5 billion in advances or 16% of its total advances with maturities ranging from 2006 through 2008. The FHLB-Dallas has acknowledged that industry consolidation could take a toll on its business prospects. In an April 14 filing with the SEC, the FHLB-Dallas wrote, "In the event we lose one or more large borrowers that represent a significant proportion of our business, we could, depending on the magnitude of the impact, compensate for the loss by lowering dividend rates, raising advances rates, attempting to reduce operating expenses (which could cause a reduction in service levels), or by undertaking some combination of these actions. The magnitude of the impact would depend, in part, on our size and profitability at the time the institution ceases to be a borrower." (*American Banker*, Patrick Rucker, 05/11/06; *Federal Home Loan Bank of Dallas Form 10 Registration Statement*, 04/14/06)

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FHLB-Seattle announces first quarter results

- The FHLB-Seattle reported net income of $8.0 million for the first quarter of 2006, compared to a $9.1 million loss for the fourth quarter of 2005 and $12.3 net income for the first quarter of last year. The Bank said that its first-quarter operating results demonstrate the progress it has made in growing its advance volumes, reducing its operating expenses, and improving its overall risk management. During the quarter, the Bank's advances outstanding grew 2.3% to $21.9 billion. The Bank's total capital was $2.2 billion or 4.26% of total assets, in compliance with its 4.25% capital ratio set forth in its three year business plan and capital plan. (*Business Wire*, 05/15/06)

The FHLB-Atlanta's SEC registration was declared effective May 16

- The FHLB-Atlanta announced that its registration with the SEC became effective on May 16, 2006. As part of the registration process, the Bank filed an amended Form 10 Registration Statement, which included financial statements for the quarter ended March 31, 2006. For the first quarter of 2006, the FHLB-Atlanta reported net income of $101 million, up 42% from the first quarter of 2005. Assets totaled $139 billion on March 31, 2006, down slightly from $143 billion at 2005 year-end. The Bank also provided preliminary guidance of its plans to pay a second quarter dividend at an annualized rate in the range of 5.25% to 5.50%. (*PR Newswire*, 05/16/06)

FHLB-Des Moines files its registration statement with the SEC

- On May 12, the FHLB-Des Moines filed its Form 10 Registration Statement with the SEC, which contained the Bank's financial statement for fiscal year 2005 and restated financial statements for years 2001 through 2004. The Bank reported earnings of $227.2 million for fiscal year 2005, up approximately 130% from restated 2004 results. The Bank warned that the restatement, which accelerated income recognition due to its misapplication of hedge accounting rules, is expected to reduce income in future periods. The Bank also stated that further reductions in its mortgage purchase business could "adversely effect" future operating results, while its ability to increase advances is "constrained." The FHLB-Des Moines disclosed that the Bank's advance balances have declined by approximately $4.9 billion or 18% at December 31, 2005 from year-end 2004. The Bank attributed this dramatic drop to its largest member, Wells Fargo Bank, N.A, which reduced its FHLB Advances from $5.5 billion in 2004 to $700 million in 2005. Wells Fargo and its affiliates reduced its mortgage sales to the Bank from $13.2 billion in mortgage loans in 2003 to $1.3 billion in 2004 and discontinued its loan sales to the Bank in 2005. The FHLB-Des Moines has recently accepted the resignation of its chief executive officer, chief financial officer and chief operating officer and is recruiting a new senior management team. (*Form 10*

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Registration Statement, FHLB-Des Moines, 05/12/06; *National Mortgage News Online*, 05/15/06)

Ginnie Mae

Ginnie Mae faces $500 million risk of loss to its investment portfolio

- CBO estimates that aggregate damage to residential structures in the affected Gulf Coast region range from $17 to $33 billion. In the region, the FHA Single-Family Insurance Fund insured 859 properties comprised of 116,000 units with an unpaid principal balance of $3 billion. The hurricanes affected 79 Ginnie Mae issuers, causing the agency to assess a $500 million risk of loss to its investment portfolio, said HUD’s Inspector General Kenneth Donohue in testimony before Congress. (*Testimony by HUD’s Inspector General Kenneth Donohue*, Federal Document Clearing House Testimony, 05/10/06)

Ten housing trade groups endorse FHA reform

- A coalition of ten trade groups representing mortgage lenders, real estate agents, and homebuilders are backing an FHA reform bill (H.R. 5121) and are urging members of Congress to co-sponsor and support the legislation. In a joint letter to the House of Representatives, the coalition wrote “Modernizing FHA will improve competition in the prime home loan and mortgage industry and effectively assist the industry in combating abusive and/or discriminatory lending practices.” The May 15 letter was signed by the American Bankers Association, National Association of Independent Mortgage Bankers, Mortgage Bankers Association, National Association of Hispanic Real Estate Professionals, National Association of Home Builders, National Association of Mortgage Brokers, National Association of Realtors, National Association of Real Estate Brokers-Investment Division, National Council of State Housing Agencies, and National Reverse Mortgage Lenders Association. (*National Mortgage News Online*, 05/17/06)

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International Mortgage Market

Japan's booming securitization market

- Over the past decade, Japan's asset-backed securities market has blossomed into a major financial market with more than $75 billion of securitized products issued in 2005, a 70% increase over the prior year. More than half of that total consisted of residential mortgages with Government Housing Loan Corp., a former state lender that was reinvented to serve as Japan's version of Fannie Mae, leading the way. Yukio Egawa, head of securitization research for Deutsche Bank in Japan, believes that the market has potential to grow much more for two reasons. First, the U.S. market for securitized products in 2005 was 15 times as large as Japan's, which has an economy half the size. "In the U.S. over 60% of outstanding mortgages are securitized. In Japan that ratio is 3%," said Egawa. Another rationale is that Japan's seven years of deflation is finally coming to an end, which represents a turning point in which corporations "will make more capital expenditures, try to expand business and acquire companies--and they will need funds," said Egawa. (*Forbes Asia*, Tim Kelly, 05/22/06)

Farm Credit System / Farmer Mac

FCS *is* responding to the needs of YBS farmers

- A report on the Farm Credit System's service to young, beginning and small (YBS) farmers and ranchers for 2005 showed that the dollar volume of loans to all three categories of YBS farmers and ranchers has increased every year since 2001. In 2005, the FCS made $5 billion in young farmer loans [versus $4.4 billion in 2004], $8.2 billion in beginning farmer loans [versus $6.8 billion] and $10.9 billion in small farmer loans [versus $9.8 billion]. At the end of the year of 2005, 12.3% of the dollar volume of the FCS's farm loan portfolio was to young farmers, 19.4% to beginning farmers and 29.2% to small farmers. A young farmer is defined as 35 years or under, a beginning farmer has 10 years or less in farming and a small farmer has $250,000 in sales annually or less. The System had outstanding loans and commitments to all farm borrowers of more than $102 billion at the end of 2005. As a percentage of the System's total loans outstanding, the $22 billion in loans to beginning farmers grew at a slightly faster pace than other YBS categories in the System, while there was a slight decrease in the percentage of the System's total loan portfolio for young borrowers ($14 billion) and for small borrowers ($33 billion). According to the U.S. Department of Agriculture census, the number of young farmers entering agriculture

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continued to decline, down from 15.9% of all farm households in 1982 to 5.8% in 2002.

- "There has been an increasing trend among the 96 FCS associations over the past five years," said John Moore, FCA's chief economist. "In the loan volume that is made to young farmers it has increased to 57%, to beginning farmers to 72% and to small farmers at 57%." FCA Chairman and CEO Nancy C. Pellett said, "It is clear from the data presented today that the FCS is making a strong effort to serve and address the needs of young, beginning and small farmers. FCA will continue to focus on YBS lending programs to ensure the FCS continues to meet the needs of YBS farmers and ranchers who are so critical to the future of agriculture and rural America."

- In January 2005, the FCA issued guidance to FCS institutions on Investments in Rural America with five pilot programs and seven other related investments, which included investments in agriculture and rural community bonds targeted at rural economic development, utilities and renewable energy projects, mortgage securities that help increase the availability of affordable housing in rural areas and a partnership that gives beginning farmers greater access to capital. (*Brownfield*, Lane McConnell, 05/12/06; *FCA Press Release,* 05/11/06)

FCA extends comment period on rule revising the risk-based capital requirements for Farmer Mac

- The FCA board of directors voted to extend the comment period on the proposed rule to revise risk-based capital requirements for Farmer Mac until May 17, 2006. (*FCA Press Release,* 05/11/06)

Farmer Mac reports first quarter income of $5 million

- Farmer Mac reported net income of $5 million or $0.44 per diluted share for the first quarter, compared to $4.9 million or $0.42 per diluted share for the first quarter of 2005. "Farmer Mac's strategic diversification of its marketing focus, begun last summer, has continued to produce tangible results," said Henry D. Edelman, Farmer Mac's president and chief executive officer. "First-quarter 2006 new business volume was $648.5 million, following on strong fourth-quarter 2005 volume of $330.5 million. …The increases in business volume in first quarter 2006 …were attributable principally to Farmer Mac's diversification of its marketing focus to include large program transactions that emphasize high asset quality, with greater protection against adverse credit performance and commensurately lower compensation for the assumption of credit risk and administrative costs, resulting in marginal returns on equity equal to or better than the current net return on equity. We are focused on the long-term growth of the business and the development of innovative ways to serve the financing needs of rural America, which we believe can

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offset the continuing adverse effects of many of the market and regulatory factors on Farmer Mac's new business development." (*PR Newswire*, 05/10/06)

Postal Service

Representative Davis is "optimistic" that postal reform legislation will pass this year

- On May 12, Representative Tom Davis (R-VA) told the Alliance for Nonprofit Mailers that CBO's budget score of postal reform legislation came in lower then predicted. He reiterated that the conferees will not be named until issues to be addressed in Conference are at a point that they are able to proceed formally with Conference. Davis said he remains optimistic that the legislation will pass and that the support is very broad in Congress. (*Alliance for Nonprofit Mailers*, 05/12/06)

- In a May 11 *Legislative Update*, the National Association of Postal Supervisors reported, "Postal reform conference discussions at the staff level are nearing completion, sources say, clearing the way for House and Senate conferees to officially meet, possibly by early June, to begin to negotiate the final terms of postal overhaul legislation. Those discussions will be challenging, everyone agrees, and will tackle the big issues, including whether the Postal Service has access to an escrow fund to pay for retiree health benefits and operating costs, and whether pension benefit funding for the military service of postal workers will be shifted to the Treasury Department. Billions of dollars and the future solvency of the Postal Service are at stake. Before the conference talks officially begin, the House of Representatives will officially appoint its team of conferees. Senate conferees were appointed in February, just after that chamber passed its version of postal overhaul legislation (S. 662). (*Legislative Update*, National Association of Postal Supervisors, 05/11/06)

- The Postal Service is lobbying against language in the House and Senate versions of a postal reform bill that the agency argues would damage its ability to compete against private companies. Both versions include provisions governing how USPS' general accounting practices will be determined following the enactment of postal reform legislation. Under both versions, the Treasury secretary, "in consultation with" the Postal Service," will recommend the accounting method that the USPS should use in pricing products such as overnight mail and parcel shipping. Treasury would submit its recommendations to the newly created Postal Regulatory Commission for final consideration. Both chambers included this provision to prevent the Postal Service from subsidizing the costs of its competitive products with revenue from first-class mail. While the Postal Service does not object to new accounting rules for its first-class and competitive products, the House and Senate language prevents the agency from having an active role in determining the guidelines and the language that should

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be altered to give the agency equal footing in negotiating how it accounts for its products, said a spokesman. The eight Senate conferees and the likely House conferees are "keenly aware" of the agency's position, and that "people are giving us a sympathetic hearing," added the USPS spokesman. (*CongressDaily*, Jessica Brady, 05/09/06)

Postal Rate Commission outlines the procedural steps for the USPS' omnibus rate filing

- The Postal Rate Commission has set a May 31st deadline for interventions, answer to motion for waiver and for protective conditions; a June 5th deadline to answer to motion for waiver of rules regarding certain library references and to answer to motion concerning the Forever Stamp; a June 7th deadline for statements identifying topics for pre-hearing conference; and a June 16th pre-hearing conference. (*Federal Register*, 05/11/06)

- "Just when you thought it was safe to go back to the post office, the United States Postal Service has begun the process of raising rates again," wrote Sam Ryan in the *Jackson Clarion Ledger* [Jackson, MS]. "The Postal Service says that this time, it's because gas prices are rising. Like the excuses it has trotted out in previous rate hikes, this one ignores the real problem. Ryan concludes, "The USPS …must stop placing the blame in all the wrong places. It's not the congressional escrow requirement or rising gas prices that has given us two back-to-back rate increases. Until the Postal Service can bring its labor costs under control, we can expect rates to keep going up." (*Jackson Clarion Ledger*, Sam Ryan, 05/12/06)

President Bush nominated Ellen C. Williams to the USPS Board of Governors

- President George W. Bush has nominated Ellen C. Williams of Kentucky to the USPS Board of Governors for the remainder of a nine-year term expiring in December 8, 2007 for John S. Gardner, whose recess appointment made in January 2006 would terminate. Previously, Williams served as a staff member in Congress and the White House over a ten year period. In April 2004, Kentucky Governor Ernie Fletcher appointed Williams to the Kentucky Public Service Commission. (*White House Press Release*, 05/08/06; *Alliance for Nonprofit Mailers*, 05/12/06)

USPS operates in the black for March

- The Postal Service generated net income of $295 million before escrow allocation during March. After the escrow allocation, the agency reported net income of $45 million, generated on revenue of $6.59 billion for March ($189 million or 3% over plan). The agency's expenses of $6.9 billion were virtually on plan. Year-to-date net income for the five months ended March 31, 2006 (before escrow allocation) was

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$1.57 billion, or $147 million over plan, while the YTD net income after escrow allocation was $74 million. (*DMNews.com*, Melissa Campanelli, 05/19/06)

USPS market share grows in U.S. air market

- During the first six months of 2005, the USPS gained share of the U.S. domestic cargo market, a "phenomenon that hasn't occurred in years, according to The Colography Group's midyear 2005 edition of *Domestic Air Cargo Trends*. The Postal Service's share of domestic air shipments rose to 37.6% in the first half of 2005 from 36.7% in the year-earlier period. Over the same period, UPS market share fell to 21.1% (from 21.6%) and DHL Express declined to 10.5% (from 11.2%). The Postal Service remains the market leader, followed by FedEx Express with 30.1%. (*DMNews.com*, Melissa Campanelli, 05/15/06)

USPS raises over $50 million for breast cancer research

- The USPS announced it raised over $50.3 million for breast cancer research through its sale of the Breast Cancer Research semipostal stamp. (*PRNewswire*, 05/09/06)

TVA

TVA loses $39 million in the last six months

- During the first six months of its fiscal year, TVA posted a $39 million loss with fuel costs increasing 36% over the period. Despite the utility's 7.5% increase in electric rates adopted in October, soaring costs for coal, natural gas and purchased power kept TVA operating in the red during the period. "Given the magnitude of the [fuel] increase, we cannot match the increases dollar for dollar," said Tom Kilgore, the utility's president. TVA sales were up 12% to nearly $14 billion during the period. The utility recently adopted a second rate increase of almost 10% to cope with higher fuel costs. TVA projects that it will end the fiscal year in the black as a result of the two rate increases. (*Chattanooga Times*, 05/13/06)

TVA issues moratorium on major land deals and considers request from Kentucky distributors to use the utility's power lines

- At the May 18 meeting, TVA board of directors approved a moratorium on major land deals, after several members requested that major land decisions be placed on hold so they could review them. The moratorium, which has not set time limit, does not cover some land transactions of 20 acres or fewer, which allows TVA to approve

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easements or allow for rights of way. The moratorium follows the board's recent approval of a deal with influential Chattanooga developer John Thornton to swap property for 578 TVA acres to build a high-end residential development on Nickajack Lake near Jasper, TN.

- The board also heard requests from five Kentucky power distributors and one from Tennessee, which comprise 2.9% of the agency's operating revenues, to use TVA transmission lines to purchase electricity from other suppliers. The board will take up this matter at a future meeting. (*Associated Press*, Rose French, 05/18/06*; Associated Press*, 05/18/06)

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