

# The **GSE** REPORT™

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## Major Events

### Second quarter capital adequate at Fannie Mae and Freddie Mac, says OFHEO

- Fannie Mae and Freddie Mac surpassed their capital requirements for the second quarter, according to OFHEO. On June 30, Fannie Mae's core capital of \$42.0 billion, exceeded its adjusted OFHEO-directed capital requirement of \$38.2 billion by \$3.8 billion and exceeded its statutory minimum capital requirement of \$29.4 billion by \$26.9 billion. Similarly, Freddie Mac's core capital of \$37.1 billion on June 30, exceeded its adjusted OFHEO-directed capital requirement of \$34.4 billion by \$2.7 billion and exceeded its statutory minimum capital requirement of \$26.5 billion by \$10.6 billion. OFHEO director James B. Lockhart, III said, "Operational, accounting and systems weaknesses at both Enterprises continue. Therefore it remains essential that the Enterprises maintain a strong capital cushion."
- OFHEO also released the qualifying subordinating debt position of both Fannie Mae and Freddie Mac in accordance with the September 1, 2005 Agreements between OFHEO and the Enterprises. At June 30, Fannie Mae's total capital and qualifying subordinated debt (\$50.744 billion) exceeded its sub debt requirement (\$42.324) by \$8.421 billion. At the end of the second quarter, Freddie Mac's total capital and qualifying subordinated debt (\$43.821 billion) exceeded its sub debt requirement (\$38.849) by \$4.972 billion. (*OFHEO Press Release, 09/29/06*)

### Freddie Mac's profits rise more than 50% in the second quarter due to rising interest rates

- Freddie Mac said it earned \$1.2 billion in the three months ended June 30, up 56% from the same quarter a year ago. Company executives said that Fannie Mae's profit benefited "significantly" for rising interest rates, which increased the value of derivative investments. "These marked-to-market gains were caused by higher interest rates in the first half [of the year]," said Freddie Mac president and COO Eugene McQuade. "As you know, what goes up must come down." A recent drop in mortgage rates could cost the company in third quarter, he warned. "While these numbers are still preliminary, they do point to the continued strength in our franchise and our ability to keep producing good, long-term results by focusing on fundamentals and keeping risks low," said McQuade. Through August 2006, Freddie Mac's credit guarantee portfolio grew to approximately \$1.4 trillion for an annualized growth rate of approximately 11%.
- Management also reiterated the company expectations of achieving long-term returns in the "low- to mid-teens." They also repeated Freddie Mac's goal of producing timely financial results before the end of 2007. Building new internal controls and accounting systems remains the top priority for Freddie Mac.

- Freddie Mac chairman and CEO Richard Syron said that the residential loans may boost the company's mortgage bond business as more homeowners refinance their "esoteric" mortgages into 30-year fixed rate mortgages. "We may see a shift back in a cyclical sense to a product that has traditionally been our sweet spot," said Syron. "We're seeing that now." Syron also noted that the U.S. housing market is heading for a "relatively bumpy landing" He added, "I think how bumpy is going to vary enormously across the country and will be downright rocky in some places."
- However, analysts continue to warn investors of continued uncertainties about the long-term risks of Freddie Mac and Fannie Mae related to the weakening real estate market and outcome of GSE regulatory reform legislation. "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," wrote Friedman Billings Ramsey analyst Paul Miller in a research note.
- Several analysts also noted that Freddie Mac appeared to back off previous guidance on when the company would return to timely financial reporting. During the October 3 investor conference call, McQuade was asked by an analyst whether Freddie hoped to become current with quarterly reporting early in the second quarter of 2007. McQuade replied, "I would be hopeful that we would be able to be delivering 2007 quarters by then -- no reason to think we're not. But we have a significant amount of work that we need to get through in the next six months, and I want to stay focused on that and not over-promising." [During an August 1 investor conference call when asked by analyst if Freddie was looking at releasing its first-quarter report in "April/May," McQuade was less equivocal. "That's entirely within the realm of possibility," McQuade responded.] A Freddie spokesman said, "Fundamentally, the guidance that we're putting out today doesn't change what we said with our last update." However, some analysts disagreed. "It does seem they pushed it off to some degree," said Michael T. Vinciguerra, an analyst at Raymond James. (*Reuters*, Al Yoon, 10/03/06; *FinancialNews-us.com*, Shanny Basar, 10/03/06; *Washington Business Journal*, 10/03/06; *Washington Post*, Terence O'Hara, 10/04/06; *Reuters*, Patrick Rucker, 10/03/06; *American Banker*, Jody Shenn, 10/04/06)

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

Senator Sarbanes says GSE reform talks “on hold”

- Senator Paul Sarbanes (D-MA), ranking member of the Senate Banking Committee, told *Market News Watch* that negotiations on GSE regulatory reform “are basically on hold” as the Senate focuses on other issues in its final days of the fall session. “Everyone is very tied up with what’s going on in the [Senate] floor now [debating the establishment of military tribunals for terrorist suspects],” he said. “This is what I’m focused on,” he said. When asked if he thought the talks might resume in the lame-duck session, Sarbanes said, “It’s hard to tell. I haven’t been really thinking about it.”
- Senate Banking Committee chairman Richard Shelby (R-AL) said that there was a chance for an agreement on GSE regulatory reform to be reached after the election, but then added “maybe.” Shelby said, “If Fannie Mae and Freddie Mac want a good bill, and a strong regulator, where they have certainty, I think we’ll get a bill. If they decide, no, they don’t want any regulator other than one they can control and so forth, or try to control, we won’t get the bill.” A Democratic Capitol Hill source dismissed Shelby’s statement and its inference that Democrats on the Senate Banking Committee Democrats take orders from Fannie Mae or Freddie Mac on GSE reform. [Some Democrats have warned that making large-scale changes in Fannie’s and Freddie’s role in the U.S. housing finance system could in itself introduce new risks and damage to the housing market.]
- An industry observer said Shelby’s comments reflects the Republicans’ frustration, after having expressed optimism about the prospects of enacting GSE regulatory reform this year. “I guess in some respect it’s stating the obvious,” said the source. The Democrats’ reluctance to strike a deal with Shelby on the portfolio issue indicates that the politics of the GSE reform bill has come down to the GSEs’ bottom lines, said the source. If Fannie and Freddie accepted the Republicans’ offer, the Enterprises “would have to take something that predictably shrinks their portfolios,” said the source. “That’s the legitimate line. I think their concern is genuine; it goes right to the cornerstone of their business model.” Bert Ely, an Alexandria, Va., banking consultant, said, “It’s literally a trillion-dollar question,” referring to the portfolio restrictions. Ely added, “I would say [Shelby’s comments] reinforce that the likelihood of a bill this year is as close to zero as it can be without saying never.”
- Senator Tom Carper (D-DE) said he is going to ask Treasury Secretary Henry Paulson to call a meeting with Republican and Democratic leaders on the House Financial Services Committee and Senate Banking Committee to try and reach a consensus on GSE regulatory reform legislation over the recess. “Given all the distractions that are going on, the change in leadership at Treasury...it’s just been difficult to get all the folks to the table and talk this through and hammer it out,” said

Carper. “That kind of leadership from the administration would - I think - be constructive and I think well received at this point.” Carper believes that time remains in the lame-duck session to reach a consensus. “The key to being successful with something like this in a lame duck is just to make good use of the time between Saturday and November 14 when we come back,” he said.

- OFHEO director James B. Lockhart, III painted a dire picture of the regulatory landscape for Fannie Mae and Freddie Mac, if Congress fails to pass GSE regulatory reform legislation. Lockhart said, “It would be ugly for everybody if we can’t lessen this uncertainty. There is all this uncertainty, and there is the [back and forth] that would have to happen as you try to look at how to make these two institutions safer and sound.” When asked if OFHEO could establish capital requirements to address the systemic risks that the GSEs pose, Lockhart said it would be difficult to do so without a GSE reform bill. “I know it would be a big fight,” said Lockhart. “There would be legal battles. It would be tough. I hope we don’t have to go there. As one of the CEO’s told me, it would be ugly if we had to.” He added, “If we can’t get the kinds of rules that are needed, there is going to be the [continual] back and forth, what is allowed and what is not allowed. It will just make the whole regulatory atmosphere not cooperative and unhelpful.” (*Dow Jones Newswire*, Damian Paletta, 09/29/06; *The Main Wire*, 09/28/06; *Bureau of National Affairs*, Richard Cowden, 09/27/06; *Dow Jones Newswire*, Damian Paletta, 09/29/06)

Congress: Stop playing political football with OFHEO
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- In a September 26 editorial appearing in *Inman News*, Marcie Geffner wrote, “The time has come for Congress to stop playing political football with [OFHEO]...OFHEO and [Fannie Mae and Freddie Mac] ...have been the subject of multiple Congressional hearings for more than two years, yet Congress has yet to increase the agency’s authority or resources. This agency needs to be empowered to achieve its mission now, not after the November elections and not sometime next year. ...The problem is known; why hasn’t the remedy been effected?” (*Inman News*, Marcie Geffner, 09/26/06)

Is Congress in bed with the housing subsidy lobby?
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- In an October 2 editorial, the *Wall Street Journal* wrote, “...Power for its own sake ... explains ...the House GOP’s decision to join the Senate Democrats in killing serious reform of Fannie Mae and Freddie Mac, despite \$16 billion in accounting mistakes or fraud. The Members are in bed with the housing subsidy lobby.” (*Wall Street Journal*, 10/02/06)

Supporters of GSE regulatory reform keep up the pressure

- In a September 25 letter to the chairmen and ranking members of the House Financial Services Committee and Senate Banking Committee, the Housing Policy Council of the Financial Services Roundtable expressed their strong support for Congress to pass GSE reform legislation this year. The Council wrote, “We believe that the remaining issues can be resolved and that a strong law can be enacted that will improve the oversight of the housing ...[GSEs]. This action will help strengthen the housing finance system for years to come.” While Fannie Mae, Freddie Mac and the FHLBs play a vital role in providing a secondary market for mortgages, “...the size and complexity of the GSEs has overtaken their regulatory structure. Improved regulation is long overdue. ...[While] Congress has made tremendous progress in advancing reform legislation[,] it would be a shame if this work was not completed. Such a failure would not be good for our housing finance system and consumers.”  
(*Correspondence to the Honorable Richard Shelby, the Honorable Paul Sarbanes, the Honorable Michael Oxley, and the Honorable Barney Frank, Housing Policy Council of the Financial Services Roundtable, 09/25/06*)
- Thirty-five owners of small independent mortgage banks came to Washington, DC to lobby 100 lawmakers and the Bush administration on the need for GSE regulatory reform legislation. (*National Journal, 09/30/06*)

Without GSE regulatory reform legislation,  
a key component to rebuilding Fannie and Freddie is missing

- In a September 28 speech to the National Economists Club, OFHEO director James B. Lockhart, III said, “[While] both companies [Fannie and Freddie], a large bipartisan group of Senators and Congressmen, and the Bush administration all support [GSE regulatory] reform, ...we cannot get the ball across the goal line. If Congress--as would now seem to be the case--does not act on legislation to strengthen the regulatory framework before leaving, there is a lot at stake for OFHEO to do its job and for the companies as they work to correct their problems. It would be my hope that Congress will come back in November and complete action on this critical legislation. ...What we have learned from [the accounting scandals at Fannie and Freddie] ...is that the companies have problems and need strengthening and that OFHEO had problems and needs strengthening too.”
- Lockhart noted the dramatic weakening in the nation’s housing market, which effects the credit quality of mortgage loans owned or guaranteed by Fannie and Freddie. Lockhart continued, “Some people have argued that a softening market means that it is not the time to make changes in the regulatory framework. I would argue just the opposite. First, softening 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 many 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 legislation currently pending in Congress is all about.”

- There is an ongoing debate, said Lockhart, about whether “bank regulators address systemic risk as part of their safety and soundness regulations, examinations and preventive actions. Being an American Studies major in college, I certainly remember that the key reason that many of the regulators and deposit insurance were created was to reduce risk of losses to financial markets, other financial institutions, and individuals. To me that is systemic risk even though we use a longer definition which is “the potential for a financial institution to experience severe difficulties that disrupt financial markets and other financial institutions enough to substantially reduce economic activity.” Again going back to American Studies that means it hurts the American people. And so my answer to the question is yes. Bank regulators are responsible for reducing systemic risk as part of their core regulatory responsibilities. Indicators of systemic risk include size, concentrations, rapid growth, lack of internal controls, management shortcomings, complexity, and operational problems that can impact inter-relationships with other firms.”
- “In their charters, both Fannie Mae and Freddie Mac were also created to foster a stable financial market, thereby reducing systemic risk. They have done that, but as they grew rapidly as GSEs they began to increase their potential for causing systemic events. Some may debate whether OFHEO was created to help reduce those systemic risks, but there is no doubt we do not have all the powers that a bank regulator has to help avoid such events.”
- Why is the GSE reform bill needed? Lockhart said, “Legislative uncertainty is another cloud over the Enterprises. As a result, both Enterprises support legislation. They believe that a stronger regulator will strengthen their credibility and new legislation will lessen the uncertainty that they and their shareholders face.” OFHEO needs more independence and bank regulator-like powers, which will even the playing field, which currently is tilted “towards the Enterprises.” The mission and new product authority needs to be combined under the GSE regulator and the GSEs’ capital requirements need strengthening. Finally, the GSEs need growth constraints. “My belief is that a key part of restoring confidence [in the GSEs] is to convince the markets that they will never grow out of control again. ... [The GSEs’] massive size, importance to housing finance markets, exposure to counterparties, and holders of their securities combined with high leverage ratios, concentration risk, 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 of the Enterprises’ mortgage portfolios, it seems clear that such should be smaller. Over time that shrinkage should enhance their ability to concentrate on their congressionally mandated mission.”
- “...The bottom line is that without [GSE regulatory] 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. Bank

regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved. Improved capital requirements and portfolio limits with clear, but flexible direction to the new regulator could significantly reduce systemic risk while also reducing market, credit and operational risks. A deadlock over the proposed growth limit has posed the biggest stumbling block to Congressional action but that is a hurdle that can - - and should - - be overcome. I believe the two sides are not very far apart at all. Everybody agrees that a strong regulator is needed. With Congress heading home soon, the window of opportunity for bridging the gap is fast closing. If done properly, the reduction of the portfolios would be through a transparent rulemaking process. After a gradual reduction to strengthen the safety and soundness, including systemic risks, the Enterprises could grow with the market. The reduction of these portfolios 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 and the Bush Administration, will be better for continued homeownership growth, affordable housing, the nation's housing finance system and all the stakeholders of Fannie Mae and Freddie Mac.”  
*(Prepared Remarks by James B. Lockhart, III, 09/28/06)*
- In a question and answer session, Lockhart noted that the Treasury Department could also take steps to control the GSEs' portfolios by limiting their access to the debt market. “One of the things about these companies is every dollar invested in portfolio has to be borrowed,” Lockhart said. Treasury claims that it has the authority to control how GSEs access the debt markets and is reviewing how to constrain the GSEs' growth, using that process, “So you could constrain growth that way, if you needed to,” said Lockhart.
- In the next few years, Fannie Mae and Freddie Mac might seek to drop their charter and become private companies. “In many ways, I think that would be up to the companies to decide going forward -- five, ten years out,” said Lockhart. With regard to privatization, he added, “At this point, from a regulator's standpoint, it is certainly not our goal. Our goal is really to strengthen these two companies.”  
*(Reuters, Patrick Rucker, 09/28/06)*

OFHEO adopts a five year strategic plan
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- OFHEO has adopted a strategic plan for fiscal years 2006-2011, which promises to create a “strengthened regulatory framework” to include a broad review of the GSEs' capital standards and more targeted examinations of the Enterprises. The new plan includes the strategic goals of (1) enhancing supervision to ensure safety and soundness; (2) supporting statutory reforms to its oversight; and (3) supporting an efficient secondary mortgage market. During the planning period, the agency plans to

review the risk-based and minimum capital requirements for Fannie Mae and Freddie Mac and to develop new ways to measure the GSEs' capital adequacy. According to the plan, OFHEO will expand its role in pushing for "the establishment of a new regulatory regime [for the GSEs] through legislative change." OFHEO Director James B. Lockhart, III said, "This plan addresses the future of OFHEO and the housing finance market, including the entities we regulate, Fannie Mae and Freddie Mac. These enterprises are at a critical point and OFHEO is focused on ensuring that they fix their major accounting, internal controls, systems, and management problems." (*Dow Jones Newswires*, Damian Paletta, 09/29/06; *Reuters*, 09/29/06; *US Fed News*, 09/29/06)

#### OFHEO Deputy Director Blumenthal leaves the agency

- September 29 was OFHEO Deputy Director Steve Blumenthal last day with the agency. Blumenthal, who served the agency four years, plans to practice law in Washington. An agency spokesman said that Blumenthal would announce the details of his plans when they are finalized. OFHEO has not announced a successor to Blumenthal. (*American Banker*, Joe Adler, Stacy Kaper, and Rob Blackwell, 10/02/06)

#### Steel's nomination to be Treasury Undersecretary receives committee approval

- On September 27, the nomination of Robert K. Steel to serve as Treasury Undersecretary for Domestic Finance passed out of the Senate Finance Committee by a unanimous voice vote. Steel, a retired director of Goldman Sachs' equities division, is widely expected to be confirmed for the post. He replaces Randal Quarles, who after five years of service at Treasury plans to return to the private sector. (*Bureau of National Affairs*, Brett Ferguson, 09/28/06)

#### Federal agency debt issuance down 5% year-to-date

- Agency debt sold by Fannie Mae, Freddie Mac and the FHLBs declined to \$138.3 billion in the third quarter from \$163.2 billion in the second quarter, according to Thomson Financial. Year-to-date, agency debt slid approximately 5% to \$469.4 for the nine months ended September 30, reflecting a decline in the GSEs' funding needs as the Enterprises shrank their mortgage portfolios. The pace of agency issuance is unlikely to increase during the last quarter of the year, said analysts and issuers. "They really are not going to be growing their portfolios like they had in the past and they just don't have the funding needs," said Margaret Kerins, U.S. agency strategist at RBS Greenwich Capital. (*Reuters*, Lynn Adler, 09/29/06)

## Fed Chairman Bernanke calls U.S. housing declines a “substantial correction”

- Federal Reserve Chairman Ben Bernanke called the recent weakness in the U.S. housing market a “substantial correction” and forecast that the weaker housing market will shave about one percentage point off of GDP in the second half of 2006. Key housing barometers have fallen sharply in recent months with housing starts dropping five times in six months and the National Association of Realtors’ housing market index falling to a 15-year low in September.
- According to an analysis by Moody’s Economy.com, 20 of the 379 metro areas could experience a “crash,” or decline of more than 10% from peak to trough. Along with the 30 metro areas already experiencing declines, 70 other areas will soon experience measurable drops extending into 2008 and 2009. The study found that more than 100 markets have a significant probability of experiencing declines within 12 months. Since these 100 markets comprise nearly half of the country’s housing stock, the study concluded that the “odds are high that national home prices will decline in 2007; the first nominal decline in national house prices since the Great Depression.” (CNN Money, Lex Haris, 10/03/06)

## Harvard “hypes” housing

- In an opinion editorial, Nicolas P. Retsinas, director of Harvard’s Joint Center for Housing Studies, wrote, “ ‘*Housing Bust Ahead*’ The headline hints of catastrophe: a dot-com repeat, a bubble bursting, an economic apocalypse. Cassandra, though, can stop wailing: The expected price corrections mark a slowing in the rate of increase — not a precipitous decline. This will not spark a chain reaction that will devastate homeowners, builders and communities. Contradicting another gloomy seer, Chicken Little, the sky is not falling. Let me alleviate some fears.”
- **“Fear One: Prices will plummet.** From the start, the much-vaunted housing “boom” was an uneven phenomenon, driven by a strong demand for housing, coupled with constrained supply, particularly on the two coasts. In much of the nation, housing prices rose modestly; in a few areas, prices did not budge. In those overheated markets — often fueled by immigration — prices were rising by as much as 20 percent a year. But even with soaring demand and limited supply, that escalation was not sustainable. Even with too-good-to-be-true mortgages, people cannot afford to buy homes that cost five times their income. So in those overheated markets, moderation is expected. Moderation means that prices will stop rising at meteoric rates: The homeowner who expected a double-digit profit after one year will be disappointed. A home will once again be more of a domicile, rather than an investment. In some regions, prices will flatten, rising around the inflation rate, which is the historic average. The fundamentals behind high prices — strong demand (more households will form in the next decade than in the last) and constrained supply — persist.”

- **Fear Two: The economy will collapse.** Housing now represents more than 20 percent of the gross domestic product (compared with 18 percent from the manufacturing sector). For most families, the investment in a home constitutes de facto savings: The build-up of equity is in the trillions of dollars. And homeowners have tapped into that equity, using their homes as ATM machines for refinancing and home-equity loans. Consequently, we are ‘well-housed.’ Indeed, two bathrooms, air conditioning, garages — the amenities our grandparents called luxuries — are standard. All this activity has fueled consumer spending.”
- “A Cassandra fear is that as home prices moderate, the moderation will show up in the gross domestic product. Yet, again, moderation is not a free-fall. The housing market will adjust slowly, with fewer sales and starts. History tells us that housing booms are not eternal — that most end — enabling incomes to catch up with prices. Furthermore, builders have been building to meet demand. In regions where the number of households is growing, so is the need for housing. That demand will not slake. So the incentives for developers remain strong. We will see more construction over the next decade than over the last — and the last decade set a record.”
- “Of course, Cassandra has not been the only one watching housing prices fall. Some Pollyannas have cheered the fall, predicting that at last housing will become more affordable: The \$200,000 home will go for \$150,000, the \$150,000 home (in some parts of the country, this is a rare ramshackle) will go for \$100,000. Renters desperate to buy into the American dream, yet lacking the down payment — much less the income to finance a mega-mortgage — will get their raised ranch. And as more middle-income renters buy homes, the shortage of rental housing will ease, rents will drop, and the “affordability” crisis will fade.”
- “...Pollyanna, though, is shortsighted. Yes, some would-be owners, previously shut out of the market, may at last buy a home. But the “affordability” crisis will persist — exacerbated by rising interest rates. The working poor face their own income-and-expenditure imbalance: Their incomes fall short of their need for housing, food, transportation and health insurance. They will still be hard-pressed to pay for a basic apartment close to their jobs. If the market “self-corrects” in the fast-growing parts of the country, that self-correction will not trickle down far enough to help the Wal-Mart clerk or diner waitress. In our new economy, low-wage jobs are growing. These people will still need public intervention.”
- “Cassandra can stop wailing, and Pollyanna can stop cheering. Home prices in some regions are moderating, but for a nation inured to CNN’s headline-of-the-moment, this moderation does not rate high on the Richter scale of cataclysm.” (*Scripps Howard News Service*, Nicolas P. Retsinas, 09/27/06)
- In a September 29 article appearing in *The Motley Fool*, Seth Jayson asks, “Why is Harvard hyping housing?” Jayson writes, “Harvard. ...A place where we can trust the research as the work of independent-minded eggheads, right? I wouldn’t be so

sure. Today, we see a by one Nicolas P. Retsinas, director of Harvard's Joint Center for Housing Studies (JCHS). In it, he seeks to reassure a nervous and gullible public that all is well with housing. Prices won't drop too much, he claims, and the overall economy is not at risk."

- Oh, really? Oddly enough, he doesn't cite any data to support these contentions. Well, maybe that's not so odd. Recent numbers from no less a home-selling partisan than the National Association of Realtors (NAR) show that prices are already dropping, not only in bubble-afflicted coastal areas, but in the previously believed-to-be-safe Midwest, as well. But Retsinas shrugs past this. "Demand," he claims, was the reason for rising prices, and demand, he says, is still here.
- Demand doesn't exist in a vacuum. ...Unless we examine the underlying factors that drove the demand, and judge whether or not those are sustainable, there is no support for his contention. And it's pretty obvious to anyone who has paid attention to how this bubble was financed that the party can't go on. Simply put, this housing bubble has been inflated by cheap money combined with a sense of 'Get in before it's too late!' urgency supplied by the NAR, get-rich quick flippers, TV home shows, and others. But in the end, even cheap money failed to keep demand pumping. The ascent of gimmicky "no doc" and "option" ARMs shows how desperate the industry had to become in order to maintain the farce of "affordability." And even this isn't getting the job done anymore.
- ...But back to Retsinas and the Harvard JCHS. Why would he pump out to the press a defense of the bubble without a single, salient data point to back it up? What's the motive? I think the answer might be found in the cozy relationship between Harvard's JCHS and the home-building, -selling, and -supply industry. Take a look at the policy advisory board at the JCHS. It just happens to be made up of a few dozen companies with an enormous financial stake in the continuation of the housing bubble, like Centex, scandal-plagued Freddie Mac and Fannie Mae, and UBS. Oh please. Don't be shocked. You knew something like this was coming, didn't you? Well, it gets even better: These companies are also cutting checks to the JCHS. According to the JCHS Web site, 'The Policy Advisory Board provides financial support and guidance to the Joint Center; this support is critical to the Joint Center's mission and advances the shared goal of making housing a priority nationally as well as locally.' Sounds like a pay 'n' play deal to me...I've got a message into Harvard to find out just how much dough is changing hands here. If it's much more than a pittance, I consider that an interesting -- and by interesting, I mean scandalous -- conflict of interest.
- In the mean time, I'd suggest Retsinas step away from his policy advisory board and take a more sober approach to the underlying numbers. With real income falling and the Fed intent on slowing inflation, exactly what is going to keep future demand at the artificially inflated levels we've seen since 2002? ...I'll need much more than simplistic sound-bites before I can believe the fairy tale the JCHS is pushing. ...Finally, I'd suggest that ...my ...readers take care before [putting] too much faith

in the prognostications of seemingly independent ‘academics.’ Always take a look behind the scenes, follow the money, and take a look at who’s pulling the strings. (*The Motley Fool*, Seth Jayson, 09/29/06)

#### President Bush signs the credit rating agency reform bill into law

- On September 29, President George W. Bush signed into law a bill to reform the registration process of credit rating agencies. The House of Representatives adopted by a voice vote S. 2850 [The Credit Rating Agency Reform Act originated in the Senate] on September 28, avoiding the need for reconciliation of the Senate bill and a House version that was passed in July. The final bill gives the SEC explicit authority to regulate credit-rating agencies and establishes clear standard for firms seeking to be designated as “nationally recognized” credit rating agencies. Senate Banking Committee Chairman Richard Shelby (R-AL) said the law “will inject long-overdue competition in this industry, and investors and issuers will reap the benefits of more timely and accurate ratings, lower fees, more transparency in the ratings process, fewer conflicts, and fewer abusive and anti-competitive practices.” (*Dow Jones Newswires*, Judith Burns, 09/28/06; *Bureau of National Affairs*, 10/03/06)

#### Fannie Mae and Freddie Mae offer mortgage documents in Spanish

- Fannie Mae and Freddie Mac announced the joint availability of 83 non-executable Spanish translations of the Fannie Mae/Freddie Mac Uniform Instruments to help lenders better serve Hispanic consumers. The new documents are meant to compliment the English-language documents, which a borrower would sign. “We encourage the distribution of these complimentary translations to Spanish-language dominant consumers early in the home-buying process, so that potential borrowers can read the mortgage documents written in English with a side-by-side Spanish translation and better understand what they will sign at closing,” said Mercy Jiménez, senior vice president of Fannie Mae. The translations, which are provided for 54 security instruments, 20 promissory notes, and nine related documents, are available for all 50 states, the District of Columbia, Guam, and the U.S. Virgin Islands and can be downloaded at [www.efanniemae.com](http://www.efanniemae.com) and [www.freddiemac.com/uniform](http://www.freddiemac.com/uniform). (*Freddie Mac Press Release*, 09/25/06)

## ***Fannie Mae***

### Fannie Mae's mortgage portfolio shrinks at an annualized rate of 7.3% in August

- In August, Fannie Mae said its mortgage portfolio shrank at an annual rate of 7.3%, the biggest contraction in 10 months, to \$726.8 billion. Under GAAP, the company said that its mortgage portfolio for purposes of the OFHEO Consent Order was approximately \$723 billion in August, in compliance with the regulatory ceiling of \$727 billion. Fannie Mae's duration gap on its portfolio averaged minus one month in August, unchanged from July. (*American Banker*, William Launder and Marc Hochstein, 09/29/06; *Fannie Mae Monthly Summary*, 09/29/06)

### Fannie Mae's restatement is massive undertaking

- To facilitate his company's restatement process, Fannie Mae CFO Robert Blakely tracks the work of 600 dedicated employees, 2,000 outside contractors and a data system that could hold the Library of Congress twelve times over in the massive restatement of the company's financial statements. Fannie Mae will spend about \$100 million on new computer hardware as a result of the restatement process, said Blakely. In his first public presentation at a Lehman Brothers investors conference, Blakely said "I feel encouraged by the progress we are making [on the restatement process]." (*Reuters News*, Patrick Rucker, 10/03/06; *National Mortgage News*, 09/25/06)

### Litigation notes

- In a court filing, former Fannie Mae CEO Franklin D. Raines argues that OFHEO approved the pay incentives that the regulator later blamed for leading Raines and other executives to manipulate earnings by \$10.8 billion. Raines said that OFHEO is withholding documents that support his contention and asked the court to require the regulator to provide him the documents. (*Washington Post*, 09/30/06)
- On September 28, OFHEO director James B. Lockhart, III told reporters that his agency will continue to pursue the executives of Fannie Mae who were responsible for gross mismanagement of the company. "Punishing the bad guys is always worth the effort," said Lockhart. Analysts are optimistic that OFHEO's pursuit of Fannie's former management will likely benefit the company, by allowing them to help OFHEO with its prosecution of former management and help the company distance itself from its former management. For OFHEO, this is a chance to go after the key figures of the accounting scandal, said FTN Financial analyst Jim Vogel. Fannie's cooperation would show that it is willing to work with OFHEO after its bruising

investigation of the company, Vogel added. Under its Consent Agreement, Fannie Mae is due to report its findings on the role of former and current management in the accounting scandal by October 20 and report if the company plans to try to “recover” compensation from any of its executives. “It works in everybody’s favor for the story to be done at this point,” said Vogel. (*American Banker*, Patrick Rucker, 10/04/06; *Market News International*, Heather Scott, 09/28/06)

- In an October 4 SEC filing, Goldman Sachs & Co. said it has been added as a defendant in amended complaints related to allegations over Fannie Mae’s accounting practices. The complaints allege that Goldman Sachs violated securities laws in connection with some Fannie Mae-sponsored REIT deals allegedly arranged by the company. The other defendants in the lawsuit include Fannie Mae, a number of past and present officers and directors, accountants and other financial services firms. The amended complaints were filed in August and September in a class action suit and a separate shareholder derivative action pending in the U.S. District Court for the District of Columbia. (*Dow Jones Newswires*, Bhattiprolu Murti, 10/04/06)

Fannie Mae CEO Daniel Mudd has major reservations about “exotic” mortgages
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- In a recent interview with *Origination News*, Fannie Mae CEO Daniel Mudd acknowledged that there is a “new competitor in town” [Wall Street firms and their conduits], but said he has major reservations about the credit characteristics of exotic mortgages. Fannie Mae is concerned that “that the credit characteristics reflected in the layering of products - products that typically get distributed through the private-label securities market - have risks that are difficult to quantify,” said Mudd. The loan features that concern him the most include teaser rates, low documentation and high loan-to-value ratios. While there is not necessarily anything wrong with these features if they are being pitched to “sophisticated” borrowers who understand them, Mudd’s chief concern is for borrowers “further down in the FICO spectrum.” (*Mortgage Line*, Paul Muolo, 09/26/06)

Fannie Mae board adopts changes to its bylaws
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- On September 19, the Fannie Mae board adopted a series of changes to the company’s bylaws and Code of Business Conduct, including two changes addressing corporate governance issues addressed previously by a settlement with OFHEO. While many of the changes are routine, one bylaw change formalizes the position of Chief Executive Officer and sets out the duties for this position. Another change stipulates that the chairman of the board of directors is to be an held by an independent director rather than an officer of the company. Among other changes, the board must also maintain a nominating and corporate governance committee with a structure that complies with the NYSE rules and an audit committee that complies with the 2002 Sarbanes-Oxley Act. The bylaw changes will also permit the CEO or CEO’s designees to authorize the use of facsimile signatures. (*Dow Jones*

*Newswires, Greg Wright, 09/26/06; AFX International Focus, 09/26/06; Associated Press, 09/25/06)*

Fannie Mae adjusts dividend rates for its variable rate non-cumulative preferred stock

- On September 28, Fannie Mae announced the next scheduled dividend rate adjustments for its variable rate non-cumulative preferred stock. For Series G stock, the new rate will be 4.59% per annum, effective September 30. The new rate for Series O will be 7.085% per annum, effective September 30. (*Marketwatch, 09/28/06*)

## ***Freddie Mac***

Freddie Mac's mortgage portfolio shrinks for fourth month

- Freddie Mac said its mortgage portfolio fell at a 6.8% annual rate in August to \$707 billion. During the month, Freddie Mac sold \$6.1 billion of mostly company mortgage securities from its portfolio in addition to \$14.5 billion in assets which matured or were refinanced. Contracts to purchase mortgages at a later date rose \$671 million to \$3.3 billion in August. Company spokesman Michael Cosgrove said, "The contraction during the month was driven by tightening mortgage-to-debt spreads in late July and August." Freddie Mac also said it would probably not increase its outstanding debt in coming months, fueling expectations that the company's portfolio would remain unchanged (or smaller) through the end of the year. The company's duration gap average zero months in August, unchanged from July. (*Reuters, 09/25/06; Bloomberg News, 09/26/06; Freddie Mac Monthly Volume Summary: August 2006, Freddie Mac, 09/25/06*)

Almost half of mortgages sold to Freddie Mac came from three lenders

- According to Freddie Mac's annual report, almost half of all mortgages sold to Freddie Mac came from three lenders last year. "These three lenders are among the largest mortgage originators in the United States," according to the report. A company spokesman declined to reveal the lenders identify. The top four sellers to Freddie Mac in 2004 were Wells Fargo Bank (\$74 billion) and its subsidiary Wells Fargo Funding (\$36 billion); Chase Manhattan Mortgage (\$39 billion) and ABN Amro (\$22 billion). (*Mortgage Line, Paul Muolo, 09/25/06*)

Freddie Mac and Wells Fargo team up to increase homeownership opportunities for Latino families in Nevada

- In conjunction with Hispanic Heritage Month, Freddie Mac, Wells Fargo Home Mortgage (Wells Fargo), the National Association of Hispanic Real Estate Professionals, the State of Nevada Department of Business & Industry Housing Division and Senator Harry Reid (D-NV) announced the launch of the new Nevada Latino Homeownership Initiative. In a collaborative effort to expand homeownership opportunities for Latino families throughout Nevada, Wells Fargo make its most flexible mortgage products available to Nevada Latinos and Freddie Mac will purchase these loans. The Nevada Housing Division will offer fixed-rate 30-year below-market interest rate mortgages for low-to-moderate income first-time buyers as well as down payment and closing cost assistance. (*PRNewswire*, 10/09/06)

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

FHLBs ask the Federal Housing Finance Board to appoint new public-interest directors by year-end

- In an October 2 letter, the chairmen and vice-chairmen of the 12 FHLBs asked the Federal Housing Finance Board Chairman Ronald Rosenfeld to appoint new public-interest directors by the end of the year. “These directors perform a vital function for each of the [FHLBs] by bringing expertise and other capabilities that are necessary for sound governance,” wrote the chairmen and vice chairmen. The letter also notes that the Finance Board, which hasn’t made any such appointments in almost three years, is required by law to make these appointments. (*Dow Jones International News*, Damian Paletta, 10/02/06)

Consolidation of the FHLBs unlikely...

- During a House Financial Services Committee meeting last month, Federal Housing Finance Board Chairman Ronald Rosenfeld said he supported the concept of the FHLBs consolidating, given the ongoing regulatory troubles of several of the Banks and recent mergers and acquisitions among the Banks’ members. “Quite frankly, I don’t understand why you need six [FHLBs] between Pittsburgh and Topeka,” Rosenfeld told the panel. Consolidation supporters argue that some of the FHLBs are dependent on a few large member institutions; that there are too many redundancies in the FHLB System; and that attempts by the FHLBs’ into new products such as their mortgage programs, appear to have failed.

- The FHLBs and their members are fighting back, arguing that there is few economic and political incentives for consolidation of the FHLB System and that the Finance Board is not likely to force the issue. Although the Finance Board has the legal authority to reduce the number of FHLBs from 12 to eight, Rosenfeld told a private meeting of FHLB directors that any consolidation efforts should come from the FHLBs themselves. A source said that Rosenfeld offered a list of reasons why the Banks should consider making the move and said he would support a decision to consolidate the FHLBs.
- Consolidation is also a tough sell politically, since lawmakers have incentives to keep the 12 FHLBs in place. Each Bank is required to dedicate 10% of the previous year's profits to affordable housing projects in their markets. If the FHLBs are consolidated, the surviving Banks would have more communities to assist. "That becomes a powerful congressional reason against consolidation," said Bert Ely, an independent consultant in Alexandria, VA. In a September 15 interview, Finance Board director Geoff Bacino said that while he supports a Bank's decision to consolidate, the political obstacles may be too high to overcome. "From first glance, you could say from a theoretical standpoint, ... [consolidation] makes sense," said Bacino. "We've got a lot of banks east of the Mississippi. But in a practical world and a political world, I really don't see anything happening." Lawmakers would likely be reluctant to sign off on a plan that would remove a bank from their district, he added
- It is unlikely that the FHLBs might push for consolidation, since there is little financial incentive to do so. The Banks' stock is not actively traded and senior management would reap few, if any, financial benefits from conducting a successful and profitable merger. "In the Home Loan banks, there's no way to pay an acquisition premium," said Alex Pollock, an American Enterprise Institute fellow and former president of the FHLB-Chicago. "Why would you give up your job when you can't make your normal payoff? There's no way to balance out the losers from the management point of view." (*American Banker*, Steven Sloan, 09/25/06)

FHLB System's assets exceeded \$1 trillion on June 30 <sup>th</sup>
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- According to the FHLBs' Office of Finance, the FHLB System's combined total assets increased to \$1.0 trillion at June 30, 2006 compared with \$997 billion on December 31, 2005. FHLB Advances increased 3% to \$638 billion on June 30, representing 63% of total assets. Investments rose 2% to \$272 billion, while member mortgage assets, which totaled \$102 billion, were down 3% from year-end. The FHLB System's combined net income for the three months ended June 30, 2006 increased 136% to \$648 million, compared with \$274 million for the three months ended June 30, 2005. Combined net income for the six months ended June 30, 2006 increased 32% to \$1.3 billion, compared with \$960 million for the six months ended June 30, 2005. Total combined capital rose to \$45 billion at June 30, 2006, a 2% increase from December 31, 2005. As of August 8, 2006, all twelve FHLB SEC registrations were effective. (*The Main Wire*, 10/05/06)

#### FHLB-Indianapolis files second quarter 10Q

- On September 29, the FHLB-Indianapolis filed its second quarter 10Q with the SEC, which was delayed because of the Bank's discussions with the SEC regarding the sufficiency of the Bank's historical methods used to statistically measure hedge effectiveness prior to 2006 in significant portions of its derivatives portfolio. Based upon these discussions, the Bank concluded that it did not need to restate its historical financial statements. (*FHLB-Indianapolis Press Release, 09/29/06*)
- On June 30, the FHLB-Indianapolis reported total assets of \$49.7 billion, advances to members of \$23.4 billion, \$9.9 billion of mortgage loans held for portfolio, and total capital of \$2.3 billion. For the three months ended June 30, the Bank reported net income of \$29.4 million, down 18.7% from the second quarter of 2005. (*Federal Home Loan Bank of Indianapolis 10Q, 09/29/06*)

#### FHLBs announce their third quarter dividends

- The FHLB-Atlanta's board of directors has approved an annualized dividend rate of 5.90%, for capital stock held from July 1, 2006 to September 30, 2006, payable at the close of business October 2. (*PR Newswire, 09/25/06*)
- The FHLB-San Francisco projects its third quarter dividend to be approximately 5.18% (annualized). The Bank expects to announce its third quarter dividend on or about October 25, after it closes its books for the period. (*Business Wire, 09/29/06*)
- The board of directors of the FHLB-Dallas has declared a stock dividend for the third quarter at an annualized rate of 4.91%, applicable to the average capital stock held by its members from April 1 through June 30, to be paid on September 29. (*PR Newswire, 09/29/06*)

#### Wamu completes groundbreaking sale of \$5.1 billion of in EU covered bonds

- Washington Mutual has settled its sale of \$4 billion euros (\$5.1 billion) of European-style covered bonds collateralized by mortgages, amid strong investor interest in the offering. "This program should make our debt more sought after on a global basis, ultimately reducing our company's cost of funds, as well as increasing our investor base beyond the U.S.," said Chairman and Chief Executive Kerry Killinger. By diversifying the company's funding through the European debt offering, WaMu will be about to lower its funding costs and reduce its reliance on FHLB advances. (*Associated Press, 09/27/06*)

- According to observers, another large mortgage player looking to diversify its funding could enter the European covered bond market as early as September. “There are at least one or two other issuers who are looking at it very closely,” said Louis Hagen, the chairman of the European Covered Bond Council, but did not the companies or speculate on the timing. Wamu treasurer Robert Williams said that Wachovia Corp., Countrywide Financial Corp., Bank of America Corp., and Wells Fargo & Co. are likely candidates to issue euro-denominated covered bonds. Mr. Williams said Wamu’s issuance helped the Seattle thrift company extend its maturity profile, gain exposure among foreign investors, and diversify its funding mix. Williams also reiterated that Wamu’s decision to enter the European bond market was driven by a desire to reduce borrowings from the FHLB System. As a FHLB bank borrower and shareholder, Wamu is concerned about changes being considered by the Federal Housing Finance Board that would reduce FHLBs’ dividends, said Williams. “This proposed regulation would confiscate capital that we would otherwise receive and clearly increases the effective borrowing cost by reducing the dividend,” he added. (*American Banker*, Jim Cole, 10/06/06)

FHLB provision excluded from regulatory relief bill
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- Before adjourning, Congress voted final passage of a scaled-down version of a regulatory relief bill, which excluded a provision which would have allowed privately-insured credit unions join the FHLB system. The provision, submitted by retiring House Financial Services Committee chairman Michael Oxley (R-OH), would have allowed privately-insured credit unions in Ohio join the FHLB system. (*Credit Union Journal*, Ed Roberts, 10/02/06)

FHLB-Atlanta’s Washington legislative affairs director joins ACB
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- Nicole Payla Freeman, formerly the Washington legislative affairs director for the FHLB-Atlanta, has joined America’s Community Bankers as its senior lobbyist. (*American Banker*, Steven Sloan and Stacy Kapper, 09/25/06)

## ***Ginnie Mae***

Ginnie Mae looking at new ways to structure reverse mortgages

- Writing in *National Mortgage News*, Paul Muolo noted that Ginnie Mae “wants to give Fannie Mae some competition for FHA-insured reverse mortgages. Agency officials are looking at different structures to securitize these mortgages, which are designed to help cash-poor seniors stay in their homes.” According to Ginnie Mae President Rob Couch, his agency’s involvement in FHA’s home equity conversion mortgages [HEMC] could increase competition in a market in which Fannie Mae is the largest investor. (*National Mortgage News Daily Briefing*, Paul Muolo, October 7-8, 2006; *MortgageWire*, 10/06/06)

[Editor’s Note: There was a typographical error in the earlier edition of the October 9, 2006 *GSE Report* that misrepresented the *National Mortgage News*’ story on Ginnie Mae. Ginnie Mae is interested in competing with Fannie Mae for FHA-insured mortgages, not Farmer Mac, as was reported in the earlier version of the *GSE Report*.]

## ***International Mortgage Market***

Russia successfully completes the public securitization of mortgage certificates

- According to the [U.S. government’s] Overseas Private Investment Corp (OPIC), a \$72.6 million securitization by Russia’s CityMortgage Bank, backed by residential mortgages originated primarily in Moscow and St. Petersburg, has been successfully completed. OPIC supported the transaction by providing a \$6 million loan to Greenwich Financial Services LLC to purchase the deal’s Class B notes. “We used U.S. structuring conventions not unlike the U.S. [agency] MBS model to improve the execution and pave the way for future deals. We designed the transaction specifically so we could replicate it to benefit investors and Russian homeowners,” said Greenwich Financial president William Frey. “By providing a Russian bank access to the capital markets for a mortgage-backed securitization, this groundbreaking transaction opens the Russian mortgage market to dynamic sources of funding, the ultimate benefit of which will be more affordable homeownership terms for Russian homeowners,” said OPIC president and CEO Robert Mosbacher Jr.
- [According to OPIC’s website, “The Overseas Private Investment Corporation ... was established as an agency of the U.S. government in 1971. OPIC helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, complements the private sector in managing risks associated with foreign direct investment, and supports U.S. foreign policy. Because OPIC charges market-

based fees for its products, it operates on a self-sustaining basis at no net cost to taxpayers. ...Currently, OPIC programs are available for new and expanding business enterprises in more than 150 countries worldwide.”] (*National Mortgage New Daily Briefing*, Bonnie Sinnock, October 7-8, 2006; *OPIC Press Release*, 09/15/06; [www.opic.gov/about/index.asp](http://www.opic.gov/about/index.asp))

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

### FCA gives big boost to HORIZONS Project

- In the September issue of *Farm Credit Watch*, Bert Ely wrote, “The Farm Credit Administration (FCA), the FCS’s regulator, is doing everything it can to advance the HORIZONS Project, FCS’s initiative to greatly expand its lending powers. The FCA helps out when it revises its regulations in a manner which stretches the Farm Credit Act as far as possible. On September 14, the FCA board took a big step in that direction by issuing for public comment a major expansionary revision of its regulation governing FCS financing of agricultural processing and marketing operations. Presently, FCS financing for these operations is restricted to entities where farmers ‘own more than 50 percent of the voting stock or equity’ and provide some of the operation’s ‘throughput,’ or raw material. Lending to these operations is restricted when an ‘eligible borrower’ regularly supplies less than 20% of the throughput.”
- The thrust of this regulatory initiative is to greatly expand the number of entities eligible for FCS financing, in three regards. First, the FCS could lend to a processing or marketing operation where eligible borrowers own 50 percent or less of the entity’s voting stock or equity, but where they have majority voting control, control over management, or ‘documented power and authority’ to run the entity. Second, eligible borrowers could own as little as 25% of the entity’s voting stock, if they provide at least 20% of its throughput. Third, the operation is a ‘direct extension or outgrowth of an eligible borrower’s operation’ and the borrower ‘provides some throughput’ to it. However, the permissible scope of the operation’s activities is very fuzzy. Combined, these provisions would open the door much wider to FCS financing of clearly non-ag related businesses, a key objective of the HORIZONS Project.”
- Ely also noted two notational votes taken by the FCA which he viewed as “puzzling.” He wrote, “One vote approved a request by CoBank ‘to invest in rural housing mortgage-backed securities under a three-year mission-related investment pilot program.’ This pilot program raises lots of questions: What type of housing will be financed? Will this housing be an exception to what the FCS is permitted to finance today, which is ‘moderately priced,’ rural homes serving as the borrower’s principal residence? What is so risky or unique about these securities that it is necessary for a GSE to buy them? Is this merely an attempt by CoBank to further arbitrage its GSE

funding-cost advantage to generate unneeded investment income? The other vote approved a proposal by East Carolina Farm Credit ‘to issue up to \$100 million of nonvoting cumulative preferred stock to its members.’ What is weird about this proposal is that East Carolina had \$796 million in assets on June 30 and \$111.5 million of net worth. Why is this association seeking to nearly double its net worth? Does it plan to acquire another association and use these funds to pay out a big one-time dividend to its members?” (*Bert Ely’s Farm Credit Watch*, Bert Ely, September 2006)

Farmer Mac to restate its FY2003 –FY2005 financial statements
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- Farmer Mac announced it will restate its financial results for 2003 through the first half of 2006 to correct accounting for certain hedges, after deciding that it could not justify its previous accounting treatment. Current accounting rules require Farmer Mac to record changes in fair market value of certain derivatives in its financial statements, rather than being deferred or offset. The restatement will be completed when the company files its third quarter 10Q with the SEC, said Farmer Mac. (*Reuters*, 10/06/06)
- In *National Mortgage News*, Paul Muolo wrote, “Yet, another government-sponsored enterprise is going into ‘accounting rehab.’ This time around the bookkeeping drunkard is none other than ...Farmer Mac, ...[which] said recently that it will restate earnings for the last three years to correct errors in hedge accounting...” (*National Mortgage News Daily Briefing*, Paul Muolo, October 7-8, 2006)

## *Postal Service*

“I do not know if [it] will be possible” to pass postal reform during the lame duck session, says Senator Collins

- According to insiders, a postal reform compromise proposed by Senate Homeland Security and Governmental Affairs Chairwoman Susan Collins (R-ME) has met enough opposition from various interest groups that final passage in the lame-duck session is now in doubt. “While I remain committed to the goal of passing the bill in the lame-duck session, I do not know if that will be possible,” said Collins in a statement. “[A]t the eleventh hour, various parties raised objections to some of the bill’s long-standing provisions, and these objections caused certain members of Congress to block passage of the legislation.”
- The pivotal issue is whether the Postal Service should price single-piece parcels based on market forces alongside competitors, or have those rates set annually by the Postal Regulatory Commission. Collins’s proposal has parcel prices set by the Commission. USPS spokesman David Bolger said the postal service, which “has voiced our opposition to [to this provision] for years,” withdrew its support of the sweeping postal reform bill during the last week of September. “Everyone knew this was the one sticking point we had,” Bolger added. Representatives of UPS and the Postal Service worked out a compromise on the pricing issue to be inserted to the bill, said Bolger, but Collins staff did not consider the proposal. Spokesman Ron Bergen said the National Association of Letter Carriers (NALC) also launched an attack on the proposal, after learning that a provision in the compromise would require postal workers to wait three days before being permitted to collect worker compensation benefits. [Employees would be expected to use vacation or sick leave for the first three days that they are out of work and would be reimbursed for that period if there were unable to return to work after 14 days, according to congressional aides.] NALC president William H. Young said he would not accept the bill, because no one had explained to him why this provision was necessary. According to congressional aides, Collins was dismayed by Young’s position, since the union had not brought up this issue in three years of negotiations on the bill and had promised to support the legislation.
- Ben Cooper, who represents direct mailers at Williams & Jensen, said, “The variables in the lame duck are too many to count.” The Collins proposal, which would have served as the conference report, has not been filed, and the House has not appointed conferees. “The bill would have moved had it not been for the NALC’s attempt to kill it,” said Cooper, who added that time is running out. “The lame duck is a problem under any circumstances, but you still have Bill Young’s opposition, other bills that must be acted on, and an election that could change everything.”

- While House Government Reform Chairman Tom Davis (R-VA) continues to be optimistic about the postal reform's chances, Davis acknowledged that provisions for postal rate increases and workers compensation policies are potential roadblocks to passage of a bill. "I think we are conceptually 99.9 percent there at this point. It's a death spiral [for the Postal Service] if you don't make some changes," said Davis at a breakfast sponsored by the Council for Excellence in Government and the *Washington Post*. Davis said that passage of a reform legislation came "within a quarter of an inch" of passing both the Senate and House –and should be passed in November. "It's not the postal bill I would have liked...but getting your plan and getting it through Congress are two different things," said Davis.
- In an October 3 letter to APWU's members, union president William Burrus wrote, "On the evening of Sept. 30, 2006, as Congress was poised to adjourn to campaign for the mid-term elections, postal workers avoided a legislative disaster. Sen. Susan Collins (R-ME), Chair of the Senate Government Affairs Committee, finalized a revised version of a Senate postal 'reform' bill and initiated parliamentary procedures for a vote. Only through the combined efforts of the postal craft unions (APWU, National Association of Letter Carriers, National Postal Mail Handlers Union, and National Rural Letters Carriers Association) were we able to delay final action on this bill that would have been bad for American citizens and bad for postal workers. We are most appreciative of Sen. Daniel Akaka (D-HI) and Rep. Henry Waxman (D-CA), for their support on issues that were important to us during the tense hours of negotiations. If this legislation had passed, the winners would have been the large mailers, their congressional supporters, and the White House. The losers would have been individual postal customers, small businesses, and postal employees. The bill would have put in motion a legal framework that would have led to the erosion of service and a reduction in wages and benefits. This is a bad bill and it does not deserve to become law."
- Some administration officials and lobbyists think that postal reform could be dead not only for this year but for two or three years, if control of Congress shifts to the Democrats. Some also doubt that Collins and the Bush administration will give in to the NALC's demands. One administration official, who participated in the negotiations and asked not to be named, noted that postal reform has survived many delays and attempts to kill it. "This has more lives than nine dead cats," he said. (*Washington Post*, Stephen Barr, 10/04/06; *APWU Burrus Update #14-06*; 10/03/06; *GovExec.com Daily Briefing*, Daniel Pulliam, 10/03/06; *GovExec.com Daily Briefing*, Jessica Brady, 10/03/06)
- The Association for Postal Commerce (APC) noted that FASB has adopted a new rule which will force companies to disclose the future costs of retirement benefits on their balance sheets, booking the unfunded costs of these benefits as a liability and overfunded benefit as an asset on its financial statement. APC wrote, "What this means is that the Postal Service's entire retirement-related liability must now show up on its books. Bad news for ratepayers. Enactment of postal reform would have put the Postal Service on the right path of ensuring that all unfunded liabilities would be

covered on a timely and predictable basis, and would have ended the escrow that provides Congress and the Administration with a wad of cash worth raiding for something other than the payment of postal retirement obligations.” (*Postcom*, Association for Postal Commerce, 09/30/06)

USPS reports net deficit of \$38 million (before escrow allocation)

- The Postal Service reported a net deficit of \$38 million before the escrow allocation in August, based upon revenues of \$6.3 billion and expenses of \$6.3 billion. Year-to-date revenue through July is \$507 million (or 0.8%) higher than plan and 4.2% above the same period in 2005. Year-to-date expenses are \$535 million, \$2.9 billion (or 0.8% higher) above the same period last year. Year-to-date (YTD) net income before escrow is \$1.3 billion. After the escrow allocation, the USPS reported a net deficiency of \$1.5 billion YTD. Total YTD mail volume is 1.6 billion pieces, 0.8% above the same period last year. First Class Mail volume is 0.4% below last year, while Standard Mail and Priority Mail are 1.8% and 4.6% above last year, respectively. (*DMNews.com*, Melissa Campanelli, 10/06/06; *USPS Press Release*, 10/06/06)

President Bush nominates Thurgood Marshall, Jr. to USPS Board of Governors

- On September 26, President George W. Bush nominated Thurgood Marshall, Jr. to the Board of Governors of the USPS. Marshall, the son of former Supreme Court Justice Thurgood Marshall, would serve as Governor for the remainder of a nine-year term expiring December 8, 2011. (*Alliance for Nonprofit Mailers*, 09/29/06)

October 26<sup>th</sup>: National day of picketing to protest “ill-advised postal consolidations”

- The Association of Postal Workers Union, AFL-CIO adopted a resolution declaring October 26 as a nationwide day of picketing to protest postal consolidations. The union’s coordinated protest is designed to highlight the potentially damaging effects of the Postal Service’s consolidation plan and expose how the USPS policy “panders to major mailers.” APWU President William Burrus said, “I urge locals and state organizations to participate in the nationwide day of picketing, and I urge them to take our message to the public: This plan will delay mail to local communities, and it is being forced on the American people without their input. We intend to change that. We will engage the public in a dialogue about their expectations and experience with postal service.” (*American Postal Workers Union, AFL-CIO Press Release*, 09/28/06)

# TVA

## Senate approves William Graves for TVA board

- The U.S. Senate approved Bishop William H. Graves of Memphis, TN to become the ninth member of the TVA board of directors, marking the first time a black director has been named in the agency's 70 year history. "[Bishop Graves] is an outstanding individual who will ably represent the ratepayers' interests," said Senator Bill Frist (R-TN), who strongly supported his nomination. "With a new, stronger board of directors and a modernized management structure, I'm confident TVA is now fully prepared to address the challenges of the 21st century." Graves, 70, is senior bishop of the Christian Methodist Episcopal Church and former 10-year member of the board of Memphis Light, Gas and Water. (*Associated Press*, 10/01/06)

## TVA board committee proposes to stop selling the utility's land for private development

- The TVA community relations committee recommended that the board stop selling the 293,000 acres of public lands that it manages for residential or retail development. The proposal, which will be open for public comment until November 3, would halt the Board's existing informal policy that allowed two major developments in Southeast Tennessee by the agency's previous full-time board. In May, TVA's expanded part-time board adopted a moratorium on further private land deals on TVA shoreline. In November, the TVA board is expected to vote on the proposed changes, which would not affect sales approved by the previous TVA board. (*Chattanooga Times Free Press*, 09/29/06; *Associated Press*, Duncan Mansfield, 09/29/06)

## TVA's plans to cut debt "realistic," says GAO

- GAO said that TVA's plan for cutting its debt by nearly a third [or \$7.0 billion] in the next decade is realistic, but warned that these plans may have to be scaled back if the utility decides to build more power plants. "Overall, GAO's review found TVA's approach to developing its plans to reduce financing obligations reasonable," said the agency in a report to Congress dated August 31. TVA has more than \$25 billion in long-term financial obligations, including statutory debt, leases and energy prepayment contracts. (*Associated Press*, 10/05/06)

## TVA board approves VA distributor's request to rejoin the system

- The TVA board of directors approved the return of Bristol Virginia Utilities (Bristol) to the TVVA system under a 20-year contract effective January 1, 2008. Bristol has been in negotiations for almost two years with TVA and its current provider, American Electric Power. The 16,000 customer distributor anticipates that their

move back to TVA will result in a rate hike of nearly 18% to its customers, which will be imposed in stages in 2007 and 2008. (*Associated Press*, 09/29/06; *Associated Press*, 09/26/06)

**Canfield & Associates, Inc.**

1401 H St., NW, Suite 560

Washington, DC 20005

Phone: (202) 661-2100

Fax: (202) 403-3924

[www.canfieldassoc.com](http://www.canfieldassoc.com)