

# The **GSE** REPORT™

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## *Major Events*

Trade groups ask HUD and OFHEO to review Fannie Mae's mortgage origination patent and take steps to require its divestiture

- In a September 19 letter to HUD Secretary Alphonso Jackson and OFHEO director James B. Lockhart, the American Financial Services Association, the Consumer Mortgage Coalition, and The Housing Policy Council of the Financial Services Roundtable (trade associations) expressed their concern about Fannie Mae's acquisition of U.S. Patent No. 7,089,503 B1 (the Patent) which expressly targets borrowers in the primary loan market. The trade associations wrote, "We are writing to request that the Office of Federal Housing Enterprise Oversight (OFHEO) review this Patent, declare that Fannie Mae's acquisition is beyond the scope of the Enterprise's charter authority, and either (1) require that Fannie Mae divest itself of the Patent and place it in the public domain, or (2) prevent Fannie Mae from enforcing or assigning the Patent. We are also writing to request that the Department of Housing and Urban Development (HUD) issue an opinion denying Fannie Mae the authority to apply the processes, systems, and methods described in the Patent to activities in the mortgage loan market, and more general loan markets, on grounds that such new program would not be in the public interest.
- According to the Patent abstract, the company's proprietary software is "[a] computerized mortgage loan system and process [which enables] borrowers to design mortgage loans that meet their particular individual needs and financial goals, and that can be adapted to fit changing needs and goals is provided. The loan requirements of the borrower are obtained and applied to a set of rules for combining loan product features. One or more loan recommendations are determined and presented to the borrower."
- The trade associations wrote, "This Patent is extremely broad and disturbing in its scope. It claims processes, systems, and methods that were in place in the mortgage industry even before the patent was applied for in 2001. The Patent thus serves to increase the dominance of Fannie Mae in the mortgage market, to the ultimate detriment of consumers who depend on a competitive mortgage market for a stream of continuing innovations. In the hands of primary lenders, who work with borrowers directly before delivering the mortgages into the secondary market, computerized loan customization processes are valuable for consumers. In the hands of Fannie Mae, this Patent can be deployed to extend the reach of Fannie Mae's automated underwriting system and connect the Enterprise with borrowers."
- "Fannie Mae was established to carry out public purposes in the secondary mortgage market. Under its charter, it receives substantial government subsidies that the Enterprise is supposed to direct to its secondary market activities. Since thousands of lenders already serve the primary mortgage market efficiently and competitively,

Fannie Mae's charter prohibits the company from engaging in loan origination. As a matter of law, Fannie Mae is permitted to undertake only those activities that are authorized by its Charter Act. The Enterprise is prohibited from undertaking acts that are prohibited by its charter. Loan origination is one such expressly prohibited activity. The Fannie Mae Charter Act, in section 304 (a)(2), 12 U.S.C. § 1719 (a)(2), prescribes that, "The corporation shall not be permitted to use its lending authority...to originate mortgage loans." Another part of that section makes clear that this prohibition applies to loan origination activities that the Enterprise would carry out either directly or indirectly, for example by advancing funds temporarily to a lender to make such loans."

- "In this case, Fannie Mae has acquired a patent that applies directly to mortgage origination. The Patent itself makes this clear: 'Users of the inventive system include potential borrowers (e.g., home buyers), loan originators, which can be mortgage companies, savings and loans or other lending institutions. Desirably, the loan originators also include prospects in the mortgage lending business.' (Patent, column 3, lines 56-60) And again: '...the loan customization process according to the present invention begins when a potential borrower contacts a lender, e.g., online or directly... Desirably, the potential borrower then provides borrower information and property information for input...' (col. 4, lines 17-21) In addition, the Patent makes clear that a 'secondary market participant' (Fannie Mae), not the primary lender, would effectively control all elements of the interaction with the borrower: 'based on the responses and mortgage product feature specifications provided by the borrower, [the system] requests a product recommendation from the secondary mortgage market participant... [T]he secondary mortgage market participant determines one or more product recommendations in response that are customized to meet the goals and requirements communicated by the borrower.' (col. 7, lines 47-54)."
- "The proposed computerized system is intended to engage in numerous activities that are part of the loan origination process:
  - Solicitation of borrower responses to a questionnaire. 'This process can occur at an online location such as the borrower's home or at the lender's office, and the lender can assist the borrower in this process.' (col. 14, lines 1-8)
  - Use of borrower responses to permit selection from among 'a myriad of loan feature combinations. Mortgage loan features open to customization according to the inventive method and the system preferably include, but are not necessarily limited to, interest rate, mortgage loan term, amortization term, loan payments, portability and assumability.' (col. 5, lines 13-18)
  - Permitting the borrower to select additional features such as credit life insurance and a home warranty. (col. 7, lines 20-31)

- Provision of ‘product recommendation(s) and associated retail pricing to the borrower for consideration...The retail price is the “rate” the borrower will pay the lender for the loan.’ (col. 9, lines 33-35)”
- “The system also is designed to support many activities that are also outside of the charter authority of Fannie Mae. One of these is the coupling of a mortgage with securities investment: ‘An investment banker enters the mortgage business in conjunction with third-party service providers by offering a financial planning mortgage that allows borrowers to pay \$100.00 extra per mortgage payment (bi-weekly) for investment in a mutual fund account. Once the balance in the mutual fund account (adjusted for expected capital gains taxes) is equal to or greater than the loan, the borrower is given the option to sell the mutual fund and pay off the loan.’ (col. 12, lines 12-21)”
- “Another activity completely beyond the charter authority of Fannie Mae is to deal in loans other than residential loans: ‘**Although discussed herein in the context of mortgage loans, it should be understood that the present invention is not limited to mortgage loans, but has application with respect to other types of loans.**’ (col. 3, lines 7-10)” (emphasis added)
- *“In summary, the patent has as its purpose the improvement of loan origination, a function that is prohibited by the Fannie Mae Charter Act.”*
- “We very well understand that the grant of a patent does not necessarily allow the owner of the patent to practice its invention. In Fannie Mae’s hands, however, the Patent can chill innovation by others in the mortgage market. ...[I]f Fannie Mae were to practice the invention as described in the Patent, it would be practicing methods and systems that are prohibited by its Charter Act; if Fannie Mae were to assert its rights against someone whom it believed was infringing on the Patent, then it could inflict substantial disruption in the mortgage market; finally, similar harm could result if Fannie Mae were to assign the Patent to another.”
- “Indeed, Fannie Mae has violated its Charter Act merely by acquiring the Patent. As a government-sponsored enterprise, Fannie Mae may exercise only the authority expressly granted by its Charter Act, or authority that is properly incidental to an expressly stated grant of authority in the act. Fannie Mae’s acquisition of the patent was not authorized by any express provision of its Charter Act.”
- “In addition, Fannie Mae’s acquisition of the Patent is not authorized by the incidental powers provision of its Charter Act. That provision, found in Section 309 (a) of the Charter Act, 12 U.S.C. §1723a, authorizes Fannie Mae, ‘to do all things as are necessary or incidental to the **proper** management of its affairs and the proper conduct of its business.’ ...The proper conduct of its business expressly excludes loan origination activities. The acquisition of the Patent is not proper because the Patent is directed at enabling Fannie Mae to engage in prohibited activities. Fannie Mae’s acquisition of the Patent was not authorized by the Charter Act and, because of

its chilling effect on the mortgage market that exists even when Fannie Mae does not yet implement the invention, constitutes an activity that is not properly incidental to any of Fannie Mae's express powers.”

- “It is important to note that OFHEO does have the authority and responsibility to address all violations of law by an Enterprise, even when safety and soundness issues are not involved. Section 1371(a) (3) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act), authorizes OFHEO to take enforcement actions with respect to ‘...any conduct that violates – any provision of this title, the Federal National Mortgage Association Charter Act’ ”
- “What then is the remedy for this violation of the Fannie Mae Charter Act? It has long been settled that acts beyond the limits of an instrumentality's charter act, so-called ultra vires acts, may be void and unenforceable under law. ...In this case, merely requiring Fannie Mae to divest itself of the Patent is insufficient. That is because of the potential of this Patent, if placed into the wrong hands, to stifle innovation and substantially disrupt the mortgage and other loan markets. Especially with complex patents such as this one, the possibility of patent infringement litigation becomes a serious one. That possibility, and the potentially huge damages that might result from an adverse decision, can stifle innovation by other companies to produce systems that similarly increase access by the consumer to customized mortgage products.”
- “...As a result of the danger to innovation that could result from Fannie Mae's assignment of its Patent into the wrong hands, we urge OFHEO, in fashioning an order to deal with Fannie Mae's violation of its Charter Act, to require Fannie Mae to either place the Patent into the public domain (by disclaimer or otherwise) or prevent it from enforcing or assigning the patent. Then the myriad of participants in the competitive primary mortgage market and other loan markets will be able to build upon any innovation claimed in the Patent, innovations that, as mentioned earlier, already existed before the Patent was filed, with innovations of their own. (Please be assured that we are not herein admitting that the Patent is valid and enforceable.)”
- “HUD also has an important role in dealing with this Patent because implementation of the mortgage-related methods and systems claimed in the Patent by Fannie Mae would constitute a new mortgage program subject to prior approval by the HUD Secretary. Note that the designation of this Patent and its application as a “new” Fannie Mae program does not imply that the processes, systems and methods are new to the mortgage industry; rather, the program is new merely for Fannie Mae. ...Section 304 of the Fannie Mae Charter Act expressly prohibits Fannie Mae from engaging in the loan origination activities contemplated by this Patent. For that reason alone, HUD should disapprove any application of this patent by Fannie Mae as being in violation of Section 1322 (b)(1)(A).”
- “In addition, Fannie Mae's application of the methods and systems claimed in the Patent also would be a violation of Section 1322 (b)(1)(c) on grounds that it is not in

the public interest. Loan origination, including core functions claimed in this Patent such as assisting consumers to select an appropriate mortgage and pricing that mortgage for the borrower, is a part of the market that is already well served by thousands of primary lenders. This is a strong contrast to the secondary market that Fannie Mae and Freddie Mac dominate as a shared monopoly. There is no doubt that a mortgage program based on this Patent that helps Fannie Mae to deploy its market power into the primary market, thereby displacing activities of competitive firms, would be anticompetitive and therefore against the public interest, if not altogether unlawful. Essentially, the Patent will allow Fannie Mae to expand significantly its monopoly control; the tie-in of each home loan to secondary market pricing effectively eliminates competition. This is anti-competitive and will work to the detriment of the industry and consumers alike.”

- “Finally, Fannie Mae benefits from an exemption from the privacy laws that apply to primary lenders. Fannie Mae could use this Patent to permit data mining and cross-selling of nonmortgage products to consumers based on information that would be protected by the privacy laws if it were done by a primary lender. For this reason too, a mortgage program based on this Patent would be against the public interest.”
- “It is important that HUD act now to notify Fannie Mae and the public that any application by Fannie Mae of the methods and systems of this Patent is disapproved effective immediately. ...Action now can make clear that any use by Fannie Mae of the methods and systems of this Patent is hereby disapproved, before the Enterprise has a chance to raise external expectations, build a political constituency, and rapidly deploy applications of the Patent’s methods and systems on a large scale.”
- “The market would have been best served if Fannie Mae had not acquired this Patent in the first place. Now that the Enterprise has acted against the terms of its charter, OFHEO and HUD will need to assure that Fannie Mae does not use the methods and systems claimed in the Patent, directly or indirectly, to stifle competition from lenders in the primary mortgage market that Fannie Mae constantly seeks to dominate.”
- “...[O]ther companies may be deterred from continuing their own technological improvements in loan origination. Fannie Mae’s Patent is drafted well: it is extremely broad in its claims and extensively detailed in particular aspects of the loan process that it seeks to replace. Few firms can afford the threat that a holder of this Patent (and Fannie Mae could easily choose some market ally to take an assignment of the Patent for this purpose) would litigate on grounds that particular patented loan origination processes constitute patent infringement. ...That is true even for companies that used the processes, systems, and methods described in this Patent before Fannie Mae applied for the Patent. ...[P]laced in the wrong hands, this Patent could be used to disrupt improvements in the origination process and in the mortgage and other loan markets that are being made currently by the numerous primary lenders that see Fannie Mae as a competitor that is increasingly displacing their functions.”

- “To avoid this kind of massive disruption of innovation in the mortgage market, OFHEO and HUD must require Fannie Mae, as a part of a remedial order, to either assign its Patent to the public domain (by disclaimer of the remaining term or otherwise) or prevent it from enforcing its Patent or assigning it to another. The industry will then be able to continue to improve their loan origination processes without fear of litigation.”
- “Given the broad nature of this Patent and its coverage of so many parts of the loan origination process, remedial action by OFHEO and HUD is a matter of considerable urgency. We respectfully request that you act immediately to deal with this issue.”  
(*Correspondence to Secretary HUD Alphonso Jackson and OFHEO Director James B. Lockhart, III, American Financial Services Association, Consumer Mortgage Coalition, and The Housing Policy Council of the Financial Services Roundtable, 09/19/06*)

**(Editor’s Note: As noted above, the Patent applies to *all* loans (auto, credit cards, commercial, etc.), not just mortgage loans. In addition, it is important to understand that the Patent applies to all loans originated, not just those loans that Fannie Mae decides to guaranty and/or purchase for their own portfolio.)**

Department of Justice’s criminal investigation of Freddie Mac “apparently over”
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- According to Freddie Mac officials, the Department of Justice’s investigation of the company has been dormant for the past two years and “apparently is over.” “The U.S. attorney’s office has not initiated contact with us in well over two years, and it is our understanding that the matter is inactive,” said company spokesman David R. Palombi. “Accordingly, we expect no further action in this matter. It is Freddie Mac’s understanding that it is the practice of the U.S. attorney’s office for the Eastern District of Virginia neither to issue official notices nor to confirm publicly the conclusion of an investigation.” It is not known if the SEC will bring any civil charges against Freddie Mac or its former executives. The *Washington Post*, citing unnamed sources familiar with the investigation, said that attorneys for Freddie Mac’s former CEO Leland C. Brendsel, former president David Glenn, and former CFO Vaughn A. Clarke have not been contacted by the Justice Department since 2004. However, OFHEO spokeswoman Stefanie Mullin said that the agency “is pursuing enforcement actions against former Freddie Mac executives,” but declined further comment. (*Washington Post*, Terence O’Hara, 09/12/06; *Townhall.com*, 09/12/06)

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

“Don’t think” we’ll have a deal on GSE reform legislation before November,  
says Senator Shelby

- Senate Banking Committee Chairman Richard Shelby (R-AL) said he does not expect an agreement on GSE regulatory reform legislation before the coming mid-term elections. “I don’t think we’re going to get an agreement before the end of next week [September 29],” Shelby said, referring to the day Congress will adjourn for the November 7 elections. “There is a chance we could get an agreement during the lame duck session,” he said. “Maybe.” The lame duck session, which is expected to begin the week of November 13 for one week and “likely” several weeks in December, is expected to focus largely on completing the 2007 spending bills. Shelby reiterated that Treasury Secretary Henry Paulson is playing an important role in trying to broker a deal on the GSE reform bill. “He’s been helpful. We’re waiting for Paulson to get back from China,” said Shelby. “We’re still talking. We’re still trying to see if we can work something out.” He added, “I think it’s going to be up to Paulson, speaking on behalf of the administration, what they are willing to do and make some recommendations to us.” A spokesman for Senate Majority Leader Bill Frist (R-TN) said that leadership was “listening closely to Senator Shelby” about a possible compromise on GSE regulatory reform legislation.
- Senator Paul Sarbanes (D-MD), ranking member of the Senate Banking Committee, told reporters [on September 19] that he was waiting to hear new proposals on GSE reform from the Treasury Department. “We’re quite happy to look at anything that comes along,” said Sarbanes. On September 18, Treasury Department and White House officials met with the Senate Banking Committee’s Democratic staff to discuss the stalemate over GSE regulatory reform legislation. The meeting came a week after meetings on Capital Hill in which the Bush administration softened its position on provisions to restrict the GSEs’ portfolios along the formulation contained in the House bill and giving the new GSEs’ regulator the authority to issue a rulemaking that would govern Fannie’s and Freddie’s asset growth. Some Democrats, including Representative Barney Frank, have shown an interest in the proposed compromise. However, Sarbanes has not indicated whether he is ready to deal with Shelby to reach a compromise.
- Senator Christopher Dodd (D-CT) said he urged Paulson to consider the House bill. “I would hope that they could take up the House-passed bill here [in the Senate]” said Dodd. “We could bring up that, adopt the House-passed bill, and the President would have a good bill-signing ceremony.” Dodd is in line to become the ranking Democrat on the committee [and possibly its chairman], following Sarbanes’s retirement this year.

- In an interview with the *Wall Street Journal*, Treasury Secretary Henry Paulson said that the Bush administration has clearly communicated a willingness to compromise with Congress to achieve a compromise on GSE regulatory reform legislation. “They’re not waiting for me, or for the administration because we’ve indicated a willingness to work something out,” said Paulson in between meetings with Chinese officials. “So the key question is whether people can get together on both sides of the aisle and get together in the House.”
- Representative Barney Frank (D-MA), ranking member of the House Financial Services Committee, said “I think there is a chance in the lame-duck session [to pass GSE reform bill]--we could do that.” When asked by reporters how Republicans’ concerns about the affordable housing fund provision could be resolved, Frank said “We’ll come up with some alternative ways. There are other ways. You could give it to state housing financing agencies. Housing trusts.” He added, some Republicans “feel that [the provision] would give a lot of people an incentive to make Fannie and Freddie more profitable. I think that’s silly, but if I were to object to everything that was silly...., I’d be too busy to talk.” To reach a suitable compromise, Frank said it was simply a matter of restructuring the formula to generate funds. “We’re looking for an alternative metric that will produce roughly the same amount of money,” he said. “If we can work out the powers for portfolio limitation, then the 5 percent [AH fund] will [fall into place]. That’s literally the only thing left,” he added. Frank said that Sarbanes, who is not interested in negotiating on the portfolio restriction, has asked Senator Jack Reed (D-RI) to see if a deal could be reached. “Jack Reed and I have been in conversation, and both Sarbanes [and Oxley] have essentially said Jack and I can work this out,” said Frank.
- In September 14 letter to the leadership of the Senate Banking Committee, 64 of the 70 members of the House Financial Services Committee urged them to find a “creative compromise” to resolve outstanding differences in the GSE legislative debate. “This Congress should not close without addressing the serious inadequacies of the current GSE regulatory system,” wrote the House members.
- Freddie Mac treasurer Timothy Bisberger said it was “significant” that the Treasury Department had backed away from its position that the GSEs would be required by law to slash their mortgage holdings. “[Freddie Mac is] very hopeful that we can get to a legislative conclusion pretty quickly,” he said, said it was doubtful that a bill could be passed before Congress goes into recess.
- Most observers see the recent movement on GSE legislation as a last-ditch attempt to revive the bill before Congress’s September 29 adjournment. Several sources expressed doubt that Sarbanes, who retires at year end, has much incentive to reach a compromise with his party widely expected to pick up seats during the November 7 election. Democrats could gamble that they will regain control of the House in November, and if they do, they would be sure to draft a substantially different GSE reform bill in 2007, said a financial services group lobbyist. If the Democrats fail to

win back the House, they may have forfeited their best chance to reach what they consider a suitable compromise for the foreseeable future, the lobbyist added.

- “We’ve got about three weeks,” said Josh Rosner, an analyst with Graham Fisher. “It’s in everybody’s interest to look conciliatory,” said Rosner, “but whether the Democrats or Republicans win the midterm [elections] will define where it goes from here.” (*American Banker*, Joe Adler, 09/21/06; *Dow Jones International News*, Damian Paletta and John Godfrey, 09/19/06; *American Banker*, Stacy Kaper, 09/20/06; *Bureau of National Affairs*, Richard Cowden, 09/18/06; *American Banker*, 09/18/06; *Dow Jones Newswires*, Damian Paletta, 09/19/06; *Dow Jones Newswires*, Allison Bisbey Colter, 09/19/06; *American Banker*, Stacy Kaper, 09/15/06; *Dow Jones International News*, Damian Paletta, 09/18/06; *Bureau of National Affairs*, Richard Cowden, Karen L. Werner, and Nancy Ognanovich, 09/22/06; *Wall Street Journal*, Michael M. Phillips and Elizabeth Price, 09/21/06; *Market News International*, John Shaw, 09/21/06; *Bureau of National Affairs*, Heather M. Rothman, 09/22/06; *Reuters*, 09/19/06)

Need for GSE regulatory reform legislation is urgent, says OFHEO director Lockhart
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- At an American Enterprise Institute Forum, OFHEO director James B. Lockhart, III outlined what is at stake if GSE regulatory reform doesn’t pass this year. The GSEs believe that a stronger regulator would strengthen their creditability and GSE legislation would lessen the uncertainty that the GSEs and their shareholders face. The status quo means that the uncertainty will continue. If Congress fails to act, OFHEO will not have bank regulator-like powers, such as explicit legal authorities of receivership, independent litigation authority and better enforcement powers. If Congress fails to act, OFHEO will not be sufficiently independent. The agency will continue to be funded through the appropriations process, even though it is funded by the entities it regulates and has no budget impact. As a result, the agency will continue to face uncertainties, such as continuing resolution freezes, and political battles of unrelated budget matters. Without new GSE legislation, mission and new product authority will remain separate, leaving OFHEO in the difficult position of considering only safety and soundness elements of activities that could be in violation of the GSEs charters. If Congress fails to act, capital requirements for Fannie and Freddie will continue to be inflexible, which weakens OFHEO’s ability to strengthen regulation of the GSEs. Without new GSE legislation, the growth of Fannie and Freddie will continue unrestrained and systemic risk will continue to grow.
- Lockhart continued, “Despite the growing consensus about the need to constrain the Enterprises’ growth, some argue against any limits. For example, the Enterprises agree that they need legislation creating a stronger regulator in order to restore the market’s confidence in them, but they do not support specific growth limits. My belief is that a key part of restoring confidence is to convince the markets that they will never grow out of control again. Reform opponents say that limits would hurt their ability to support the secondary mortgage market and to fulfill their liquidity,

stability and affordability missions. However, neither the Senate nor House bill limits their major business of buying mortgages and then packaging them with guarantees for securitization. These mortgage backed securities (MBS) not owned by the Enterprises total about \$2.6 trillion or 26 percent of the total U.S. mortgage market. Less than 30% of the Enterprises' combined retained mortgage portfolios of \$1.4 trillion is not needed to fulfill their very important mission. About 54 percent of their portfolios are invested in their own MBS, which receive no additional credit toward their affordable housing goals and are easily saleable. A significant percentage of their private label MBS and whole mortgages do not qualify as supporting affordable housing."

- "As for market liquidity and stability, an active trading capability coupled with a inventory of securities backed by the ability to expand rapidly to cope with market liquidity emergencies should serve those purposes. This expansion capability should only be granted for short periods, after which portfolios would gradually return to their previous size in an orderly fashion."
- "Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the systemic risk elsewhere. If the portfolios downsizing were handled through normal repayments and a gradual sell-off, I believe, along with many experts, that the market impact would be small. The driver of their portfolio growth until recently has been the increased investment in their own MBS... However, over the last two years, the Enterprises' agency MBS portfolios shrank by over \$280 billion without market disruption."
- "Some of the proceeds from the sale of these investments were used to repay Enterprise debt. In many cases, investors may have replaced Fannie and Freddie direct debt with higher-yield MBS guaranteed by the Enterprises with no change in outstanding debt in the market place. Obviously, there would be less concentration of the market if other investors bought the divested securities. Many of the new investors may be better capitalized than the Enterprises. They also may be better able to take the risk of longterm mortgage assets which might lessen the need to utilize the derivative markets."
- "There is a large and growing international demand for agency MBS. The benefits of the Enterprises' large asset portfolios are limited, but the risks are significant. It should be noted that despite the higher risk and volatility of their mortgage portfolios than their basic MBS business, the returns on equity are very similar. Mortgages, especially fixed-rate mortgages, have complex and difficult to anticipate payment patterns requiring extensive hedging activities. For example, despite no growth in their portfolios this year one of the Enterprises' derivative book has grown by over \$100 billion. The interest rate risk in its portfolio caused massive losses to Fannie Mae in the early 1980s and more recently in 2002, and the operational risk in their portfolios has caused serious problems for both Enterprises in recent years."

- “Their \$5.5 trillion size and importance to housing finance markets, counterparties, and holders of their securities combined with high leverage ratios, concentration, lack of market discipline, and lack of bankruptcy or receivership provisions, present significant systemic risk to the financial markets. Weighing the benefits and the risks, it seems clear that Enterprise mortgage portfolios should be much smaller. Over time that shrinkage should enhance their mission.”
- “The bottom line is that without legislation an important component of the rebuilding of the Enterprises will be missing. They need to be strengthened to deal with changing markets and so does the regulator. Other regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved or where prudential regulatory action is needed. Improved capital requirements and portfolio limits - - particularly those set forth in the Senate bill, with added flexibility - - could significantly reduce systemic risk while also reducing market, credit and operational risks.” (*The Urgency of GSE Reform: What’s at Stake*,” James B. Lockhart, III, 09/13/06)
- In an interview with *Mortgage Banking*, OFHEO Director James B. Lockhart, III reiterated that Fannie Mae’s and Freddie Mac’s state of affairs is terrifically worrisome. “They have about \$2.6 trillion in guaranteed MBS [mortgage-backed securities] outstanding, and they own another \$1.4 trillion of mortgage assets, whether they’re MBS or home mortgages. And they have about \$1.5 trillion in debt and \$1.3 trillion in derivatives to hedge the difference between the debt and the investments. And they’re very large,” said Lockhart. “So, very small capital supporting very large positions. And their eggs are all in one basket, if you will, because it’s all in the mortgage market.” *Mortgage Banking* reporter Louise L. Schiavone observed, “It used to be that that kind of talk was derided by senior executives at Fannie and Freddie, undercut in whispers by the best Washington lobbyists money can buy, and ignored by many in Congress-courted, as they were, by corporate largesse. [However,] James B. Lockhart III is an elegant, assertive, yet soft-spoken Ivy League brainiac with a specialty in corporate risk management. It could be argued that President Bush’s decision to appoint Lockhart at this juncture was inspired.” (*Mortgage Banking*, Louise L. Schiavone, 09/01/06)

<p>Treasury re-iterates its plans to rein-in Fannie and Freddie if GSE reform legislation is not passed by Congress</p>
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- In a September 19 speech before the National Association of Federal Credit Unions, Emil Henry, assistant secretary for financial institutions, said that the Treasury Department is mulling ways to rein-in Fannie Mae and Freddie Mac, if Congress fails to pass GSE regulatory reform legislation. “We have argued strongly that these concerns need to be addressed and that the best way to do so is through a legislative solution,” said Henry. “The Treasury will remain engaged on this important, principled issue and is reviewing options in the event there is no legislation before

Congress lets out prior to the November elections.” (*MarketWatch*, Robert Schroeder, 09/19/06)

- U.S. Treasury and Federal Reserve Board officials met on September 21 to discuss the rules governing how Fannie Mae and Freddie Mac access the debt markets, sources familiar with the meeting said. The Treasury Department, which has asserted that it has the authority to approve the issuance of Fannie’s and Freddie’s debt because they are GSEs, started a formal review of its debt approval process in June which is ongoing. At the September 21 meeting, Treasury and Fed officials discussed their concerns about the GSEs’ level of debt, which some say is dangerously bloated. (*Reuters*, 09/21/06)

Freddie Mac chairman and CEO Syron rejects Treasury’s systemic risk argument

- During a question and answer session at Lehman Brothers Financial Services Conference, Freddie Mac chairman and CEO Richard Syron rejected claims by Republican lawmakers and Treasury Department officials that government-sponsored enterprises pose a “systemic risk” to the financial markets. “I don’t agree with the systemic argument vis-à-vis the GSEs,” said Syron. One of the biggest risks facing the mortgage finance markets is prepayment risk, said Syron. Freddie Mac distributes that risk by selling mortgage-backed securities to more than 1,000 investors instead of allowing the mortgages to be concentrated in just a few investors, he added. “From a systemic perspective, the situation would be more difficult - not less difficult - without the GSEs,” Syron said.
- Syron also noted critics concerns about the size of Freddie Mac’s and Fannie Mae’s mortgage portfolio which total more than \$1.4 trillion. While he conceded that the GSEs are large, Syron said there were other “very, very large” financial services companies.” The way you’ve got to handle that concern about the size of institutions is through appropriate supervision and regulation,” said Syron. (*Dow Jones Newswires*, Damian Paletta, 09/12/06)

“Freddie, Fannie need reins,” says *Orlando Sentinel*

- In a September 16 editorial, the *Orlando Sentinel* wrote, “Congress needs to rein in Fannie Mae and Freddie Mac... Nonprofit [sic] and federally chartered, neither is subject to the regulatory requirements and scrutiny of most private companies. And there have been multibillion-dollar accounting scandals at both in recent years. Congress created Fannie Mae and Freddie Mac decades ago to expand homeownership by pumping money into the mortgage market. The two companies were to buy mortgages from banks and resell them to investors. But both have amassed their own investment portfolios worth more than \$700 billion each. Fannie Mae has grown into the second-largest financial institution in the country. Another

episode of financial mismanagement at either company could rock the housing market and the broader economy.”

- “Last year the House passed a bipartisan proposal to create a new federal regulator for the two mortgage giants and give it discretion over the size of their portfolios. The Senate Banking Committee passed a tougher proposal to restrict, upfront, the size and kinds of assets the companies could hold. But opposition from Senate Democrats, concerned that the restrictions could diminish the availability of affordable housing, has stalled the bill from coming to a vote on the floor.”
- “Those concerns are valid but shouldn’t block the Senate from passing a bill and entering talks with the House on a compromise. Without stronger oversight, Fannie Mae and Freddie Mac pose an unacceptable risk to the economy.” (*Orlando Sentinel*, 09/16/06)

Facing the facts on Fannie Mae and Freddie Mac
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- In a recent *Forbes* article, Peter J. Wallison, resident fellow at the American Enterprise Institute, wrote, “Until recently, the Democrats on the [Senate] banking committee had never made clear why they opposed restrictions on the size of the portfolios. But now, in a recent statement of ‘Additional Views,’ they have finally declared their reasons for holding up the committee bill. ‘The retained portfolios of Fannie Mae and Freddie Mac help keep interest rates low; they have helped markets function effectively, even when other sectors experienced severe credit crunch problems; and they attract funds from all over the world to be invested in the U.S. mortgage markets,’ the Democratic Senators reported. Perhaps not surprisingly, this is exactly what Fannie and Freddie have been saying in their intensive lobbying campaign to fight restrictions on their highly profitable mortgage portfolios. Trouble is, none of it’s true.”
- “...Do Fannie and Freddie’s portfolios of mortgages and mortgage-backed securities keep interest rates low? No, according to the Federal Reserve economists. Reviewing the actual impact on mortgage interest rates of the two companies’ purchases of mortgages and mortgage-backed securities, the economists could find a difference of only two basis points (1/50th of 1%) attributable to the activities of Fannie and Freddie. So their purchasing activities, the Fed economists concluded, ‘have economically and statistically negligible effects on mortgage rate spreads.’ In other words, they noted, the effect on interest rates was ‘not statistically different than zero.’ ”
- “Have Fannie and Freddie helped markets function effectively, when other sectors experienced severe credit crunch problems? No again. If their purchases of mortgages and mortgage-backed securities during the 1998 credit crunch had any effect in stabilizing the market, it would have shown up in moderated interest rates. But while the two purchasers bought these investments during this period—as profit-

maximizers would—their purchases again had no significant effect on interest rates, according to the Fed economists. So, they note, the Fannie and Freddie ‘portfolios do not influence rates either in normal or abnormal times.’ ”

- “Well, then, do Fannie and Freddie’s portfolios attract foreign funds to the U.S. residential mortgage markets? Nope. The Fed economists did not deal with this question, but a front page article in *The Wall Street Journal* almost one year ago headlined ‘Housing-Bubble Talk Doesn’t Scare Off Foreigners; Global Investors Gobble Up Mortgage-Backed Securities, Keeping Prices Strong.’ The article noted that ‘overseas investors are the fastest-growing source of demand. ... The foreigners’ holdings rose 26% last year and have continued to bound ahead so far this year.’ In other words, Fannie and Freddie’s portfolios--and the debt issuance they entail--are not necessary to attract foreign investment to the U.S residential mortgage market. ...The Fed economists agree that issuing mortgage-backed securities rather than accumulating and holding portfolios of mortgages is the right course for Fannie and Freddie.”
- “Summing up their views, they note that Fannie and Freddie could perform their missions without issuing the debt that’s necessary for them to acquire their huge mortgage portfolios. Instead, they can simply issue the securities, which do not require them to take the interest rate risk that is the basis of the enormous risks they create for the taxpayers and the economy.”
- To use a current cliché, these are inconvenient facts. But will they make any difference to the Senate Democrats? John Maynard Keynes was once chided for changing his views, to which he is said to have replied, ‘When the facts change, sir, I change my mind. What do you do?’ ” (*Forbes*, Peter J. Wallison, 09/15/06)

Unless there is a dramatic fall in housing prices, it is unlikely that the 30-year fixed rate mortgage--and the GSEs-- will dominate the mortgage market
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- In a September 18 telephone conference, analyst Nancy Vanden Houten of Stone & McCarty Research addressed the factors contributing to the slower growth in GSEs balance sheets and their prospects for growth. She noted that Fannie Mae and Freddie Mac have faced significant competition in the market for mortgage assets that they invest in from commercial banks, which have increased their holdings of mortgage-backed securities to record levels, and foreign investors, who have increased their investments in both MBS and corporate securities, secured by mortgage assets.
- Over the past three years, Vanden Houten said that there have been dramatic changes in the mortgage market with the rise of “affordable mortgage products” such as interest only and Alt-A mortgages. While there may be some retrenchment by lenders in the origination of nontraditional mortgages due to regulatory concerns, she

anticipates that there will continue to be strong demand for affordable mortgage products, such as hybrid-option ARMS and 40-year mortgages. In the short-term, there may be a wave of refinancing of nontraditional mortgages as interest rates rise, Vanden Houten anticipates that some portion of the loans will be refinanced, using affordable products. Unless a dramatic decline in house prices occurs, Van Houten concluded that it is unlikely that the 30-year fixed rate mortgage will be the dominant mortgage product in the future, which will further diminish the GSEs' dominance in the mortgage market in the future. Vanden Houten anticipates that Fannie Mae and Freddie Mac will try to make more inroads into the non-traditional mortgage market in the future. (*Outlook for Fannie Mae and Freddie Mac telephone conference, Nancy Vanden Houten of Stone & McCarthy Research Associates, 09/18/06*)

OFHEO's analysis of Fannie Mae's and Freddie Mac's participation  
in the subprime and alt-A markets

- In a September research report titled *Mortgage Markets and the Enterprises in 2005*, OFHEO wrote, "Fannie Mae and Freddie Mac continued to be active in the markets for subprime and Alternative-A mortgages and MBS backed by those loans in 2005, but the Enterprise presence in the market was lower than in 2004. According to *Inside Mortgage Finance*, the Enterprises purchased \$169 billion in subprime MBS in 2005, representing 33 percent of those securities issued, down from \$176 billion in purchases in 2004, which accounted for 44 percent of 2004 issuances. Freddie Mac reported purchasing approximately \$49.7 billion of A- loans in 2005, up from \$36 billion in 2004. Fannie Mae reported purchasing \$23 billion of Expanded Approval/Timely Payment Reward Mortgages in 2005, up from \$18 billion in 2004. Under the Timely Payment Reward program, the interest rate on an A- loan is initially higher but is reduced if the borrower makes payments on time for 24 consecutive months. Fannie Mae also purchased approximately \$56 billion of low-documentation loans— mortgages to borrowers with good credit who chose to avoid the normal paperwork associated with getting a mortgage—in 2005, up from \$49 billion in 2004. Freddie Mac purchased approximately \$21 billion of low-documentation loans in 2005, up from \$15 billion in 2004." (*Mortgage Markets and the Enterprises*, OFEHO Office of Policy Development and Research, Valerie L. Smith, Forrest Pafenberg, and Laura Goren, September 2006)

Just how hard a landing will we have in the housing market?

- In a September 12 speech at Lehman Brothers Financial Services Conference, Freddie Mac chairman and CEO Dick Syron said the slow-down in the housing market has many policy makers and market participants wondering if we will achieve a soft landing or something perhaps "rougher." Clearly the rapid pace of home sales and price appreciation experienced from 2001 through 2005 had moderated, he said. "We do expect home appreciation to slow from the double-digit growth last year, and for home sales and housing starts to follow suit," he added. "At the levels we anticipate,

2006 would come in pretty much like 2003, or about the third best year for housing ever.” Should the growth of home prices slow or go negative, Freddie Mac is well diversified from credit shocks and its guarantee business is in position to weather even a harsh credit environment, Syron assured investors. On balance, Freddie expects that “the recent choppiness in regional house prices trends will continue with some MSAs and local markets seeing year over year declines while others continue to chug along,” said Syron. “...We will continue to be active across the entire US, throughout periods of weakness, and will not pull out of declining areas. This is a fundamental aspect of our mission and we will continue to perform it.” (*Prepared remarks by Richard Syron, chairman and CEO of Freddie Mac, 09/12/06*)

- In a Senate subcommittee on the housing market, housing economists cautiously assured the panel that the inflated housing sector is not about to “burst,” but agreed that a rapid market correction is underway. David F. Seiders, chief economist for the National Association of Home Builders, said “We should avoid doing anything that might move the mortgage rates up,” warning that taking to “Draconian” measures to rein in Fannie Mae’s and Freddie Mac’s mortgage portfolios could push interest rates higher. [In a speech at an event sponsored by American Enterprise Institute, OFHEO director James B. Lockhart, III countered that argument by saying “...I would argue just the opposite. First, softening (in the real estate market) is not a result of lack of mortgage funds, but rather it is a natural deceleration due to the fact that appreciation rates have exceeded income growth rates for the last several years. Secondly, if the market experiences more credit losses, the companies must be strong and the oversight of them must be stronger which is what the (GSE regulatory reform) legislation currently pending in Congress is all about.] (*Bureau of National Affairs, Richard Cowden, 09/14/06; The Urgency of GSE Reform: What’s at Stake,* James B. Lockhart, III, 09/13/06)
- Merrill Lynch economists believe that housing prices could decline by 5% next year, which could push the United States toward a recession. “The much-vaunted housing market correction, which has finally hit the U.S. economy, has the potential to pull the U.S. to the brink of recession by early 2007,” wrote to Merrill Lynch’s global economic team. “Merrill Lynch expects an outright decline in housing prices of about 5% next year.” Housing has become “extremely overvalued” by 20% to 40%, they warned. Moreover, new home construction could be in for a prolonged slump. “Judging from past experience, housing starts decline by 50% peak-to-trough, and the correction lasts well over two years,” said the Merrill economists. (*Mortgage Wire, 09/18/06*)
- In a September 17 editorial, the *New York Times* wrote, “The housing boom would never have lasted as long as it did if mortgage lenders had to worry about being paid back in full. But instead of relying on borrowers to repay, most lenders quickly sell the loans, generating cash to make more mortgages. For the past few years, the most voracious loan buyers have been private investment banks, followed by government-sponsored housing agencies, like Fannie Mae. The buyers carve up the loans into mortgage-backed securities — complex i.o.u.’s with various terms, yields and levels

of risk. They then sell the securities to investors the world over, at breathtaking profit. The investors earn relatively high returns as homeowners repay their mortgages. The process has encouraged homeownership and created wealth. But there is a downside, too, which demands attention.”

- “As the boom thundered on, the pool of available credit grew larger than the pool of creditworthy borrowers, resulting in an explosion of risky mortgages with features like no money down, interest-only payments and super-low teaser rates. Investors — including mutual funds, pension funds, hedge funds, insurance companies and foreign central banks, to name a few — currently hold \$2 trillion in mortgage-backed securities from investment banks, triple the amount from three years ago. Investors also own \$4 trillion in mortgage-backed securities from government-sponsored agencies. In a market so vast and dynamic, everyone knows that if mortgage defaults should rise, damage could reverberate throughout the financial system. So far, defaults have inched up. But many homeowners are at a dangerous juncture. Interest rates on adjustable mortgages are rising as home values are weakening, precluding for many the chance to refinance. Economists calculate that \$750 billion of outstanding mortgage debt is now at measurable risk of default — about 7 percent of the total.”
- “No one can predict the depth of the housing slowdown or its effect on the global economy. Even the Federal Reserve has taken, for now, a wait-and-see approach. Meanwhile, markets seem to take comfort in the belief that if housing hits the skids, the Fed would exert damage control by aggressively lowering interest rates. There is no guarantee, however, that interest-rate easing would have the same powerful effect it had in the past. What if it didn’t? Market makers and central bankers don’t talk about that, for fear of unleashing a self-fulfilling prophecy. But we sure hope someone in charge has a fallback plan.” (*New York Times*, 09/17/06)
- In a recent letter to investors, Gilchrist Berg, founder of Water Street Capital [\$2 billion hedge-fund firm], said that Fannie Mae could lose \$22 billion to \$29 billion if the housing bubble bursts, causing subprime foreclosure loss rates to rise to between 6% and 8%, as he expects. “We are not sure the folks running the show fully embrace the risk of declining house prices,” wrote Berg. If the housing market continues to decline “a major portion of Fannie Mae’s value could be wiped out.” Berg’s estimated losses of \$22 to \$29 billion represents more than half of Fannie Mae’s capital, estimated at approximately \$40 billion at the end of March, according to OFHEO. Berg, who declined further comment, has been shorting Fannie stock since the summer of 2003
- Some experts argued that when Fannie purchases subprime MBS, it usually only buys triple-A-rated tranches. Fox-Pitt, Kelton analyst Ed Groshans estimated that if losses in these pools of mortgages reached 10%, investors in the triple-A tranches would still get all their interest and principal back. “Higher interest rates will cause more people to go delinquent on their mortgages, but not enough to push losses on these pools over 6%,” Groshans added. Berg said most analysts and investors are underestimating the impact of the unwinding of the “historic housing and mortgage

bubble.” He added, “We are only postulating that the subprime book could get in trouble and experience normal losses. Things could get far worse than our mildly bearish assumptions.” (*MarketWatch*, Alistair Barr, 09/18/06)

### Midterm Election rumblings

- With midterm elections less than seven weeks away, the results of November 7 may have a big impact on the face of financial services policymaking. At a minimum, the House Financial Services Committee will get a new chairman along with turnover among subcommittee leaders, while the Senate Banking Committee will have (at least) a new ranking Democrat. According to mid-September polls, 25 Republican and 9 Democratic seats in the House are deemed “competitive,” including six House members on the Financial Services Committee: Representatives Deborah Pryce, Michael Fitzpatrick, Jim Gerlach, Melissa Bean, Geoff Davis, and Christopher Shays. Four committee members are not running for re-election, including chairman Michael Oxley (R-OH) and Representatives Bob Ney, Katherine Harris, and Bernard Sanders. The Democrats need a net gain of 15 seats to regain control of the House, which political analysts deem “possible.” If the Republicans retain control of the House, either Representative Richard Baker (R-LA) or Representative Spencer Bachus (R-AL) would become committee chairman, which would create a vacancy atop either the financial institutions subcommittee chaired by Bachus or the capital markets subcommittee led by Baker. The housing subcommittee will also get a new chairman, because the current chair, Representative Ney is retiring. [Ney recently pleaded guilty to at least one felony corruption charge in a plea bargain with federal prosecutors and has resigned as the committee chairman; he awaits sentencing on October 13]. If the Democrats regain control of the House, Representative Barney Frank (D-MA) is expected to be elected chairman of the House Financial Services Committee. Frank said that the committee under Democratic control would press federal regulators on their enforcement of consumer protection laws, including passage of a federal predatory lending law and a bill to increase consumer protection from identity theft. The committee also would focus more attention on international poverty, by working with the World Bank and International Monetary Fund, Frank added.
- In the Senate, seven Republican and six Democratic seats are considered hotly contested, including three members of the Senate Banking Committee—Senator Rick Santorum (R-PA), Deborah Stabenow (D-MI) and Robert Menedez (D-NJ). With the retirement of Senator Paul Sarbanes (D-MD) as ranking member of the panel, Senator Christopher Dodd (D-CT) is expected to succeed him. (*Dow Jones Newswires*, *Damian Paletta*, 09/21/06; *American Banker*, Stacy Kaper, 09/12/06; *CQ Today*, 09/20/06)

- Robert Steel, President Bush's nominee for the Treasury Department's top domestic finance post, told the Senate Banking Committee that his top priorities as undersecretary would include ensuring that the U.S. remains a leading capital market; improving the finances of Social Security, Medicare and Medicaid; and reforming the regulation of Fannie Mae and Freddie Mac. Steel told the panel that he wants "a stronger regulator" that can protect against systemic risks and ensure that the housing market remains strong. If confirmed, Steel will succeed Randal Quarles as undersecretary for domestic finance and the Department's point man for GSE regulatory reform. Steel recently retired from Goldman Sachs, where he worked for nearly three decades. (*Dow Jones International News*, Campion Walsh, 09/21/06; *Dow Jones Capital Markets Report*, 09/21/06)
- President Bush has nominated Michele Davis, a deputy national security adviser and former senior vice president of regulatory policy at Fannie Mae, to be the Treasury Department's top spokesperson. If confirmed, this would be Davis' second stint as the agency's assistant secretary for public affairs, having served in this position for then-Treasury Secretary Paul O'Neill. She is expected to play an expanded role as a senior strategist on communication and policy for Treasury Secretary Henry Paulson. Davis would replace Tony Fratto, who is stepping down to be a White House spokesman. (*National Journal's CongressDaily*, 09/19/06; *Reuters*, 09/14/06; *Wall Street Journal*, 09/14/06)
- An inspector general's report charges that HUD Secretary Alphonso Jackson urged staff members to favor friends of President Bush when awarding agency contracts, but found have found no direct proof that Jackson's staff obeyed. Jackson's chief of staff told investigators that the HUD secretary, "personally intervened with contractors whom he did not like . . . these contractors had Democratic political affiliations," said the IG report, made available to *The Washington Post*. "[The investigation] did not disclose any pattern or practice of issuing contracts based on political affiliation . . . [H]owever, there were some limited instances where political affiliation may have been a factor in contract issues involving Jackson," said the report. "[The investigation found] no evidence that a contract was canceled, rescinded, terminated or not issued as a result of the encounter between Secretary Jackson and the contractor." Jackson said the report cleared him of wrongdoing. "As I stated previously, during my tenure, no contract has been cancelled, rescinded, terminated, awarded or not awarded due to the personal or political benefits of the recipient," said Jackson in a statement. "I sincerely regret my April 28 remarks that led to this investigation." (*Washington Post*, Elizabeth Williamson, 09/22/06)

### Senate passes credit agency reform bill

- On September 22, the Senate passed legislation designed to promote competition in the credit rating industry. The bill, sponsored by Senator Richard C. Shelby (R-AL) would establish a new system for the SEC for granting official recognition to agencies that issue ratings. On July 12, the House of Representatives passed a similar bill, which is opposed by many Democrats who charge the legislation would make it too easy for rating companies to gain SEC recognition. Consumer groups favor the Senate version, which one lobbyist said could be cleared by the House the week of September 25 before lawmakers break for the mid-term elections. (*CQ Today Midday Update*, 09/22/06)

### Committee on Capital Markets Regulation to recommend changes to SarbOx

- A new independent commission, comprised of business, financial, investor and corporate governance, legal accounting and academic leaders, plans to recommend changes to the 2002 Sarbanes-Oxley Act and other regulations which the panel believes hinders the competitiveness of U.S. capital markets. The commission, called “The Committee on Capital Markets Regulation,” will be co-chaired by former chairman of President Bush Council of Economics Advisors R. Glenn Hubbard and former Goldman Sachs President John L. Thornton. [Other members include such heavy hitters as former Commerce Secretary Donald Evans, leveraged-buyout magnate Wilbur Ross, and Dupont CEO Charles O. Holliday.] The commission plans to issue its findings by the end of November, which will include recommendations on the Sarbanes-Oxley Act, “with major emphasis on Section 404, which requires auditors and senior major to certify the adequacy of internal controls.” Treasury Secretary Henry Paulson said the issue of competitiveness of U.S. public capital markets “is important to the future of the American economy and a priority for me. I look forward to reviewing their findings and ideas.” (*Mineweb*, 09/15/06; *Reuters*, 09/12/06; *New York Sun*, 09/21/06)

## ***Fannie Mae***

OFHEO will “more than likely” sue Fannie Mae’s former executives

- OFHEO director James B. Lockhart, III said that it is “more than likely” that his agency will be filing litigation against Fannie Mae’s former CEO Franklin D. Raines and other former officers, seeking to recover bonuses and salary and possibly impose fines related to the company’s accounting scandal. When asked by reporters if action was likely against Raines and former CFO J. Timothy Howard, Lockhart responded, “They are the top two.” Through a spokesman, Lockhart declined to comment further on the matter, but confirmed the accuracy of media accounts of his comments. One lawyer with knowledge of the case, who spoke on condition of anonymity, said OFHEO could file a lawsuit before the end of the year. The agency may be waiting on the completion of a mandatory investigation by Fannie’s independent directors to determine whether the company itself should sue Raines, Howard or others. Fannie Mae’s investigation is expected to be completed by the end of October. (*Washington Post*, Terence O’Hara, 09/14/06)
- In *TheStreet.com*, Colin Barr wrote, “Former Fannie Mae ...chief Franklin Raines may soon have his day in court. ...James Lockhart [director] of the Office of Federal Housing Enterprise Oversight... said this week that he expects to sue Raines and his former finance chief, Tim Howard. Lockhart’s comments come less than a month after federal prosecutors said they wouldn’t pursue criminal charges against Fannie Mae itself. They left open the prospect of actions against individuals. ...[Lockhart’s] comment was seen as a shot across the bow of Raines and Howard, who spent years raking in huge checks as Fannie’s accounting errors piled up. Before the two were forced out in December 2004, Raines engaged in an unseemly public lobbying campaign against his chief critic and Lockhart’s predecessor, Armando Falcon. Falcon was among the first to highlight Fannie’s chicanery. But Raines screamed until he was blue in the face, against much evidence to the contrary, that Fannie’s accounting was not only proper -- it was too sophisticated to even discuss. ‘The accounting standards,’ he advised in testimony before a 2004 House subcommittee, ‘are highly complex and require determinations over which experts often disagree.’ The prospect of a civil suit doesn’t seem likely to shake Raines, who saw May’s settlement between Fannie and regulators as just another opportunity for grandstanding. His lawyer said with some pride back then that Raines had ‘promised in October of 2004 that he would hold himself accountable if it was determined that Fannie Mae misapplied accounting rules.’ You’ll get your chance yet, Frank.” (*TheStreet.com*, Colin Barr, 09/15/06)
- In a recent court filing, former Fannie Mae CEO J. Timothy Howard said OFHEO is showing a “cavalier disregard of the federal rules” in withholding documents related to Fannie’s \$10.8 billion in accounting errors. The agency “has utterly disregarded the rules of procedure” by defying subpoenas for Fannie Mae documents related to

their defense, said Howard. (*Washington Post*, 09/22/06)

#### Fannie Mae board elects two new board members

- Fannie Mae's board of directors elected Brenda Gaines, the former president and CEO of Citigroup Inc.'s Diners Club North America, and Karen Horn, a former president of the Federal Reserve Bank of Cleveland, to the board, replacing Ann Korologos and Donald Marron who resigned in July. Gaines, 57, was previously the deputy chief of staff and commissioner of housing under former Mayor Harold Washington of Chicago. She will sit on Fannie Mae's compensation committee and housing and community finance committees. Horn, 62, currently is a limited partner of Brock Capital LLS. She will sit on Fannie Mae's audit and risk policy and capital committees. (*Associated Press*, 09/18/06; *American Banker*, Steven Sloan, 09/19/06)

#### Fannie Mae "embraces change"

- In a September 14 speech at Lehman Brothers 2006 Financial Services conference, Fannie Mae executive vice president and CFO Bob Blakely said, "...[A]s to Fannie Mae, I would say it's a company clearly embracing change. It is challenging in a very fundamental way all the basic assumptions of the company---the way they did things in the past and importantly the way they're going to have to do things in the future with a dynamic and changing marketplace." (*LehmanLive: Lehman Brothers 2006 Financial Services Conference*; 09/14/06)

#### Fannie Mae extends the application deadline for temporary housing program in Gulf Region

- Fannie Mae has extended the application deadline for its temporary housing program for hurricane evacuees from the Gulf Region beyond the Sept. 15 date. The program allows qualifying evacuees to live in real estate owned properties for up to 18 months for free, with the option of buying once that period is up. The temporary housing program has housed more than 900 evacuee families so far, said Fannie Mae spokesman Christina McHenry. ([www.austinchronicle.com](http://www.austinchronicle.com), 09/22/06)

## ***Freddie Mac***

Freddie Mac “still plans” to separate its president and chairman positions, says Syron

- Freddie Mac chairman and CEO Richard Syron told reporters that the company still plans to divide the chairman and chief executive positions into separate positions. The board will discuss the timing of that change with OFHEO, he added. (*Dow Jones Newswires*, Damian Paletta, 09/08/06)

Freddie Mac increases its investment  
in variable-rate and alternative mortgage products

- In a September 18<sup>th</sup> speech at Bank of America’s 36<sup>th</sup> Annual Investment Conference, Freddie Mac’s senior vice president and Treasurer Timothy Bitsberger said that his company has increasingly purchased and guaranteed a higher percentage of variable rate securities and alternative mortgage products. “On the retained portfolio side, Freddie has increased our investment in highly rated variable rate securities to 40% of our portfolio as of June 30, from about 29 percent at the end of 2004,” said Bitsberger. “...Freddie has also increased our activity in alternative mortgage in 2006. As of the end of June, these products accounted for roughly 6 percent of our total guarantee book, up from less than 1 percent in 2003.”
- On the funding side, Bitsberger said that Freddie Mac has increased its issuance of callable debt to more than \$300 billion over the past three years. The company’s growth in callable debt balance has allowed the company to fund more than 70% of its fixed-rate mortgage portfolio and cover more than 50% of its convexity risk. Through the issuance of callable debt, Freddie Mac has diversified its hedging activities away from the top 10 broker dealers and into the hands of over 1,000 global debt investors, said Bitsberger. (*Prepared Remarks of Timothy Bitsberger, Senior Vice President and Treasurer*, 09/18/06)

Freddie Mac names its new chief information officer

- Freddie Mac has hired James D. Hughes, a former National City Corp. executive, to serve as its new chief information officer (CIO). Previously, Hughes served as the CIO, branch banking division head, and executive vice president for Nat City, where he supervised more than 11,000 employees and 1,250 retail bank branches in seven states. Hughes, 48, will report to Joseph A. Smialowski, the company’s executive vice president for operations and technology. He will be responsible for managing information systems planning and development that supports Freddie’s finance, investment, sourcing and servicing divisions and corporate functions. (*American Banker*, Jody Shenn, 09/19/06; *DSNews.com*, Kristin Campbell, 09/18/06)

Public Accounting Oversight Board taps Freddie Mac's former CFO Bauman

- Martin Baumann, Freddie Mac's former CFO, has joined the Public Accounting Oversight Board (PCAOB) as deputy director in the office of research and analysis. Bauman, 58, served as Freddie's chief financial officer from June 2003 through March 2006. In a statement, Bauman said, "My decision to join the PCAOB reflects my view of the importance of the integrity of financial reporting to our capital markets. I was committed to that for over 30 years at [PricewaterhouseCoopers], and I joined Freddie Mac to restore accuracy, integrity and reliability to its financial reporting. The PCAOB gives me an opportunity to meld that experience with public service." (*Dow Jones Newswires*, Siobhan Hughes, 09/13/06)

Freddie Mac expands its Home Possible loan program to veterans

- Freddie Mac has expanded its affordable mortgage program Home Possible (HP program) to the 1.5 million active-duty and reservists serving in the U.S. military. Under the HP program, Freddie Mac will purchase low- and zero down-payment loans with flexible payment standards, and will reduce the interest rate by 150 basis points for the first year if the borrower receives a gift from relatives or veterans organizations. The buydown will be phased out over a three year period and the source of the downpayment funds can come from a wide range of sources, said Freddie. (*MortgageWire*, 09/21/06)

BofA, Bank of Texas Mortgage, and Freddie Mac sponsor "educational" mini-series

- Educating viewers on financial issues while entertaining them is the goal of "Nuestro Barrio," a 13-part mini-series sponsored by Freddie Mac, Bank of America and Bank of Texas Mortgage, beginning September 27 on KVPA-TV. The mini-series will include themes such money management, credit, homeownership, predatory lending and foreclosure prevention played out against the traditional novella themes of romance, jealousy, greed and conflict. (*Phoenix Business Journal*, 09/20/06)

Freddie Mac underwrites former Clinton HUD Secretary Henry Cisneros' "sessions" to write *Casa y Comunidad: Latino Home and Neighborhood Design*

- Former Clinton HUD Secretary Henry Cisneros spearheaded the publication of *Casa y Comunidad: Latino Home and Neighborhood Design*, describing the untapped Latino mortgage market. Published by BuilderBooks, an imprint of the National Association of Homebuilders, *Casa y Comunidad* is a 225-page, full-color, large format paperback, written by fourteen writers. Two years ago, Cisneros gathered the

writers in San Antonio along with co-editor John Rosales to explore issues such as creating communities in which Hispanics will be attracted; locating close to metropolitan areas; and building more affordable homes. Freddie Mac underwrote the cost of the San Antonio sessions. (*San Antonio Express-News*, Elaine Ayala, 09/21/06)

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

Federal Housing Finance Board approves a new exam rating system for the FHLBs
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- Beginning January 1, 2007, the FHLBs will be rated based upon exposures to risk by the Federal Housing Finance Board's Office of Finance, under a proposal approved by the Finance Board on September 14. Under the proposed exam rating system, the Office of Finance would assign each Bank a composite risk rating on a scale of "1" (denoting the lowest degree of supervisory concern) to "4", based upon their evaluation of corporate governance, market risk, credit risk, and financial condition and performance. The rating would replace the Finance Board's current exam rating system, which designates each Bank as satisfactory, fair, marginal or unsatisfactory. The new rating system proposal will be published in the Federal Register soon and will be open for comments for a period of 30 days.
- At its September 13 meeting, the Finance Board also approved a final rule incorporating amendments to the FHLB System's affordable housing program to streamline and reorganize existing regulations. On January 1, 2007, the final rule will be effective. The Finance Board also approved the agency's \$36 million operational budget for 2007 and adopted a strategic plan for 2007 to 2012 and a performance budget for FY2007. (*Bureau of National Affairs*, Karen L. Werner, 09/14/06; *American Banker*, Rob Blackwell, 09/14/06)
- During the Finance Board's September 13 meeting, chairman Ronald Rosenfeld dropped several hints that he plans to move ahead and finalize the controversial capital rule proposal, requiring the FHLBs to increase their retained earnings. Although Republican and Democratic members of the House Financial Services Committee have urged Rosenfeld to withdraw the proposal, the chairman appeared to be unfazed, commenting that the meeting to finalize the rule would probably be a very long session due to the number of comment letters the proposal generated. (*National Mortgage News Online*, 09/14/06)

- A day before Federal Housing Finance Board Chairman Ronald Rosenfeld appeared before Congress to defend his agency's retained-earnings proposal [on September 7], Finance Board member Geoff Bacino called the plan "flawed" and suggested that the board scrap the proposal start from scratch with a new rule. In an interview with *American Banker*, Bacino struck a more conciliatory tone, but said the Finance Board should slow down and give the plan closer scrutiny. "I would like more time to go over the entire proposal," said Bacino. "From a policy standpoint, I think we have to look at each section and say, 'Does this make sense?'" He continued, "Maybe you get it done by saying, 'Look, we're going to take everything into account and we're going to take our time doing it.' I'm not saying any of the stuff that we've got right now is right or wrong, but we need to look at it and take the commenters seriously and factor in those thoughts," he said.
- Noting that Congress is unlikely to enact a GSE regulatory reform bill before year-end, Bacino said that the time had come to fill the public-interest director spots at each FHLB. While the Finance Board is legally required to make such appointments, Rosenfeld has held back, saying he would not do so while lawmakers continue to debate GSE legislation. If the Finance Board does not make appointments by the end of the year, 82 of the FHLBs' 200 directorships [41%] will be vacant, a condition that some industry observers say is a "safety-and-soundness hazard." "I would hope we would start moving forward on filling those slots," said Bacino, suggesting a phasing in of new directors and renominating some current ones to ensure the FHLBs' boards have enough experience. He appeared sympathetic to Representative Barney Frank's recent suggestion that it was disingenuous for Rosenfeld to say on the one hand that the Finance Board must move quickly to finalize its retained-earnings plan, and then to slam the brakes on public-interest director appointments until the fate of GSE legislation is known. "We have to be careful that we don't use one argument one way and then use the same argument another way," said Bacino.
- Blanco, who has strong ties with the credit union industry, was nominated to the Finance Board in July, at a time when the industry was voicing complaints that they did not have sufficient representations on the FHLB boards. Bacino insisted that his nomination was not "the bone thrown to credit unions." He added, "I'm very cautious about looking like the credit union guy. I realize that's the majority of my past. In coming here, I feel I've got to put that aside and say, 'You know what, I'm a regulator for the banks and the people who use them.'" The 44-year-old calls himself a "free-market Democrat" and says he considers his role on the Finance Board to be similar to that of a referee: making calls but not deciding the plays. "It's our job to determine the safety and soundness of an act, not whether or not we feel that act fits best in the overall structure of a financial institution," he said. (*American Banker*, Steven Sloan, 09/22/06)

#### Campaign against the Finance Board's proposed rule on retained earnings continues

- The Coalition on Homelessness & Housing in Ohio (CHHO) and the Community Services of Arizona (CSA) issued (separate) press releases “in response” to the Federal Housing Finance Board’s proposed rule on retained earnings. In his release, CHHO director Bill Faith argued that the proposed rule could trigger a “dramatic decline in the amount of money available in our region and throughout the United States” and implored the Finance Board “to stop trying to fix something that isn’t broken.” In CSA’s press release, the group’s president Brian Swanton argued that FHLB System is one of the most crucial sources of funding for affordable housing in Arizona, which “could be slashed by 50%” [if the rule were implemented] at a time when home building costs are skyrocketing. Both groups stated flatly their opposition to the Finance Board rule and provided readers a phone number to contact groups’ representatives [two individuals who work for Sloan & Company, a public relations firm] “to discuss how this rule could impact families” in Arizona and Ohio. (*Business Wire*, 09/21/06; *Business Wire*, 09/21/06)

#### S&P affirms its rating for the FHLB System’s consolidated obligations and its counterparty ratings for 11 of the 12 FHLBs

- On September 22, Standard & Poor’s affirmed its “AAA” rating for the FHLB System’s consolidated obligations and affirmed its counterparty credit ratings on 11 of the 12 FHLBs. S&P raised its counterparty credit rating of the FHLB-New York to “AAA/A-minus 1 plus” from “AA plus/A-minus 1 plus” with a stable outlook. The credit rating agency affirmed the FHLB-Des Moines’s “AAA/A-minus 1 plus” rating and removed the Bank from CreditWatch. However, S&P said that the FHLB-Des Moines’ rating outlook is negative. (*The Main Wire*, 09/21/06)

#### FHLB-New York elects John Scarchilli to its board

- The FHLB-New York said that John M. Scarchilli, the president and CEO of Pioneer Savings Bank, Troy, NY, to its board of directors. Scarchilli will be filling the term of Sanford A. Beldon [who retired in July], which expires on December 31. (*American Banker*, Steven Sloan, 09/22/06)

#### FHLB-Cincinnati hires Dooley as director of internal auditing

- James G. Dooley has joined the FHLB-Cincinnati as vice president, director-elect of internal audit. Previously, Dooley served as senior vice president of audit and risk assessment with Provident Bank, headquartered in Cincinnati, OH. (*The Cincinnati Enquirer*, 09/19/06)

## ***Ginnie Mae***

### FHA reform provisions on track for passage in November

- RBS Greenwich Capital reports that Ginnie Mae President Robert Couch and Assistant Secretary for Housing-Federal Housing Commissioner Brian Montgomery recently met with officials at the Bond Market Association, the Asset Securitization Forum, and a number of Wall Street analysts to discuss pending FHA reform legislation. Couch and Montgomery said that FHA reform has bipartisan support and appears to be on track for passage as an attachment to the appropriations bill in November. The reform bill proposes to increase in the FHA's loan limit for high cost areas to 100% conforming limit from 87%; to eliminate the FHA's 3% down payment requirement ; and to increase FHA's maximum loan term from 30- to 40-years, among other things. FHA does not plan to make interest-only loans, but instead pans to focus on the "graduated payment" loans. If the reform provisions are adopted by Congress, Ginnie Mae officials believe that their loan volume can double in the next five years. (*Asset Securitization Report*, 09/19/06)

## ***Farm Credit System / Farmer Mac***

### FCA board approves rule affecting processing and marketing operations

- On September 14, the FCA board of directors approved a proposed rule to amend the criteria used to determine whether a processing or marketing operation is eligible for financing from an FCS institution. The current rule provides that a legal entity engaged in processing or marketing is eligible to borrow if eligible borrowers own more than 50% of the voting stock or equity. The proposed changes recognize the changing ownership structures of processing or marketing operations. The first proposed criterion defines eligibility for financing for processing or marketing operations by measuring the extent to which eligible borrowers control the entity. The second criterion defines eligibility by measuring the commitment (as defined through ownership and throughput) of eligible borrowers to the processing or marketing entity. The third proposed criterion defines eligibility by the extent to which the processing or marketing entity is an extension or outgrowth of an eligible borrower's production operation. The proposed rule will be published in the Federal Register for a 60-day comment period. (*US Fed News*, 09/14/06)

## Blurring the lines through branding

- Farm Credit Services of Missouri is changing its name to FCS Financial and will have two sub-brands: Ag and Business, [which focuses on customers involved in agriculture and agribusiness] and Land and Home, [which serves customers seeking loans, insurance, and financial guidance on real estate and investment property and land]. (*Jefferson City News Tribune*, 09/16/06)

## ***Postal Service***

### Postal reform languishes despite compromise offer

- Postal reform legislation, a project 12 years in the making, appears to be languishing, as House and Senate negotiators mull a recent compromise measure submitted by Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins (R-ME) to House negotiators before the August recess. The proposal, which essentially mirrors the Senate-passed bill, upholds the Senate's stricter rate cap provision which requires that postal rate increases not exceed the rate of inflation and provides an exit clause that allows the USPS to break the cap only in times of major emergencies. Despite the Collins proposals, the outlook for final passage of postal reform remains uncertain. The White House opposes provisions in the Conference Report, which allow the Postal Service to use some its \$3 billion escrow account to pay operational costs rather than solely fund retirement benefits and transfers payment of military retirement benefits from the USPS to the Treasury Department. A spokesperson for House Government Reform chairman Tom Davis (R-VA) said that Davis and others "continue to work on consensus language on a daily basis. We are closer than ever to reaching agreement, getting through conference, and moving the legislation to the floor." Most recently, Davis predicted that the conference committee would meet to approve the bill before October. The Senate named its conferees shortly after approving a reform bill in February; the House, which approved its measure in July 2005, has not yet appointed its conferees. (*CongressDaily*, Jessica Brady, 09/11/06)

### Postal rates likely to go up (again) on May 6, 2007

- In a September 20 speech, Postmaster General Jack Potter said that mailers should expect to see the Postal Service's proposed R2006 implementing rules published in the Federal Register during the week September 25<sup>th</sup>. While the anticipated decision will come some time in early March, Potter said that the USPS must prepare for a possible implementation on May 6. While many have asked that the Postal Service push back the actual implementation date, he said such a decision will be up to the

Board of Governors and would most likely be impacted by the state of USPS finances. (*Postcom*, Association of Postal Commerce, 09/20/06)

The USPS Board of Governors approves the Postal Service's budget for 2007

- On September 13, the U.S. Postal Service Board of Governors approved a fiscal year 2007 [starting October 1] integrated financial plan that includes cost reduction programs totaling \$1.1 billion, while maintaining universal service to an expanding delivery network. The plan's cost reductions assume a planned decrease of 40 million workhours from the estimated FY 2006 level, achieved through automation improvements and implementation of additional "breakthrough productivity" initiatives. The plan assumes a 3.2% increase in revenue [generated through a postal rate increase taking effect in May 2007] and a 2.6% increase in expenses over the current year's forecast, resulting in \$1.7 billion in net income. However, the estimated \$3.3 billion escrow requirement results in a net deficiency after escrow of \$1.6 billion. The plan assumes continued slower growth in the U.S. economy and an expected overall mail volume decrease of 0.5%. The budget does not include, however, the effects of the possible passage of postal reform legislation. (*USPS Press Release*, 09/12/06)

USPS sets strict guidelines for expense reimbursement, following "unacceptable conduct" by a senior postal official

- The USPS has set strict guidelines for meal and alcohol expense reimbursement, following an inspector general report that accused agency vice president Azeezaly Jaffer of excessive spending on entertainment. Jaffer has subsequently resigned from his post of running the UPSP's public affairs office with a staff of 160 and \$20 million budget, after spending tens of thousands of dollars of the agency's money on meals, drinks, and hotel accommodations for himself, other postal workers, friends, family and business associates according to the IG report. House Government Reform Committee Chairman Tom Davis (R-VA) and ranking member Henry Waxman (D-CA) sent a letter to Postmaster General John Potter on September 15, seeking all records related to Jaffer's resignation. (*Washington Post*, Elizabeth Williamson, 09/18/06)

Daily equivalent of email: 133 pieces of mail a day

- KSDK NewsChannel 5 [St. Louis, MO] reported, "According to researchers, if, instead of email, you got the equivalent mail through the United State Post Office, it would amount to 133 pieces of mail every day" – or \$49.21 in lost revenue to the Postal Service. (*KSDK NewsChannel 5*, Karen Foss, 09/19/06)

## TVA

### TVA hires veteran utility executive William Orser to be interim COO

- TVA has hired veteran private utility executive William “Skip” Orser to serve as interim COO, while the utility conducts its search for a permanent CEO. Orser will be responsible for TVA’s core businesses of fossil, nuclear, and river systems operations and will report to interim CEO Tom Kilgore. In 1995, Orser retired from Progress Energy [Raleigh, NC], where he served as group president. He has more than 30 years executive experience with a number of facilities, where he focused in the nuclear energy area. (*Huntsville Times*, 09/13/06; *US Fed News*, 09/12/06)

### Graves is warmly received at his confirmation hearing on his nomination to serve as TVA director

- Bishop William H. Graves, 70, senior bishop of the Christian Episcopal Church in Memphis, TN, breezed through a confirmation hearing on September 13 as the first African-American nominated to TVA’s board of directors. If confirmed, Graves will fill the ninth and final seat on the revamped and expanded TVA board. The son of a sharecropper, Graves has also pastored in Atlanta, GA, Gary, IN, Beloit, WI, and Los Angeles, CA. He also served for ten years on the Memphis Light, Gas and Water Division’s board of directors, TVA’s largest customer. In his remarks to the committee, Graves said, “As a resident of the Tennessee Valley, I would consider it a great honor and a humbling challenge to serve on the board of TVA. My background as a pastor and as a bishop gives me a profound appreciation for TVA’s mission of service to the 8.6 million people in the valley. It is a mission based on making life better, improving our communities, and supporting our families as they live and work in concert with God’s natural world. It is a worthy mission indeed and I will use all my faculties, my strength, and the power that is in me to consider the challenges facing TVA and make sound and careful determinations. (*The Commercial Appeal* [Memphis, TN], Bartholomew Sullivan, 09/14/06)

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