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The GSE REPORT ™

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Major Events

Treasury Secretary Henry Paulson holds private meetings
with Freddie Mac's chairman and CEO Syron and Fannie Mae's CEO Mudd

- According to sources, Treasury Secretary Henry Paulson met privately with Freddie Mac chairman and CEO Richard Syron on October 16 and with Fannie Mae president Daniel Mudd on October 20. According to *Dow Jones Newswires*, the topic of these meetings was "unclear," with spokesmen for Fannie Mae and Treasury declining to comment. A Freddie Mac spokesman confirmed the Syron met with Paulson, but had no other comment.

- Senate Banking Committee Chairman Richard Shelby (R-AL) has accused the companies of using their political influence to block GSE regulatory reform legislation. In October, Shelby said, "If Fannie Mae and Freddie Mac want a good bill, a strong regulator where they have certainty, I think we will get a bill. If they decide no, they don't want any regulator other than one they can control...or try to control, we won't get a bill."

- Paulson has encouraged Republican and Democratic lawmakers to work on a compromise in the time that remains this year. Lawmakers from both parties have said that they will try to reach an agreement during the lame duck session of Congress after the November elections and have urged Paulson help make the negotiations happen. Treasury has also signaled that it is considering limiting the level of debt that Fannie Mae and Freddie Mac issue to grow their mortgage portfolios. While such a power has never been exercised before and the GSEs would likely challenge such actions in court, several Treasury officials have said that the agency has the authority to limit debt and is willing to exercise it if Fannie and Freddie continue to grow without adequate regulatory oversight. (*Dow Jones Newswire*, Damian Paletta, 10/18/06)

- If Republicans hold onto their majorities in the House and Senate, Democrats may be willing to resume discussions with Senate Republicans on regulating the size and growth of Fannie Mae's and Freddie Mac's mortgage portfolios. "It depends on what kind of a lame-duck session it is," said Senator Christopher Dodd, (D-CT), who would serve as chairman of the Senate Banking Committee if his party wins control of the Senate. "I'm hoping both houses [House and Senate] are in different hands the morning of the November 8. If that is the case, I think we will have a rather short lame-duck session," said Dodd. "I think the administration missed an opportunity. House Democrats and Republicans put together a pretty good bill (H.R. 161)," said Dodd, adding that he will try to pass the House version next year if he reigns as chairman of the Senate Banking Committee. If Democrats retake the House, Representative Barney Frank (D-MA), ranking member of the House Financial Services Committee, has pledged to keep momentum going for reforming Fannie and

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Freddie and emphasize harnessing congressional power to beef-up affordable housing. According to *Credit Union Journal*, "The Democrats are not as heated [as the Republicans] about a new regulatory regime [for Fannie and Freddie] but are excited about new affordable housing funds, as much as $700 million a year, that would be created." (*MarketWatch*, Robert Schroeder, 10/09/06; *National Mortgage News*, 10/09/06; *Dow Jones Business News*, Robert Schroeder, 10/16/06; *National Mortgage News*, Brian Collins, 10/09/06; *National Mortgage News*, 10/16/06; *Credit Union Journal*, 10/16/06)

- While Friedman, Billing Ramsey analyst Paul Miller is skeptical about the prospects for passage of GSE regulatory reform legislation this year, he acknowledges that political risk for the GSEs is not fading. "As government-sponsored enterprises, the companies may continue to be haunted by perceived political risk, as fears abound that politicians may try to change the manner in which the GSEs operate and/or are regulated," said Miller in FBR's *Weekly Mortgage Report*. Moreover, the GSEs face a "high degree of litigation risk" resulting from questions about their accounting policies and the appropriate application of accounting principles. While the upcoming election are viewed as a "wildcard" in the regulatory outlook for Fannie Mae and Freddie Mac, "that does not remove the operational threat of a stronger OFHEO and the Treasury Department both turning the screws for the remainder of the Bush administration's term, which still has over two years to rein in the GSEs," said Miller. "In the absence of meaningful legislation, we believe the administration will resort to other means to rein in the two companies," (*National Mortgage News*, 10/16/06)

Freddie Mac chairman and CEO Syron and OFHEO director Lockhart
debate the systemic risks posed by the GSEs

- In an October 18 speech to the Commonwealth Club of California, Freddie Mac chairman and CEO Richard Syron said, "…[T]he [U.S.] housing finance system works better with the GSEs playing a vital role. Still, there are those who persist in trying to say we add risk to the financial system, in the guise of a concept – which is often imprecisely specified – called 'systemic risk.' Well, I'm an economist but I'm still a practical man. And here some facts as opposed to theories. Freddie Mac just came through another quarter when interest rates moved considerably. Yet as usual, Freddie Mac's duration gap – a key indicator of risk that measures how well our assets balance our liabilities – did not budge from zero months. Which is a sign that, in the real world, we manage interest rate risk very conservatively."

- "As a bank regulator and central banker for the best part of 25 years, I've spent a lot of time on these issues. And I will continue to fundamentally disagree with and debunk the charge of systemic risk as it has been misapplied to the GSEs. People need to understand there's no free lunch. The risk inheres in the fixed-rate mortgage instrument, not the institution. And if you want all the benefits as a nation of the American Mortgage, someone is going to have to manage this risk. The GSEs are

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mechanisms to transfer this risk from households out to the capital markets, which are much better equipped to handle it. If we don't handle this task, it will simply have to go to someone else. Put differently, the question is not whether this risk exists, but rather, how well it can be managed."

- "And here there is scant evidence that a handful of big banks – whose mortgage portfolios are approaching the GSEs' in size, and throughout this decade have been growing much faster – can handle the risk any more safely than we do. In fact, there is strong evidence to the contrary, including the GSEs' much greater use of callable debt. Simply put, the system is safer with the GSEs playing our current role, than if we are arbitrarily cut back in what we can do for our housing mission."

- "I don't want to let my fundamental disagreement on systemic risk obscure an important point. Since the day I arrived at Freddie Mac more than two and a half years ago, we have supported legislation to strengthen regulatory oversight of the GSEs. We still want very much to see an appropriate bill signed into law. And we are playing a constructive role in that process." (*Prepared Remarks of Dick Syron to the Commonwealth Club of California*, 10/18/06)

- In an October 20 speech at the Hudson Institute, OFHEO director James B. Lockhart, III addressed specifically comments made by Freddie Mac chairman CEO Richard Syron on October 18, in which he "debunk[ed] the charge of systemic risk as it has been misapplied to the GSEs." Lockhart responded, "OFHEO's definition of systemic risk is: '… the risk that a financial institution unexpectedly experiences severe financial difficulties and those difficulties disrupt the financial sector enough to cause a reduction in economic activity.' Both Fannie Mae and Freddie Mac have said that they want a stronger regulator with bank regulator-like powers, but they question broad authority to address portfolio limits, and their portfolios' impact on systemic risk. In fact, just yesterday, one Enterprise suggested they reduce risk to the financial system. So there is a two-prong debate going on as to whether bank regulators address systemic risk and whether the Enterprises' portfolios increase systemic risk."

- "I believe the key reason that bank regulators and deposit insurance were created was to reduce risk of losses to financial markets, other financial institutions, and individuals. Therefore, bank regulators are responsible for reducing systemic risk as part of their core regulatory responsibilities. Indicators of systemic risk include not only an institution's risk profile and its quality of risk management, but also measures of its importance to other institutions and to financial markets. Some key indicators of concern for the Enterprises are their high leverage, their continued inability to produce financial statements, their weak internal control environment, their huge mortgage asset portfolios that contain substantial interest rate and operational risks, the very limited market discipline they face, the importance of their obligations to other institutions and markets, uncertainty about the status of claims against an insolvent Enterprise, and the degree of reliance placed on them by many mortgage lenders. In their charters, both Fannie Mae and Freddie Mac were created to foster a

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stable and liquid housing finance market, thereby reducing systemic risk. They have done that, but as they grew rapidly as GSEs they began to increase their own potential for causing systemic events. Some may debate whether OFHEO was created to help reduce those systemic risks, but there is no doubt OFHEO does not have all the powers that a bank regulator has to help avoid such events."

- "Yesterday, one of the CEO's [Freddie Mac's Richard Syron] said that the systemic risk is being 'misapplied to the GSEs.' His argument is that by concentrating risk into two massive portfolios and then hedging their duration with some callable debt and large derivative portfolios makes the system 'safer.' Of course, the callable debt and derivatives just pass the mortgage prepayment risk elsewhere. Also, it is a fact that they do retain some of this prepayment risk to increase their returns. He ignores the inability of the GSEs to diversify to reduce risk, unlike banks. He also ignores the fact that systemic risk is much broader than market risk and can be caused by operational problems, including deficient models or unauthorized trading. A stronger regulator and smaller portfolios should help to reduce the potential for systemic risk."

- "…The bottom line is legislation is needed for a stronger [GSE] regulator so that the rebuilding of the Enterprises can be completed. They have a critical mission and also significant funding and other advantages, arising from their status as GSEs. They need to be strengthened to deal with changing markets and so does the regulator. We simply must have more bank regulator-like powers to meet our responsibilities. Unconstrained growth led to and compounded operational and management problems at both companies. The rapid growth of the portfolios size over a 10-year period was dictated by the shareholders and not the companies' mission. Moreover, there is no credit market discipline to reduce systemic risks to the financial markets and institutions. Bank regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved. They also have more flexibility when addressing capital needs of the institutions they regulate. OFHEO's capital requirements are too low and too inflexible. Improved capital requirements and portfolio limits with clear, but flexible guidance to the new regulator could significantly reduce systemic, market, credit and operational risks. The portfolio reduction could be through a transparent rulemaking process. After a gradual reduction, they could grow again with the mortgage market. The reduction would allow the Enterprises to free up capital that could be used for their core MBS business or returned to shareholders."

- "It is my hope and belief that Congress will act on GSE reform legislation when they return this November. The enhanced supervision and stronger regulatory regime, as proposed by the Congress and supported by OFHEO, the Bush Administration, and the Enterprises, will strengthen Fannie Mae and Freddie Mac so that they can better fulfill their mission of providing liquidity, stability and affordability to the nation's housing market." (*Prepared remarks by OFHEO Director James B. Lockhart, III*, 10/20/06)

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Fannie Mae and Freddie Mac are failing in their mission to cut the cost of homes, concludes a Federal Reserve Bank of Boston study

- According to a study by the Federal Reserve Bank of Boston, Fannie Mae and Freddie Mac are failing in their mission to cut the cost of housing by selling mortgage bonds, challenging a core rational for the companies to operate as GSEs. "We find no evidence that the GSEs' activities have contributed" to this phenomenon, said the study based on nationwide data on home purchases.

- In response to the Fed's findings, Freddie Mac spokesman Douglas Duvall said, "We provide liquidity, stability, and affordability to the housing finance market every day. Mortgage loans that Freddie Mac buys are consistently 25 to 30 basis points more affordable than those that we are prohibited from purchasing." (*American Banker*, 10/18/06)

Bush Administration changes: DeMarco to OFHEO; Steel at Treasury

- OFHEO has named Edward J. DeMarco as deputy director and chief operating officer of the agency. DeMarco, currently the Assistant Deputy Commissioner for Policy at Social Security Administration (SSA), will join OFHEO on October 30. Prior to joining the SSA, DeMarco conducted economic and financial analyses of the GSEs and other financial institutions at GAO, where he developed recommendations on improving the safety and soundness regulation and evaluating the government's exposure to risk at the GSEs. DeMarco received a BA in Economics from the University of Notre Dame and a Ph.D. in Economics from the University of Maryland. OFHEO director James B. Lockhart, III said, "Ed brings to this position a wealth of experience in matters affecting the Government-Sponsored Enterprises (GSEs) and other financial and regulatory institutions. Ed has a broad-based understanding of the financial and operational issues affecting the safety and soundness of Fannie Mae and Freddie Mac and the benefits and risks they present to maintaining vital housing and mortgage finance markets. His leadership will be a strong addition to the OFHEO team." (*OFHEO Press Release*, 10/10/06)

- On October 10, Robert K. Steel was sworn in as the new Treasury undersecretary in charge of policies and legislation affecting Fannie Mae and Freddie Mac. Steel's arrival at Treasury comes at a time when Secretary Henry Paulson is anxious to resolve a legislative stalemate over GSE regulatory reform legislation. Steel replaces Randal Quarles, who is returning to the private sector. (*National Mortgage News*, 10/16/16)

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Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac meet their affordable housing goals

- HUD announced that Fannie Mae and Freddie Mac met the agency's 2005 affordable housing goals. Freddie Mac also met three of HUD's home purchase sub-goals, while Fannie Mae met two of the sub-goals and narrowly missed a third sub-goal. For low- and moderate-income home purchases, Freddie's ratio for 2005 was 46.85% [meeting HUD's subgoal of 45%], while Fannie Mae's 2005 total was 44.59%.

- In 2005, Fannie Mae and Freddie Mac financed 3,581,440 owner-occupied and rental housing units occupied by low- and moderate- income families totaling $431 billion; 1,787,438 housing units occupied by special affordable housing families [very-low income families or families living in low-income neighborhoods] totaling $154 billion; and 3,089,180 housing units located in underserved neighborhoods totaling $388 billion. (*HUD Press Release*, 10/11/06)

Foreign purchases of US debt cuts long term rates about 90 basis points

- According to a study issued by the National Bureau of Economic Research (NBER), foreign purchases of U.S. government and agency debt have significantly reduced long-term U.S. interest rates by as much as 90 basis points. "In the hypothetical case of zero foreign accumulation of U.S. government bonds over the course of an entire year, long rates would be almost 100 basis points higher," according to the NBER study, co-authored by Francis Warnock, a University of Virginia professor and former Fed economist, and his wife, Veronica Cacdac Warnock, a professor in the School of Architecture at the University of Virginia. "The impact on corporate bond rates and long-term (30-year) fixed mortgage rates is very similar to that on the 10-year Treasury yield, but we find that short-term rates are less affected by foreign flows, perhaps because they are deeper markets that are more closely linked to the federal funds rate," said the study. (*Dow Jones Newswires*, Campion Walsh, 10/13/06)

"So what's with Housing secretary Jackson and HUD contractor Abt Associates?"

- In the October 21-22 issue of *National Mortgage News Online*, Paul Muolo wrote, "So, what's with Housing secretary Alphonso Jackson and HUD contractor Abt Associates? Apparently, the HUD secretary has a grudge against the firm. And according to [an] IG report obtained by *National Mortgage News* via the Freedom of Information Act, Abt is the firm hired by HUD to analyze Fannie Mae and Freddie Mac's automated underwriting systems to see if they discriminate against minorities. The Abt study has never seen the light of day. At one time HUD kept the report in a

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secure room to keep proprietary information in it safe." (*National Mortgage News Online*, Paul Muolo, October 21-22, 2006)

"Bumpy" and for some a "downright rocky" correction in the housing market, says Freddie Mac CEO Richard Syron

- Freddie Mac chairman and CEO Richard Syron said the correction we are going through in housing "will not be smooth," and in some markets will be "downright rocky." Syron said, "The correction we're seeing today is in the long run a healthy thing. The double-digit price increases of recent years were unsustainable. This should give incomes a chance to catch up somewhat with prices. There is enough froth coming out of enough markets, however, to affect the broader economic picture. I've been saying for some time now that the slowdown in housing will reduce GDP by about 1 percent. The Federal Reserve Chairman made the same point recently. That's because, along with fewer jobs in housing construction and related fields, robust home equity growth and extraction will no longer drive consumer spending – as it has for the past several years." (*Prepared Remarks of Dick Syron to the Commonwealth Club of California*, 10/18/06)

- In an October 17th speech to the American Bankers Association's Annual Conference, Federal Reserve Governor Susan Schmidt Bies said, "…Growth in housing wealth may slow or stagnate while the debt service obligation continues to rise, as teaser rates expire and fully-indexed loan rates eventually catch up with increases in market rates. While we continue to expect that mortgage delinquencies will remain manageable, lenders should closely monitor future developments." (*Remarks by Governor Susan Schmidt Bies at the American Bankers Association's Annual Conference*, 10/17/06)

- According to Equifax and Moody's Economy.com, 2.33% of mortgages were delinquent on September 30, the highest level since 2003. Foreclosure activity in the third quarter relative to the second quarter of 2006 and was 39% higher than the same period last year. Florida, California, Michigan, Texas and Colorado accounted from 66% of September's foreclosure activity, according to Bargain Network (BN). "Florida and the western states are known for their predominance of negative amortization loans in which mortgage holders pay only interest, not equity, on their properties," said BN president and CEO Tom Adams. According to industry analysts, more than $200 billion worth of adjustable rate mortgages will "reset" at higher rates in 2006 and more than $1 trillion will reset in 2007. (*Business Journal* [Tampa, FL], 10/09/06; *Wall Street Journal*, Ruth Simon, 10/19/06)

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Fannie Mae

Fannie Mae to provide OFHEO its internal review of personnel on October 23

- Fannie Mae is scheduled to provide its regulator an extensive internal review of personnel and board members, as required under its May 23 regulatory agreement. The review, which has been shrouded in secrecy, requires Fannie Mae to determine if current executives and board members should be fired or whether current or former management should have to repay salaries and bonuses. Neither Fannie Mae nor OFHEO would comment to *Dow Jones International News* on this review.

- On October 20th, OFHEO director James B. Lockhart, III said he expects Fannie Mae's internal review of executives and directors to lead the company to order the repayment of bonuses or stock options. "I'm waiting to hear their recommendation and then we'll look at it and see if we agree," said Lockhart. "I don't want to prejudge what they are recommending at this point, but certainly [we] would expect some activity related to bonuses and stock options." He predicted this review would be publicly released "eventually," adding, "[b]ut certainly it has to go through our process to make sure that we agree with whatever is in there." While Lockhart would not say how many people are included in Fannie Mae's report, he did say that former chairman and CEO Franklin D. Raines and former CFO Timothy Howard are not going to be in the company's report. OFHEO is working on a separate report on Raines and Howard and potentially other executives who have left Fannie Mae. Lockhart added that he expects OFHEO will eventually file lawsuits against Raines and Howard to recoup some of the compensation they received during their tenure at Fannie.

- Paul Miller, a managing director at Friedman Billings and Ramsey, said that Wall Street will most likely be watching to see if the report leads to any senior executives being forced from the company. "I think the Street cares if one of these big guys takes a fall," said Miller. Since the Fannie Mae board members have stood behind Mudd, Miller doesn't expect Mudd or any other senior level officials to be fired. "The Street has such a tremendous feeling about Fannie Mae and (rival) Freddie Mac, thinking all their bad stuff is behind them," he added. (*Dow Jones International News*, Damian Paletta, 10/19/06; *Dow Jones International News*, Damian Paletta, 10/19/06)

Fannie Mae lobbyist becomes campaign issue in Tennessee Senate race

- In an October 11th Tennessee [U.S.] Senatorial debate, Republican candidate Bob Corker said, "…I would like for you [Representative Harold Ford Jr. (D-TN)] to explain …that when you went on the Financial Services Committee--the one that Fannie Mae comes in front of, the huge, multi-, multibillion-dollar operation that

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deals with banks, deals with people all across the country for loans--why was it, why was it that within 60 days your dad [former U.S. representative Harold Ford, Sr.] became the registered lobbyist for Fannie Mae -- to lobby you in Washington. …[W]hy was it with all of the things that have happened with Fannie Mae, all the irregularities and billions of dollars that have been lost, why is it that you continue, while you're on that committee, to talk about what a wonderful job they've been doing?"

- Ford, Jr. responded, "Attacking my father has no place in this campaign, Mr. Corker. You came to Memphis and called my family a political machine. I wonder if you feel the same about the Bush family or even former Senator Baker, whose father preceded him in the Congress. My father is too good of a person, too decent of a person and raised me to try to do any of the things my opponent who is now -- I didn't think he'd stoop lower in to the gutter than he has in the campaign but it looks as if rock-bottom hadn't hit there yet. My dad, more any member of my family never lobbied me more would I allow it…" After the debate, Ford Jr. told reporters that he never talked to his father about any Fannie Mae issues while he lobbied for the GSE. "The thing he wanted to dwell on, once again, was my family. …You can't say anything to bring any distance between them and me."

- According to the Corker campaign, Harold Ford Sr. earned at least $280,000 in lobbying fees from Fannie Mae and Ford Jr. took $15,000 in contributions from Fannie Mae PAC and the company's employees. "This creates, at a minimum, an appearance of impropriety," said Corker campaign spokesman Todd Womack. (*CSPAN2*, 10/116/09; 09:32:42; *The Tennessean.com*, Bonna de la Cruz, 10/12/06; *Chattanooga Times Free Press*, 10/11/06)

Fannie Mae announces fourth quarter dividends

- On October 17, Fannie Mae's board of directors declared a fourth quarter dividend of $0.26 a share on the company's common stock, unchanged from the prior quarter. The fourth quarter dividends will be paid to holders of record on October 3, payable on November 27. The board also declared dividends for the company's preferred stock in accordance with the terms of the issues. (*PR Newswire*, 10/17/06)

Lenders are heeding appraisal warnings from Fannie Mae's DU

- According to Fannie Mae director Mark Simpson, more lenders are paying attention to his company's messages about inflated appraisals because these warnings are correct about 66% of the time. When lenders process loans through Fannie Mae's Desktop Underwriter, they receive messages if the appraisal "materially exceeds our value for the property," based upon local market data. "We find that we are right about two-thirds to three-quarters of the time," said Simpson. "We are seeing more of our customers paying attention to this information." (*National Mortgage News Online*, October 14-15, 2006)

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Freddie Mac

Freddie Mac names Buddy Piszel as its new chief financial officer

- Freddie Mac has named Anthony S. "Buddy" Piszel to be its new executive vice president and chief financial officer, effective November 13. Since 2004, Piszel, 51, served as executive vice president and CFO of Health Net Inc., a large managed-health-care company. Previously, he held financial positions with Prudential Financial, Inc, where he helped covert the mutual institution to a SEC-registered, public company, and with Deloitte & Touche and FASB. Piszel succeeds Martin Baumann as Freddie Mac's CFO, who joined the company in 2003 and resigned in early 2006. After announcing his resignation, Baumann joked that his three years at Freddie Mac "felt like six [years]." He said that the challenges going forward at Freddie Mac in required the building of a top-notch accounting infrastructure, which didn't fall within his skill set. In September, Baumann has joined the Public Company Accounting Oversight Board as deputy director of its office of research.

- "Buddy Piszel brings deep financial accounting experience to Freddie Mac," said Eugene McQuade, company's president, COO and interim CFO. "His broad experience, particularly in financial remediation, will be a tremendous asset to Freddie Mac as we continue our ongoing efforts to enhance our internal financial reporting infrastructure and return to timely, GAAP-compliant financial reporting."

- Fox-Pitt, Kelton analyst Edwin Groshans said Piszel would not be able to solve the company's accounting woes alone or overnight. "There is no way he can step in as CFO and start running that from the beginning," said Groshans. The continued involvement of McQuade, who has served as the interim CFO since Baumann left, will be helpful to the company. Groshans added, Piszel "has an enormous amount of learning ...in front of him." (*Washington Post*, David S. Hilzenrath, 10/17/06; *CFO.com*, Stephen Taub, 10/16/06; *American Banker*, William Launder, 10/17/06; *Freddie Mac Press Release*, 10/16/06; *Dow Jones International News*, 10/16/06)

Freddie Mac plans $500 million IPO offering of non-cumulative preferred stock

- On October 11th, Freddie Mac priced an offering of 20 million of preferred shares at $25 a share. The company provided its underwriters [Lehman Brothers, Merrill Lynch, Banc of America Securities, Bear Stearns & Co., Goldman Sachs, J.P Morgan Chase and Morgan Stanley] an underwriting discount of $0.25 per share for an aggregate underwriting discount of $5 million. The issue, which closed on October 16, provides Freddie Mac the option to redeem all or parts of the shares on or after September 30, 2011 at $25 a share plus accrued dividends. (*Freddie Mac Press Release,* 10/10/06*; Freddie Mac Supplement*, 10/11/06; Associated Press, 10/11/06)

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Freddie Mac's purchases of IO loans more than double that of last year

- During the first six months of 2006, Freddie Mac's purchases of interest-only loans comprised 14% of its total loan purchases, double the share of its IO purchases in 2005. While the share of these loans is likely to rise over time, IO loans comprise only 3% of Freddie Mac's outstanding portfolio of owned and guaranteed loans, according to company officials. Although analysts have expressed concern about how these risky loan products will perform in a housing downturn, officials argued that Freddie Mac has placed a set of limits on its purchases and holdings of risky loan types. (*Home Equity Wire*, 10/15/06)

Freddie Mac asks FASB (again) to reconsider a portion of FASB 155

- For the second time, Freddie Mac urged FASB to change FASB 155, governing "embedded derivatives," which they fear will make the holders of mortgage-backed securities record gains and losses on the MBS in their income statements and make earnings more volatile. Freddie Mac has asked FASB to "reconsider" a portion of FAS 155 known as DIG Issue B39. According to Freddie Mac's corporate controller James Egan, this portion of FAS 155 is "highly problematic and not an improvement to financial reporting." Wall Street is anxious for FASB to respond to this issue, since the rule, as written, has already affected the issuance of CMOs, which are collateralized by agency MBS and whole loans. Analysts argue that banks and insurance companies are avoiding CMOs to avoid the complicated financial reporting under FASB 155. Freddie Mac argues that investors will begin buying other types of bonds to avoid the accounting rule, which would raise the yields on bonds and mortgage rates to consumers. FASB is expected to consider industry comments about FAS 155 at October meeting. (*Reuters*, Al Yoon, 10/09/06)

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Federal Home Loan Banks

FHLB-San Francisco exits the secondary mortgage market

- On October 6th, the FHLB-San Francisco announced it will no longer offer new commitments to purchase mortgage loans from its members. Dean Schultz, the FHLB-San Francisco president, said, "Over the coming months, we will work closely with members that currently participate in the Mortgage Partnership Finance Program to complete their outstanding commitments and to ensure a smooth transition. We intend to retain our existing portfolio of mortgage loans, which had outstanding balances of $4.9 billion as of June 30, 2006, representing approximately 2.1% of the Bank's total assets." The Bank's move to withdraw from the MPF program comes as the FHLB-Seattle is terminating its own version of the secondary market, as required by under its supervisory agreement with the Federal Housing Finance Board. (*Dow Jones Newswires*, John Connor, 10/12/06; *Credit Union Journal*, Ed Roberts, 10/16/06)

Federal Housing Finance Board approves temporary excess stock pool for FHLB-Seattle

- The FHLB-Seattle has received regulatory approval to use existing excess stock to capitalize advances, so that its members don't have to purchase additional stock in the troubled Bank. Under the plan, members can tap a shared pool of more than $370 million in excess stock when borrowing from the FHLB during the next two years. The plan comes amid concerns that the FHLB-Seattle may have problems selling its stock and as the Bank attempts to rebuild its advance business following the demise of its MPF program. The proposal received unanimous approval by the Finance Board, but director Geoff Bacino warned that the plan should not be construed as a quick fix for the Bank's financial difficulties. "The Seattle bank didn't get in trouble overnight, and it's not going to be solved overnight," said Bacino. (*American Banker*, Steve Sloan, 10/12/06; *National Mortgage News*, 10/16/06)

Board election results at the FHLBs

- B. Proctor Caudill, Jr., a director of Kentucky Bank, Paris, KY, was elected to the FHLB-Cincinnati's board of directors to serve a three year term beginning in 2007. Billie W. Wade, president and CEO of Citizens Union Bank, and William J. Small, chairman and CEO of First Federal Bank of the Midwest, Definance, OH, were also re-elected to serve a three-year term on the Bank's board of directors. (*PrimeZone Media Network*, 10/19/06)

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- Michael A. DeVico, executive vice president and chief information officer of Salt Lake City-based Zions Bancorporation, has been elected to the FHLB-Seattle's board of directors to serve a three year term. Craig Dahl, president and chief executive officer of Alaska Pacific Bank in Juneau, Alaska, and Russell J. Lau, vice chairman and chief executive of Finance Factors Ltd., Honolulu, HI were also re-elected to serve a three-year term on the Bank's board of directors. (*MortgageWire*, 10/20/06)

Ginnie Mae

Ginnie Mae announces new MBS collateralized by reverse mortgages

- On October 17, Ginnie Mae introduced a new mortgage-backed security product that will be collateralized by home equity conversion mortgages (HECMs), which will an accrual MBS that will not have a payment schedule. The new product, called the HECM MBS, is expected to ride on a wave of 65-and-older retirees that will rise from about 34 million today to more than 70 million by 2030. Ginnie Mae's president Robert M. Couch said the HECM MBS is "an extension of our existing mission to expand access to affordable housing opportunities in America by linking the global capital markets to the nation's housing market. …This MBS will be a new class of Ginnie Mae security backed by HECM loan participations under the umbrella of the Ginnie Mae II custom program." The new products may be sold to investors as a free-standing security or they may be used as collateral for a Ginnie Mae Real Estate Mortgage Investment Conduit (REMIC), he added. According to research, Ginnie Mae's guarantee reduces borrowing costs between 30 and 80 basis points, which should eventually migrate to the HECM market. "A 50 basis-point reduction in borrowing costs would result in a savings of $10,000 over the life of the average HECM loan of $118,000," said Couch. The Ginnie Mae HECM MBS products should be introduced in the marketplace sometime during the current fiscal year. (*Bureau of National Affairs*, Richard Cowden, 10/18/06)

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Farm Credit System / Farmer Mac

ABA fiercely opposes the proposed expansion of FCS's lending powers

- In an interview with *American Banker*, Earl D. McVicker, the incoming chairman of the ABA [and chairman and CEO of Central Financial Corp., Hutchinson, KS], protested the Farm Credit System's recent attempts to expand its lending powers. The FCS, created by Congress in 1916 to ensure that farmers had a reliable source of credit, is exempt from paying federal taxes [but pay state and local taxes] on the income its lenders make from long-term farm real estate loans. McVicker argued that FCS's real estate tax exemption gives the System an unfair advantage when pricing loans to farmers. Moreover, the Farm Credit System is lobbying for the power to make more commercial loans and other loans not directly related to agriculture--changes which the ABA fiercely opposes, said McVicker. (*American Banker*, Ben Jackson, 10/18/06)

Wall Street takes Farmer Mac restatement in stride

- So far, investors seem to be taking in stride the news that Farmer Mac will be restating its earnings for the past three years. Farmer Mac determined that it did not qualify for hedge accounting under SFAS 133 and will eliminate the use of hedge accounting for hedge accounting for its derivatives used to manage interest rates. Although Farmer Mac's share have declined from their recent highs in September, its share price moved only modestly downward after it announced the restatement news on October 6. According to SEC filings, Farmer Mac's CEO Henry Edelman and CFO Nancy Corsiglia exercised options and then sold the shares at profits of $315,350 and $117,032, respectively [before the restatement was made public].

- Robert Coleman, director of the office of secondary market oversight at the Farm Credit Administration, said that his agency has been working closely with Farmer Mac in recent weeks regarding the restatement. "We found that Farmer Mac's operations are fundamentally sound as of the last examination," said Coleman.

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Postal Service

The Postal Service's future is in jeopardy

- In a September 8th letter to Congress, Robert McLean, executive director of the Mailers Council, wrote, "Because the Postal Service continues to see a steady decline in first-class mail volume, postage prices will continue to increase and mailing industry jobs will be eliminated, unless the Postal Service can take the necessary steps to reduce its operating costs."

- USPS spokesman Victor Dubina agreed that changes must be must be made to his agency, which employs more than 704,000 individuals, and operates 37,000 post offices and 450 mail processing centers. According to Dubina, the Internet, higher fuel costs, 1.5 million new addresses a year, increasing employee costs, and a host of other reasons have created challenges that threaten the ability to provide high-quality, universal postal service at affordable rates. In 2001, the Postal Service handled 103.7 billion pieces of first-class mail, but by 2005 that figure had dropped to 98 billion pieces. "Overall first-class mail is down about 5.5% since 2001," he said. [Before the advent of the Internet, first-class mail increased about 3% to 5% annually.]. "If that downward trend continues, and we think it will, something has to change," said Dubina. "The business environment has changed and continues to change," he added. "Postal employees and management see it, mailing associations see it, members of Congress see it, and it scares the hell out of all of us." (*The Register-Herald* [Beckley, WV], Fred Pace, 10/11/06)

Bill Young feels "badly" [sic] that he killed postal reform

- "I feel badly," said William H. Young, president of the National Association of Letter Carriers (NALC), about blocking legislation to overhaul the USPS. However, Young added, his union members were his highest priority, making it impossible for him to accept a provision that would single out injured postal employees for different worker compensation rules than other federal employees. Young said he was trying to contact Senator Susan Collins (R-ME), the chief sponsor of a compromise bill, "to determine where our communications failed."

- In an October 4th newsletter, the Alliance for Nonprofit Mailers wrote, "We are all left scratching our heads. Why did the National Association of Letter Carriers use a minor issue to bring down a bill that contained so much good for their members? They had beaten back every attempt to include provisions harmful to their members and won every important legislative battle. They had won the war. So why did they pull the plug?" (*Washington Post*, Stephen Barr, 10/11/06)

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- *Postcom*, quotes a "postal wag" as saying, "... Bill Young's claim that he is 'sorry' for killing postal reform is the biggest canard [being] passed in Washington. …After all, Young was being advised by George Gould, one of the best lobbyists in town. Young knew full well what he was doing and did so willingly and, I think, eagerly." (*Postcom*, 10/11/06)

- On October 12, NALC announced that long-serving lobbyist Gould will retire at the end of the year. Gould, who joined the union in 1979, previously had a distinguished 15-year career on Capital Hill with his last three years spent as staff director of the House Subcommittee on Postal Operations and Services. (*US Newswires*, 10/12/06)

Devil is in the details on R2006-1

- In an October 18th notice to its members, the Alliance of Nonprofit Mailers wrote, "From a mail classification perspective, R2006-1 is probably the most comprehensive rate case we have ever seen. The USPS designed the case to cover the costs that are directly attributable to each individual class of mail. On September 27, the USPS proposed rules to provide the mailing standards that would accompany the new prices if R2006-1 is adopted. Comments on these sweeping changes are due to the USPS on or before November 13th. Remember, it has been said before that the 'devil is in the details.' " (*Postcom, Association for Postal Commerce*, 10/18/06)

- In an August 30th letter to Deputy Postmaster General Patrick R. Dohahoe, Clifton F. Knight, Jr. Executive EVP of BMG Columbia House wrote, "…[O]perational and classification changes that the Postal Service has proposed will make it impossible for us to remain in the business of selling music and video product by mail." Knight noted that his company currently spends more than $100 million in postage annually for shipping its products. (*Correspondence to Deputy Postmaster General Patrick R. Dohahoe*, Clifton F. Knight, Jr., 08/30/06)

- In *Direct* magazine, postal commentator Gene Del Polito wrote, "The Governors of the Postal Service could easily put mailers' anxiety to rest by simply declaring that no rate changes will be made until mailers have been given sufficient time to accommodate them. Absolutely *nothing* prohibits the Governors from announcing at their next public meeting that new rates will not be implemented before July 2007. …The R2006 rate case is the most complicated change in rates and classifications I've seen in my 23 years within this industry. The case the Postal Service has put together is far from being a slam-dunk over at the Postal Rate Commission. There's anxiety enough over how any business can swallow a 40-90% increase in key postal rates and still remain afloat. The last thing anyone needs is the added anxiety caused by an unnecessary and potentially catastrophic precipitous implementation of new rates and rules." (*Postcom, Association for Postal Commerce*, 10/15/06)

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Dan Blair rumored to be the next chairman of the Postal Rate Commission

- According to *Linn's Stamp News (LSM)*, President George W. Bush plans to nominate Dan Blair, deputy director of the OMB, to be chair of the Postal Rate Commission. "Although the White House has not announced the Blair appointment, three postal industry officials told Linn's the president had selected him for the job," wrote Bill McAllister on *LSM*. Blair is a former aid to Congressman John McHugh (R-NY), who has worked on previous postal reform legislation. He has frequently served as the Administration's spokesperson, who defended the requirement that the Postal Service foot the bill for military pensions for its employees. McAllister's adds, "Blair's appointment to a five-year term is a highly significant move signaling that the administration wants a strong commission to oversee the Postal Service." (*Postalnewsblog.com*., 10/13/06)

TVA

TVA board names Tom Kilgore as its new CEO

- The TVA board of directors has appointed acting CEO Tom Kilgore to serve as the agency's first chief executive officer. Kilgore, a 58-year-old native of Sand, AL who has served as the agency's acting CEO since March, was approved unanimously by the nine-member board. TVA director Skila Harris, chairwoman of the board's Human Resources Committee, said that Kilgore was well qualified for the position, given his three decades experience in both public and private utility management. "[His service as interim CEO] has been a long, very intense interview for Tom," said Harris. Kilgore's compensation will be decided after the board completes a full executive pay study later this year. "It is an honor and an opportunity that I accept with gratitude and humility," Kilgore told the board. He pledged to continue to improve the utility's performance and boost its power generation without adding TVA employees or raising executive pay.

- To help TVA meet power demands during peak periods and limit power interruptions, the utility's board of directors also approved the purchase a mothballed gas-fired power plant near Clavert City, KY. In 2001 and 2002, Duke Energy spent more than $200 million to build the eight-unit, 680-megawatt plant, which was operated less than 200 hours before the facility was closed during to rising natural gas prices. TVA is buying the plant for a fraction of its original cost, but Kilgore declined to disclose the purchase price. The plant acquisition is TVA's first purchase of a power plant since 1984, but will likely not be its last this year. "There are some more (gas-fired plants in and around the Tennessee Valley), and we're going to look at buying some of those," said Kilgore. "We'll be judicious, and we hope to get an even better price on the next one we buy, so we don't want to disclose the price for this plant at this time." TVA also plans to increase its nuclear power generation in

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May 2007, when it returns to service the Unit 1 nuclear reactor at Browns Ferry (near Spring City, AL) for a cost of $1.8 billion. Unit 1 is scheduled to be returned to service in May 2007. By the summer of 2007, TVA also plans to decide whether to finish a second reactor at the Watts Bar Nuclear Plant. (*Associated Press*, Duncan Mansfield, 10/14/06; *Chattanooga Times Free Press*, Dave Flessner, 10/14/06; *Chattanooga Times Free Press*, Dave Flessner, 10/13/06; *Huntsville Times*, Brian Lawson, 10/21/06)

Preserve TVA's natural areas around its lakes and reservoirs,
urges the *Chattanooga Free Times Press*

- In an October 9 editorial, the *Chattanooga Free Times Press* wrote, "The Tennessee Valley Authority's board has seemed overly willing in recent years to sell off prime lakeshore property along its numerous reservoirs to developers eager to exploit it for a profit. That has always seemed contradictory both to TVA's public charter, and to the stewardship responsibility it assumed when the agency, in its early days, seized the land from its owners by eminent domain to serve the public interest. Against that history, TVA's newly expanded board should be commended for considering a proposed policy revision that would ban most such sales."

- "The proposed policy, created by a committee of board members and due for a vote by the full board in November, would preserve 293,000 acres of TVA land for public use. Private residential development and industrial development would be banned on that land. Another 7,000 acres would be earmarked for potential industrial development, and would be sold only for manufacturing businesses to spur economic development. TVA would continue to lease and grant public easements for recreation areas, but would stop deed modifications to allow any more residential development."

- "The proposed policy revision follows months of public hearings and an overwhelming expression of public sentiment in favor of keeping TVA's reservoir land available for public use and recreation. It was not unanimously embraced by the board when it was introduced, however, and it leaves some critics discontented."

- "Officials in Rhea and Meigs counties, for example, view it is an unwelcome reversal which would thwart their attempts -- originally favored by TVA -- to allow residential and commercial development along 1,700 acres of property around the Watts Bar reservoir. TVA board member Bill Baxter also still favors selective development along TVA's reservoirs. He believes the tax income and job benefits that accrue from lakeshore developments -- such as the resort on Tellico Lake, the pending residential development on Nickajack Lake, and the half dozen residential projects allowed along Chickamauga Lake over the past decade -- merit private use of TVA land."

- "That's arguable. Residential development is transient and, in any case, would occur elsewhere if the lakeshore property were preserved for enduring public use and enjoyment. By contrast, the enduring public benefit of keeping the land in the public

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domain is the greater value, and certainly more in keeping with the stewardship responsibility that TVA accepted when it seized the land from its earlier owners -- many of whom fought tooth-and-nail to keep their land."

- "TVA obviously seized more of their land than was strictly necessary for the reservoirs, otherwise the agency would not now have so much land that developers want. Yet if that land cannot be returned to its owners' heirs, TVA should at least retain stewardship responsibility for public use."

- "Indeed, TVA's lakeshore land has become as much a park as the national parks and forests that citizens regularly visit. It is equally treasured by many boaters, paddlers and fishermen for the solace and spiritual retreat it offers. With a rapidly growing population and increasing congestion in parks, that value should not be diminished. Future generations assuredly will treasure the natural spaces and retreats they will find along TVA's reservoirs."

- "It would a deep injustice, and an insult to TVA's founding mission, for TVA's board to negate that immeasurable public value for the private benefit of a few. The proposed policy for preserving TVA's natural areas around its lakes and reservoirs should be unanimously adopted. Citizens here would do well to express their support to the TVA board for the proposed policy." (*Chattanooga Free Times*, 10/09/06)

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