

The **GSE** REPORT™

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Major Events

Fannie Mae reports after-tax loss in earnings of \$7.9 billion on its derivative contracts

Editor's Note

Fannie Mae continues to face enormous challenges, says OFHEO director Lockhart

Former accounting manager "blows the whistle"
on Fannie Mae's *current* handling of accounting problems

Reactions to Fannie Mae's restatement

- In its December 6 10-K filing with the SEC, Fannie Mae reported after-tax loss in earnings totaling \$7.9 billion for fiscal years 2002 through 2004, stemming from an \$8.4 billion dollar loss on derivatives and a revised after-tax net gain on derivative mortgage commitments of \$535 million. Previously, the company had estimated the cumulative losses for the period to be approximately \$10.8 billion. In its filing, Fannie Mae highlighted the cumulative impact of its financial restatement as a total reduction of retained earnings totaling \$6.3 billion through June 30, 2004. In Fannie's description of the restatement process, the company cited a \$7 billion net decrease in previously reported earnings prior to FY2002. Fannie Mae reports restated net income of \$4.97 billion (\$4.94 per share) for FY2004, down from its restated net income of \$8.1 billion (\$8.08 per share) for FY2003. For FY2002, the company's restated income was \$3.91 billion or \$3.81 per share. Fannie Mae's restatement process has taken an army of 4,000 employees and outside contractors more than two years to complete at a cost of more than \$1.4 billion. [According to Fannie Mae CFO Robert Blakely, the company also plans to spend \$1.05 billion on restatement work during fiscal year 2007.]
- In the company's 10K, Fannie Mae reported 11 material weaknesses in the company's internal controls, including deficiencies in "tone at the top," roles of executives and directors, internal audit, and its whistleblower program. The company also disclosed that CEO Mudd received a total compensation of \$13.1 million, including a salary of \$908,121, a \$2.6 million bonus, and a restricted stock award valued at \$9.5 million.
- Fannie Mae also announced the increase of its quarterly dividend by 54% to \$0.40 per share. To meet this goal, the board declared a special dividend of \$0.14 a share per share payable on December 29, which supplements the company's previously declared dividend of \$0.26 per share paid on November 27. In the announcement of the company's completion of its financial restatement along with its increase in dividends, Fannie Mae president Daniel Mudd stressed that importance of the

company's accomplishments. "The restatement and results we filed today mark a critical milestone in Fannie Mae's progress toward building a stronger, better company..." said Mudd. "Our 2004 Form 10-K provides a critical foundation for the work still ahead."

- In a December 7th conference call with investors, Mudd offered an upbeat assessment of the company's efforts to restore confidence in the GSE, saying that Fannie Mae has "completed the foundation" and will "rebuild the house" for a solid mortgage finance business in the future. Mudd said, "The restatement did more than just change our financial results. I think it helped change our entire company. It was difficult, yes. It was expensive, yes. And we would rather it hadn't been necessary, yes. But I think there are lasting benefits." With regard to bringing the company's financial statement current, Mudd said, "Results for 2005 will come out in a single digit number of months. We're going to focus on catching up and getting current as soon as possible [which includes] restoring a competitive dividend."
- Citing the company's progress in its accounting restatement and its stronger capital position, Standard & Poor's removed its 'AA-' rating on Fannie Mae from CreditWatch. S&P also affirmed its ratings of the GSE and an outlook of negative. "Although Fannie Mae's filing of the financial statements is a significant milestone, we continue to view the pervasiveness of the deficiencies discovered in its internal controls over financial reporting as a concern and therefore we will closely evaluate further progress made toward full remediation of material weaknesses," said S&P's credit analyst Victoria Wagner. The agency's negative outlook reflects Fannie Mae's status as not being current with financial filings, as well as the restrictions it faces under its Consent Agreement with OFHEO. Moody's Investors Service said Fannie Mae's restatement "is a positive development" The agency added, "This action is one of the first of several steps that will result in Fannie Mae becoming current in its financial statements. ... Much remains to be done before all aspects of control, governance and operational issues that led to the restatement are behind Fannie Mae." Fitch Ratings also upgraded and removed from "rating watch negative" Fannie Mae's preferred stock. (*Bureau of National Affairs*, Steve Burkholder and Richard Cowden, 12/07/06; *Bureau of National Affairs*, 12/08/06; *Reuters*, Patrick Rucker and Lynn Adler, 12/07/06; *Washington Post*, David S. Hilzenrath, 12/07/06; *Reuters*, Patrick Rucker, 12/06/06; *Dow Jones News Service*, Siobhan Hughes, 12/06/06; *Bloomberg News*, James Tyson, 12/07/06; *AFX International Focus*, 12/07/06; *Associated Press*, 12/08/06; *CFO.com*, Stephen Taub, 12/07/06; *Associated Press*, Marcy Gordon, 12/06/06)

Editor's Note

- For a rough estimate of what Fannie's 12/31/01 capital position would have been, the following was reported:

<u>Before restatement:</u>	
Assets	\$799.948

Total capital:	18.118
Capital/Assets	2.3%

Restatement impact:	
Adjustment to capital	7.000
Adjusted capital	11.118
Reduction of capital	39.1%

Source of 12/31/01 balance sheet data, before restatement:

<http://moneycentral.msn.com/investor/invsb/results/statemnt.aspx?Symbol=FNM&lstStatement=Balance&stmtView=Ann>

- Since it was not provided in the 10K, we were unable to calculate a capital ratio for the restated balance sheet. While we know that the write-down of net worth was 39.1% (\$7 billion/\$18 billion), we do not know how Fannie Mae booked the other side of the accounting entry(s). Portions of the entry(s) could have been booked into Other Liabilities (which would have increased assets and reduced the GSE's capital ratio, while portions could have decreased total assets and had no impact on their capital ratio.
- What we do know, as reported above, is that Fannie Mae overstated its earnings by \$7 billion prior to FY 2002. The adjustment represented 39.1% of the company's capital on 12/31/01.

Fannie Mae continues to face enormous challenges, says OFHEO director Lockhart

- The OFHEO director James B. Lockhart, III applauded Fannie Mae's completion of its financial restatement, but warned that the company continues to face enormous challenges. In a December 6 statement, Lockhart said, "Today Fannie Mae released its financial statements for 2002 and 2003 and, for the first time, its audited financial statements for 2004. This is a key step forward for the company and represents two years of hard work. We congratulate the Fannie team. While an important milestone, much remains to be done. As reflected in the 10-K, Fannie Mae faces enormous challenges in fixing its operational and risk management systems, in Sarbanes-Oxley compliance, and in producing audited financial statements for 2005 and 2006. Concerns remain with the speed of returning to full and timely financial reporting, the robustness of the Enterprise's internal controls (as reflected in the large number of material weaknesses), and the accuracy of its accounting systems. OFHEO will continue to monitor Fannie Mae's efforts to correct its problems, to operate in a safe and sound manner and to maintain an adequate capital cushion during this time of uncertainty." (*OFHEO Press Release*, 12/06/06)
- Separately, Lockhart told the *New York Times* that OFHEO plans to press charges before the end of the year against Fannie Mae's former chairman and CEO Franklin D. Raines and former CFO J. Timothy Howard to recover money that the men

received through the company's manipulation of earnings. [According to OFHEO, Raines received at least \$52 million of compensation tied to bonus targets, as part of his total \$90 million in compensation from 1998 through 2003.] Lockhart said, "We will file charges within the next couple of weeks. Unfortunately, the legal process is very cumbersome." Since the agency lacks the power to bring charges independently in federal court, OFHEO must bring them instead in an administrative court, increasing the difficulty of winning a penalty or forcing the two former executives to disgorge ill-gotten gains. If OFHEO is successful in its litigation, the former executives can appeal the judgment in federal court, where OFHEO would likely have to partner with the Justice Department to respond to such an appeal. (*New York Times*, Eric Dash and Michael J. de la Merced, 12/07/06, *Forbes Magazine*, Jessica Holzer, 12/07/06; *Reuters*, 12/07/06)

- In an interview with *Market News International*, Lockhart also indicated that OFHEO is expecting more action following Fannie Mae's extensive internal report on what should be done with current personnel and board members as a result of the accounting scandal, which the company submitted to his agency. "I would expect some restitution one way or another from some of these individuals," said Lockhart, referring to current employees who may be asked to repay bonuses granted based on false earning statements reported from 1998 through 2004 or may potentially lose their positions. "I'm not going to say how many people are on this list or who they are on this list," he added. (*Market News International*, Margaret Chadbourn, 11/24/06)

Former accounting manager "blows the whistle" on Fannie Mae's current handling of accounting problems

- A former Fannie Mae manager is publicly challenging the company's accounting practices and alleges that the company's problems are worse than what it presented to OFHEO, according to a complaint filed by Thomas Inman in August with the Labor Department's Occupational Safety and Health Administration. During his six months at Fannie Mae, Inman said he had a front row view of some of the company's accounting practices and what he saw raises questions as recently as May about how Fannie is handling its accounting for previously disclosed problems. Shortly after he raised questions about a \$50 million item, he said his supervisory duties were cut and several months later he was fired. (*The Wall Street Journal*, Anita Raghavan and James R. Hagerty, 12/07/06)
- On December 7, CNBC reporter Maria Bartiromo interviewed Inman on *CNBC's Closing Bell*. She asked Inman to give her the crux of his claim. Inman responded, "[As a Fannie Mae accounting manager,] I was investigating, documenting and analyzing various errors that were basically system errors that had been identified by Fannie Mae to OFHEO, but what I found was that the magnitude of the errors was substantially in excess of what Fannie Mae had in fact reported to OFHEO. Bartiromo asked, "You were with the company less than six months?" Inman responded, "That's correct." Bartiromo followed up, "In that amount of time you

were able to uncover major accounting problems. Inman responded, “Well, the first one was in January, when a direct report [employee] came to me and indicated that she was unable to analyze what turned out to be a \$50 million error that was subsequently recorded to the general ledger, in spite of the fact that the error had been analyzed and identified. And then I was informed that the managers, up to and including the controller, had decided to go ahead and book the error to the general ledger. I was told they were going to discuss that with OFHEO but in a meeting last week with OFHEO, I guess we got the impression that they in fact had not discussed it. That’s my impression.”

- Bartiromo asked, “How were you treated once you brought these issues to your superior? I am assuming you did bring these to your superior.” Inman responded, “I reported that \$50 million and the related analysis to my superior at the end of January. And then there was a \$2.4 billion dollar income item in April that we prevented from being recorded to the general ledger. That also exceeded by orders of magnitude the error level that had been previously provided to OFHEO in a white paper dated November of 2005. There was -- I would characterize it as increasing hostility. ...It appeared to me they did not want me analyzing and identifying errors that they had not previously identified.”
- Bartiromo asked, “When you say increasing hostility, what does that mean? How were they hostile toward you?” Inman responded, “Well, tone of voice, being critical about things that I think prudent people would view as proper behavior. An example of that, in the course of the investigating the \$2.4 billion dollar system error, I consulted with senior people in the accounting policy area. And frankly, my supervisor was critical of me for having discussed that.”
- Bartiromo asked, “And then you were terminated? Inman responded, “Terminated without notice, ...escorted out of the building. I was allowed to go back to my desk, under guard basically, to pick up a picture of my children. ...Bartiromo asked, “What specifically were the answers to why you were fired?” Inman responded, “They said that I had performed poorly as a manager...”
- ...Bartiromo asked Michael Cohen, Inman’s attorney: “...Mr. Cohen, what are you looking for here? What are you trying to accomplish? And look, you and your client, Mr. Inman, filed this ...in late August. Why are you now talking about this? Why is this coming out now?” Cohen responded, “We were contacted by OFHEO last week. This is a part of the Sarbanes Oxley remedies whistleblower protection. It’s an indication that the system works. As a result of filing the complaint, OFHEO learned of the problems and asked Mr. Inman in to talk. And when we heard that it appeared that the problems had not been addressed and when OFHEO indicated that it seemed to be a larger problem than just Mr. Inman, that other people were having similar types of retaliatory actions against them--we realized that we had to go forward. It’s not, I don’t think, a positive aspect to Mr. Inman’s career to have to do this. He does it reluctantly. And I think it’s an indication that Sarbanes Oxley can work. ...This is an opportunity for the stakeholders to go forward and say ‘Hey, we want people like

Mr. Inman watching our books. Get him back there as quickly as you can.' And that's a process that's going to unfold eventually..."

- During Bartiromo's interview of Inman, Fannie Mae representatives called *Closing Bell* and provided (off-air) a response to Inman's charges. Bartiromo said, "The Company tells CNBC an outside accountant has reviewed Inman's claims and that the investigation has revealed all accounting matters Inman raised have already been identified and are being fully addressed through the Company's restatement. Finally, Inman's claims in no way impact the validity of the Company's 2004 10-K filing with restatement results nor will they in any way impact the validity the Company's subsequent financial statements in 2005 and there after." (*CNBC's Closing Bell*, 12/07/06, 16:15:52)

Reactions to Fannie Mae's restatement

- "[Fannie Mae's] on a boat that's moving quite well down the river," said Fox-Pitt, Kelton analyst Ed Groshans. "The restatement news is overall very good. They did it on time, the amount of loss that they originally expected turned out to be significantly less. ... And they lifted the dividend and there's an expectation that there's room to lift that dividend going forward." (*Reuters*, Patrick Rucker and Lynn Adler, 12/07/06)
- Fannie Mae's 10K filing is another step in a "long tortuous process toward producing current financials," said Marshall Front, chairman of Front Barnett Associates LP. "That is the end game in this and is really what we're looking for." He added, The dividend boost is the first indication that the clouds are beginning to lift for Fannie Mae. This should give investors some confidence." (*Bloomberg News*, James Tyson, 12/07/06; *Reuters*, Patrick Rucker, 12/06/06)
- Tom Schatz, president of the Council for Citizens Against Government Waste (CCAGW), said, "After two years of investigation and the expenditure of more than \$1 billion on thousands of accountants, lawyers and consultants, Fannie Mae ...publicly disclosed the full extent of its accounting transgressions and earnings manipulation between 2001 and mid-2004. ...While many in the investment and financial community are hailing the announcement as a significant step forward for the beleaguered company and are relieved that the restatement is less than the \$10.8 billion originally anticipated, taxpayers should take little comfort in this news. The company, which, together with ...Freddie Mac, owns or backs almost half of the nation's \$8 trillion residential mortgages and carries \$1.4 trillion in debt, has still not filed financial statements for ...2005 [or 2006]. Had the [NYSE] not passed a special exemption on its behalf, Fannie Mae would have been delisted for its failure to file timely financial reports. Former Fannie Mae officials Frank Raines and Timothy Howard, who presided over the massive scandal and still managed to pocket millions in severance pay, have yet to pay back one cent of the compensation they received as a result of the inflated earnings reports that flourished under their leadership. Most importantly, the GSEs are still not under the scrutiny of a bona fide federal regulator

with broad, bank-like powers to ensure safety and soundness and to protect taxpayers from having to bail out a poorly-managed GSE. Taxpayers have Congress to thank for that unwelcome development.”

- “Over many years, members of Congress, many of whom were the beneficiaries of the GSEs’ financial and lobbying largesse, consistently turned a blind eye to incontrovertible evidence that Fannie and Freddie were engaging in risky activities outside their congressional charters. Finally, in the wake of the high-profile scandals at both Freddie Mac in 2003, and Fannie Mae in 2004, Congress was forced to take action. Yet, throughout the three years since, Congress dragged its feet and failed to adequately address the obvious need for tougher oversight of the GSEs.”
- “In the face of intense pressure to rein in the GSEs, the Senate Banking Committee, under the leadership of Chairman Richard Shelby, finally passed sensible, ambitious and comprehensive GSE reform to establish a tough new federal regulator for Fannie Mae and Freddie Mac, but could not get the bill to the floor for a vote before the November election. And though incoming House Financial Services Chairman Barney Frank (D-Mass.) promises to pass GSE reform in the very early months of 2007, press reports indicate that the Bush administration is already compromising with Democrats on some of the bill’s most important elements, namely the ability of the new regulator to shrink the GSEs’ portfolios in order to protect taxpayers and ensure the soundness of the nation’s financial systems. On behalf of its million members and supporters nationwide, CCAGW urges the Bush administration, the Treasury Secretary, the [OFHEO] Director..., and members of the 110th Congress to stand behind a bill that includes strong legislative language shrinking the GSEs’ mortgage-backed securities portfolios. Restraining the GSEs’ growth and forcing them to refocus on their congressionally-chartered mission is the only way to protect taxpayers from a potential GSE bailout and safeguard the nation’s entire financial system in the event of a GSE bankruptcy.” (*U.S. Newswire*, 12/07/06)

Issues unresolved on Fannie Mae’s offer to make its new patented technology available to the mortgage industry “royalty free”

- Banking industry trade groups continue to voice concerns about Fannie Mae’s proposal to make its newly patented loan technology available to the mortgage industry under an “open patent license” on a non-exclusive and royalty-free basis. According to a source, the patented technology is not available as a useable process yet. “It’s still conceptual,” a source told the *Bureau of National Affairs*. “There is no software application available right now that someone could use. To make it a reality, you would have to develop a product or software yourself.”
- Steve O’Connor, the Mortgage Bankers Association’s senior vice president and principal deputy general of its Legal Department, said “We still have questions and need clarifications, but we see [Fannie’s proposal] as a positive step in the right

direction.” O’Conner said the best solution was for Fannie Mae to place the technology in the public domain. While Fannie pledges to make the technology accessible royalty free is helpful, it does not resolve certain potential legal issues, said O’Connor. Under the terms of Fannie’s proposal, a potential software developer of the technology may not be protected from possible legal liabilities, while Fannie Mae’s liabilities would be limited [to \$50,000], he pointed out. Moreover, a future developer who wished to apply the technology would have to seek permits to use the process, which Fannie Mae would have the authority to grant, he added. “Our primary concern is that this not stifle innovation in mortgage technology,” said O’Connor. Another area of concern is the question of whether Fannie Mae has exceeded the bounds of its chartered mission of supporting the secondary market. “That’s an issue Congress could potentially have an interest in as a policy making focus,” he added.

- The MBA, Consumer Mortgage Coalition and other industry groups expect to meet with Fannie Mae officials to discuss the patent agreement and these concerns. “We don’t want to reach conclusions until we hear what Fannie Mae has to say on some of these points. We will be talking with them shortly,” said O’Connor.
- To date, OFHEO believes that Fannie Mae is taking the right steps in promising not to use the patent and offering to license it to lenders without charging royalties. However, OFHEO director James Lockhart said his agency has not reviewed Fannie’s licensing agreement. When asked at a recent Women in Housing and Finance luncheon about this issue, Lockhart said, “Fannie applied for a patent, I think maybe five years ago, in their heyday, when they were taking over the world,” which was granted by the Patent Office in August 8. “[Fannie and Freddie] were not created to be primary lenders,” said Lockhart. “They were created to be secondary lenders.” (*Bureau of National Affairs*, Richard Cowden, 11/28/06; *Dow Jones International News*, Damian Paletta, 11/29/06)

As expected, the 2007 conforming loan limits remain at \$417,000
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- On November 28, OFHEO announced that it has left the conforming loan limit of \$417,000 unchanged for single-family loans that Fannie Mae and Freddie Mac can purchase in 2007. The loan limits also remain unchanged for two-family properties (\$533,850), three-family properties (\$645,300) and four-family properties (\$801,950). According to the Federal Housing Finance Board, the average price for single-family home purchases was \$306,258 in October, down \$501 from October 2005. “This amount is in keeping with OFHEO’s recent announcement of an orderly and transparent process for any downward adjustment,” said agency director James B. Lockhart. “We made this decision so as not to disrupt the end-of-the-year pipeline of mortgages or the market for mortgage-backed securities.” According to the agency’s earlier guidance, this year’s price decrease will be netted against any potential increases in prices next year, when the 2008 conforming loan limit is set. If prices continue to decline in 2008, the conforming loan limit will drop by at least this year’s

percentage price decline in 2008. Early next year, OFHEO plans to provide more detailed guidance on its plans for setting loan limits for 2008. (*Dow Jones Newswires*, Campion Walsh, 11/28/06; *MarketWatch*, Amy Hoak, 11/28/06)

Congress passes postal reform legislation,
overhauling the Postal Service's operations for the first time since 1970

- In the final hours of the 109th Congress, the House and Senate passed historic postal reform legislation, after Senators Susan Collins, (R-ME), Tom Carper (D-DE) and Representatives Tom Davis (R-VA) and Henry A. Waxman (D-CA) brokered an agreement to modernize the USPS, ensure its solvency, and stabilize mail volume and stamp prices. The Postal Accountability and Enhancement Act will force the Postal Service to concentrate processing and delivering mail to all Americans and dramatically restructure the way the agency prices its products. To protect businesses and mailers from sudden and dramatic price hikes, the legislation ensures that price increases be kept below inflation-based ceilings for a 10-year period, after which it will be reviewed the by Postal Regulatory Commission. The bill also gives the Postal Service the freedom to introduce new, innovative products or tailor existing products to meet customers' needs, which should help attract new business and increase revenues. The bill repeals a provision in current law that made the USPS responsible for its employees' military pension benefits, returning this obligation to the U.S. Treasury and permanently corrects the Postal Service's flawed pension formula, which lead to significant overpayments and contributed to higher postal rates. These provisions will free up billions of dollars, giving the Postal Service the ability to begin paying down its debts. The bill also installs a three-day waiting period before a USPS employee is eligible to receive workers' compensation for job-related injuries. [Before the adjournment of Congress on October 1, the National Association of Letter Carriers had withdrawn its support of postal reform legislation because of the three day waiting period provision.]
- The Postal Accountability Act also expands the authority of the newly-created Postal Regulatory Commission. The bill provides the Commission tools, such as subpoena power, to ensure that the Postal Service is in compliance with the law and that the interests of the mailing public are protected. It also gives the Commission the power, as an expert regulatory body, to monitor the new rate system in future years and make whatever changes are necessary to ensure that it continues to meet postal customers' needs. The bill also adds an Inspector General of the Postal Regulatory Commission to monitor the regulator in the use of its expanded powers.
- Senator Susan Collins (R-ME), a sponsor of the legislation, called its passage "great news for the future of an institution that is critical to our economy and will ensure the continuation of universal postal service at an affordable rate." (*PR Newswire US*, 12/09/06; *DMNews.com*, Melissa Campanelli, 12/09/06; *Washington Post*, Jonathan Weisman and Stephen Barr, 12/10/06)

Fannie Mae and Freddie Mac

Last minute efforts to reach a compromise on GSE regulatory reform fail

- Despite last minute efforts to craft a compromise, the 109th Congress adjourned without passing a GSE regulatory reform legislation bill. Incoming House Financial Services Committee chairman Barney Frank (D-MA) said, “I’ve been encouraged lately [by negotiations with the Bush administration.] I think we’re in a position where fairly early next year we could be able to get a bill.” Frank added, “[One] sticking point about the portfolio issue has been resolved between House Democrats and Republicans and the administration.” Frank also remains committed to creating an affordable housing fund and easing current restrictions on conforming loan limits, as a part of next year’s GSE regulatory reform legislation. Frank said he believes that Treasury will ultimately agree to correlate the mortgage cap to the price of housing in an area, rather than a flat conforming loan limit which now applies. He threatened to kill the GSE reform bill, if such a provision was not included. In earlier comments, Frank also said, “I think people are underestimating the extent to which Fannie Mae and Freddie Mac are going to have to listen to their regulator. I think that the reality is that you are going to see a regulator that has a great deal of power over Fannie and Freddie.”
- In the waning days of the lame duck session, Frank, outgoing chairman Michael Oxley (R-OH) and Treasury Department officials tweaked language limiting the size of the GSE portfolios in an effort to reach a compromise on the legislation. The new language, drawing on language in both the House and Senate bills, would require the new GSE regulator to establish within 180 days “standards by which the portfolio holding, or rate of growth of portfolio holdings ... will be deemed consistent with the mission and the safe and sound operations of the enterprises.” The proposed legislative language said that the new GSE regulator must consider a number of factors, including the size and the growth of the mortgage market, the need for the portfolio to support the affordable housing mission of the GSEs, and “any potential risks posed by the nature of the portfolio holdings.” According to an industry observer, this provision is an important development, since it would empower the GSE regulator to compel the GSEs to adjust the size of their portfolio through an order, rather than through a complex, rule-making procedure.
- According to the document describing the compromise language, the three issues which remain unresolved include the creation of an affordable housing fund, changes to determination of the GSEs’ conforming loan limits, and the appointment of public interest directors at the FHLBs. According to a “discussion draft” document credited to Frank, an affordable housing fund is being proposed which would require Fannie and Freddie to set aside 4.2 cents for every \$100 in unpaid principal of new mortgage purchases. For example, if Fannie and Freddie purchased \$1 trillion of mortgages, as they did in 2005, they would have to set aside \$420 million in an affordable housing

fund under this proposal. The funds would be given to HUD for distribution to state housing agencies. The fund would sunset after five years. According to source, Treasury is pushing for a \$500 million cap on the fund. Treasury proposes to drop the statutory requirement that the regulator appoint public interest directors to the FHLBs' boards of directors and, instead, have all board directors be elected by the Banks' membership. According to proposed language, at least two board members should be chosen from organizations that represent consumer or community interests at each FHLB.

- According to sources, the conforming loan limit issue is the most problematic. Senate Republicans oppose such a provision which would reward Fannie and Freddie by letting them make inroads in the jumbo mortgage market. Source say that it's also unclear if Senate Democrats would support such a measure. Several banking trade groups oppose the provision, while the National Association of Realtors and National Association of Homebuilders support the measure.
- The Treasury-House agreement strengthened other provisions in the House bill. Under the agreement, the new GSE regulator could set new minimum and risk-based capital requirements for the GSEs. [Under the House bill, the regulator could only raise minimum capital temporarily to address safety and soundness concerns.] The new language also adds a provision that would force the new regulator to put a GSE into receivership if it were insolvent or it defaulted on its debts, a provision which was in the Senate bill but not the House bill. (*American Banker*, Rob Blackwell, 12/05/06; *Boston Globe*, Susan Milligan, 12/04/06; *CQ Today*, Michael R. Crittenden, 12/06/06; *Reuters News*, Patrick Rucker and John Poirier, 12/06/06; *Market News International*, John Shaw, 12/07/06; *Dow Jones International News*, Damian Paletta, 11/29/06; *Dow Jones International News*, 12/06/06; *Bureau of National Affairs*, Richard Cowden, 12/05/06)
- During closing days of the lame duck session, the chairmen of the Senate Banking and House Financial Services committees made it clear that their 2007 agendas would reach far beyond banking. Senator Christopher Dodd, the incoming chairman of the Senate Banking Committee, spent much of his December 8th press conference stressing topics such as national security and prosperity, but took few positions on banking issues. He touched briefly on topics, including creating a permanent government program to provide terrorism risk insurance and GSE reform. Dodd credited Frank for his effort to reach a compromise on reforming GSE oversight and. Dodd said he hopes a final deal will be stuck soon "not in a manner that will cripple [the GSEs'] ability to safely and soundly deliver innovative and affordable housing financing. Rather, in a way that establishes a world-class regulator for the GSEs and at the same time deepens the pool of capital to create affordable housing." Dodd said he wants to focus on terrorist financing, the growing of homeownership, and investor confidence. He added that he will decide early next year whether to pursue a presidential campaign in 2008 and hinted that he would let subcommittee chairmen take an active role, should he decide to enter the race. In a December 6 press conference, incoming House Financial Services committee Barney Frank (D-MA)

said he plans to focus the Committee's efforts on predatory lending, affordable housing, data privacy, as well as GSE issues. (*Press Release from the office of Senator Christopher Dodd*, 12/07/06; *American Banker*, Stacy Kaper, 12/08/06; *Dow Jones Newswires*, Damian Paletta, 11/30/06; *Bureau of National Affairs*, 12/07/06)

- The House Republican conference has named Representative Spencer Bachus (R-AL) the ranking minority member of the House Financial Services Committee. Bachus, who has served on the panel since 1993, currently serves as chairman of the Financial Institutions and Consumer Credit Subcommittee. According to a source, Bachus received an overwhelming majority of the steering committee's votes in a two-person contest against Representative Richard Baker (R-LA) In a statement, Bachus highlighted data security, global competitiveness, Sarbanes-Oxley implementation, terrorism risk insurance, and predatory lending as issues in which he believes "bipartisan consensus already exists ...and we have an opportunity to achieve real progress on many fronts." (*American Banker*, Steven Sloan, 12/08/06; *Bureau of National Affairs*, Heather M. Rothman, Jonathan Nicholson, Derrick Cain, and Karen Werner, 12/08/06)

OFHEO director Lockhart continues his campaign for passage of GSE reform
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- In a December 5th article appearing in *The Hill*, OFHEO Director James B. Lockhart, III asked, "Why is [GSE] reform necessary? The story of Fannie Mae's and Freddie Mac's unconstrained growth, earnings manipulation, accounting problems and gross mismanagement has been well-reported. It has cost shareholders tens of billions in market value, fines, and expenses to fix the problems; and in turn, shareholders have sued for billions of dollars. ...Fannie and Freddie will not file current quarterly financial reports until sometime next year at the earliest. It will take several years to truly fix all of their problems. Although not on the same scale, several of the FHLBanks are working their way out of similar problems."
- "Congress created [OFHEO] 14 years ago to ensure taxpayers would never have to pick up the tab in the event of failure at Fannie Mae or Freddie Mac. Unfortunately, OFHEO does not have all the tools it needs. Considerable problems at one or both of these companies could have serious repercussions in domestic and even global financial markets. Their government charters enable these companies to take on more risk than other major financial institutions. In addition to their significant operational difficulties, the Enterprises have lower capital requirements than banks, massive investment and derivative portfolios, limited discipline from credit markets, an inability to diversify their investments and no limit on bank investments in their securities."
- "There were no constraints on shareholders' pressure for growth and management's desire for maximum bonuses. To put this growth in perspective, compare the Enterprises' growth to that of the nation's GDP and mortgage market. During the last 15 years, the nation's GDP doubled, the mortgage market tripled, the Enterprises'

guarantees quadrupled and their portfolios grew tenfold. Unconstrained growth is a recipe for disaster. Fannie Mae and Freddie Mac present potentially very large systemwide risks to financial markets and financial institutions. That's why it is vital that Congress pass legislation creating an empowered regulator now." (*The Hill*, James B. Lockhart, III, 12/06/06)

- In a November 29 speech to the Women in Housing & Finance Housing Finance Symposium, Lockhart argued for reducing the size of Fannie Mae's and Freddie Mac's mortgage portfolios to reduce the risk of a failure of a GSE. Lockhart said, "The Enterprises could perform their important [housing] mission and respond rapidly during times of turmoil with smaller portfolios. Shrinking their portfolios would reduce the risk of Enterprise failure and any potential adverse effects on the secondary mortgage and other financial markets. ...If there is one lesson that these two companies should have learned from their multi-billion dollar scandals, large SEC fines, and massive shareholder lawsuits, it is that unconstrained growth focusing on earnings-per-share is much worse for shareholders."
- Lockhart added, "...The new regulator needs the powers to address the risks that these massive portfolios present. The legislative solution is now to provide the regulator with the power to address portfolio size and composition. The regulator would do so by regulation, based upon guidelines that ensure the companies can fulfill their housing mission and that recognize the risks the portfolios present. Although the Enterprises have questioned the need for portfolio constraints, I believe that a key part of restoring confidence is to convince the markets that they will never grow out of control again." (*Dow Jones International News*, Damian Paletta, 11/29/06; *Prepared remarks by OFHEO Director James B. Lockhart, III*, 11/29/06)

Federal Reserve Governor Kevin Warsh reiterates the Fed's concerns about the GSEs

- In a November 21 speech at the New York Stock Exchange, Federal Reserve Governor Kevin M. Warsh said "...The Federal Reserve has ...highlighted the systemic risks associated with the large portfolios of Fannie Mae and Freddie Mac. The inherent lack of counterparty discipline is a significant problem associated with the regulation of these government-sponsored enterprises (GSEs). Currently, this lack of market discipline, which is a consequence of conjectural federal government guarantees, is self-perpetuating: It has engendered a cost of capital for the GSEs that is nearly comparable to that of the federal government. It should be no surprise, then, that the GSE portfolios have grown dramatically since the early 1990s. Their growth rates have subsided more recently in light of recent accounting, regulatory, and governance problems, but without significant improvements in market discipline, it is likely that the rapid growth of GSE portfolios will resume." (*Prepared remarks by Federal Reserve Governor Kevin M. Warsh*, 11/21/06)

- In a 48-page study authored by former President Reagan’s last budget director James Miller and James Pearce, vice president of Welch Consulting, the authors concluded that Fannie Mae and Freddie Mac provided a huge economic impact on the price of mortgages in 2005. The study, sponsored by Freddie Mac, updates a 2001 study prepared by Miller on behalf of the company. [The assertions made in Miller’s original study have been widely debated by economist ever since.] “In 2005, borrowers saved between \$16.2 billion and \$20.7 billion in mortgage interest costs because of the GSEs,” said Miller, in an interview posted on Freddie Mac’s Web site. The Freddie Mac interviewer asks Miller, “Economists at the Federal Reserve have published a study that concludes the GSEs have virtually no impact on mortgage rates. Your study obviously contradicts their conclusion. Who’s right?” Miller responded, “The study by the Fed economists produces estimates that are what researchers call ‘outliers’ - they are substantially below the range of estimates produced not only by our work but also from quite a few other independent researchers.”
- In a study released in May, five Federal Reserve economists concluded that Fannie Mae’s and Freddie Mac’s presence in the housing market offered close to zero benefit to home buyers. Their study argued that the GSEs’ presence lowered interest rates by only two basis points from April 1997 through September 2005. “Current estimates of the mortgage rate reduction are not statistically different than zero,” said the Fed economists.
- In the Freddie Mac study, Miller and Pearce also argue that the best way to reduce the risks posed by the GSEs’ portfolios is by oversight, not by reducing their size. “Placing statutory limits on the GSEs’ portfolios would reduce the liquidity in the mortgage market and constrain growth in homeownership, while reducing risk only marginally at best,” said Miller and Pearce. “Accordingly, we conclude that the current path of more focused, effective regulation is the best way to maximize the net contributions of the GSEs.” In May study, the Federal Reserve economists argued that the “only” purpose of the large portfolios was to boost “GSE shareholders’ profitability, with no obvious public benefit.”
- Freddie Mac didn’t disclose how much it paid for the updated study. (*Dow Jones Newswires*, Damian Paletta, 11/29/06)
- *Dow Jones Capital Markets* reporter John Connor observed, “Fannie Mae, back in the days when it rode high, wide and handsome across the political landscape, commissioned a series of papers in which distinguished economists and ex-public servants ...held forth on topics related to the company. While Fannie and the authors were mum on fees, it appears safe to conclude that these papers were not pro bono work. Not surprisingly, the Fannie Mae papers backed the company’s position on the hot topics of the day. Which wasn’t the least bit surprising since the firm was vexed with regularity by critical GSE studies from such places as the Congressional Budget

Office and the Fed. Then, as we know, Fannie Mae a while back was hit by a full-blown accounting scandal, a variation of which earlier had whacked Freddie Mac. Like Freddie, Fannie witnessed an executive suite shakeup and endured various investigations and incurred substantial cleanup costs that continue to pile up. As things developed, Fannie Mae, now under the leadership of Dan Mudd, renounced its old in-your-face ways, and, lo and behold, the Fannie Mae papers disappeared from the company's Web site."

- "Meanwhile, over at Freddie Mac, now under the leadership of Richard Syron, a firm once known to the outside world as having a bean-counter culture (yes, that was ludicrous in light of the accounting scandal) and as having a relatively non-combative public style, took to exhibiting a certain post-scandal feistiness in ways such as dismissing as wrongheaded Bush Administration and Fed arguments about the dangers posed by the GSEs' portfolios. Now comes a new study adorning Freddie Mac's Web site, enumerating upon and extolling the savings to homeowners last year attributable to Freddie and Fannie Mae. The study ...runs counter to a study done earlier this year by economists at the Fed, and, if memory serves correctly, to a previous CBO study. To be sure, [co-author James] Miller did a similar study for Freddie Mac back in 2001. The new study updates the old one, with contemporary themes added and addressed by the authors with what seems like a fresh head of steam."
- "Accompanying the new study is a Q & A with Miller, during which he said among other things that 'after reviewing the latest research, as well as the disclosures the GSEs provide on their risk management, we concluded that the risks posed by the portfolios are not very large, and they are certainly manageable.' So does it make sense to place limits on the size of GSE portfolios? Miller was asked. Miller, who also chaired the Federal Trade Commission under President Reagan and currently is a senior fellow at the Hoover Institution and a consultant to Freddie Mac, replied: 'Because the risks posed by the GSEs' portfolios are modest, you would not get much additional reduction in risk from capping or reducing them. But you would limit - maybe substantially - the benefits of GSE mortgage investment.' One lesson in all this may be that there's still some life left in the GSE study business after all." (*Dow Jones Capital Markets Report*, John Connor, 11/29/06)

More "scaremongering" on Fannie and Freddie

- In a November 26 Letter to the Editor to the *Washington Post*, William R. Maloni, Fannie Mae's former [retired] senior vice president for government relations, wrote, "William Poole, president of the St. Louis Federal Reserve, was quoted in a November 17 Business item as saying that the 'Fed does not have the legal authority' to come to the aid of Fannie Mae and Freddie Mac should they require financial assistance. That silly statement probably has the Fed's lawyers scratching their heads. Neither company has ever asked the Fed for help, and their federal charters declare -- and require the companies to note on all of their printed securities -- that

they do not represent the full faith and credit of the federal government. Still, Mr. Poole wants Congress to take away their federal charters, presumably so the large banks that have long coveted the [GSEs'] mortgage market position can inherit it. Most knowledgeable financial people realize that the Federal Reserve is the nation's lender of last resort. It has the residual authority, often working in concert with the Treasury, to support any institution if its failure could lead to major financial market dislocation. No matter how Fannie Mae and Freddie Mac were structured, if serious problems ever struck them, the Fed would have ample authority to structure relief for the companies. The help would be for the companies, not their shareholders. Similar Fed discretion would apply to many of the giant financial services companies for which Mr. Poole seems to be carrying water." (*Washington Post*, William R. Maloni, 11/26/06)

OFHEO may limit the GSEs' purchase of exotic mortgages

- In question and answer session at the Women in Housing & Finance Housing Finance Symposium, OFHEO director James B. Lockhart, III said, "We are looking at putting out a guidance [for nontraditional mortgages] similar to [that of] the other bank regulators," which is expected to cover GSE purchases of private-label securities secured by nontraditional loans. Lockhart revealed his agency's NTM initiative in responding to a question about the GSEs' purchasing subprime mortgage securities that could have abusive or predatory features. "I agree, we have to be careful that they are not exploitative," Lockhart responded. OFHEO officials declined to provide *MortgageWire* any specifics about the NTM guidance. (*MortgageWire*, 12/04/06)

In 2006, subprime mortgage delinquency rate is up to 8% and foreclosure rate at 2%

- According to UBS, the rate of subprime loan delinquencies of 60 days or more has climbed to about 8%, up from about 4.5% a year ago. Not only have delinquencies for subprime mortgages risen faster in 2006 than in earlier years, but 2006 loans have entered the foreclosure process faster, said David Liu, head of mortgage credit for UBS. In October 2006, the foreclosure rate was about 2%, compared to 1% a year earlier. Tom Zimmerman, head of ABS research for UBS, said, "I guess we are a bit surprised at how fast this has unraveled." While it's "not a secret that subprime collateral has performed pretty disastrously so far," he said, "I must say we were a bit surprised by the magnitude with which" the loans "deteriorated this year." (*Associated Press*, 11/21/06)

109th Congress passes a deduction for mortgage insurance premiums

- In the nearly \$40 billion tax and trade bill passed by Congress on December 9, a provision will allow taxpayers who itemize their deductions to deduct premiums for mortgage insurance. Currently, only the interest paid on a home mortgage is deductible for taxpayers who itemize their deductions. The new insurance premium deduction applies only to mortgage contracts issued in 2007 to taxpayers whose adjusted gross income does not exceed \$110,000 or \$55,000 for married taxpayers filing separately. (*CNNMoney.com*, Jeanne Sahadi, 12/09/06)

Fannie Mae

Fannie Mae's retained portfolio declines 7.3% (annualized) in October

- Fannie Mae's retained portfolio declined by an annualized rate of 7.3% in October, following annualized rates of decline of 2.1% in September and 7.3% in August. Year-to-date, the company's retained portfolio is down 1.1% to \$720.9 billion on October 31. For purposes of its consent order with OFHEO, Fannie Mae estimated the mortgage portfolio balance is approximately \$719 billion compared to \$723 billion in September. In October, Fannie's portfolio purchases were \$13 billion, down from \$20.2 billion, while its sales totaled \$6.7 billion compared to \$9.7 billion in September. The GSE's liquidations totaled \$11 billion in October, while its net retained commitments fell to just under \$8 billion, down from \$10.4 billion in September. Fannie Mae reported a one basis point deterioration in delinquencies (90 days or more) for September to 61 basis points, while its duration gap of the portfolio remained unchanged at zero months in October. (*Asset Securitization*, Sally A. Runyan, 12/04/06)

Fannie Mae awards \$2.1 million restricted stock grant to its new chief information officer

- Fannie Mae has awarded Rahul N. Merchant, its new EVP and chief information officer, 37,000 shares of the company's stock. The restricted stock grant, worth about \$2.1 million, will be paid to Merchant in three equal installments beginning November 2007. Merchant was hired in November to succeed Julie St. John, who has retired. (*American Banker*, Steven Sloan, 11/29/06)

Fannie Mae to close its Charleston, WV office at year-end

- Three years after opening its Charleston, WV office “with much fanfare,” Fannie Mae is closing its three person office. The company plans to service West Virginia, Kentucky, Tennessee and Ohio through its East Central Group in Lexington, KY. (*Charleston Daily Mail*, George Hohmann, 11/28/06)

Fannie Mae Foundation spending falls 43% in 2005

- The Fannie Mae Foundation’s spending declined 43% to \$71.2 million, as a result of an 80% reduction in community support grants and cuts in operational expenses. As part of its cutback, the Foundation slashed its operating expenses more than 60% to \$29 million, by eliminating 12 of its 87 jobs and closing regional offices in Atlanta and Chicago. Compensation to officers and directors totaled \$2.0 million in 2005, roughly the same as 2004. The Foundation also reduced funding of its grants to almost 19% from its 2004 level to \$38.8 million. However, funding of grants to groups serving the Washington, DC area increased 16% from 2004 to \$15 million, representing more than 38% of the Foundation’s grants for the year. (*Dow Jones Newswires*, Damian Paletta, 11/27/06)

Fannie Mae seeks to replace the “struggling” Charles D. Smith Foundation in Bridgeport, CT development project

- The *Connecticut Post* reports, “Daniel Pfeffer, president of Midtown Equities and the city’s Steel Point developer, said ...Fannie Mae ...recently contacted him about becoming a partner in a multi-million dollar initiative to revitalize portions of the East End [in Bridgeport, CT]. The Smith Foundation, which is beset by allegations of financial mismanagement, is now on the ground floor of the Fannie Mae effort, and has received some ‘seed’ money from Fannie Mae as part of the program. There are allegations that those funds have been misused. ‘We are talking to Fannie Mae about what they have to do with Smith,’ Pfeffer revealed during an editorial board meeting last week with the *Connecticut Post*. “It may become a partnership with Fannie Mae. They asked us to be a developer,” Pfeffer said. Pfeffer said the effort, called “Deep Dive,” involves building upwards of 300 housing units in the East End.”
- “While Pfeffer suggested his company would take over the Smith Foundation’s role as developer, officials at Fannie Mae, who would only speak on background, declined to say that’s the case. The official said that it is possible Midtown would become a housing developer for the Deep Dive program. The Smith Foundation, the official explained, had been tapped to perform some services, such as marketing and running a literacy program. But the official said it’s unlikely the Smith Foundation, which is taking steps to become a nonprofit developer, could be lead developer for the Deep Dive program. And the official said recent financial problems at the foundation have

prompted Fannie Mae -- a private bank dedicated to 'expanding access to homeownership' -- to 'back away' from the organization."

- "...The Smith Foundation, whose main mission is to provide programs for disadvantaged youths, has been trying to branch out into economic development. Its founder, former National Basketball Association player and Bridgeport native Charles Smith, has told people for months that his organization is set to become the Fannie Mae developer. But over the last several weeks the *Post* has published a series of articles, based on internal foundation documents, that allege that the charity is \$1.2 million in debt, owes more than \$400,000 in back payroll taxes and operated for two years without required liability insurance. Other documents allege that nearly three quarters of \$101,000 in Fannie Mae funding already allocated to the foundation as part of the housing initiative was diverted to operating expenses, a violation of program agreements with the organization. The charity's former executive director, Deborah Sims, has been accused of using tens of thousands of dollars in foundation money to fund lavish personal shopping sprees. Former program director Maria Valentin allegedly benefited from Sims' purchases." (*Connecticut Post*, Bill Cummings, 12/03/06)

Fannie Mae's former SVP of portfolio transactions joins Impac Mortgage Holdings

- Andrew McCormick, Fannie Mae's former SVP of portfolio transactions, has joined Impac Holdings Inc. (Newport Beach, CA), as executive vice president and chief investment officer. (*National Mortgage News*, 11/27/06)

Freddie Mac

Freddie Mac increases its fourth quarter dividend 6.4%

- On December 8, Freddie Mac's board of directors voted to increase its quarterly dividend 6.4% percent to \$0.50 per share up from \$0.47 for the prior quarter. The dividend will be paid on December 29 to shareholders of record on December 18. (*Associated Press*, 12/08/06)

Freddie Mac Foundation celebrates its 15th anniversary

- To mark its 15th anniversary, the Freddie Mac Foundation held a reception honoring its grantees and surprised each attendee with a \$1,000 contribution [totaling nearly \$150,000] to further their work in the community. "As we celebrate our 15 years, we are proud of the nearly two million children and their families whose lives we've touched. However, our investments are only as good as the organizations we invest in. That's why we have focused our anniversary celebration on honoring the real heroes: our region's outstanding nonprofits. Their work and dedication have ensured that significantly more children face brighter futures," said Ralph F. Boyd, Jr., Freddie Mac's EVP and chairman of the Freddie Mac Foundation. (*Freddie Mac Foundation Press Release*, 11/30/06)

Federal Home Loan Banks

<p>PR offensive against Finance Board's proposal to increase the FHLBs' retained earnings continues</p>

- The Federal Housing Finance Board's proposal to increase the FHLBs' retained earnings would keep the FHLB System from serving "its original purpose of providing money for affordable housing," said Emily Porro with Sloane & Co, a public relations company that represents one of the regional FHLBs. The policy, Porro added, will result in less AH funding from the FHLBs.
- Frank Pinto, president and CEO of the Pennsylvania Community Bankers Association, believes that Finance Board Chairman Ronald Rosenfeld's retained earnings proposal was an overreaction. Once the board members review the feedback and see how negative it is, they will withdraw the proposed rule, said Pinto. The board is not going to do anything that would jeopardize affordable housing programs, he added. "On a scale of 1 to 10, the chances of the proposal being adopted is a 1," said Pinto. The Finance Board is expected to make a decision on the proposal soon, as early as December. (*Morning Call* [Allentown, PA], Beth W. Orenstein, 11/26/06)
- In a letter to members, the FHLB-San Francisco said it will not meet its \$296 million target for retained earnings [based upon the Finance Board's proposed rule] until the second quarter of 2010. This announcement follows the Bank's announcement that it would make 90% of its earnings available for dividends – up from its previous payout ratio of 80%. "Assuming that the Bank's financial performance remains relatively consistent with its recent performance, the Bank would be expected to reach the \$296 million target in the second quarter of 2010," said Dean Schultz, the FHLB-San Francisco's president and chief executive, in a letter to members. Doing so would put the Bank in violation of the Finance Board's rule, but the industry has been pressuring the agency to give the FHLBs more time to comply with the new capital requirement. (*American Banker*, Steven Sloan, 12/05/06)

<p>FHLB-Indianapolis rejects finding a merger partner and opts to pursue cost cutting measures</p>
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- Plagued with declining profitability, the loss of three of its large members, and the prospects of higher capital requirements, the FHLB-Indianapolis's board of directors appointed a task force last spring to study the Bank's strategic options, including finding a merger partner. The Bank's board rejected the merger option and opted instead to adopt a cost-cutting program, offering early-retirement packages to all workers age 50 or older with more than ten years of service with the Bank. The Bank's CEO Martin Heger, who earned \$978,000 in 2005, has announced his early retirement effective December 29. By accepting the Bank's buyout offer, Heger will

add \$95,652 to his annual retirement benefit or opt to receive a lump-sum payment of \$1.5 million. Milton J. Miller, II, the Bank's senior vice president and CFO, and Vincent A. Cera, the Bank's senior vice president of information systems have also announced plans to accept the early retirement offer effective December 29, but the details of their buyouts were not disclosed. Since no other Bank executive officers meet the early retirement eligibility requirements, the FHLB-Indianapolis said that no other named officers will be accepting its offer. Brian K. Fike, senior vice president and director of marketing, will serve as the Bank's interim CEO, while the board conducts a search for Heger's successor. (*Indianapolis Business Journal*, 12/04/06; *Federal Home Loan Bank of Indianapolis Press Release*, 12/04/06; *American Banker*, Steven Sloan, 11/28/06)

FHLB-Boston increases its quarterly dividend

- The FHLB-Boston declared a third quarter dividend of 5.75%, up from 5.50% for the second quarter. (*Credit Union Journal*, 11/27/06)

FHLB-Atlanta announces election of directors to the Finance Board's designated directorships

- The FHLB-Atlanta announced that B.K "Skipper" Goodwin, III and Thomas H. Webber III have been elected to the Bank's board of directors, along with incumbents W. Russell Carothers, II and J. Thomas Johnson, to serve three year terms starting on January 1. Goodwin, the president of FirstFed Bankcorp, Inc and chairman, president and CEO of First Financial Bank, Bessemer City, AL, will fill one of the two directorships designated by the Federal Housing Finance Board for the state of Alabama, while Carothers, the president and CEO of The Citizens Bank of Winfield [AL], will fill the other Alabama directorship. Webber, the vice president and CFO of IDB-IIC Federal Credit Union, will fill the directorship designated by the Finance Board for the District of Columbia. Johnson, the vice chairman and EVP of First Community Bank of Lexington, SC, will fill the Finance Board's designated directorship from South Carolina. (*FHLB-Atlanta Press Release*, 12/01/06)

FHLB-Dallas announces board member election results

- The FHLB-Dallas announced the election of Gary Blankenship to the board of directors representing Texas to a three year term commencing January 1. Blankenship is the chairman and CEO of Bank of the West, headquartered in Irving, TX. (*FHLB-Dallas Press Release*, 12/01/06)

Ginnie Mae

Incoming House Financial Services chairman Frank favors raising FHA coverage ceiling to help cover cost of risk-based premiums

- On November 29, incoming House Financial Services chairman Barney Frank (D-MA) indicated that one of his first legislative initiatives next year will be a proposal to use revenues from higher FHA lending ceilings to defray the cost of covering higher-risk mortgage insurance programs. Frank has proposed raising the current flat, nationwide ceiling for mortgages that FHA insures to allow higher-cost properties to be included in the program. Frank proposes to use the additional revenue generated by FHA through such a policy change to cover the costs associated with a shift from the current flat standard premium to a risk-based rate model. “We would raise the limit on what FHA can do in high-cost areas...,” said Frank. “...The CBO gives us a positive score for that because the FHA makes money for the federal government. What I would like to do then is to recycle the money we make in that bill because we comply with [pay-as-you-go budget rules] to extend the FHA downward” to serve mortgages with higher loan loss rates. “[Such a provision] would probably still make some money for the FHA, depending on how you did it, and you would then get a lot more people into the FHA system,” Frank added. (*Bureau of National Affairs*, Richard Cowden, 11/30/06)

Farm Credit System / Farmer Mac

Are some Farm Credit lenders too heavily concentrated in ethanol plants?

- According to the November issue of *Farm Credit Watch (FCW)*, “[Farm Credit Services of America’s] CEO, Doug Stark, reported [at the annual meeting] that FCSA ‘has loans in place or under consideration for 47 existing or planned ethanol plants in the Midwest. The cooperative has loaned about \$150 million on the plants and may loan \$500 million more.’ If Stark’s projection is correct, FCSA could have over 6% of its loans in ethanol plants. That is a heavy lending concentration in an industry which may experience rough times financially if there is an overbuilding of ethanol plants (a real possibility) and/or a drop in oil prices -- that has happened before and could again. *FCW* wonders how well the FCSA board is on top of this potentially risky lending where FCSA has little experience. How closely, too, are Farm Credit Administration (FCA) examiners watching FCSA’s ethanol-plant exposure, as well as the entire FCS’s credit exposure to ethanol[?]”

- FCW also noted that only 40 people attended FCSA’s annual meeting on November 2 --ten months after the close of its fiscal year. *FCW* wrote, “...FCSA hardly has an active, involved membership; most likely, this is true at the other large FCS associations, which reinforces a point FCW has made on many occasions -- far from being a true cooperative, with active member involvement, the FCS has become a club run by its management in close cooperation with a few directors who themselves are wealthy farmers and ranchers least in need of taxpayer-subsidized FCS credit. In this regard, it was interesting to note that the powers-that-be within FCSA are trying to dump the current board chairman, Robert Slaughter. According to [an Omaha, NE] *World-Herald* article, Slaughter was not nominated for a new three-year term on the FCSA board even though he had served as board chairman for two years and vice chairman for one year. One wonders if the dump-Slaughter movement is retribution for the role Slaughter may have played in 2004 in trying to sell FCSA’s loan book to Rabobank. Slaughter is not going quietly, though, for he received a director’s nomination from the floor.” (*Bert Ely’s Farm Credit Watch*, Bert Ely, November 2006)

Nearly 60% of FCA workforce eligible to retire within next five years

- In the November *Farm Credit Watch*, Bert Ely also wrote, “There are many reasons to merge the FCA into a new regulator who would regulate all five GSEs. FCA’s aging workforce is yet another reason why the FCA should be merged out of existence. At a recent meeting with FCA employees, FCA’s head of human resources reported that 157 FCA employees, almost 60% of its workforce, would be eligible to retire within the next five years. Not all of them will retire, of course, but many of the 157 will, which will further impair the FCA’s ability to regulate the FCS at a time when (1) the FCS is growing rapidly (12.3% loan growth in the twelve months ended September 30), (2) it is plunging deeper into off-farm lending, such as for ethanol plants, and (3) it is aggressively seeking, through its HORIZONS Project, to greatly broaden the scope of its lending in areas with which FCA examiners are not familiar. These factors are a potent recipe for financial disaster.” (*Bert Ely’s Farm Credit Watch*, Bert Ely, November 2006)

Will Congress address FCS in next year’s farm bill?

- When the Farm Security and Rural Investment Act of 2002 expires next September, Farm Credit lenders and banks are pushing Congress to address the Farm Credit System when they begin debating a farm bill in the 110th Congress. Farm Credit lenders would like for the bill to include provisions widening the scope of their lending beyond agriculture, while the banking industry would like for the bill to consider privatizing the 90-year old Farm Credit System.
- With new Democratic majorities in the House and Senate, it is “unclear” if leadership would be willing to address Farm Credit-related issues in the farm bill. In an

interview with the *American Banker*, House Agriculture Committee spokeswoman Alise Kowalski said that the general feeling is that any change in the Farm Credit System should be made directly, through amendments to the Farm Credit Act. While not ruling out a debate on Farm Credit issues, Kowalski said, “We would be very cautious about adding anything [to the next farm bill]. Once you start doing that, there is no end in sight.” If specific language or bills were offered, Kowalski said that they could be considered. And if a debate occurs, it should answer whether the system’s lenders are adequately meeting the needs of U.S. agriculture. “If they’re not, that is when we go into how do we make this better and how do we change it,” said Kowalski. (*American Banker*, Ben Jackson, 12/07/06)

Going way beyond agriculture...

- A recent Carolina Farm Credit (CFC) radio ad script reads: “Now I’m not a farmer. In fact, the closest thing to a South 40 I have is a slightly weed-infested flower garden. But when I need financing for my new house, I found Country Mortgages by Carolina Farm Credit...” CFC has \$1 billion of loans outstanding to more than 13,000 customers in 54 North Carolina counties. (<http://www.carolinafarmcredit.com/credit-radio-spot.asp>)

Postal Service

Outlook for the Postal Service's mail revenues is not improving

- According to the Postal Service's Revenue, Pieces and Weights (RPW) Report for fiscal year ended September 30, first class single piece volume fell 1.3 billion pieces or 3%. Total first class volume was down only 0.5%, because the volume in the discounted Automated Presort Category (which generated \$0.32 per piece) actually increased during the period. Standard mail was up by 1.5 billion pieces or 1.5% with average revenue of \$0.194 per piece. While Priority Mail was up by 4.1%, this category represents only about 7% of the agency's total mail revenue. According to the *PostalNews Blog*, "...What it all boils down to is this--like it or not, the high revenue, monopoly-status volume is continuing to decline. The lower revenue, less stable advertising volume will continue to increase. Right now the conventional wisdom seems to be that hard copy, mailed ads and catalogs can drive both mail order and online sales. That's an equation that's subject to change, however, as the web mindset matures- given the cost difference between electronic and postal ad delivery, it might not take much to arrive at a tipping point where electronic delivery of advertising sweeps hard copy delivery away." (*PostalNewsBlog.com*, 12/01/06)

Postal Service and the NALC take their differences to arbitration, while APWU and NARLC reach contract agreements with the agency

- The USPS and the National Association of Letter Carriers (NALC) have broken off contract negotiations and will take their differences to arbitration. In an email to members, NALC president William H. Young said outsourcing was the main issue preventing an agreement. According to Young, the Postal Service "has signaled its intention" to use contractors for "existing city carrier work," such as delivering mail to homes and businesses in metropolitan areas. Young wrote, "In taking this course [to outsourcing], the [USPS] decision makers have not only placed our jobs in jeopardy, they are also threatening the survival of the U.S. Postal Service. The union will not stand idly by and let them do this; we will fight for our members and fight for all Americans who want and deserve high-quality universal postal services." The arbitration process typically takes six months or longer. (*Washington Post*, Stephen Barr, 12/05/06; *NALC e-Activist Network*, William H. Young, 12/01/06)
- APWU President William Burrus announced that his union has reached a tentative four-year contract agreement with the USPS. Burrus said, "This is an outstanding agreement that protects the rights and interests of postal workers and the American people." On December 7, the APWU Rank-and-File Bargaining Advisory Committee voted unanimously to approve the union's tentative 2006 Collective Bargaining Agreement, which provides for two wage increases and an upgrade for all APWU-represented employees, in addition to Cost-of-Living Adjustments (COLAs) twice per

year. The Agreement also provides for the elimination of part-time flexibles as a workforce category in large offices, no later than December 1, 2007, and the conversion of all PTFs in these offices to full-time regular by that date. The Postal Service will pay 95% of healthcare premiums for employees enrolled in the APWU Consumer Driven Health Plan; for workers enrolled in other health plans, the employees' share of premiums will increase 1% percent per year for four years, beginning in 2008.

- The USPS and the National Rural Letter Carriers' Association (NRLCA) have reached a tentative four-year contract agreement, which upon ratification by union members, will run through Nov. 20, 2010. The agreement covers NRLCA's approximately 66,000 career employees and 52,000 non-career employees who deliver mail to residences and businesses on rural delivery routes.
- Contract negotiations continue between the USPS and the National Postal Mail Handlers Union. (*Washington Post*, Stephen Barr, 12/05/06; *APWU Web News Article #81-06*, 12/06/06; *APWU Web News Article #81-06*, 12/06/07; *US Fed News*, December 8, 2006)

TVA

TVA board adopts land policy banning sale of its land for development

- By a vote of 8 to 1, TVA's board of directors adopted a land policy banning the sale of the agency's 290,000 acres for residential and retail development. Under the policy, TVA's land sales would be limited to about 7,000 acres for industrial purposes only. The agency also could continue leasing designated lands for commercial recreation, like marinas. TVA director Susan Williams said, "The overriding theme of the TVA land policy is the basic premise to preserve reservoir land remaining under TVA's control in public ownership." TVA's public hearing in August on the proposed policy attracted dozens of speakers and more than 5,000 written comments with 92% of them supporting a residential development ban. "We appreciate the public's interest in this issue," said Williams. "We heard and we have listened." Casting the only vote against the new land policy, former TVA chairman Bill Baxter argued that the policy was too restrictive and will stymie growth in many communities. "This policy is less flexible than we need in order to pursue and to achieve our (TVA's) core mission of economic development," said Baxter. U.S. Representative Zach Wamp (R-TN) also expressed concerns that TVA's new policy is too restrictive and will have a "substantial adverse impact" on the region. Mike Butler, executive director of the Tennessee Wildlife Federation, said "[TVA's land

policy] has been a long time coming. Everybody knows what the rules are [now]. It is fair. It is predictable.”

- TVA’s land policy impacts about a dozen projects which were in process, said TVA’s senior vice president for environmental stewardship Bridgette Ellis. “Several of those will move forward based on the policy,” said Ellis. “Some of them will be tied up in a recreation assessment that will need to be done. And then others will not move forward.” (*Associated Press*, Duncan Mansfield, 11/30/06; *TimesDaily.com* [Florence, AL], Dennis Sherer, 12/01/06)
- In a December 3 editorial, *The Decatur [AL] Daily* wrote, “...By banning sale of TVA land for residential and retail development, the board has in reality made the land less accessible to the public. TVA has been a major catalyst in economic development in the Tennessee Valley — especially in the Decatur area. Public-private partnerships have been a key in helping the region grow and prosper. By adopting a rigid land development policy that effectively eliminates private residential or retail investment, TVA has limited growth potential along the system and taken away the flexibility inherent in any responsible land-use policy. (*The Decatur [AL] Daily*, 12/03/06)
- In a December 3 editorial, the *Huntsville Times* wrote, “The [TVA] board has acted properly to stop the sale or lease of shoreline land for residential and commercial development. The TVA board... said the action was needed to reflect and preserve the agency’s central mission. ...In a way, the board’s action is consistent with the growing national sentiment about private property and improper uses of the powers of eminent domain. The land TVA owns was once largely privately owned and was acquired starting in the 1930s after the agency’s creation. Some of that land was taken against the wishes of the owners. If the public no longer supports the condemnation of private land for another private use - Alabama last year passed a law banning such condemnations - the new TVA policy will be more in line with that thinking. The logic seems undeniable: Private land taken by government ought to be for public use only, not for some vaguely defined concept of ‘public benefit.’ In addition, when the power of eminent domain is abused, that abuse undermines the legitimate use of such power. (*Huntsville Times*, 12/03/06)

TVA to purchase a second turbine plant for \$23 million

- The TVA board of directors approved the \$23 million purchase of a 546-megawatt gas-fired combustion turbine plant in Gleason, TN from Allegheny Energy Inc., headquartered in Greensburg, PA. According to TVA executive vice president Terry Boston, TVA is paying “about 10 cents on the dollar” for Allegheny Energy’s original investment in the facility. The Gleason plant is already connected to the TVA power grid and is capable to being upgraded to a combined cycle plant to boost output to 870 megawatts. “We’re trying to position ourselves to meet our customer requirements at the lowest possible cost,” said TVA spokesman John Moulton.

“We’re buying these plants at attractive prices, and they will help us meet our peak demands, which have been growing about 2 percent a year.” (*Associated Press*, 11/28/06; *Chattanooga Times Free Press*, 12/02/06)

Warren Rural Electrical Cooperative elects to return to TVA

- The Warren Rural Electrical Cooperative, which had announced plans to join East Kentucky in 2008, has announced it will instead purchase power from TVA. The Warren cooperative said it made the decision because of projected increased costs of power related to delays in obtaining regulatory permits and higher construction costs. (*Herald Leader*, Scott Sloan, 12/08/06)

Why is NC Attorney General Cooper spending \$2 million in law suit to force TVA to do what it is already required to do?

- In a December 7 Letter to the Editor of the [Raleigh, NC] *News & Observer*, TVA’s SVP of communications Peyton T. Hairston Jr. wrote, “Your November 27 editorial about the lawsuit filed by North Carolina’s attorney general against [TVA] appropriately pointed out that [our agency] has taken significant steps to reduce emissions by 80 percent or more from its coal-fired plants. TVA strongly believes that energy production and environmental protection go hand-in-hand. It is also appropriate to point out that contrary to the impression created by the lawsuit, TVA has made emission reductions faster than utilities in North Carolina. The addition of emissions control equipment by TVA has been credited by air quality officials as one of the major reasons that metropolitan regions in Tennessee, including seven counties near the Tennessee-North Carolina border, are ahead of schedule to meet the national ozone air quality standard. Regional air quality is better and will continue improving as other utilities match the progress made by TVA.”
- “Rather than the hard-nosed attitude ascribed to TVA in the editorial, we sought to have the suit dismissed because such litigation is wasteful and unnecessary. New rules enacted by the Environmental Protection Agency in 2005 require both TVA and North Carolina to continue reducing emissions beyond levels required by North Carolina. Attorney General Roy Cooper should be asked why he is spending \$2 million to force TVA to do what it is already required to do.” (*News & Observer*, Peyton T. Hairston Jr., 12/07/06)

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