

The **GSE** REPORT™

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Major Events

Subprime mortgage fallout triggers a
“Minsky moment” in the global financial markets

President Bush announces the administration’s plan to use FHA to help distressed
homeowners

The Fed will act, if needed, says Federal Reserve Chairman Bernanke

Fannie Mae and the Democrats launch campaign to raise the GSEs’ portfolio caps
to improve the secondary market’s liquidity

House Financial Services Chairman Frank calls for more regulation

Democrats seize on the market turbulence as a 2008 campaign issue

The public debate begins on a bailout of the subprime market

The rating agencies’ role in the subprime market comes under greater scrutiny

Are new rules need for a “wider” financial system?

This is really just the beginning...

Concerns about an economic slowdown grow

Subprime mortgage fallout triggers a “Minsky” moment in the global financial markets

- In *Financial Times*, George Mangus, senior economics advisor at UBS, wrote, “The ‘Minsky moment’ in financial markets, the point where credit supply starts to dry up, systemic risk emerges and the central bank is obliged to intervene, has duly arrived. The Federal Reserve’s decision to lower the discount rate [in mid-August], while largely a symbolic act, was greeted with much enthusiasm not least because of a sense of relief that the Fed was prepared to act. This followed a week in which both the Fed and the European Central Bank had injected large amounts of liquidity to help maintain orderly markets. ... [T]he Bank of England also injected liquidity into UK markets as credit supply and funding tightened up.”
- “But while equity markets have [stabilized] temporarily in anticipation of policy loosening by the Fed, credit markets remain deeply troubled. The immediate focus is on short-term funding, financing flows and counterparty risk. [During the week of August 20], three-month US Treasury bills touched 2.99 per cent, compared with a

yield of 5 per cent a month ago. Investors are avoiding securities [collateralized] against or invested in mortgages. This Minsky moment is not yet over. [I]nterest rates in the U.S. and perhaps elsewhere will come down sooner or later. The path ahead is littered with losses, lawsuits and greater regulation..." (*Financial Times*, George Magnus, 08/23/07)

President Bush announces the administration's plan to use FHA to help distressed homeowners

- On August 31, President George W. Bush announced four-part plan for the government to assist homeowners in need of assistance to avoid foreclosure. Bush urged Congress to pass FHA reform legislation, which would lower down-payment requirements, allow the agency to insure bigger loans, and provide FHA more pricing flexibility. To address borrower's needs, the Administration is launching a new initiative called "FHA Secure," which will allow FHA to offer loans to creditworthy borrowers who have fallen behind on payments due to resets. Borrowers who qualify for this program must have a history of on-time mortgage payments before their teaser rate expired; their rate reset must reset between June 2005 and December 2009; have 3% cash equity in their home; have a sustained history of employment; and sufficient income to make the mortgage payment. HUD estimates that approximately 240,000 families can be helped by the FHA Secure loan program. The President also asked Congress to provide temporary tax relief to ensure that cancelled mortgage debt on a primary resident is not counted as income for the borrower. The Administration is also launching a new foreclosure avoidance program to help struggling homeowners find a way to refinance their mortgages. The President has asked Treasury Secretary Henry Paulson and HUD Secretary Alphonso Jackson to reach out to a wide variety of groups that offer counseling and refinancing for homeowners, including community organizations such as NeighborWorks, mortgage lenders and servicers, FHA, Fannie Mae and Freddie Mac. The goal of this initiative is to expand mortgage financing options, identify homeowners before they face hardships and help them understand their financing options, and help the borrowers find a mortgage product that works for them.
- President Bush also supports the actions being taken to protect homeowners and prevent these types of problems from occurring again. These actions include the federal banking regulators' development of improved disclosure requirements and strengthening of mortgage lending standards; HUD's initiative to propose reforms [this fall] to RESPA that would improve the borrower's ability to identify the best loan terms, provide clearer disclosures, limit settlement cost increases and require loan fee disclosure; the state-based efforts to create a comprehensive mortgage brokerage system; the creation of a Presidential Council on Financial Literacy; and the Justice Department's pursuit of fraud and wrong-doing in the mortgage industry. President Bush has also asked Secretary Paulson to lead the President's Working Group on Financial Markets to examine the broader market issues underlying the recent mortgage problems. The group, comprised also of Federal Reserve Chairman Ben Bernanke, SEC Chairman Christopher Cox and Commodity Futures Trading

Commission Acting Chairman Walter Lukken, will examine the role of credit agencies in the marketplace and how their ratings are used in lending procedures and how securitization of mortgage assets has changed the mortgage industry and related business practices. (*White House Press Release*, 08/31/07)

- In his September 1st radio address, the President outlined the steps his administration is taking to help troubled homeowners. The President said, "...The fundamentals of America's economy remain strong. But the mortgage industry is going through a period of adjustment. And some Americans are worried about the impact this is having on their ability to make their monthly mortgage payments. I have made it a priority to help American homeowners navigate these financial challenges, so that as many families as possible can stay in their homes. The Federal government will not bail out lenders—because that would only make a recurrence of the problem more likely. And it is not the government's job to bail out speculators, or those who made the decision to buy a home they knew they could never afford. But I support action at the Federal level that will help more American families keep their homes... Homeownership has always been part of the American Dream. During my Administration we've achieved record homeownership rates. We'll continue to work hard to keep our housing market strong, to ensure that American families can afford the homes they buy, and to help bring the dignity and security that comes with homeownership to more of our citizens." (*Radio Address by the President to the Nation*, 09/01/07)
- Senate Banking Committee Chairman Christopher Dodd (D-CT) has said that reforming the FHA will be one of his top priorities when Congress returns from its summer recess. On May 4, the House Financial Services Committee approved an FHA reform bill which would authorize the agency to make zero down-payment loans and raise loan limits in high cost real estate markets. The bill awaits passage by the House of Representatives. (*Marketwatch*, Robert Schroeder, 08/31/07)
- In a research report, RBS Greenwich bond analyst David Ader wrote, "[Bush's proposal] is not going to reverse things. This proposal is something that may help a small slice of the market, but we don't see it as a broad solution." According to HUD, the FHA Secure Program might help as many as 240,000 distressed borrowers, roughly 12% of the estimated 2 million homeowners at risk of foreclosure [according to housing advocates.] Henry Savage, president of PMC Mortgage Corp., Alexandria, VA, said, "It's very well-timed that FHA emerge as a viable alternative to conventional lenders. They're stepping in and providing mortgage products that they used to offer but had been taken over in the last 20 years by conventional lenders. Now that private lenders are dropping out of that, FHA is stepping in. It will especially help the bigger cities where home prices are highest, but it will help almost any area." Tomas Davidoff, assistant professor at the Haas School of Business at the University of California, Berkley, said, "This is helpful. But you had millions of people taking out loans they should not have been taking, and investors lending money at too low interest rates. Nothing is going to make those bad decisions go away." (*New York Times*, Steven R. Weisman, 08/31/07; *Bloomberg News*, Roger

Runnigen, 08/31/07; *MarketWatch*, Robert Schroeder, 08/31/07; Barclays *Capital U.S. Securitization Research*, Joseph Astorina, 08/31/07)

- In a September 3rd editorial, the *Washington Post* wrote, “Like most other politicians, President Bush basically ignored the subprime crisis while it was incubating. Last week, though, he unveiled a proposed fix--and not a moment too soon. A month from now, \$50 billion worth of adjustable rate mortgages will ‘reset’ from the low interest rates at which they originated in October 2005 to much higher rates that will be due for the next 28 years. Hundreds of thousands of people are about to be hit with 30 to 40 percent increases in their monthly payments. Since house prices are falling and October’s resets are just the first of many, a long wave of foreclosures seems inevitable.”
- “The U.S. economy is going to take a hit, though no one can say when or how big. Government’s challenge is to limit the damage—especially to low- and moderate-income borrowers—without protecting lenders and investors from the consequences of their own bad business decisions. In this respect, with his plan, Mr. Bush wisely resists calls from some Democrats to let Fannie Mae and Freddie Mac buy up ‘jumbo’ loans in expensive markets or loosen current limits on the size of their portfolios. That form of relief is too indiscriminate; it would prop up the price of houses generally, including the many that were bought by speculators. Single-family housing is already heavily favored by government—through the mortgage interest deduction, the implicit federal guarantee to Fannie and Freddie and other policies. Lower prices are tough on current owners. But they benefit people who could not afford to buy previously.”
- “The president’s proposal appropriately focuses government resources where they are likely to do the most good: on subprime borrowers who are behind on their payments but have the means to handle modified loans at reasonable terms. In this, he agrees with leading Democrats, who never claimed that everyone can or should be saved. Democrats have, however, correctly argued that, given the huge costs of foreclosure—to borrowers, lenders, middlemen and bond buyers—it would be in everyone’s interest to renegotiate where possible...” (*Washington Post*, 09/03/07)

The Fed will act, if needed, says Federal Reserve Chairman Bernanke

- On August 31, Federal Reserve Chairman Ben Bernanke said that the central bank will take the necessary steps to shelter the economy from the turmoil in the financial markets, but will not bail out investors who made mistakes. At a symposium organized by the Kansas City Federal Reserve, Bernanke said that in August the Fed had taken steps to address unusual strains in the money market, including a cut in the discount rate of 50 basis points and adjustments to the Reserve Banks’ usual discount window practices to facilitate (renewable) borrowings for as long as 30 days to provide the market a backstop source of liquidity. Bernanke said, “The Federal Reserve stands ready to take additional actions as needed to provide liquidity and

promote the orderly function of markets. It is not the responsibility of the Federal Reserve--nor would it be appropriate--to protect lenders and investors from the consequences of their financial decisions. But developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy. ...The Committee continues to monitor the situation and will act as needed to limit the adverse effects on the broader economy that may arise from the disruptions in financial markets.” (*Wall Street Journal Online*, Ben Bernanke, 08/31/07)

Fannie Mae and the Democrats launch campaign to raise GSEs’ portfolio caps to provide liquidity in the secondary market

- In an August 10th statement, Fannie Mae CEO Daniel Mudd said he had asked OFHEO to raise the cap on his company’s mortgage portfolio by 10% “to help alleviate the ongoing credit crunch in the markets and bring an additional measure of stability.” In an interview on CNBC, Mudd said that Fannie Mae had asked OFHEO to ease the company’s caps to enable the firm to purchase more loans. “Right now we’d like to be able to buy those mortgages,” said Mudd. “We’re ready to start investing now.” Concurrently, Senators Christopher Dodd (D-CT) and Chuck Schumer (D-NY) argued that worsening conditions in the subprime mortgage market meant urgent action was needed by Fannie Mae and Freddie Mac to help distressed borrowers. Dodd said it “may be appropriate, consistent with safe-and-sound practices as determined by the regulator, to ease the temporary regulatory cap on Fannie and Freddie’s mortgage portfolio.” Schumer urged OFHEO to consider temporarily raising the mortgage caps on the GSEs “to allow them to perform their critical role as a market stabilizer.” (www.fanniemae.com, Statement by Fannie Mae CEO Daniel H. Mudd, 08/10/07; *Financial Times*, Jeremy Grant, 08/10/07; *Dow Jones Newswires*, James R. Hagerty, 08/06/07; *Financial Times*, Jeremy Grant, 08/13/07; *Washington Post*, David S. Hilzenrath, 08/08/07)
- In an August 10th letter to Senator Chuck Schumer (D-NY), OFHEO director James B. Lockhart, III wrote, “...[T]he principal market segment served by the Enterprises is liquid and working. Raising portfolio caps would not allow the Enterprises to purchase mortgages in this market segment, but would not respond directly to those segments having the most difficulties [e.g., jumbo and subprime mortgage loans].” Lockhart said OFHEO “will keep under active consideration [the GSE’s] request for an increase in portfolio caps, but we are not authorizing any changes at this time.” He added, “...The market should have confidence that the Enterprise securities are trading efficiently in the marketplace. The Enterprises will remain active market participants and OFHEO will continue to monitor closely both the markets and the Enterprises’ safety and soundness, and will continue to consider changes as needed to ensure the current liquidity in the Enterprise securities remains.” (*Letter to the Honorable Charles E. Schumer*, James B. Lockhart, III, 08/10/07)

- In an August 9th press conference, President George W. Bush repeated that Congress should pass GSE regulatory reform legislation before Fannie Mae and Freddie are allowed to expand their investment portfolios. Bush said, “As you know, we’ve put up a robust reform package for these two institutions, a reform package that will cause them to focus on their core mission, first and foremost, a reform package that says, like other lending institutions, there ought to be regulatory oversight. And, therefore, first things first when it comes to those two institutions. The Congress needs to get them reformed, get them streamlined, get them focused, and then I will consider other options.” Schumer reacted swiftly, accusing President Bush of disregarding the spillover effects of the subprime mortgage market’s collapse. “Even as the evidence mounts that the liquidity crisis in the subprime market is spreading to the broader credit markets, the Bush administration is putting its head in the sand and shying away from admitting there is a problem,” said Schumer. “We need short-term solutions and long-term vision, not stalling, rhetoric and ideology. That action should begin with lifting the portfolio caps on Fannie Mae and Freddie Mac to help stabilize the market.” Dodd said, “There is no reason why such [GSE] reform is a necessary precondition of the cap that is done in a safe and sound manner.” (*Wall Street Journal Online*, Henry J. Pulizzi, 08/09/07; *American Banker*, Steven Sloan, 08/10/07)
- Representative Richard Baker (R-LA) urged OFHEO to be cautious in raising the mortgage caps for Fannie and Freddie because of the amount of potential risk the GSEs could face. Baker said, “We have to weigh whatever marginal liquidity they would add to the market against this greater concentration of credit risk - in other words, is it worth increasing the potential risk to the American taxpayer, and will it even be helpful?” (*Dow Jones Newswires*, 08/10/07)
- On August 17th, Senate Banking Committee Chairman (and presidential hopeful) Christopher Dodd (D-CT) called upon the Bush administration to allow Fannie Mae and Freddie Mac to increase their mortgage holdings by 5% to boost liquidity in the secondary mortgage market. He castigated President Bush for leaving this decision to OFHEO, the GSEs’ safety and soundness regulator. “Where’s the president?” asked Dodd. “Why is a regulator determining this? ... You know, this is an economic crisis that demands leadership out of the White House and the Treasury. And the fact that I’ve got a federal regulator deciding whether or not to have additional liquidity put into the market is really not his job in my view. I mean, he may agree or disagree personally; that’s his right. But the fact is, you have a regulator announcing economic policy while the president’s up on his boat in Kennebunkport is a little troubling to me.”
- On August 17th, House Financial Services Chairman Barney Frank (D-MA) and Representative Gary Miller (R-CA) urged the Senate to pass GSE regulatory reform legislation which would increase the GSEs’ conforming loan limit. “It now is clear we underestimated in the House bill how far we should raise the conforming loan limit, and the current crises in the mortgage market demonstrate we should raise it to a higher level,” said Frank. “I urge the Senate to make this a priority as part of GSE

reform, because we now have the opportunity to help homeowners get access to needed credit by allowing Fannie Mae and Freddie Mac to play a larger role.” [While Dodd has promised to move GSE regulatory reform legislation through his committee, the chairman has yet to introduce legislation or hold hearings on the issue.] (*Bureau of National Affairs*, Richard Cowden, 08/20/07)

- In an appearance on CNBC, Treasury Secretary Henry Paulson said, “There have been issues [in the mortgage market], there have been issues in the non-conforming jumbo market and the subprime market. In order for the GSEs to participate in the jumbo market, the riskier market, where loan-to-value is high, this takes legislation. ...Raising the cap on [the definition of] a conforming loan is a legislative solution.” (*American Banker*, Steven Sloan, 08/28/07)
- Senate Banking Committee Chairman Dodd (D-CT) met with Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson to discuss the problems in the U.S. mortgage market. In a press conference after the meeting, Dodd repeatedly called for action [but declined to take any himself]. Instead, he emphasized that the problems should be handled by Bernanke and Paulson. “There is need for some action here,” Dodd told reporters. “Clearly there are some steps that can be taken to minimize this problem from becoming broader... The ball is really in their court.” Dodd reiterated his demands that Treasury lift the portfolio caps for Fannie Mae and Freddie Mac and suggested that the administration establish a fund to keep people in their homes and prevent foreclosures. Dodd told reporters that the impression he received from Paulson in the meeting was “sort of like, ‘It’s really your responsibility to do some legislation,’ but Dodd argued that the White House should take immediate steps to address the GSEs’ portfolio caps since the legislative process would take time. In an appearance on CNBC later that day, Dodd said, “We’re clearly this fall going to deal with some legislation dealing with GSEs generally.” (*American Banker*, Steven Sloan, 08/22/07; *Dow Jones International News*, Damian Paletta, 08/21/07)
- In a August 26th *Washington Post* commentary, Steven Pearlstein observed, “As markets were melting down and there were fresh reports of record numbers of households falling behind on their mortgage payments, there was Senator Chris Dodd (D-CT) demanding that government officials use ‘all the tools available’ to prevent millions of Americans from losing their homes. The powerful chairman of the powerful Senate Banking Committee had just met with the chairman of the Federal Reserve and the secretary of the Treasury, whom he had summoned to Capitol Hill to ‘brief’ him. As news-hungry markets hung on his every word, Dodd recalled who said what to whom, blamed the administration and regulators for falling down on the job, opposed any government bailout while taking credit for arranging \$100 million for homeowner relief, and promised that Congress would step in if necessary, just as soon as it returns from its month-long vacation. Perhaps because he’s been so long in the Senate, where holding a hearing qualifies as action, it never occurred to Dodd that he and his Senate colleagues might bear some responsibility for the mortgage mess. By not acting on proposals to require more disclosure in the mortgage origination

process. By failing to update the laws governing Fannie Mae, Freddie Mac and the Federal Housing Administration. By refusing to beef up regulation of hedge funds and derivatives markets that made all those subprime mortgages possible. The mortgage crisis hit the front page six months ago. You'd think that would have been enough time for the Senate and its banking committee to do something about it." (*Washington Post*, Steven Pearlstein, 08/26/07)

- Senator Chuck Schumer (D-NY) joined the Democratic chorus calling for the Bush Administration to temporarily raise the limits on loan purchases made by Fannie Mae and Freddie Mac. If regulators do not take action to allow the GSEs to perform their critical role as market stabilizers, Schumer said he would introduce legislation in September to temporarily raise Fannie's and Freddie's caps. "This emergency measure is not only important to restore confidence in the mortgage market for current and aspiring home buyers, but it would also allow Fannie and Freddie to engage in subprime foreclosure relief efforts across the country before the 'October surprise' of subprime resets further shocks the mortgage markets," said Schumer.
- Senator Schumer also has called on lenders, regulators, and accountants to encourage them to help struggling borrowers. In letters to 40 lenders, the Senator has asked the lenders to provide him information on the steps that they have made to modify subprime loans to help borrowers and asked them to detail "what major obstacles remain to refinancing troubled loans that would benefit from policy actions taken by the federal government or legislation in Congress." In separate letters to Treasury Secretary Henry Paulson and federal banking regulators, Schumer has asked that the agencies "use their influence over major market players to encourage them to engage in a major effort to modify or refinance the loans that have a high probability of defaulting." The Senator asked the agencies to direct "additional federal resources" to nonprofits certified by HUD to help troubled borrowers. The Senator has also sent letters to the Big Four accounting firms, urging them to ensure that their clients know how to modify subprime loans that are in risk of defaulting. Schumer wrote, "My hope is that you will assist this country's mortgage crisis by ensuring that your clients are aware of the recent SEC and FASB guidance on FAS 140, and by otherwise encouraging them to modify subprime loans at risk of default." He added, "I am concerned that many of the investors holding securitized mortgage assets are continuing to cite FAS 140 as a reason to avoid loan modifications and refinancings." (*Mortgage News Daily*, 08/20/07; *American Banker*, Rob Blackwell, 08/23/07; *Bureau of National Affairs*, 08/31/07)
- In an August 27th letter to Senator Chuck Schumer (D-NY), Federal Reserve Chairman Ben Bernanke responded to the Senator's concerns about the potential effects the volatility of the financial markets might have on the economy as a whole. Bernanke wrote, "I want to assure you that the Federal Reserve, in cooperation with other federal agencies, is closely monitoring developments in financial markets... It might be worth considering at this juncture whether the private and public sectors, separately or in collaboration, could help the situation by developing a broader range of mortgage products which are appropriate for low-and moderate-income borrowers,

including those seeking to refinance. ...One public agency with considerable experience in providing home financing for low-and moderate-income borrowers is the Federal Housing Administration (FHA). The Congress might wish to consider FHA reforms that allow the agency more flexibility to design new products and to collaborate with the private sector in facilitating the refinancing of creditworthy subprime borrowers facing large resets.”

- Bernanke continued, “As you note [in Schumer’s letters dated August 8 and 22], the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac are currently assisting in subprime refinancings. However, the GSEs’ charters limit their ability to take on higher-risk mortgages and their programs are relevant only to a relatively small share of subprime borrowers. The GSEs should be encouraged to provide products for subprime borrowers to the extent permitted by their charters. The current caps on GSE portfolios--which were imposed for safety and soundness reasons--need not be lifted to allow them to accommodate new borrowers. Currently, the GSE portfolios include substantial holdings of GSE-guaranteed mortgage products, which are easily placed in the private secondary market even under current conditions. Thus, the GSEs could readily sell these securities to make space for new mortgages if they wished to do so. Policymakers may also want to encourage the GSEs to increase their mortgage securitization efforts, which are not constrained by their portfolio caps...” (*Correspondence to the Honorable Charles E. Schumer*, Ben S. Bernake, 08/27/07)
- Three key banking and housing trade group asked OFHEO Director James B. Lockhart to reverse his decision to prohibit Fannie Mae and Freddie Mac from growing their retained mortgage portfolios beyond their regulatory caps. The Mortgage Bankers Association, the National Association of Homebuilders, and the National Association of Realtors wrote, “The nation’s mortgage markets are facing a liquidity crisis of a force and magnitude not seen in decades. The chill will have far reaching effects throughout the housing market if stability is not restored. A temporary increase in the allowable size of the GSEs’ loan portfolios for the purpose of easing this credit crunch would help stem the crisis.” The trade groups asked Lockhart to approve a conditional increase in the portfolio restrictions which could be limited to a specific size and types of assets available for purchase. “Quick and reasonable action is urgently needed to provide liquidity and stability to the mortgage markets and to serve the financing needs of America’s current and aspiring homeowners,” said the trade groups. (*Dow Jones Newswires*, Damian Paletta, 08/13/07)
- In an August 14th interview with the *Wall Street Journal*, Treasury Secretary Henry Paulson was asked by *WSJ* reporter David Wessel, ... “[W]hy not widen the authority of Fannie Mae and Freddie Mac and increase the [current \$417,000] ceiling on the mortgages they can buy?” Paulson responded, “When you look at the prime mortgage market, that market is open and there’s liquidity. The issues are in the jumbos. They’re not performing and Fannie and Freddie can’t participate in that market without legislation or in the riskier mortgages where there’s lower equity to value

ratio. And they can't participate there without legislation, so lifting the caps doesn't deal with either of the issues. Wessel asked, "There's nothing that the regulator could do or the administration could do to widen their authority?" Paulson responded, "I think this has been confused. We have the prime conforming market the agencies [Fannie and Freddie] deal in, and I give them credit, that market's performed well, they've done what they should be doing in that market. Where we've got issues are in the riskier mortgages and in the jumbo prime mortgages where legislation is necessary for [GSE] participation. Clearly we're looking at all the policy levers available to us to increase liquidity in the markets, that's the job you'd expect us to be doing right now. And in that context, of course we'll look at what levers are available here. One thing I'd encourage the GSEs to do is to utilize the ability they already have in the subprime market, including Freddie's \$20 billion commitment and similar initiatives undertaken by Fannie Mae." (*Wall Street Journal Online*, David Wessel, 08/14/07)

- In an interview with the *Bureau of National Affairs*, former OFHEO Director Armando Falcon, now a principal at the Canonbury Group in Washington, D.C., said "I think OFHEO was just right on this in both its decision and its analysis." Echoing OFHEO's assertion that even within the constraints of their current asset restrictions, Falcon said that Fannie Mae and Freddie Mac have ample freedom to participate in the sector of the mortgage market they traditionally serve. Noting that the GSEs are prevented under current rules from purchasing loans of more than \$417,000, Falcon said, "That's not on the table." Both companies are prohibited under their regulatory structure from purchasing distressed subprime mortgage products, added Falcon. "Both enterprises have all the tools they need to serve the market," he said. (*Bureau of National Affairs*, Richard Cowden, 08/15/07)
- According to *International Strategy & Investment*, "[OFHEO] ...rejected Fannie Mae's request to increase the size of its [retained mortgage] portfolios... The argument that allowing the [GSEs] to expand their balance sheets would have a measurable impact on the subprime, Alt-A or jumbo markets is without merit, administration officials believe. Considering the companies 1) are prohibited by law from participating in the jumbo market, 2) have little interest in buying subprime or Alt-A securities, and 3) even if they did, they would buy only AAA MBS anyway; it's difficult to argue with the Administration's view." (*International Strategy & Investment*, 08/13/07)
- In an interview with the *Washington Post*, Bill Fleckenstein, president of Fleckenstein Capital, said the market is going through a correction in which securitized mortgages that fueled the housing boom are being marked to their real value. "There's going to be a shutdown in the housing market. And Fannie Mae and Freddie Mac are not going to be able to bail it out, nor should they," said Fleckenstein. "If Fannie Mae and Freddie or somebody bails out the housing market, then you tell me why we don't start up Gambler Mae so that any lottery ticket owner, any football bettor, any guy at the track, any stock operator who loses money can get bailed out, too." (*Washington Post*, David S. Hilzenrath, 08/08/07)

- In an August 16th *Wall Street Journal* article, Ethan Penner wrote, "...Our current subprime-lending crisis seems to have initiated the latest credit-tightening drive. Is it a coincidence that both of these tightening periods in the credit cycle were set off by mortgage lending issues? I posit no, and lay the blame at the feet of Fannie Mae and Freddie Mac (and their congressional cronies), whose unchecked growth into second mortgages, subprime loans and many other assets -- not to mention their continued creep into the upper echelons of the home-mortgage industry through their current lending limit of \$417,000 -- has pushed other mortgage-market participants further out on the risk spectrum in search of a livelihood."
- "To put this lending limit issue into perspective, and thus to understand how much of the mortgage-market share is now touched by these two out-of-control entities: The average U.S home costs in the vicinity of \$200,000, and with the exception of the San Francisco/Bay Area and Manhattan markets, most homes fall well within the values to qualify for the Fannie Mae/Freddie Mac subsidy. Recent estimates are that 50% of all mortgages originated are now guaranteed or owned by Fannie Mae or Freddie Mac."
- "It is thus incredible that Fannie Mae recently petitioned Congress to increase its approved lending limit so that it can 'better help the market during this period of distress.' Not only should this offer be summarily rejected, these entities also need to be shrunk considerably and through proper regulation be returned to serving their original purpose. As long as Fannie Mae and Freddie Mac can utilize their government-agency status to tap the debt markets, they ought to limit their business activities to those that serve a public need. If they want to compete with the private sector, they should not have this taxpayer-subsidized funding advantage. Until those in Congress are willing to serve the best interests of the public that elected them, the price that our economy and society will pay will only increase over time."
- "The current crisis is the result of the normal ebb and flows of credit cycles, and the free market will amply handle the correction that is already happening. Calls for Federal Reserve intervention or for other governmental involvement -- including an increase of the Fannie Mae/Freddie Mac lending limits -- must be rejected." (*Wall Street Journal*, Ethan Penner, 08/16/07)
- A number of newspaper and magazine editorial boards weighed in on the Democrats' demands that the GSEs' mortgage caps be raised. In an August 11th editorial, the *Washington Post* wrote, "[O]ne unconvincing proposal is to let Fannie Mae and Freddie Mac, the two [GSEs] that already dominate the mortgage-backed securities market, buy up more loans. ...[OFHEO] has capped Fannie Mae's portfolio at \$727.2 billion (the level of Dec. 31, 2005), while Freddie Mac's \$712.1 billion portfolio may grow only by 2 percent annually. The regulators imposed these conditions because of accounting scandals at Fannie and Freddie—and it seems unwise to tap them for a bailout now, especially when such an action would leave

them holding billions of dollars in new assets of ambiguous value...” (*Washington Post*, 08/11/07)

- In an August 11th editorial, the *Los Angeles Times* wrote, “President Bush has come under fire—deservedly—for dismissing instability in mortgage markets as little more than a hiccup in an otherwise ‘thriving’ economy. ...But Bush was right on Thursday [August 9] when he rejected calls to lift investment limits on Fannie Mae and Freddie Mac. ...Proponents of lifting the limit believe letting Fannie and Freddie own more loans again will stabilize the housing market. It might help increase the supply of money for housing loans, counteracting investors’ wariness of mortgage-backed securities, but it’s no solution to the subprime mess. The companies don’t buy the high-risk loans that have put so many borrowers into foreclosure. And they shouldn’t: The government (or, in this case, its affiliates) doesn’t belong in the business of creating a market for ill-advised financial schemes. More important, as Bush noted, the companies still aren’t out of the accounting-fraud woods. Fannie Mae has yet to report earnings for this year or last.”
- “Lifting the investment limit is not the only way the companies can pump funds into the market. They can still package loans and sell them as bonds. The market might be skittish now, but mortgages with reasonable terms should attract investors before long. As publicly traded companies, Fannie and Freddie may want to expand their holdings at a time when mortgage debt is cheap. But with taxpayers potentially on the hook if they fail, they haven’t earned that opportunity.” (*Los Angeles Times*, 08/11/07)
- In an August 8th editorial, the *Wall Street Journal* wrote, “With Wall Street openly lobbying for someone to ride to its rescue in the credit markets, the news is that Fannie Mae and Freddie Mac have offered to step into the breach—for a price. Their offer deserves to be treated with the same skepticism as their claims some years back about bullet-proof accounting. The irony here is that Congress chartered Fannie and Freddie expressly to expand access to ‘affordable’ housing. Yet the two mortgage giants have long sought their profit opportunities in the more credit-worthy segments of the market. ... Their real game here is to get back in the business of using their borrowing advantage from their implicit taxpayer subsidy to once again dominate the MBS market. No wonder Fannie’s stock was up 10% Monday and another 4% yesterday on the prospect that the regulator might remove the shackles. But confusing private profit with public benefit is what got Fan and Fred in trouble in the first place. The portfolio caps were put in place to contain the systemic risk that those portfolios pose to the economy, so lifting them now would be ill-advised in the extreme.” (*Wall Street Journal*, 08/08/07)
- In an August 21st editorial, the *National Review* wrote, “...Fannie Mae officials argue that they can provide badly needed liquidity to the mortgage market. But as economist Brian Wesbury pointed out ...liquidity is not the issue. The issue is a lack of information—no one seems to know how much these [subprime] mortgages are really worth. The best thing the government can do is stay out of the way while the

market reprices these securities. ...Demagogues in Congress and on the campaign trail should learn a lesson here. Lenders, hedge funds, ratings firms, and, yes, foolhardy borrowers are paying a price for their excesses. Let's not compound their folly by enacting a poorly thought-out policy." (*National Review*, 08/21/07)

House Financial Services Chairman Frank calls for more regulation

- In an August 20th article in the *Financial Times*, House Financial Services chairman Barney Frank (D-MA) wrote, "Reality has broken into our economic programming, with an important message: the subprime crisis demonstrates the serious negative economic and social consequences that result from too little regulation. In the debate between those who believe in essentially unregulated markets and others who hold that reasonable regulation diminishes market excesses without inhibiting their basic function, the subprime situation unfortunately provides ammunition for the latter view."
- "The epidemic of mortgage foreclosures is the result of a powerful negative synergy stemming from the large increase in mortgages originated by unregulated entities, and an essentially uncontrolled secondary market into which those originators sold their products. Until recently, the great bulk of residential mortgages were originated by deposit-taking institutions closely supervised by federal and state regulators. If these entities had continued to be the overwhelming source of mortgage originations, we would not be dealing with the subprime crisis. It is the unregulated sector of the mortgage industry that has disproportionately contributed to the large number of imprudently made loans. A major reason that these originators could make such loans is that soon after they did so, they sold them into the secondary market, which left them free of any financial responsibility. By contrast, entities that make loans and retain ownership of them have a financial stake in the ability of borrowers to pay them off. This analysis yields several recommendations for public policy."
- "First, all mortgage originators must be subject to reasonable regulation substantively similar to those that apply to depository institutions. This means some form of licensing and the proscription of loans that should not be made because there is no reasonable prospect of their being repaid. Some states have already moved in this direction but others have not, so Congress must act. To those who argue that we should let the borrowers suffer the consequences of their mistakes, there is a two-fold answer. Many loans were accompanied by fraud, deception, inadequate information and other failures of responsible marketing. Additionally, inappropriate subprime loans have not been randomly geographically distributed. They are concentrated in some neighborhoods, and this has a wholly undesirable and unjustified impact on the majority of homeowners in those neighborhoods who are keeping up their mortgage payments. Having a foreclosed, vacant home next to your home or four doors down leads to a deterioration of your neighborhood and the value of your property."

- “Effective enforcement of any lending standards means that those who package and sell those loans into the secondary market must also have some responsibility. Setting clear guidelines, which securitizers must follow to guard against being vehicles for unsound loans, can be done in a way that enhances the attractiveness of the secondary market to investors and serves as a safe harbor against liability. Of course, we will be told by some that putting any restrictions on the ability of servicers to package and sell will prevent the market from functioning. (Connoisseurs of the argument that any regulation of a securities market will bring about its demise are urged to turn to the debates over the establishment of the [SEC] in the 1930s.)”
- “These considerations are also relevant to the current debate over the supervision of Fannie Mae and Freddie Mac. The outstanding issue is the insistence by the Bush administration that Fannie’s and Freddie’s portfolios should be reduced in favor of increased reliance on the secondary market. But loans held in their portfolios are more amenable to the flexible workouts that are important in diminishing the current foreclosure problem, and Fannie’s and Freddie’s ability to serve as refinancers for existing mortgage holders who are seeking relief from abusive loans would be substantially diminished if they could sell these only into the secondary market.”
- “That brings me to one of the silver linings. Those of us who have a serious aversion to cliches can take comfort that in this debate over regulation for the secondary market, we are unlikely to hear anyone invoke that tritest of conservative arguments, ‘If it ain’t broke, don’t fix it.’”
- “There are two further public policy debates on which this crisis sheds light. Congressional Republicans have ended most federal programs in which the federal government collaborates with the private sector to construct affordable rental housing, and have instead held out home ownership as the only valid answer to those seeking decent housing, even for those whose economic circumstances and the high cost of housing in their areas make this economically unsustainable. One goal of the Democrats is to return to public/private partnerships to construct subsidized rental housing, which will remove one of the push factors contributing to the current crisis.”
- “Further, we must now address the questions raised by the instability in the financial markets triggered by the subprime problem. It is clear that updated regulation is required to deal with innovations in the mortgage business. There have been even more profound changes in the broader financial markets. Private and public sector policymakers must also ask whether current regulatory frameworks are adequate to dealing with them.” (*Financial Times*, Barney Frank, 08/20/07)
- Chairman Frank has scheduled a September 5th hearing on the recent turmoil in the credit markets. Testimony will be heard from Robert K. Steel, Under Secretary of Domestic Finance, Department of the Treasury; John C. Dugan, Comptroller of the Currency; Erik R. Sirri, Director of the Division of Market Regulation, SEC; and Sheila Bair, Chair, FDIC. (*Dow Jones Newswire*, 08/20/07; http://www.house.gov/apps/list/hearing/financialsvcs_dem/090507.shtml)

- *American Banker* reports that the House Financial Services Committee leadership is planning to introduce a bill in September that would “broaden the definition of high-cost mortgages, create new underwriting standards for mortgage originators and add limited liability provisions for the secondary market, according to sources who attended closed door meeting with panel staff on Thursday [August 9].” Committee Chairman Barney Frank (D-MA) is focusing on holding Wall Street firms accountable for unsound loans that they securitize into mortgage-backed securities, rather than banning certain types of loans or loan features which could be easily replaced through market innovations, said sources. Another key goal of the bill is to create a system where all mortgage originators are held to the same set of standards. The Committee staff held a series of meeting with industry, consumer, and banking regulatory representatives to discuss the goals of the reform legislation and solicit their input. (*American Banker*, Stacy Kaper, 08/10/07)
- On September 1st, the *Financial Times* wrote, “The U.S. subprime loan crisis has turned into a morality play. Subprime borrowers—people with bad credit who took out high-priced mortgages to buy homes beyond their means—are cast as hapless victims. Subprime lenders (and the investors who bought their securitized loans on Wall Street) are portrayed as Shylocks preying on the American poor. Now the whole crew is looking to the government to step in, and spare them the consequences of their financial alchemy. Washington should resist.”
- “President George W. Bush ...[has] announced some modest measures to help truly needy borrowers, but he ruled out a bailout for the merely greedy (whether borrowers or investors). Unfortunately, Congress will probably not stop there. Millions of Americans could still be about to lose their homes, and millions more will lose money in the markets. That is the kind of crisis politicians cannot resist meddling with.”
- “...The powerful House financial services committee will hold hearings next week that could lead to legislation within weeks. The chairman of the committee, Democratic congressman Barney Frank, has made clear that he thinks the subprime crisis proves U.S. financial markets are under-regulated. He favors everything from new underwriting standards to a new right to sue everyone from brokers that sold the loans, to banks that originated them, to investors that bought them in the secondary markets. The result could be a stifling new web of rules and liabilities that will choke off lending to the people that subprime loans were originally meant to serve: those who need a modest home, but cannot get a normal mortgage because of credit problems. That would be a shame: Congress should be careful not to over-react. U.S. markets are already burdened with litigation risk; the last thing they need is more liability.”
- “Much can be done to save Americans from themselves: mortgage loans should be more transparent, so borrowers know how much they really owe. Borrowers can be educated to make good decisions about their mortgage (life’s most important financial decision). But if Congress loads on too much litigation risk, mortgage

finance for non-ideal borrowers will simply dry up. More regulation and liability is probably inevitable: but those who have done due diligence on their loan should be exempted. Not every subprime loan is a scam. There is no sense in adding the huge cost of litigation to a problem that is already cripplingly costly. The market has learnt its lesson; do not lend to people who cannot pay. It is hard to see how the legislators can improve on that.” (*Financial Times*, 09/01/07)

- In a Letter to the Editor of the *Financial Times*, Kimbell Duncan wrote, “The ‘subprime crisis’ has not arisen because of too little regulation... The crisis, which is about opaque leverage of financial structures in general, is the result of rampant greed. Greed on the part of borrowers who stretched for houses they could not afford with loans that appeared ‘too good to be true.’ Greed on the part of mortgage originators that emphasized volume as opposed to underwriting. Greed on the part of financial intermediaries who saw no limit to what and how much could be securitized and distributed. Greed on the part of the end investors who aggressively reached for additional yield in a low-return environment in an attempt to attract additional assets under management at the expense of cynical underwriting. There is culpability along the entire spectrum of participants in this chain.”
- “It is the illusion of a controlled market that is ultimately responsible for the extremity of this ‘crisis.’ However, left to its own devices, the market (in spite of the manipulations of the Fed) will correct the errors made over the past few years. After the dust has cleared, credit will again be available to borrowers on the basis of their ability to meet the debt service obligations they choose to assume. New regulation is not required. To the extent that there was fraud and deception, as claimed by congressman Barney Frank, existing laws are more than adequate to prosecute offenders.”
- “However, the law should be applied equally to borrowers who defrauded lenders. If Congressman Frank is worried about an ‘effective enforcement of lending standards’ he need look no further than the stock prices of the most aggressive lenders - the markets have already shut them down and there is no need for regulation to curtail their lending practices. There is simply no way for a small clique of legislators to determine the best way to regulate credit so that it is forthcoming to worthies and denied to deadbeats. The market is actually pretty good at it - the correction we are witnessing today is not a sign of market failure but of the effectiveness of markets to self-correct. Congressman Frank certainly makes a subprime argument for more regulations.” (*Financial Times*, Kimbell Duncan, 08/20/07)

Democrats seize on the market turbulence as a 2008 campaign issue

- From a political perspective, the wave of subprime mortgage foreclosures will likely be “crashing” over the next 12 to 18 months during next year’s primary and general election campaigns. To date, 136 mortgage companies have shut down or ceased operations since late 2006; more than 40,000 mortgage jobs have been lost along with

nearly 20,000 construction jobs; and foreclosures rose 93% nationwide in July, while the Standard & Poor's Case-Shiller index recorded a 3.2% drop in second quarter home prices. "This is really just the beginning," said Karen Weaver, Deutsche Bank's director of securitization research. "There's a big wave of defaults coming over the next 12 to 18 months." According to John Mauldin with Millennium Wave Advisors, "We have just seen \$197 billion of mortgage resets so far this year. That is less than we will see in two months (February and March) of next year. The first six months of next year will see more than the total for 2007 or \$521 billion. This suggests to me that the number of foreclosures is due to rise dramatically from the already high current levels, putting more homes into a weak housing environment." (*International Herald Tribune*, Edmund L. Andrews, 08/28/07; www.goldseek.com, John Mauldin, 08/02/07; *SeekingAlpha.com*, Judy Weil, 08/31/07; *Associated Press*, Ieva M. Augstrums, 08/22/07; *Wachovia Economics Group Weekly Economic & Financial Commentary*, 08/24/07)

- Democratic candidates have seized the crisis in the subprime mortgage market and are offering their own "solutions." Senator Hillary Clinton (D-NY) plans to introduce legislation in September which will address lending abuses in the mortgage market and "crack down on unscrupulous brokers." Clinton's proposal encompasses eliminating prepayment penalties, tightening the regulatory supervision of mortgage brokers and establishing a national registry of mortgage originators, expanding federal government support for homeowners facing foreclosure and boosting funding for affordable housing by allocating \$1 billion of federal funding for state and local housing programs. Clinton said she will introduce legislation in September, which will encompass her proposals. If President Bush and the Republicans fail to act on this crisis, Clinton promised she will address these problems as president. In reaction to the Senator's statement, the National Association of Mortgage Brokers criticized the Senator for singling out small business owners and calling for wider scrutiny of the mortgage market. The NAMB said, "The entire mortgage system needs to be examined from stem to stern for the home shopping phase, bankers, brokers and lenders, all the way to Wall Street and the rating agencies." Brad Inman, publisher of *Inman News*, added, "I find it odd that mortgage brokers carry the weight of the blame for this entire web of sins."
- A day after Clinton presented her proposals, presidential hopeful Senator Chris Dodd (D-CT), who serves as chairman of the Senate Banking Committee, released his plan for reforming the mortgage industry. Dodd wants to stop paying mortgage brokers higher fees for placing their clients in loans with higher interest rates than necessary. "This perverse incentive to overcharge home buyers should be prohibited," said Dodd. The Senator noted that many brokers give the borrower a false impression that they are working on their behalf. "Brokers should have to act either as agents of the borrower, thereby owing them a fiduciary duty, or as agents of the lenders, who would be responsible for the brokers' sales practices," said Dodd. In his plan, Dodd proposes to (1) end prepayment penalties; (2) tighten underwriting standards, so that borrowers are qualified based upon their ability to repay the loan at the fully indexed rate rather than teaser rate; (3) require lenders to escrow for taxes and insurance and

disclose those expenses to the borrowers; and (4) “cut down” loans that require little or no documentation proving the borrower’s assets or income. Dodd also wants FHA to provide more loan insurance to borrowers who need it. Like many other Democrats, the Senator would allow Fannie Mae and Freddie Mac to purchase more mortgage loans for their portfolio, which would provide liquidity to the secondary market.

- In an August 29th article in *Financial Times*, Senator Barack Obama said that the implosion of the subprime lending industry “is a cancer that...threatens to spread with devastating impact to housing and to our economy as a whole, unless we act to contain it.” He added, “It is also a parable about how an excess of lobbying and influence can defeat common sense rules of the road, placing consumers and our nation’s economic well-being at risk.” Obama noted that “while predatory lenders were driving low-income families into financial ruin, 10 of the country’s largest mortgage lenders were spending more than \$185 [million] lobbying Washington to let them get away with it.” He argued that unscrupulous lenders who deceptively sold subprime mortgages to millions of Americans should be fined and the proceeds should be used to bail out borrowers who are facing foreclosure. Obama added, “[I]f we really want to make sure that this never happens again, we need to end the lobbyist-driven politics that made it possible.” The Senator also proposes to enact regulatory and disclosures laws, which would create a Home Score system that would provide a simplified, standardized metric for home mortgages in place of the APR metric used today. “President Bush believes that the market will just correct itself,” said Obama. “We need a president who will help families own their own homes rather than how to help the lenders that got us into this problem in the first place.”
- In April, presidential hopeful John Edwards issued a series of proposals to address the subprime mortgage crisis which included a national Home Rescue Fund to help families that might lose their homes. Edwards proposes allowing homeowners to shed “excessive mortgage debt in bankruptcy” and use to the “large” Home Rescue Fund to help prevent foreclosures. He said he would also create a Family and Savings Commission to help protect consumers and consolidate the “crazy quilt” of federal regulation
- In an August 19th debate, Senator Joe Biden (D-DE) argued that more transparency is needed in the operation of hedge funds and private equity firms. “They are the ones that are causing this to go under, and there’s no transparency, no accountability.” New Mexico Governor and presidential hopeful Bill Richardson added, “The credit crisis is the Katrina of the financial markets The president has let these people regulate themselves, and as a result, the necessary checks and balances have been overlooked. This must change.” (*Associated Press*, Philip Elliott, 08/07/07; *Bloomberg News*, Kristin Jensen and Alison Vekshin, 08/07/07; *New York Times*, Patrick Healy and Michael Cooper, 08/07/07; *Reuters*, Jeremy Pelofsky, 08/15/07; *Salon.com*, Andrew Leonard, 08/07/07; *CNNMoney.com*, Les Christie, 08/13/07; *Washington Post*, Jeffrey H. Birnbaum, 08/23/07; *Financial Times*, Barack Obama, 08/29/07)

- To date, Republican candidates have urged caution by Congress in reacting to the mortgage crisis. In an August 13th appearance on CNBC, former Mayor Rudy Giuliani said, “Let’s get ourselves through this [market liquidity crisis] first, then take a look back and see what more could be required. He added, “Honestly, I think at most more transparency, more information [should be required]. People have a right to take a risk with their money. That’s what these people did.... You’ve got to take responsibility for the decisions you make. If you invest in something risky, you get a possibly greater return - so there’s a greater risk. And everyone knew that subprime was risky. So if you put money into those mortgages, you knew that you were a greater risk, and you saw the possibility of a greater return. Now you’ve got to live with the consequences of that.” (*Dow Jones Newswire*, Damian Paletta, 08/13/07)
- In earlier comments to the press, former Governor Mitt Romney said he believes that government should punish the “bad actors” and simplify the mortgage process to ensure that regulators better monitor the industry. When asked how he would address the subprime situation during an August 27th interview of Bloomberg’s *Starting Bell*, Romney responded, “You have to allow the markets carry out the function and you would hope the Fed will take the kind of action is now taken. Obviously the Fed is independent, you cannot tell the [Fed] what to do, but they are providing liquidity that will presumably keep the credit crunch in ...the housing arena from spreading to broadly and slowing down the entire economy. From the president’s standpoint, you want to make sure you communicate to the American people the successes of the economy and not have people overreact. The area where we all feel concern is for those home owners who took out loans and not understand the nature of the resets, and people will lose their homes, that is a real frustration.” When asked if the federal government should step in and help troubled homeowners, Romney said, “I am not one of those who says ‘let’s have Freddie Mac and Fannie Mae start buying up loans.’ A lot of people assume the federal government will stand behind those institutions. They have financial challenges ...and I [do] not want to add to the challenges, which the change some are speaking about [would do]. But clearly if you have a concern and great sympathy, it is for those home owners that may lose savings or lose their homes without having understood the nature of the obligation they were assuming, and point out a failure on Washington’s part not making sure there are better communications of risk.” (*Transcript of Governor Romney’s Remarks on Bloomberg’s Starting Bell*, 08/27/07; *Washington Post*, 08/23/07)
- Senator John McCain (R-AZ) has said that he wants to avoid a broad bailout of the mortgage industry. Instead, McCain would like to target assistance to borrowers who have been taken advantage of by unscrupulous lenders. The Senator also advocates providing prospective borrowers more consumer education to help them make more informed loan decisions. (*Washington Post*, 08/23/07)

The public debate begins on a bailout of the subprime market

- Public debate on a federal government bailout of the housing market began in August, initiated largely by William H. Gross's August 24th article in the *Washington Post*, entitled "Why We Need a Housing Rescue." Gross, the founder and chief investment officer of PIMCO, wrote, "...In the early 1990s the government absorbed the bad debts of the failing savings and loan industry. Why is it possible to rescue corrupt S&L buccaneers, yet 2 million homeowners must be thrown to the wolves today? If we can bail out Chrysler, why can't we support American homeowners? Critics warn of a 'moral hazard.' If we bail out homeowners this time, they claim, it will just encourage another round of speculation in the future. But there's never been a problem in terms of national housing price bubbles until recently. Home prices have been the most consistent, least bubbly asset aside from Treasury bills for the past 50 years. Only in the past few years, when regulation has broken down, when the Fed has failed to exercise appropriate supervision, have we seen 'no-doc' and 'liar' loans and '100 percent plus' loans. If you enforce regulation, you'll have no problem with moral hazard."
- "This rescue, which admittedly might bail out speculators who deserve much worse, would support millions of hardworking Americans. Those who would still have them eat Wall Street cake (as a *Wall Street Journal* editorial suggested, saying they should get used to renting once again) should look at it this way: your stocks and risk-oriented leveraged investments will spring to life anew. Republican officeholders would win a new constituency of voters for generations. Get with it, Mr. President. This is your moment to one-up [Representative] Barney Frank and the Democrats. Create a Reconstruction Mortgage Corporation. Or, at the least, modify the existing FHA program, long discarded as ineffective. Bail 'em out -- and prevent a destructive housing deflation that Ben Bernanke cannot avert. After all, you're the Decider, aren't you?" (*Washington Post*, William H. Gross, 08/24/07)
- In an August 26 interview with the *Orange County Register*, Gross said, "I'd ask my critics [of his proposed bailout], how else will you solve it?" Gross explained that while he was recovering from what he described as an unnerving two weeks of frantic trading amid the sharp mid-August credit crunch, he decided to float his bailout idea in his widely read commentary, published on Pimco's website. Gross acknowledges that there are other options, such as lowering interest rates, which will help homeowners but would hurt the U.S. dollar and further flame inflation fears. As Gross sees it, another option is to let nature run its course and let homeowners sink into foreclosure, which he sees would push home prices down another 10% or more and, in places like California, 20% or more. Gross suggests that the result of that carnage to "the biggest assets for most Americans" is the likely cost of a national recession. He concludes that a bailout, which isn't an easy sale politically, is the most efficient and direct fix. "Does [a bailout] give help to those who didn't read the fine print? Yes! Does it help speculators trying to make a buck? Yes! But the ambulance

doesn't pass you by as you're lying there bleeding because the accident was your fault," said Gross. "Something has to be done." (*Orange County Register*, Jonathan Lansner, 08/26/07)

- James J. Cramer, founder of *TheStreet.com*, and CNBC commentator, loudly voiced his demand for a bailout on television and in print. In his now-famous August 3rd "capitalist manifesto" rant on CNBC, Cramer urged the Fed to act on behalf of the greatest among us—"My people [that is, hedge fund operators, private equiteers, and assorted tycoons] have been in this game for 25 years. And they are losing their jobs and these firms are going to go out of business"—as well as the least among us. "Fourteen million people took a mortgage in the last three years. Seven million of them took teaser rates or took piggyback rates. They will lose their homes." (*Slate Magazine*, Daniel Gross, 08/27/07)
- In the *New York Magazine*, Cramer wrote, "...Who else can unlock the [seize up of financial markets]? ...In other times, you might expect a president or a Treasury secretary to get involved, perhaps to pressure Fannie Mae, the organization set up in the thirties to issue emergency loans to alleviate just the kind of homeowning credit squeeze that we have right now, to lend a hand. But this administration seems to be either totally clueless or totally heartless, or both, and doesn't want to goad Fannie Mae into helping. Maybe they hate that quasi-governmental institution set up by bleeding-heart Democrats to help struggling home buyers of a different, more liberal and compassionate, era. Or maybe they just think that anything short of an FDR-era Agricultural Adjustment Act for homes, where we bulldoze whole housing projects instead of cornfields to get price stability, just won't work."
- "I fear that the pain and contractions in the housing and credit markets could cause as many as 7 million homeowners who bought houses in the past few years to flee or be tossed from their dwellings, even if the rest of the stock market thrives. It's why I went off the reservation and screamed about this problem on television the other day (my latest unhinged rant). I see what could go wrong. I see how the forgotten man gets forgotten, and I feel helpless because I don't see anyone doing a whole hell of a lot about it." (*New York*, James J. Cramer, 08/20/07)
- In an interview with the *New York Times*, House Financial Services chairman Barney Frank (D-MA) acknowledged, "You cannot simply decree that there will be no foreclosures. You can't just give people a free ride." In an interview on [Fox News'] *Your World with Neil Cavuto*, Freddie Mac chairman and CEO Richard Syron said, "...I am not in favor of a bailout. I think the most important thing we can do, what we can learn, is to prevent these kinds of things from happening again." (*International Herald Tribune*, Edmund L. Andrews, 08/28/07; *Marketwatch*, Robert Schroeder, 08/31/07; *Fox News Your World with Neil Cavuto*, Richard Syron, 08/06/07)
- In the August 27th issue of *New Yorker*, James Surowiecki wrote, "...Wall Street so dominates our image of the U.S. economy these days that it's easy to assume that

what's bad for the Street must be bad for everyone else. But, while it's true that a complete market meltdown would have disastrous effects on the economy as a whole, market downturns like those of the past few weeks often have only a small effect on businesses and consumers. In part, that's because much of what happens on Wall Street consists of the shuffling of assets among various well-heeled players, rather than anything that's fundamental to the smooth functioning of the U.S. economy. (The economy did fine before the advent of hedge funds and private-equity funds, and would probably do fine in their absence.) Similarly, while stock-market tumbles are always painful, they have no concrete impact on most American consumers, who own little or no stock. (In any case, the S. & P. 500 is still up ten per cent over the past year, which hardly suggests imminent disaster.) And, in the short run, they're irrelevant to most corporations, too, since few companies actually use the stock market to raise capital."

- "The bond and loan markets do, of course, matter quite a bit to companies and to individuals, because no economy can run without a steady supply of credit. But, although standards for corporate lending have tightened in recent weeks, and interest rates on corporate bonds may have risen steadily, they're still low by historical standards, while the rates for most traditional mortgages have barely risen. That may be why the economy as a whole shows few signs of imminent doom. Corporate profits continue to go up. Unemployment is still relatively low, and wages in the last quarter rose at a surprisingly fast rate. Likewise, in July, retail sales were healthier than expected, and industrial production was reasonably brisk."
- "That's not to say that the economy has suffered no fallout from the subprime collapse. The fall in housing prices, the drying up of new construction, and the sharp rise in foreclosures in many areas are having a serious impact on employment and economic growth. But these are not problems that the Fed's action will solve. Cutting the discount rate is not going to help subprime borrowers get new loans, nor will it get the housing market moving again. What it will do is reassure investors and save some money managers from well-deserved oblivion. It may be that the risk of a full-fledged credit crunch was high enough to make this worth doing. But there is something unseemly about watching the avatars of free-market capitalism rely on the government to pay for their bad bets. And there is something scary about contemplating the even bigger bets they'll make in the future if they know that the Fed is there to bail them out." (*New Yorker*, James Surowiecki, 08/27/07)
- In the August 17th issue of *Fortune*, Allan Sloan wrote, "Wall Street loves to talk about letting financial markets weed out the weak. But when the Street itself gets in trouble, it sticks out its little tin cup, asking for help. And gets it. The subprime-mortgage-market meltdown is a classic example of the way small fry get devoured, but the whales of Wall Street get rescued. Here's the deal: People with crummy credit who took out mortgages are being allowed to fail in record numbers. The mortgage companies that made those loans are being allowed to fail. The Street itself? It's bailout city..."

- “...If you believe in markets - which I do - this rescue is especially galling, because Wall Street enabled this mess in the first place. How so? By happily sucking up hundreds of billions of dollars’ worth of suspect mortgages from marginal U.S. borrowers-and begging mortgage makers to create more of them. The Street sliced and diced this financial toxic waste into a variety of esoteric securities, making a nice markup when it sold them and generating a continuing stream of profits when it made markets in them. Somehow analysts at credit-rating agencies, looking at computerized scenarios rather than at the real world, decided that the bulk of the securities backed by these trashy loans could be rated triple-A. It’s really amazing: Most of the loans to substandard creditors borrowing 100% of the purchase price of homes they couldn’t afford were rated the same as GE and the federal government. That makes no sense. But the money rolled in, and Wall Street—by which I mean the world’s biggest and most important financial institutions—didn’t care about the real world or ask any questions. It was too busy making money, and cashing bonus checks generated by subprime-mortgage profits.”
- “But the world’s central banks aren’t letting the big guys fail. Think of it as the Escape of the Enablers. The reason this is happening, of course, is the same reason that the Fed orchestrated a bailout of the infamous Long-Term Capital Management hedge fund a decade ago-and about 20 years ago didn’t close some of the nation’s biggest banks, even though they were effectively insolvent because unrealized losses had wiped out their capital. It’s the “too big to fail” syndrome. In a world in which big players make incredibly large and complex deals with one another—that’s what derivatives are—regulators don’t dare let a big or important institution fail for fear that the collapse of one would lead to ‘cascading failures,’ and other institutions wouldn’t be able to collect what the collapsed institution owed them. The Fed’s job, you see, isn’t to protect you and me and our retirement portfolios, or even many of the nation’s largest companies and biggest employers. The Fed’s job is to protect the financial system. That’s why it’s trying to rescue the gigantic subprime enablers while letting borrowers and mortgage companies go under.”
- “Your collapse or mine wouldn’t bother Fed chairman Ben Bernanke or the world’s other central bankers. But if, say, a big German institution loaded to the eyeballs with subprime securities croaked, Bernanke and his fellow central bankers would care a lot. Sure, we know that Ben and the boys will always bail out the biggies. And none of us - I think, anyway - wants the world’s financial system to implode. But I’d feel a lot better if the Street had to pay a serious price to its rescuers--say, having to fork over a big equity stake and pay a loan shark interest rate. That way taxpayers, who are picking up the tab for the rescue, would get paid big-time for taking on big-time risk. After all, that’s the Wall Street way.” (*Fortune*, Allan Sloan, 08/17/07)
- On his *Washington Post* blog, Howard Kurtz, the paper’s primary media writer, wrote, “Memo to the media: Everyone who is defaulting on a home mortgage is not necessarily a victim. I feel sorry for anyone in that situation. Losing a home is an awful thing. Some were undoubtedly pressured into buying by unscrupulous lenders. Too many greedy players on Wall Street got away with making shaky loans for too

long. They sliced and diced mortgage debt into increasingly exotic paper and lost sight of the risks involved, figuring the Fed would bail them out if things got out of hand.”

- “But let’s face it: Most of the people who took out home mortgages for no money down knew that this was a roll of the dice. Who gets to buy a house without a down payment? And most of those who took out adjustable-rate mortgages knew that their rate would balloon in a couple of years, and could do so at a level that would be hard to afford. They took the risk anyway. No one forced these folks to take on big mortgages they could barely handle.”
- “...But when the mortgage meltdown pieces are written or broadcast, the lead is inevitably someone who is about to lose his or her house, with not so much as a nod toward the notion that these people might have overreached or bears any responsibility at all for their financial plight. Perhaps inevitably, Hillary Clinton has now proposed a \$1-billion fund to help struggling families catch up on their mortgage payments, and John Edwards also wants to give money to those who can’t make their payments. So the taxpayers should bail out folks who took out these loans with their eyes wide open? Again, I’m not unsympathetic. And there’s plenty of blame to go around. But we shouldn’t let homebuyers completely off the hook just because it makes for a better narrative.” (*Washington Post Blog Commentary*, Howard Kurtz, 08/23/07)
- In the August 28th issue of *BusinessWeek*, Dawn Kopecki observed, “The sweeping proposals being floated are better suited for grabbing headlines than for rectifying the current problems [in the subprime mortgage market]. They tend to be politically unfeasible, unwieldy, or simply foolish. Consider for a moment talk of a possible taxpayer-funded bailout for Countrywide Financial ...and New Century Financial ...—the same subprime lenders that helped fuel the credit bubble. Then there are those who think government-sponsored mortgage buyers Fannie Mae ...and Freddie Mac ...can save the entire U.S. housing system from ruin. Only in Washington is it hard to understand that profit-driven, shareholder-owned corporations won’t be willing buyers of clearly bad investments.”
- “...The foreclosure rescue programs Senators Clinton and Schumer want to finance with taxpayer money won’t actually rescue borrowers from imminent foreclosure. State housing officials say many of those borrowers are too far behind on their payments, don’t have enough equity in their homes to justify helping, or never had enough income to qualify for a loan in the first place. That’s why state officials are instead focusing on people who are not yet behind on their payments but could be at risk once their interest rates are adjusted. ‘It was never intended to be a foreclosure rescue program,’ says Joel Ghitman, director of homeownership for the Ohio Finance Agency... ‘If somebody is already headed down the path of foreclosure, they will be unable to participate in the program and I don’t know if anyone will be able to help them. The whole emphasis is to help these borrowers before they get too deeply in trouble.’ Many economists believe that bailouts usually are not the best solution.

‘Our focus is on liquidity, not a bailout,’ says ...[Mortgage Bankers Association’s chief economist Doug] Duncan. A bailout creates its own problems, he says: ‘You’re going to change behavior in the marketplace in ways you hadn’t foreseen.’ “
(*BusinessWeek*, Dawn Kopecki, 08/28/07)

Are new rules needed for a “wider” financial system?

- In the aftermath of the financial market seize up in August, Clive Crook examines what steps need to be taken to avert the next financial crisis. In the August 22nd issue of *Financial Times*, Crook wrote, “The harder question [to answer] is whether new rules are needed for the wider financial system. On the face of it, the answer is Yes. One rationale for excluding non-bank lenders from Fed scrutiny is that they pose no systemic risk. So much for that. Wall Street financed the subprime boom by buying the loans repackaged as securities, stamped AAA by the credit-rating agencies and selling them on. This model, of course, made the original lenders even less attentive to loan quality. On the other hand, it spread the risk throughout the system, which was also thought to be a good thing until the loans started to go bad. Then, it turned out, investors wanted to know where the risk was and nobody could say. Arriving as if from nowhere, that fear led to the freezing up of the credit system.”
- “How are regulators to grapple with this? If the opacity of the system is the problem, then new scrutiny and disclosure requirements for secretive investors such as hedge funds and private-equity firms must be part of the remedy. But it could be that complexity, more than lack of transparency in its own right, is the issue. The accelerated pace of financial innovation and the ever-proliferating complication of modern financial instruments seem to defy the ability even of the products’ designers to fathom what is going on. And the new instruments are often thinly traded, if at all, so values are guessed by simulation or calculation, not in the market. Sophisticated investors are left poorly informed about the risks they are bearing; unsophisticated investors have not got a clue. Desirable as fuller disclosure by hedge funds and private equity firms may be, it is hard to believe that it will be enough.”
- “In other words, financial innovation itself is the problem. This poses a dilemma. The benefits of modern finance are real: as its champions rightly say, it deserves much of the credit for the relative stability of the world economy in the past two decades. Stifling this innovation, or attempting to manage it, looks unpromising.”
- “Part of the answer and, along with fuller scrutiny, perhaps the best that can be done is to create a climate where excessive risk-taking is more effectively discouraged, and punished when things go wrong. Here the role of the Fed is crucial, both in the boom phase of speculative cycles and in the bust. Fast-rising house and other asset prices have been buoyed by very low interest rates. It was enough for the Fed that consumer-price inflation was low; asset prices, in their own right, were not its concern. This set the scene for America’s remarkable debt-fuelled house-price surge whose inevitable end was the proximate cause of the subprime collapse. The Fed’s

long-maintained reluctance to weigh asset prices in its monetary policy calculations needs to go.”

- “Then, when financial markets seize up, the Fed must take care, as far as possible, to avoid bailing out the culprits. As the economists, Willem Buiter and Anne Sibert, have argued, the Fed was wrong to cut the discount rate last week, and will compound the error if it soon cuts the more important Fed funds rate as many now expect unless there is evidence of harm spreading to the real economy. Instead, honoring Walter Bagehot’s maxim, it should provide liquidity at a penalty rate (against conservatively valued collateral) to those so lacking in liquidity that they are willing to pay it. That memorably costly help should be available not just to banks, as now, but to hedge funds and other financial firms willing to accept the Fed’s terms. It is a cliché, but nonetheless true, that the end of each financial crisis sows the seeds of the next. Better regulation has a place, but the Fed is the key to attacking that cycle.” (*Financial Times*, Clive Crook, 08/22/07)
- Steven S. Roach, chairman of Morgan Stanley, Asia, said, “For the second time in seven years, the bursting of a major-asset bubble has inflicted great damage on world financial markets. ... The current financial crisis is a wake-up call for modern-day central banking. The world can’t afford to lurch from one bubble to another. The cost of neglect is an ever-mounting systemic risk that could pose a grave threat to an increasingly integrated global economy. It could also spur the imprudent intervention of politicians, undermining the all-important political independence of central banks. The art and science of central banking is in desperate need of a major overhaul before it’s too late. (*Fortune*, Steven S. Roach, 09/03/07)

The rating agencies’ role in comes under greater scrutiny and fallout ensues

- In the September 1st issue of the *Asia Times* [Kowloon, Hong Kong], Peter Morici, a University of Maryland School of Business professor and former chief economist at the US International Trade Commission, wrote, “The pope and U.S. Federal Reserve chairman Ben Bernanke both rely on a higher force to motivate millions. The pope relies on faith in the Resurrection; poor Ben depends on the credibility of the bond market. The latter, ultimately, rests on the integrity of investment banks and bond-rating agencies, and those have proved faulty.”
- “In the days of usury laws and regulated interest rates for savings accounts, mortgages in the United States were fairly straightforward. ... Today, U.S. loans go through complicated chains. Many more do not qualify to be sold to Fannie Mae, and many never pass through the granite confines of a community bank. Often an agent hanging around the real-estate office takes an application and forwards it to a mortgage company, which may or may not be his employer. The mortgage company processes the loan, and sells it to an investment bank, or similar entity, that bundles mortgages into bonds. The investment bank sells those securities to hedge funds, pension funds, mutual funds and other investors. As mortgages vary significantly in

quality, mortgage-backed bonds are rated by Standard and Poor's and other rating agencies.”

- “At each step along the way, information can be lost and temptations build up to understate the risk of default. The agent gets a big fee for writing the loan only if it is approved, so he puts the prospective homeowner in the best possible light and finds an appraiser who aggressively values homes. Mortgage companies get their cut from origination fees and are able to push off the risk of default on to the ultimate purchasers of the bonds. Hence they are inclined to be lenient with agents. Investment banks earn money on the spread between the interest rate charged borrowers and the interest rate on the bonds. The less risky bundles of mortgages that go into bonds appear, the lower the interest rates on the bonds and the more profits the mortgage bankers receive. As we peel this onion, we are finding many purposeful compromises that look much like the insidious corruption that characterizes commerce in some countries. In essence, Wall Street manufactures bad bonds.”
- “But it gets worse. Large builders established mortgage-writing subsidiaries. When they built more houses than the market could absorb, those subsidiaries exaggerated the incomes and qualifications of buyers on loan applications, and pressed for exaggerated appraisals of their properties to move houses. Those entities operated on lines of credit and resold the loans to investment banks, which bundled them into bonds. Both the large builders and investment bankers had incentive to put lipstick on pigs. Also, investment banks sought and received collaboration from bond-rating agencies in bundling mortgages of differing quality into bonds. In the process, bond raters such as Standard and Poor's were compromised.”
- “Subprime mortgages are hardly the whole credit market, but the meltdown of their bonds cast a spotlight on the decaying integrity of investment banks and bond-rating agencies. These institutions underwrite and rate all manner of credit, and if they could be corrupted in the subprime-mortgage market, then all commercial paper and bonds become suspect. Over the past several weeks, creditors have increasingly sensed they can't trust banks or bond-rating agencies, and they have fled to short-term Treasury securities. This was much worse than the collapse of mortgage companies that originated housing loans, because it caused all segments of the credit market to collapse. Good businesses with sound cash flows couldn't borrow operating capital, and good companies faced escalating interest rates for new bond offerings. Together, those threaten to throw the US economy into recession.”
- “For Bernanke, the corruption of the investment banks and bond-rating agencies is terrible news. It is akin to the pope learning Easter morning was a hoax.” (*Asia Times*, Peter Morici, 09/01/07)
- Internationally, politicians, regulators and financial specialists [outside the U.S.] are seeking a role in the oversight of American markets, banks and rating agencies, after banks and investment funds around the world suffered losses on CDOs secured by subprime mortgages. “In a globalized economy with hedge funds, leveraged buyouts

and all these investment funds, we have to ask the question about more transparency,” said Claude Bébéar, the chairman of the supervisory board of the insurance company AXA. The subprime crisis appears to have emboldened those in Europe, who have pushed for stricter international rules and an international code of conduct for hedge funds. Some economic advisers to the German government now are suggesting that rating agencies be nationalized, that large-scale loans be registered publicly, and that minimum standards be developed for complex debt securities. Christian de Boissieu, president of the Council of Economic Analysis in France, said hedge funds should be subject to stricter disclosure rules about their risk exposure and is calling for a global register of hedge funds. In addition, complex securities should be scrutinized before being sold to bank portfolios, said de Boissieu. President Nicolas Sarkozy of France has asked his finance minister, Christine Lagarde, to prepare a proposal for stricter disclosure rules on market participants before an October meeting of finance ministers from the Group of 7. In an August 27th speech on foreign policy, Sarkozy called again for stronger global regulations to avoid financial crises and assure transparency in the markets. The European Commission has launched an investigation into how successfully credit agencies gauge credit risk, which may likely lead to new European Union regulation to address this issue. “If the rating agencies believe this is going to be business as usual, they are very wrong,” said one Commission official. “The securitized subprime mortgage market would not have grown to the extent that it did without the favorable ratings given by some agencies.”

- In the U.S., much of the attention has focused on the role of rating agencies, which are paid by banks for rating investment products. “It’s not just the U.S. regulators that failed, though they did fail,” said Josh Rosner, managing director of the research firm Graham Fisher. “[International regulators have] thrown the keys to the rating agencies,” leaving them in charge of the safety and soundness of bank capital, insurance and pension money. House Financial Services Committee chairman Barney Frank (D-MA) said he plans to hold hearings on the credit rating agencies’ performance in September, noting the agencies “had not done a good job” during the current crisis. Senate Banking Committee chairman Chris Dodd (D-CT) expressed “great concern” about how credit rating agencies assessed and rated CDOs [collateralized by subprime mortgages] and called for an examination of the role of the credit rating agencies in valuing the subprime mortgage market. At an August 20th news conference at the U.S. Mission to the European Union, Senator Richard Shelby (R-AL) said that the worst repercussions of the subprime mortgage industry collapse in the United States were yet to come, but responses should avoid unnecessary regulation of financial services. Shelby joined the growing ranks of politicians criticizing credit rating agencies for their obvious conflicts of interest. He added that it was “mind boggling” that S&P’s and Moody’s gave investment-grade ratings to securities to subprime, mortgage-backed bonds. “Anyone can see there are some conflicts of interest here,” said Shelby. “I think the credit rating agencies have played a central role in the subprime debacle and they have to shoulder some of the blame here. They are getting paid as consultants by the very firms whose bonds they rate and that is a problem.” (*Reuters*, John Poirier and Rachelle Younglai, 08/17/07; *Financial Times*, Tobias Buck, 08/16/07; *International Herald Tribune*, Heather

Timmons and Katrin Bennhold, 08/28/07; *Wall Street Journal Online*, Peppi Kiviniemi, 08/16/07; *Bureau of National Affairs*, 08/21/07)

- The credit rating agencies have begun their public relations campaigns, in an attempt to explain their role in the CDO market and to deflect criticism over their role in the subprime mortgage debacle. In a commentary titled “Don’t Blame the Credit Rating Agencies” appearing in the August 31st edition of the *Wall Street Journal*, Vickie Tillman, executive vice president of Standard & Poor’s Credit Market Services, argued that the fallout from the subprime mortgage market had “provoked a rush to judgment, and some are now blaming the credit-rating agencies for the recent market turbulence.” In an August 30th interview with *Reuters*, Moody’s Investors Services president Brian Clarkson said that the credit market has been experiencing an unprecedented loss of confidence due to the lack of transparency over where exposures lie rather than underlying credit quality problems. Meanwhile, Moody’s, Fitch and Standard & Poor’s have all reassessed the assumptions in their models for analyzing MBS collateral, and made modifications as needed. In light of recent criticism, several credit agencies have also take steps to reorganize their corporate structure and address management issues. On August 7th, Moody’s announced it was reorganizing its operations into two divisions and separating its credit rating unit from its sales and marketing to underscore the independence of its opinions on debt securities. The agency named Brian M. Clarks, 51, as president and COO of the credit ratings unit and Mark Almedia, 47, as head of Moody’s Analytics. On August 31, McGraw-Hill Cos. replaced its top executive at Standard & Poor’s, amid criticism of the agency’s role in the subprime mortgage crisis. Deven Sharma, 51, a senior McGraw-Hill executive who joined S&P in late 2006, will replace Kathleen Corbet, as president of the agency. (*Reuters*, 08/30/07; *Bloomberg News*, 08/08/07; *Wall Street Journal*, Aaron Lucchetti and Serena Ng, 08/31/07; *Wall Street Journal*, Vickie Tillman, 08/31/07)

Concerns about an economic slowdown grow

- What are the economic consequences of the “Minsky moment?” In his *Financial Times* article, George Mangus, senior economics advisor at UBS, responded, “Hypothetical scenarios revolve around whether declines in interest rates will spur a new round of risk-taking and debt, or whether we will be left pushing on that wretched piece of string. If the former, it will give longevity to the economic expansion, culminating in 2008 in the revival of higher inflation and interest rate fears. If the latter, we may at best face slow growth and higher unemployment until 2009, with interest rates declining in most places through next year.”
- “In my view, two main propositions define the outlook. First, the flight from debt in this downswing may be as potent as the rush towards it was on the upswing. In the U.S., the credit share of gross domestic product rose from 270[%] in 2000 to 340[%] in early 2007, mainly as households and financial institutions relied on borrowed money or leverage to increase spending on goods and services and assets. It is most

likely that the reduced availability of cheap credit is going to lead to a sharp reverse in spending.”

- “Second, current credit cycle concerns are about solvency, not liquidity per se as was the case in 1998, after which the world economy recovered quite promptly. This time the problem is about solvency among homeowners, builders, mortgage providers and financial institutions. Despite the fact that aggregate corporate balance sheets are in reasonably good shape, the rapid deterioration in financial conditions and rising cost of capital will almost certainly lead to higher default rates. Currently, most people are focused on the availability of capital. But in due course the price of capital will become more significant and tend to depress borrowing, capital raising and capital spending and employment.”
- “The U.S., of course, is on the front line, but there will be knock-on effects elsewhere. Europe and Japan should expect to slow down in sympathy as financial and capital market developments join with trade linkages as dampers of growth momentum. But unless the U.S. goes into a deep recession or there are country-specific financial or housing market shocks, Europe and Japan may be spared a worse outcome. Asia, and many emerging markets that have strong current account positions, high reserves, plentiful liquidity and strong corporate balance sheets, would appear to have learnt their lessons of 1997-98 well. The threats to growth in most cases appear to lie in the as-yet-uncertain impact on growth in developed economies, especially the U.S.”
- “The most likely outcome will not be a total decoupling in which the U.S. takes it on the chin and other regions get off scot-free. The world economy is likely to lose momentum and the only question is how much. This will depend on the extent of the U.S. slowdown. Lower interest rates might work again. But downside risks to house prices and construction remain, with threats of an increase in both housing inventories and home repossessions. Added to these worries is an increase in the cost of capital, a cyclical switch from building up debt to rebuilding savings and probable declines in consumer and business confidence. Taken together, these all suggest that the business cycle is going to get quite rough.” (*Financial Times*, George Magnus, 08/23/07)
- In an August 26 appearance on ABC’s *This Week*, former U.S. Treasury Secretary Lawrence Summers said that that risks of a recession are greater now than anytime since the September 11th attacks due to the conditions in the real estate market and liquidity strains in the international markets. “I do not think we yet would have a basis of for making a prediction that there will be a recession,” said Summers. “But I would say that the risks of recession are now greater than they’ve been anytime since the period in the aftermath of 9/11. ...It would be far premature to judge that this crisis is over [with regard to market liquidity.] There’s been repair, but we’ll have to see what happens.” (*Reuters*, Kevin Drawbaugh, 08/26/07)

Freddie Mac's second quarter net income plunges 45%
due to the deteriorating housing market

- Freddie Mac's net income fell 45% to \$764 million (\$1.02 per share) from \$1.4 billion a year earlier, after making a \$320 million loan loss provision to cover expected losses from its deteriorating loan portfolio. Credit related expenses jumped \$336 million from \$63 million a year earlier, driven by the company's increased loan loss provisions to reflect credit deterioration. The company's revenue dropped 8% to \$2.26 billion during the quarter, while its net interest income skidded 17% to \$973 million, largely due to high costs for long-term borrowings. The company reported a surge in its purchase of "interest only" loans, which accounted for about 25% of Freddie Mac's purchases during the first half of 2007, up from 13% during the first half of 2006. Buddy Pizel, Freddie Mac's CFO said the company had reduced its exposure to Alt-A loans, which totaled \$120 billion on June 30, and risk-layered loans, which comprised about 8% of its total single-family guarantee portfolio on that date. Pizel said the company has "negligible" exposure to subprime loans and "the likelihood of us taking losses on that exposure are remote," since the assets are highly rated. Pizel noted, "Delinquencies are low, but they're trending upward." At June 30, 0.42% of the single-family mortgages that Freddie Mac guaranteed were at least 90 day past due and deemed "seriously delinquent." Credit losses will persist throughout 2007 and rise next year, said Pizel. "Assuming nothing changes over the balance of the quarter, [the value of the securities that Freddie guarantees] will put pressure on our fair-value returns. ... We are in a relatively stronger credit position than anybody out there in the broad market," he added. "We think we are certainly in a manageable position to weather this for the long run."
- Freddie Mac's increased loan loss provisions reflect deterioration in the real estate market has spread from subprime borrowers to [prime] borrowers with good credit. In a conference call with investors, Freddie Mac CEO Richard Syron said he was surprised by the extent of the housing downturn. "I was an early bear [on the outlook of home prices], I was not bearish enough," said Syron. "We were not immune to market forces and we continue to take a cautious view toward the housing market." He added that he believes that severe predictions for a housing downturn are too harsh, adding that he expects a recovery over the next 18 months. After announcing their second quarter financial results, the company's shares declined 5%, their biggest one-day loss in four years.
- After the release of Freddie Mac's second quarter results, Portales Partners analyst Gary Gordon said, "[Freddie Mac is] going to have a lot of trouble growing earnings. ... They are adding a big addition to their reserves, clearly anticipating their losses are going to rise a lot more. ... Their credit losses will increase into 2010 and past that. This won't be the last reserve building they do in this cycle."
- In June, Freddie Mac returned to regular quarterly reporting of its earnings, the first time in five years, following its disclosure in 2003 that the company had understated

its earnings results by \$5 billion. To date, OFHEO has refused the company's request to expand its mortgage portfolio holdings during secondary market disruption that occurred in August. Echoing comments made by President George W. Bush and Federal Reserve Chairman Ben Bernanke, OFHEO director James B. Lockhart, III said that the GSEs' priorities should be to fix their accounting systems [and controls] and return to regular financial reporting to shareholders. [Freddie Mac has yet to register its financial statements with the SEC, which the company has committed to OFHEO to pursue.] During the conference call with investors, Syron said Freddie Mac want to avoid "getting into a protracted conflict with our regulator" over raising the regulatory cap [or eliminating it] on its mortgage holdings. Syron added that the company is in discussions with OFHEO about increasing the federal ceiling on the size of mortgages that the GSEs can purchase. (*Wall Street Journal*, Damian Paletta and Lingling Wei, 08/31/07; *Bloomberg News*, James Tyson, 08/30/07; *Washington Post*, David S. Hilzenrath and Dina Elboghady, 08/31/07; *Reuters*, Patrick Rucker, 08/30/07)

Fannie Mae reports a 36% decline in profit for FY2006

- On August 16, Fannie Mae reported a 36% decline in net income for fiscal year 2006 to \$4.1 billion (\$3.65 share), down from \$6.35 billion or \$6.01 a share in fiscal year 2005. Fannie attributed its lower profits to the company's lower interest income caused by a decline in mortgage investments, higher expenses [approximately \$1 billion] related to its financial restatement, and its increased credit-related expenses [which increased from \$428 million to \$783 million]. Fannie Mae also said that it expects increased credit losses from its purchases and securitization [and guarantee] of high-risk mortgages, which will likely reduce its earnings in 2007 "and also could adversely affect our financial condition."
- According to the company's 10K, Fannie Mae's negative-amortizing adjustable rate mortgages comprised approximately 3% of its single-family business volume in 2005 and 2006, while interest-only ARMS made up 9% of its mortgage volume for FY2006 and 7% as of June 30, 2007. Combined, both loan products represent approximately 6% [or \$156 billion] of its credit book of business [\$2.6 trillion] at year-end 2005 and 2006 and on June 30, 2007. Fannie also said about 12% of its single-family mortgage book of business [\$310 billion] on June 30 was Alt-A mortgages or structured Fannie MBS collateralized by Alt-A loans, up from 11% on December 31, 2006. "We remain comfortable with our credit exposure given the level of subordination we have in place for these securities," said the company. Subprime mortgages made up 2.2% of Fannie's single-family book of business on June 30, with most of comprised of private-label mortgage-backed securities.
- In a conference call with analysts, Fannie Mae CEO Daniel Mudd said, "Tough market, more to come. You all know that the market is very choppy....From where we sit the situation is changing daily, even hourly." While the GSE's credit losses are expected to increase this year due to the deteriorating housing market, Mudd said that

Fannie Mae is well positioned to weather the market turmoil. “Overall, I would assess the company is in better shape,” Mudd said. “We are more than adequately capitalized. We’ve regained market share.” The company had been rebuilt “from floor to ceiling,” he added. Fannie Mae expects the housing market will continue to deteriorate through the remainder of 2008, with housing prices expected to decline by 2% in 2007 and 4% in 2008, before prices begin to recover. “This is clearly a market poised for more severe overall credit losses,” said Enrico Dallavecchia, the company’s risk officer, during the investor conference call. Mudd acknowledged that the housing finance market has entered into a challenging phase. “I expect we will take some lumps,” said Mudd. “But that’s what we’re paid for. On a relative basis, our risk position is excellent. ... We’ll come out of this in pretty good shape.”

- Mudd repeated a statement he made earlier in the month that Fannie should be allowed to grow its retained mortgage portfolio 10% above OFHEO’s regulatory cap [currently set at \$727 billion] to meet the liquidity needs of the credit markets. Although OFHEO director James B. Lockhart refused to lift the cap, Mudd suggested that his company will continue to press on the issue, particularly if market conditions remain jittery. “The OFHEO agreement contemplated addressing issues in a time of market dislocation,” said Mudd. “We’re having a constructive and a respectful conversation, but a conversation all the same, that we think that that disruption is here and that we think this is what the company was built for.” He added, the company would “continue to address the issue of the cap on our mortgage portfolio.”
- Fannie Mae’s 10K for fiscal year 2006 also noted that the company determined that it previously paid executives more stock under an incentive plan than the executives were due, based upon the company’s restated financial statements. A Fannie Mae spokeswoman declined to comment on this disclosure.
- Fannie Mae said it expects to file future financial reports on a timely basis beginning with its filing in late February 2008. During the investor conference call, Mudd also promised that the company would file its 10Q earnings statements for the first three quarters of 2007 by December 31 of this year. In an August 16th statement, OFHEO Director James B. Lockhart, III, said, “Fannie Mae has passed an important milestone in its remediation efforts with the filing of its 2006 Annual Report on Form 10-K with the SEC. This helps reinforce Fannie Mae’s ability to serve its core mission. We will continue to work with the company as it completes the task of resolving key operational and accounting issues and becoming a current SEC filer early in 2008.” (*Washington Post*, David S. Hilzenrath, 08/17/07; *Bureau of National Affairs*, Richard Cowden, 08/17/07; *Wall Street Journal*, Kevin Kingsbury, 08/16/07; *Associated Press*, Marcy Gordon, 08/16/07; *Dow Jones Newswires*, Damian Paletta, 08/16/07; *Wall Street Journal*, Damian Paletta and Kevin Kingsbury, 08/17/07; *Reuters*, 08/16/07; *OFHEO Press Release*, 08/16/07; *Reuters*, Patrick Rucker, 08/16/07; *Federal National Mortgage Association Form 8-K*, 08/16/07)
- Effective August 17, former AOL executive Stephen M. Swad became the new CFO for Fannie Mae, succeeding Robert Blakely, who stepped down as finance chief but

remains with the company as an executive vice president. Swad joined Fannie Mae in May 2007 as the company's executive vice president and CFO designate. (*Washington Business Journal*, Neil Adler, 08/24/07)

Fannie Mae exploring purchase of C-Bass's Litton Loan Servicing

- On August 9, the *Wall Street Journal* reported that Fannie Mae was working on plans to purchase Litton Loan Servicing LP [LLS], according to two people familiar with the negotiations. A Fannie Mae spokesman and an OFHEO spokeswoman declined to comment on the matter. Litton is a subsidiary of Credit-Based Asset Servicing and Securitization LLC [C-BASS], which specializes in servicing loans to borrowers who are having difficulty making payments. The expansion of Fannie Mae's operations into the loan servicing space would likely anger critics, who have argued that the company is trying to leverage the problems in the subprime mortgage market to the GSE's advantage. Fannie Mae would likely need the approval of its acquisition of LLS by OFHEO, its safety and soundness regulator. While the company is not barred from servicing loans, Fannie Mae may also need the approval of HUD, which approve the GSE's new business ventures, if it planned to service mortgage loans that the company did not own. (*Dow Jones International News*, Damian Paletta, 08/09/07)

Fannie Mae and Freddie Mac

The right man at the right place at the right time...

- After delivering his emotional tirade against Federal Reserve Chairman Ben Bernanke that turned heads on Wall Street and Washington, CNBC commentator Jim Cramer turned his wrath on OFHEO director James B. Lockhart, III. On *RealMoney.com*, Cramer wrote, “Should the most hated man in American be a faceless bureaucrat by the name of James Lockhart? You don’t know him. Nobody outside the Beltway does. But he is at the heart of the chokehold on America’s mortgage markets. When the book is written, ...Lockhart might be the man who is responsible for making more unforgotten men forgotten (and here I refer to the title of the excellent book on the Great Depression) than anyone since Herbert Hoover.”
- “First of all, I don’t want to make it sound that Lockhart means badly. What bureaucrat does? He was put in by President Bush to keep Fannie Mae ... ‘clean’ after a series of debacles at Fannie that are all well-documented. And awful. Fannie was very poorly run. Plus, if you are looking at it from President Bush’s perspective you have to believe that Fannie Mae seemed anachronistic, a quasi-government entity created by FDR to make it so hardworking middle-class and lower-middle-class people could buy a home. In the last 20 years so many entities have gotten into mortgage lending and loan repackaging, who needed Fannie?”
- “But now there is a gigantic 1930s-like freeze-up again. Think of it—American Home..., New City Financial, Fremont General..., and all the other ne’er-do-wells are no longer in the game and the big banks like Wells Fargo ...don’t want to extend the credit to mortgage brokers anymore. We can’t just rely on Countrywide Financial ...for heaven’s sake? So Fannie Mae needs to get into the game, gets its caps lifted and help people. Lockhart has the ability to step aside, or better, take a leadership role in saying he will maintain oversight but that the caps on Fannie’s lending should be raised. Many people, mostly uncreative ones, have said, ‘Don’t even think that Fannie Mae will come to anyone’s rescue. It only backs up loans that have insurance and the loans aren’t for big amounts.’” (*RealMoney.com*, James Cramer, 08/09/07)
- In the *Financial Times*, John Dizard notes, “At a time when America, or at least Wall Street, needs a spineless hack as the head of a key agency, it is saddled with a credible man of principle: James Lockhart, OFHEO’s director. Yale graduate, Harvard MBA, lieutenant in the nuclear navy, risk management software entrepreneur, senior insurance executive, and former head of the Pension Benefit Guarantee Corporation. ‘A real hard-ass’ in the words of a mortgage finance executive. It doesn’t seem as though he can be intimidated by the threat of being sent back to Plano, Texas, to work in his uncle’s car dealership.”

- “Lockhart was appointed in the middle of last year to the directorship when there was no immediate, obvious cost to anyone of having a competent, effective regulator who actually knows what those buttons on his computer are connected to. What is worse, his resistance to Fannie and Freddie ballooning their balance sheets and loosening their controls is reinforced by his experience in a previous job. The Pension Benefit Guarantee Corporation, a thinly capitalized government insurance operation, which charged inadequate premiums for covering beneficiaries of failed pension funds, was in turnaround, as they say in Hollywood, during his tenure from 1989 to 1993. Lockhart had to clean up other peoples’ messes and one can guess he doesn’t want to do that again. So it will only be after many more problems surface and under strict conditionality that [Fannie and Freddie] will pump a bunch of new money into the housing finance pipelines. (*Financial Times*, John Dizard, 08/28/07)

<p>Federal Reserve has begun working on proposed rules to define unfair and deceptive lending practices</p>

- The *American Banker* reports that the Federal Reserve Board has begun working on a proposal that would define unfair and deceptive lending practices, “according to sources familiar with the situation.” While the Office of Thrift Supervision moved forward with a broad plan in August, the sources say that the Fed is expected to take a narrower tack. “The Federal Reserve Board is actively considering a rule-writing approach of its own,” said an industry source. “The Fed is addressing a similar set of [unfair and deceptive practices] issues as the OTS [did].” Sources caution that the Fed may ultimately abandon its plan to write the rule, which is in an early phase. At this point, the Fed is holding discussions with OTS and the National Credit Union Administration, which have the authority to define unfair practices for thrifts and credit unions, respectively. In an interview with *American Banker*, Sandra Braunstein, the director of the Fed’s division of consumer and community affairs, declined to discuss the issue directly. “We are not taking anything off the table, including writing UDAP rules under the FTC Act,” said Braunstein.
- In a comment letter to the Federal Reserve in connection with the central bank’s hearing on the Home Equity and Ownership Protection Act (“HOEPA”) and the adequacy of existing regulatory and legislative provisions to protect consumers’ interests, the American Bankers Association and America’s Community Bankers urged the Fed to use caution as it develops new rules. The groups wrote, “We believe it is unnecessary and unwise ... to apply to prime and fixed-rate mortgages the underwriting requirements discussed [at the Fed’s July 14 hearing]. Prime borrowers are well served by the type of flexible underwriting that is performed in the market currently.” They also urged the Fed to “exercise caution” when considering banning prepayment penalties, because loans that include them can often carry lower interest rates. (*American Banker*, Steven Sloan, 08/16/07)
- In an August 14th comment letter on this issue, Anne Canfield, executive director of the Consumer Mortgage Coalition, attributed the deterioration of subprime lending

standards to the lack of due diligence by investors in collateralized debt obligations (CDOs), which resulted in a dysfunctional market. These investors, who bought about 70% of the lower-rated classes of subprime securitizations, relied on the rating agencies and CDO managers and “did not even realize they were the key risk takers” in the subprime market. As a result, “absentee” investors created a “dysfunctional” market. To prevent the re-occurrence of dysfunctional markets, Canfield suggested that the Fed can impose capital requirements on all mortgage lenders and brokers and impose constraints on CDO managers and rating agencies to make the secondary market more transparent. CMC urged the Federal Reserve to be cautious in amending its HOEPA regulations, given the risk of further exacerbating liquidity problems in the subprime market. “Ultimately the mortgage market can only function properly when those who bear the risk of mortgage investments are closely involved in the process of mortgage origination,” wrote Canfield. (*National Mortgage News*, 08/15/07)

OFHEO reports housing values increased only 0.1% in second quarter

- On August 30, OFHEO reported that housing values increased by only 0.1% in second quarter and by only 3.2% over the last 12 months – the lowest appreciation rate since 1994. The agency’s data also showed significant variations in trend by region with the greatest year-over-year rates of price appreciation during the quarter occurring in the West South Central and Mountain Census divisions. The top states in price appreciation in the West or Northwest included Utah (15.28%), Washington (9.12%), Montana (9.06%), New Mexico (8.81%), Idaho (8.42%) and Oregon (8.18%). “These newest data show price declines in many areas that were once at the center of the housing boom,” said OFHEO’s chief economist Patrick Lawler. Two of the three states with the lowest year-over-year appreciation rates were Nevada (-1.45%) and California (-1.38%). The slump has also hit New England, where Massachusetts (-0.99%) and Rhode Island (-0.97%) recorded year-over-year price declines in the second quarter, and much of the industrial Midwest, where Michigan (-1.42%) and Ohio (-0.69%) showed negative year-over-year price appreciation. (*Bureau of National Affairs*, Richard Cowden, 08/31/07)

Another threat to the U.S. housing market

- Representative John D. Dingell, chairman of the House Energy and Commerce Committee, plans to introduce comprehensive climate-control change legislation in September, which will “remove the mortgage interest deduction on McMansions—homes over 3,000 square feet.” Dingell says he recognizes that his proposal will spark much criticism, but argued that it is essential to reducing carbon emissions by 60% to 80% by 2050. “In order to address the issue of climate change, we must address the issue of consumption,” said Dingell. “We do that by making consumption more expensive.”

- Lawrence Yun, senior economist for the National Association of Realtors, said that the elimination of the mortgage tax deduction for housing larger than 3,000 square feet would result in a national median-house-price decline of 4% on all homes—not just large house. There are approximately 10.4 million single family homes with interior areas exceeding 3,000 square feet, which accounts for about 15% of the owner-occupied housing stock. Citing industry research, Yun said that Dingell’s plan could push up foreclosures because for every 1% decline in the median market price, an additional 70,000 foreclosures occur. Thus, Dingell’s plan could result in an *additional 280,000* foreclosures. National Association of Home Builders policy advocate Bill Killmer called Dingell’s plan “wrong-headed” in its focus on house size. “We believe a better approach would be to look at consumer behavior—how efficient are the appliances they have installed, how energy-efficient are the windows, the insulation, heating and air conditioning...” (*Washington Post*, Kenneth R. Harney, 08/25/07)

Fannie Mae

Fannie Mae's mortgage portfolio holdings jump nearly 13% in July

- Fannie Mae's investment in its retained mortgage portfolio jumped nearly 13% in July to \$729.8 billion, leaving the GSE "scant room"[approximately \$4 billion] to grow under the current limitations set by OFHEO. The company's mortgage holdings increased for the third straight month, bringing its growth to 1.3% annualized year-to-date. Fannie Mae said that its mortgage-backed securities and other guarantees grew at a 15.5% compound annualized rate in July, resulting from its MBS issuance of \$56 billion and a decline in loan liquidations. Fannie's agency-backed MBS issuance totaled \$97 billion in July, up 31% from the company's MBS issuance volume in June, while its non-agency MBS/ABS issuance totaled \$55 billion, down 13% from year-ago levels. Fannie Mae's single-family serious delinquency rate rose 2 basis points to 0.64% in June, while its multi-family serious delinquency rate declined 2 basis points to 0.09% in July. The GSE's effective duration gap averaged plus one month in July. (*Reuters*, Lynn Adler, 08/24/07; *Fannie Mae Monthly Volume*, July 2007)

Fannie Mae's loan production jumps by nearly 33% during first six months of 2007

- Fannie Mae's production volume jumped by nearly a third during the first half of 2007, as a result of the company's improved loan offerings and new products. According to the company, Delegated Underwriting and Servicing (DUS) lenders delivered \$14 billion in loan volume, a 31% increase from the \$9.3 billion delivered during first six months of 2006. Much of Fannie Mae's volume growth occurred in its seniors housing area, in small to mid-size loans [between \$3 million and \$25 million], and in large portfolio acquisitions, as well as continued strength in student housing and manufactured housing. Smith, chief operating officer of [DUS lender] Green Park Financial, said, "They're more competitive than they've been in the past."
- Fannie Mae's business has been buoyed by the ongoing meltdown in the subprime mortgage industry, which has resulted in slashed ratings on commercial mortgage-backed securities (CMBS) and forced more conservative loan underwriting by conduit lenders. "The reason behind that increase [in DUS lending] has been the increasing volatility and uncertainty in the conduit market and the flight to certainty of execution," said Heidi McKibben, Fannie Mae's vice president and head of multifamily production. "We're seeing a shift back in the market on credit; we've seen conduits pull back on aggressive structuring. We'll see likely continued volatility on the pricing side."
- During the first six months of 2007, Fannie Mae committed \$620.5 million in equity investments that qualify for low-income housing tax credits (LIHTCs), a nearly 38%

decline from company's \$1 billion commitment during the year-earlier period. Demand for these investments has diminished as yields fell last year, said the company.

- In fiscal year 2006, Fannie Mae's small loan volume declined 25% to \$3.9 billion from \$5.2 billion for fiscal year 2005. The GSE defines small loans as those up to \$3 million for market-rate properties, and up to \$5 million in high-cost metro areas such as New York and Boston. Fannie Mae recently has revamped its 3MaxExpress small loan program, by reducing its debt-service coverage ratio (DSCR) fees from the traditional 1.25x to 1.20x. The company also streamlined many requirements for third-party reports, such as engineering, appraisal, and environmental reports, to make the program more cost-effective for small loan borrowers. "We've looked at the underwriting requirements and said, 'Is this the appropriate level of due diligence for a small-balance loan?'" said Rick Wolf, manager of Fannie Mae's small-balance multifamily loans. "Small-loan borrowers are almost more willing to increase the spread that they pay on the loan than they are to write a check to pay for third-party costs. Fannie also has loosened the standards on economic vacancy rates by lowering the threshold from 10% to 5%, which allows borrowers to get incrementally higher loan proceeds.
- In June, Fannie Mae rolled out its acquisition rehab mezzanine product, called the Community Investments Mezzanine-Moderate Rehabilitation program (CI Mezz-Mod Rehab), which aims to address the aging affordable housing stock. CI Mezz-Mod Rehab loans, designed for properties undergoing renovations of \$5,000 or more a unit, are secured by a pledge of the borrower's interest. For single assets, the minimum loan amount is \$500,000 and ceiling is \$50 million; multiple asset portfolios have a maximum loan amount of \$150 million. (*Affordable Housing Finance*, Jerry Ascierito, September 2007)

Freddie Mac

Freddie Mac's mortgage holdings grew 14% in July – the fastest pace in 16 months

- In July, Freddie Mac's retained mortgage portfolio grew 14.3% annualized to \$720.6 billion, the biggest one month rise since March 2006. Freddie Mac's portfolio growth in July followed a 1.2% rise in June, bringing its year-to-date growth to 4.1%. FTN Financial Capital Markets analyst Jim Vogel said Freddie Mac took advantage of cheaper valuations on mortgage bonds in July, as well as the settling the purchases that it made in June. "The portfolio increased within a couple billion of what we anticipated," said Vogel. "But it was mostly in line with our expectations." With almost \$8 billion of sales settling in June, the GSE was able to absorb June's "extraordinary" \$40 billion in net purchase commitments with minimal strain, he added. The company's portfolio growth in July was overwhelmingly in its own MBS, while its holdings of non-agency mortgage-backed securities declined. Freddie Mac can grow approximately \$17 billion in August and September, before its reaches the September 30 cap mandated by OFHEO.
- Freddie Mac's total mortgage portfolio, which includes its retained mortgage portfolio and the company's mortgage securities held by outside investors, grew at an annualized rate of 7.1% in July to approximately \$1.965 trillion, up 12.9% for the seven months ended July 31, 2007. The GSE's duration GAP was zero months in July, unchanged from the previous month. (*Reuters*, Julie Haviv, 07/23/07)

Freddie Mac spent \$4.3 million on lobbying during first six months of 2007

- During the first six months of 2007, Freddie Mac spent \$4.3 million for lobbying on data privacy, home insurance, tax bills and other legislation pertaining to the company, according to its most recent disclosure form. (*Associated Press*, 07/24/07)

Freddie Mac names Mike Perlman to serve as its EVP for operations and technology

- Freddie Mac has named Mike Perlman as its Executive Vice President, Operations and Technology, responsible for managing the GSE's mortgage origination and servicing, investment and capital operations, and information systems. Previously, Perlman was a managing director for the operations and technology infrastructure for Morgan Stanley's Fixed Income and Global Operations divisions. Before joining Morgan Stanley, he was a founding partner at AT&T Solutions' Financial Services Group and a partner at Deloitte & Touche, where he specialized in large-scale business and technology renovation. (*Freddie Mac Press Release*, 08/09/07)

Freddie Mac Foundation awards \$1.1 million grant
to the JC Nalle Community School in Washington, D.C.

- The Freddie Mac Foundation announced a \$1.1 million grant over the next 18 months to provide additional support for the JC Nalle Community School, a full-service community school designed to improve the academic performance of students adversely impacted by poverty and violence. The Foundation's grant will support the schools' programs for extended day services, summer enrichment, Saturday school, mental and health services, and a parent university. (*Freddie Mac Foundation Press Release, 08/22/07*)

Federal Home Loan Banks

FHLBs of Dallas and Chicago hold preliminary discussions about combining operations

- On August 8, the FHLB-Chicago and FHLB-Dallas jointly announced that they are engaged in discussions and due diligence reviews concerning a merger of the Banks' operations. According to sources, the Banks' negotiations are moving quickly and an announcement concerning a merger agreement could be announced as soon as mid-September. The merger talks are driven in part by the FHLB-Chicago's financial difficulties and the FHLB-Dallas's shrinking membership base. If the Banks agree to merge, it would be the first merger within the FHLB System since 1946, when the FHLB-Los Angeles merged with the FHLB-Portland and later moved to San Francisco. The combined institutions would create the third largest FHLB, with assets of \$141 billion and 1,745 members. "Our focus is on identifying whether and how a combination would produce advantageous results and improved value for members of both organizations and the affordable housing needs of their communities, while also supporting the ongoing strength of the Federal Home Loan Bank System," said Terry Smith, President and CEO of the FHLB-Dallas and Mike Thomas, President and CEO of the FHLB-Chicago.
- During the second quarter of 2007, the FHLB-Chicago's earnings continued to plummet, falling 50% from a year earlier to \$27 million due in part to problems with its mortgage program and lower interest income, caused by maturing funding being replaced by higher cost debt. "We anticipate that these factors also will significantly lower future net income in 2007 and beyond compared to previous years and expect income over the remaining six months of 2007 to further decrease as compared to the first six months of 2007," said the Bank said in quarterly filing. To cut costs, the Bank cut its operating expenses through the layoff of 81 employees during the first six months of the year. The Bank's continuing financial woes are a primary driver behind their merger discussions with the FHLB-Dallas. In contrast, profits at the

FHLB-Dallas grew 2.9% to \$28.7 million during the second quarter, while its advances dropped 11.5% to \$36.4 billion.

- The issue of mergers among the FHLBs has been a controversial topic for years. In September 2006, Finance Board Director Ronald Rosenfeld told a House Financial Services subcommittee that the current FHLB System of 12 independent banks did not make sense. “Quite frankly, I don’t understand why you need six banks between Pittsburgh and Topeka, but if that’s what members want, and that’s what the members are willing to pay for, that’s their prerogative,” said Rosenfeld. In an interview earlier this year, Rosenfeld said, “You may well see, in the near future, centers of excellence evolving where a bank that does something really good — whether it’s managing mortgages or technology — will perform that service for other banks. You have 12 banks. You don’t need to do every function 12 times.” While federal law requires the FHLB System to have at least eight banks, sources said that if a merger of the Chicago and Dallas banks happened, regulators at the Finance Board would support further consolidation. (*American Banker*, Steven Sloan, 08/09/07; *FHLB-Chicago and FHLB-Dallas Press Release*, 08/08/07; *American Banker*, Steven Sloan, 08/21/07)

FHLBs’ demand for advances spike up during the market’s liquidity crisis
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- The Federal Home Loan Bank System has seen a spike in demand for advances from member institutions since late July as liquidity pressure increased on financial institutions. During the first 16 days of August, the FHLB-Atlanta had advanced approximately \$7 billion to its members for an increase of 6.5% over existing advance levels, representing nearly double the Bank’s growth in advances from June 30 2006 to June 30 2007. [Countrywide Bank FSB is a member of the FHLB-Atlanta; in an August 2nd filing, Countrywide said that it could still seek up to \$11.9 billion in advances from the FHLB-Atlanta.] The FHLBs of Cincinnati, Seattle, and New York all reported similar increases in demand for advances, reflecting in part the recent increase in volatility and widening of credit spreads in the capital markets. “That’s exactly what the [FHLBs] are there for,” said Allan Mendelowitz, a director on the Federal Housing Finance Board. “In this liquidity crisis, the Home Loan Banks have stepped up to do what they are chartered to do.” (*Dow Jones International News*, Damian Paletta, 07/16/07)

Bill introduced in the Senate to allow FHLBs to guarantee tax-exempt bonds
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- Senator John Rockefeller (D-WV) has introduced a bill that would allow the FHLBs to guarantee tax-exempt bonds. The bill is co-sponsored by Senators Mike Capro (R-ID), Tom Carper (D-DE), Robert Casey (D-PA), Tim Johnson (D-SD) and Debbie Stabenow (D-MI). The bill, identical to legislation introduced by Representative Sander Levin (D-MI) in May, would make it easier for community banks to finance

local projects and allow the FHLBs to earn additional fee income. (*American Banker*, Steven Sloan, 08/10/07)

FHLB-San Francisco announces its 2007 board of directors' election results

- The FHLB-San Francisco announced that incumbent directors W. Douglas Hile and David A. Funk have been elected to new terms on the Bank's board, each for a three-year term beginning January 1, 2008, and ending December 31, 2010. Hile is chairman and CEO of Meridian Bank, N.A., Wickenburg, AZ. Funk serves as the president and a director of Nevada Security Bank, Reno, NV. (*FHLB-San Francisco Press Release*, 08/21/07)

FHLB-Atlanta names Steven Goldstein as its chief financial officer

- The FHLB-Atlanta has named Steven Goldstein, the bank's interim CFO since April, to serve as its executive vice president and chief financial officer. "Steve is an excellent addition to our team," said Richard Dorfman, the Bank's chief executive. "He combines formidable technical knowledge, sound operational expertise, and the valuable perspective of previously managing finances and reporting at a large, global financial services provider." Previously, Goldstein was a senior vice president and CFO for Royal Bank of Canada. (*American Banker*, Steven Sloan, Rob Blackwell, and Joe Adler, 08/20/07)

Ginnie Mae

Ginnie Mae lifts VA loan cap to boost financing for veterans

- In a bid to help military veterans buy homes in high cost markets, Ginnie Mae will eliminate the cap on the size of certain government-backed mortgages that it accepts Effective September 1, Ginnie Mae will accept as collateral for its mortgage bonds loans of more than \$417,000, the current limit that is insured by the Department of Veterans Affairs. "We expect this change will expand the availability of low-cost financing and increase homeownership opportunities for America's veterans, particularly in high cost areas, by encouraging lenders to make more VA loans," said Michael J. Frenz, EVP of Ginnie Mae. The federal agency will continue to require that the down payment, plus the amount of the VA guaranty, equal at least 25% of the value of the home. (*Dow Jones Newswires*, Lingling Wei, 08/30/07)

International Mortgage Market

Morgan Stanley completes the UK's first residential property derivative with an embedded exotic option

- Morgan Stanley and an undisclosed counterparty have agreed an exotic swap based on the Halifax House Price Index, the UK's definitive index for trading movements in UK house prices. Under terms of the transaction, the counterparty gains if the Index rises, subject to a maximum payout, but the counterparty's capital is protected unless the Index falls beyond an initially specified point. While the pricing of the deal and length of contract remains confidential, Guy Ratcliffe, Executive Director, Fixed Income at Morgan Stanley, told Reuters the transaction is worth more than 1 million pounds (\$2.01 million). "We have always enjoyed a leading presence in the direct property market but this deal illustrates our ambition to expand into the exotic derivatives market," said Ratcliffe. "It shows we are willing to do more than just the typical vanilla contract." Morgan Stanley hopes the deal, which comes amid turmoil in global debt markets, will breathe life into the derivatives market. "Demand for these products is growing. This deal is tailored to cater for customers with a specific risk profile and these trades could become a larger feature of the retail investment market in the future," said Ratcliffe. (*Reuters*, Sinead Cruise, 08/30/07)

Farm Credit System / Farmer Mac

Expanding credit to the ethanol industry and establishing a secondary market for ethanol loans is critical to the industry's future

- In the September issue of *Ethanol Producer Magazine*, W. Bruce Crane, president of Crane Consulting [a renewable energy financial consulting firm], wrote, "As the ethanol industry continues to grow, so does the need for additional financing. However, there is a lack of underwriting expertise with community banks and a perceived long-term risk associated with ethanol loans. If the number of renewable energy companies is to continue to grow, federal action must be taken to educate the lending community and provide banks with the tools needed to service the debt financing needs of the new companies."
- "Renewable energy financing has its roots in production agriculture and farmer cooperatives served by the Farm Credit System, which is a [GSE] created by Congress in 1916 to provide American agriculture with a dependable source of credit.

However, more non-farmers are now involved in the development of renewable energy, and these entrepreneurs do not have access to the Farm Credit System member institutions. Instead, they rely on community bankers for financing. For the most part, 'Main Street' lenders have yet to develop an understanding of the underwriting necessary for financing ethanol and biodiesel plants, anaerobic digester projects, wood pellets plants and other sources of renewable biomass energy. Little education has occurred to teach community bankers how to best determine the financial viability of a renewable energy project. Even with government guarantees provided by the USDA and the U.S. DOE, banks still perceive the risk to be too great and thus do not make funding available for these projects that in many cases could provide an important economic boost for their communities.”

- “Some would argue that community banks ‘redline’ these projects, much like banks were accused of doing with inner-city businesses and housing in the latter part of the 20th century. To overcome that obstacle, Congress and banking regulators established the Community Reinvestment Act (CRA). Enacted in 1977, the CRA is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate. It also mandated lenders to demonstrate how they serve the underserved segments of their communities.”
- “Banks argue that loans to renewable energy and other less conventional ventures have to stay on their books for years and lenders are thus subjected to market risks that many small banks are simply unable to absorb. Unlike mortgage and rural land loans, a ‘secondary market’ that allows banks to sell these loans off to an entity like Fannie Mae or Farmer Mac does not exist. Banks argue that without a further way to mitigate risk, their participation in this new domestic industry will be limited. Creating a secondary market would ‘liquefy’ these funds thereby freeing up bank capital that can be further invested in other renewable energy projects or commercial and residential ventures.”
- “To overcome this obstacle to a steady flow of commercial credit for renewable energy, the following recommendations should receive serious consideration in Washington, D.C. First, Congress should work with federal and state financial institution regulators to expand the CRA requirements imposed on depository institutions to include loans made to entrepreneurs and companies commercializing renewable energy projects in their communities. This will entice and encourage lenders to learn how to make loans to these companies and produce much-needed debt financing for these projects.”
- “Congress should also consider the creation of a secondary market for renewable energy loans that would mitigate some of the risk associated with long-term financing necessary for renewable energy projects such as ethanol, biodiesel and other ventures. This secondary market could be pursued in one of three ways:
 - Expanding the charter of Farmer Mac or the Federal Home Loan Bank System to allow these GSEs to purchase renewable energy loans at a premium from lenders.

- Authorizing the establishment of the ‘Renewable Energy Government Loan Corporation (Reggie Mac)’ that has a mission of purchasing renewable energy loans from lenders. As with other GSEs, these loans would be pooled, securitized and sold to investors who are interested in buying AAA-rated paper from other GSEs such as Fannie Mae and Freddie Mac. Pooling different types of renewable energy projects further helps mitigate risk and helps stabilize funding for future developments.
- Authorizing a study to be carried out jointly by the USDA and DOE to examine the feasibility of an in-house secondary market entity like Ginnie Mae that would be charged with purchasing renewable energy loans from lenders. Congress should require the departments to seek that advice and counsel of the Office of Housing Enterprise Oversight (Fannie Mae and Freddie Mac’s Federal regulator) while conducting this study.
- Finally, national renewable energy associations should work with federal banking regulators, USDA Rural Development, DOE, the American Bankers Association and other banking associations to offer underwriting education to teach lenders how to underwrite renewable energy loans.”
- “If renewable energy continues to grow in this country, everything possible must be done to ensure that federally insured depository institutions such as banks, thrifts and credit unions are willing and able to provide the much-needed debt financing for renewable energy projects.”
- “The banking community is essential to the economic development in our communities. To make sure mostly rural areas, where renewable energy plants are located, get access to debt and credit needed to run a business, we need to bring lenders into the renewable energy community as active participants. This must be done in a way that makes lenders understand the potential for this new and growing book of business. However, bankers must be provided with the underwriting education and lending tools necessary to serve renewable energy companies without damaging the stability of their own financial institutions. Doing so will make bankers become willing partners in this ever-growing segment of our economy that over the long term will be an important new customer base for the nation’s depository lending institutions.”
- “For this reason Congress and President George W. Bush’s administration should act now to do the same for the renewable energy market that they did for other underserved segments of society. Banks should receive credit toward their CRA lending requirements for making renewable energy loans. Also, banks should be given access to a secondary market for renewable energy loans similar to the secondary markets that exist for housing and student loans. Mitigating risks is essential to any type of business, and providing the necessary incentives, education and financial support will allow banks to serve renewable energy companies without

jeopardizing the viability of these local institutions that are essential to the economic stability and growth of our communities.”

- “One would be hard pressed to argue that domestically produced renewable energy is any less important than a steady flow of credit for housing, student loans or farming operations. Therefore, necessary lending education needs to be offered, and legislation, policies and regulations need to be enacted to ensure that debt financing critical to successful commercialization of renewable energy companies is readily available from local lending institutions.” (*Ethanol Producer Magazine*, W. Bruce Crane, September 2007)
- According to the FCA’s 2006 annual report, the Farm Credit System’s “total exposure to ethanol plants at year-end 2006 was about \$2.6 billion, which was 10.5[%] of capital and 2.1[%] of gross loans. This total does not include loan commitments.” FCA noted that the risks associated with the System’s exposure in the ethanol industry included (1) price volatility of oil and corn; (2) the industry’s dependence on the \$0.51 per gallon blender subsidy and its continuance; (3) corn production volatility; (4) collateral risk associated with recent surge in farmland values; (5) foreign competition, particularly if the current import tariff on ethanol is allowed to expire on December 31, 2008; and (7) long-term demand risk related to the future of the Federal Government’s ethanol policy and its continuance of incentives and mandates for ethanol use. (*2006 Farm Credit Administration Annual Report on the Farm Credit System*, June 2007)
- After the House of Representatives voted to strip provisions which would expand the FCA’s lending authority from the Farm Bill Extension Act of 2007, House Agriculture Committee chairman Collin C. Peterson (D-MN) and House Financial Services Committee chairman Barney Frank (D-MA) agreed to hold joint subcommittee hearings after Congress’s August recess to examine the adequacy of credit to farmers and farm-related businesses, particularly ethanol plants. Crain’s arguments about the need for additional financing for the ethanol industry and the creation of a secondary market for these loans appears to be the opening salvo in the upcoming Congressional debate on this issue. (*GSE Report*, 08/06/07)

FCA approves rule revising the risk-based capital stress test for Farmer Mac
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- On August 9, the FCA board of directors adopted a proposed rule that revises the agency’s regulations governing the risk-based capital stress test for Farmer Mac. The test, which calculates Farmer Mac’s minimum amount of regulatory capital, would be revised to add a component recognizing the risk-reducing characteristics of structures such as off-balance-sheet AgVantage, a new loan product whose volume accounts for a growing percentage of Farmer Mac’s program volume, said FCA. Other proposed new components would recognize counterparty risk on non-program investments and revise the estimated carrying costs of nonperforming loans. The proposed rule will be

published in the Federal Register for a 45-day comment period. (*Bureau of National Affairs*, 08/10/07)

Farmer Mac reports its second quarter results

- Farmer Mac reported net income of \$18.4 million or \$1.74 per diluted share for the second quarter of 2007, compared to \$13.4 million or \$1.16 per share for the second quarter of 2006. The agency's core earnings declined to \$5.5 million (\$0.53 per diluted share) for the quarter, compared to \$6.3 million (\$0.56 per diluted share) for the prior year quarter. The company said that its core earnings in the second quarter of 2006 benefited from items that were not predictable sources of ongoing revenue, including representation and warranty claims income, gains on the sale of REO and significant recoveries from the allowance for losses.
- Henry Edelman, President and CEO of Farmer Mac, said, "We are pleased with the growth in Farmer Mac's guarantee portfolio to a record \$8.4 billion and confident of the high credit quality of the assets in that portfolio. The growth of the portfolio, and our confidence in its performance, derive from the success of business strategies we implemented in the fall of 2005 that emphasize large program transactions with high asset quality, providing greater protection for Farmer Mac against adverse credit performance with commensurately lower compensation for its assumption of credit risk and administrative costs." Farmer Mac said that its guarantee portfolio, consisting of guarantees, loans and commitments, was performing well, with delinquencies at historic lows in terms of both dollars and percentages.
- Looking ahead, the agency noted that two recent governmental actions might affect its operations. In July, the House of Representatives passed its version of a 2007 Farm Bill that would expand Farmer Mac's charter to authorize it to purchase and guarantee securities backed by rural utilities loans made by cooperative lenders, particularly the National Rural Utilities Cooperative Finance Corporation and institutions of the Farm Credit System. No assurance could be given, however, that the legislation would be enacted into law, or if enacted, would result in substantial additional businesses for Farmer Mac. On the regulatory front, the company noted that FCA has adopted proposed amendments to the risk-based capital regulation applicable to Farmer Mac. If the proposed regulation had been in effect as a final rule on March 31, 2007, Farmer Mac's regulatory capital requirement would have been somewhat greater than the regulatory capital requirement under the existing rule, but less than the statutory minimum capital requirement. (*RTT News Global Financial Newswire*, 08/09/07)

Postal Service

Postal Regulatory Commission publishes proposed regulations to establish a ratemaking and classification system for mail products

- On August 15, 2007, the Postal Regulatory Commission published proposed regulations to implement a modern ratemaking and classification system for market dominant and competitive mail products. This announcement comes ten months ahead of the PRC's statutory requirement to promulgate such regulations. Comments to the proposed regulations are due by September 14, 2007. The proposed rulemaking consists of three parts: regulations related to competitive products; regulations related to rate adjustments for market dominant products, including the formula for calculation of the rate cap under which annual adjustments may be made; and establishment of a Mail Classification Schedule, which categorizes products as either market dominant or competitive.
- "This is the third in a series of orders designed to establish regulations implementing a modern system for regulating rates and classes for market dominant and competitive products," said the PRC proposal. "In response to those earlier orders, the commission received more than 100 comments from interested parties. The commission has reviewed these comments carefully. They have been useful in clarifying the commission's analysis." According to the proposal, the early implementation of a ratemaking framework prior to the statutory deadline will allow the USPS to use new, streamlined procedures to initiate rate (and class) changes as needed to respond to its financial needs and market conditions. "The commission hopes that establishing the new system quickly will allow the USPS to operate with the flexibility envisioned by the [Postal Accountability and Enhancement Act]," said PRC chairman Dan G. Blair. The proposed regulations are available on the Commission's website, www.prc.gov. (*United States of American Postal Regulatory Commission Order Proposing Regulations to Establish a System of Ratemaking*, 08/15/07; *DMNews.com*, Giselle Abramovich, 08/16/07)

Postal Service's business model: Not a pretty picture

- Tony Conway, a longtime postal manager who now heads the Alliance of Nonprofit Mailers, told the *Washington Post* that he expects the Postal Service to "evolve, probably into more of a focus on the strength of the organization, which is its delivery network. That's the heart and soul of the organization, no current private carrier can compete with it. ...[But] it may or may not be a government organization." He added, "The \$64,000 question is how to keep the delivery network affordable," noting the decline of first-class mail. With the USPS's only significant growth area being standard mail, primarily consisting of advertising, Conway asked, "At what point do you start losing that volume growth [as the cost of postage rises]?" He concluded,

“The days of reckoning are coming sooner than people probably now appreciate. The post office is adding 2 million new delivery points every year, raising costs on a declining revenue base. “That’s not a pretty financial model.” (*Alliance for Nonprofit Mailers*, 08/09/07)

The Postal Service’s downward spiral continues

- In the *Federal Times*, Charles Guy, adjunct fellow with the Lexington Institute, wrote, “The U.S. Postal Service and one of its largest unions, the National Association of Letter Carriers (NALC), just reached a tentative agreement on a new five-year contract. Union head William Young called the agreement a ‘win-win deal for the Postal Service and the nation’s city letter carriers.’ A ‘one-sided victory’ would be more accurate. The terms of the contract mark a big win for the union, and an equally big loss for the Postal Service.”
- “Apparently, the Postal Service would prefer to cave in to union demands rather than confront the long-term challenges of its burgeoning labor costs. USPS also capitulated earlier this year in its negotiations with the American Postal Workers Union, its largest union. By all accounts, the NALC achieved a major coup for its members. The tentative contract provides for guaranteed raises of almost 9 percent for all union members over five years, irrespective of job performance. Letter carriers will enjoy yearly raises at a clip far exceeding that achieved by their counterparts in the APWU earlier in the year. Beyond these raises, the contract also includes cost-of-living adjustments, estimated to be around \$3,000 per worker each year. It even provides for a 2.5 percent yearly increase in the uniform allowance, to \$371 by 2011.”
- “Meanwhile, the Postal Service has reportedly proposed in its negotiations with the National Rural Letter Carriers Association (NRLCA), to establish a locality-based pay system, under which carrier pay would vary based on their geographic location. Having settled with its two largest workforces before seeking this important cost savings tool suggests that Postal Service management lacks a focused wage policy for its workforce. Certainly, union leadership deserves credit for advancing the financial interests of its members so effectively. And most letter carriers deserve to be compensated appropriately for their hard work.”
- “The Postal Service’s management, however, got virtually nothing in return, such as increased labor flexibility, for its generosity. Ultimately, First Class stamp buyers -- who are captive to the USPS monopoly on letter delivery -- will pay the price for this failure to negotiate significant cost-controlling measures.”
- “On two important issues -- the contracting of routes to private carriers and the ability to hire temporary employees -- USPS simply capitulated to union demands. In fact, the NALC contract prohibits the subcontracting of existing work, institutes a moratorium on future contracting, and forbids the hiring of truly temporary

employees. Labor costs account for about 80 percent of the Postal Service's expenditures, and contract workers, who tend to cost about half as much as unionized workers, represent an effective method of reining in the runaway costs responsible for ever-increasing postage rates."

- Union leaders often raise concerns about the safety and sanctity of the mail if private contractors deliver it. But these fears ignore the fact that USPS already engages in significant work-sharing agreements with private firms to transport, sort, and even deliver mail throughout the country. If private contractors go through routine security checks, safety should not be a concern. And as the rise of online banking illustrates, an ever-increasing number of Americans are willing to trust private firms with sensitive financial information. Further, there should be no fear of job losses, as Postmaster General John Potter has already pledged that contract workers would not replace unionized employees under any circumstances. Such union intransigence on contracting is detrimental to the Postal Service's fiscal health. And USPS leadership seems all too willing to yield."
- "The proposal to the rural carriers' union to enact locality based pay, common in the private sector, makes a great deal of sense. Costs of living vary across the country, and a geographically based payment system would ensure that Postal Service resources were used most efficiently. If USPS management were serious about its commitment to control labor costs, it would be pushing for similar provisions with all its unions. Instead, it's making deals that are only a 'win-win' for the leadership of the big unions. For everyone else, they come at all too high a price. (*Lexington Institute*, Charles Guy, 08/06/07)

How <i>can</i> an inefficient company—like the USPS—stay in business?

- Christina Kohn with the Mackinac Center for Public Policy writes, "At 41 cents per stamp, paying a bill, sending a birthday card or keeping in touch with a pen pal can be pretty expensive. Postal fees continue to rise, but deliveries aren't faster, mail isn't safer and the lines at the Post Office don't get any shorter. All this leads one to ask, 'How can such an inefficient company stay in business?' The answer, of course, is by force of law: Competing with the United States Postal Service in the delivery of first-class mail is illegal. The Post Office has held its statutory mail monopoly since our country's infancy, when government officials contended that private companies could not handle the awesome responsibility of delivering the mail. But the truth is that private mail services have existed all along and have generally lowered prices, introduced innovations and intrepidly challenged the government's statutory control of the mail delivery market. ...The Post Office still clings to its government-enforced monopoly on first-class mail because it knows that if it had to compete fairly in the market, we'd all be buying our stamps from its competitors." (www.mackinac.org, Christina M. Kohn, 08/16/07)

- “During the past few weeks, both the Senate and the House have held so-called oversight hearings concerning the Postal Service,” reports Cary H. Baer at *DMnews.com*. “The House hearing was to concentrate on ‘Infrastructure and Realignment,’ while the Senate’s hearing was on ‘Service Standards and Performance Measurement Systems.’ Also, the Senate held a separate hearing titled ‘Views from the Postal Workforce on Implementing Postal Reform.’ Postal reform is often known as the Postal Accountability & Enhancement Act (PAEA).”
- “Let’s review the hearing at the House, regarding the implementation of postal reform. Much of the discussion revolved around the issue of the subcontracting of delivery routes. This issue appears to have been settled, at least temporarily, and essentially taken off the table by the recent contract agreement between the Postal Service and the letter carriers union. However, Bill Burrus, president of the American Postal Workers Union, apparently is quite the seer. He told the subcommittee that the subcontracting of delivery routes is just a step in the direction of converting the Postal Service, a vital public service, ‘... to one performed privately for profit.’ Perhaps Burrus is aware of some magic elixir that postal management can drink to become profitable and draw the attention of hedge funds and the leveraged buyout crowd, let alone get the Democratically-controlled Congress to permit privatization through new legislation. Meanwhile, it will be interesting to hear his thoughts, and those of others in the postal labor hierarchy, as to exactly how the Postal Service can live within PAEA’s Consumer Price Index cap on rate increases.”
- Testifying before the House subcommittee about infrastructure and realignment, Bill Galligan, USPS SVP for operations, laid out some important facts regarding postal operations and workload. His testimony noted that the Postal Service operates a nationwide network of almost 37,000 processing, distribution, retail and delivery sites, some owned, some leased. The USPS’s delivery network is expanding and must accommodate almost 2 million new homes and businesses each year. On the other hand, mail volume is in decline, with the Postal Service projecting a total drop of 1 billion pieces in all mail classes this year. First Class mail, which had its peak of 107 billion in 2001, was at 98 billion last year [representing an 8.4% drop in volume]. To meet the challenges, Galligan pointed out that the Postal Service, ‘... must have the ability to adjust our infrastructure to reduce excess capacity, duplicative processes and their associative costs.’ Another factor in the need for infrastructure adjustment is the Services plan for new automated flat sequencing equipment. This equipment requires a lot of space — space that is unavailable in many of its existing facilities.”
- “This hearing also featured testimony from a number of high-ranking members of Washington-based postal-oriented trade associations. To me, however, the most significant testimony came from Mike Winn, director of postal affairs and mailing operations for R.R. Donnelley and a member of Postcom’s Board of Directors. Winn was able to provide testimony based on his experiences and responsibilities at Donnelley. First, he said, ‘The objective of network alignment must be aimed at

achieving the lowest combined cost of the Postal Service and the mailing community.' Winn was reinforcing the lowest-combined-cost statements made years ago by former Post Master General Bob Tisch, and echoed by subsequent PMGs. That is, the objective of USPS cost-reduction strategies must not be to move expenses off the Postal Service's ledger and transfer them to mailers, unless there is a net total reduction in USPS and mailer costs. Winn also pointed to the need for the Postal Service to improve its communications to mailers regarding its network realignment plans. Winn, as a large mailer and logistics provider, was able to point out that changes to the Postal Service's mail processing network has a significant impact on mailer distribution plans, and their own plant realignments..." (DMNews.com, Cary H. Baer, 08/31/07)

Robert Otto, the USPS's chief technology officer, announces plans to retire October 1st

- Robert Otto, the Postal Service's chief technology officer and a vice president, will retire October 1st. Otto is responsible for the USPS's information technology support to 325,000 USPS employees in addition to hundreds of national applications critical to daily operations, including the payroll for more than 700,000 USPS employees and millions of payments to contractors. He is also responsible for the world's largest intranet, which connects 38,000 post offices through out the country. Since January 2003, Otto has held the position of CTO and chief information officer, a position he has held since 2001. He began his career with USPS in 1980 as the agency's head of nationwide computer security. (*Federal Computer Week*, Ben Bain, 08/22/07)

Things are bad when the airlines' service is worst than that of the USPS

- *The Detroit Free Press* reports, "As airline delays mount and more bags are mishandled, it's not an idle worry. About one of every 130 domestic airline passengers [0.77%] had luggage go astray during the first four months of 2007, according to the U.S. Bureau of Transportation. That's the highest since last summer's airline bankruptcy-inspired delays. To be on the safe side, you can ship your luggage ahead. Around for about eight years, luggage delivery services are being used more as airlines crack down on luggage allotments. While not all guarantee your bags will arrive, most ship several days ahead so you're likely to get delivery on time. After surveying prices and policies, and being the cheapskates we are, the *Detroit Free Press* tried the cheapest method of mailing a small suitcase fast, the good old U.S. Postal Service..." (*Detroit Free Press*, Ellen Creager, 08/13/07)

Inscription at the General Post Office, NYC (8th Ave. & 33rd St.):
“Neither snow nor rain nor heat nor gloom of night stays these [postal] couriers from the swift completion of their appointed rounds”

- *Associated Press* reports, “One block of Capitol Hill is plagued with so many bird droppings that even the U.S. Postal Service says there are days it won’t deliver the mail.” (*Associated Press*, 08/26/07)

The veritable postal service within the USPS

- According to the *Boston Globe*, “Six million people know the experience: You order a DVD from the Netflix website and a day or two later it appears in a red paper envelope. You watch the movie, mail it back, and soon another disc arrives. This cycle happens in America 20 times every second and 1.6 million times every day, making Netflix, the movie-rental company, a veritable postal service within the postal service.” (*Postcom.org*, 08/26/07)

TVA

TVA’ reports 19.8% growth in net income for the third quarter

- For the three months ended June 30, TVA reported net income of \$194 million, compared to \$162 million for the same period in 2006. “Record dry conditions that have lingered for most of the fiscal year continue to impact our budget, reducing our hydro generation and increasing our fuel and purchased power costs as we strive to meet the highest power demands in TVA’s history this summer,” said TVA president and CEO Tom Kilgore. “To offset some of the financial impact on our budget, we have identified ways to reduce operating and maintenance costs for the remainder of the year, and we urge consumers to continue to use energy wisely.” The utility forecasts that its net income for the fiscal year ending September 30 will be approximately \$31 million less than budgeted due to the unseasonably warm winter weather and the dry summer season. TVA has notified its power distributors that beginning in October it will raise its monthly fuel cost adjustment fee to reflect its higher fuel costs incurred by the utility. The average TVA customer with a \$100 monthly power bill will see the fuel adjustment increase from \$3 to roughly \$6. (*Associated Press*, 08/15/07)

Caution urged with TVA's plans to complete its second nuclear reactor

- In an August 10th editorial, the *Knoxville News Sentinel* wrote, “Completing Unit 2 at Watts Bar Nuclear Plant may be the right decision, but that doesn’t mean the decision should be taken lightly. The [TVA’s] board of directors voted unanimously ...to finish the Unit 2 reactor at the Spring City, TN plant, about 65 miles southwest of Knoxville. Construction is expected to take five years and cost \$2.49 billion. ...TVA management said that, because of growing demand for power, rising fuel costs and impending regulation of carbon emissions from fossil fuel plants, completing Unit 2 at Watts Bar is necessary. ‘We are convinced Unit 2 offers TVA and its stakeholders the most economically and environmentally sound means of serving the valley’s future power needs,’ said Howard Thrailkill, a board member, before the vote. Although we agree in principle, adding another nuclear plant brings concerns that bear watching.”
- “...TVA officials say they are taking a more measured approach to nuclear power now, and that’s certainly needed. But each step must be approached in the same way, making sure the failures of the past are not repeated. We also urge TVA to pay attention to the concerns expressed by state Rep. Jim Cobb, whose district includes Watts Bar, that consideration be given to the impact of construction on Rhea and Meigs counties. The construction effort is expected to include the employment of 2,300 workers at its peak, and Cobb pointed out that schools in the area already are overcrowded. We are confident this project can be safe and can be a benefit not only to the immediate counties but also to the TVA system and the Tennessee Valley. But nothing can replace good planning and commonsense precautions for the problems that will be encountered along the way.” (*Knoxville News Sentinel*, 08/10/07)

TVA agrees to pay \$18 million in overcharge settlement

- TVA has agreed to pay \$18 million to settle claims that the utility overcharged industrial customers during a heat wave in 1998. With attorneys receiving more than a third of the settlement, the 436 businesses sharing in the settlement will receive only a fraction of the more than \$100 million originally sought in a 1999 lawsuit. The settlement, which must be formally approved by the court, will likely be disbursed to those involved in the case next year, said the settlement administrator, Tighman & Co. TVA spokesman John Moulton said that the utility denies that it overcharged any of its customers. “But this settlement is a business decision to get this behind us,” said Moulton. (*Associated Press*, 08/21/07)

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