

The **GSE** REPORT™

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Contents of GSE Report™

Major Events

- [OFHEO's claw back: Agency sues three former Fannie executives for \\$215 million \(p. 3\)](#)
 - [The scandal behind the scandal \(p. 6\)](#)
 - [Is OFHEO's lawsuit "fair"?? \(p. 6\)](#)
 - [Fannie Mae's former execs may need Steven Oberfest's services \(p. 7\)](#)
 - [Raines is singing a different tune today... \(p. 8\)](#)
- [Fannie Mae sues KPMG for \\$2 billion, while KPMG plans to counter-sue the GSE \(p. 9\)](#)
- [OFHEO determines that Fannie Mae was significantly undercapitalized for 2002 and 2003 \(p. 10\)](#)
- [Freddie Mac expects \\$550 million loss for the 3rd and 4th quarters of 2006 \(p. 10\)](#)
- [OFHEO directs Fannie and Freddie to follow the nontraditional mortgage risk policy \(p. 12\)](#)

Fannie Mae and Freddie Mac

- [House Financial Services chairman Frank says GSE regulatory reform bill will be passed by the April recess \(p. 13\)](#)
- [Fannie Mae spent \\$10.48 million in 2006 to lobby Congress and to block passage of GSE regulatory reform legislation \(p. 14\)](#)
- [Chairman Frank envisions larger role for Fannie and Freddie \(p. 14\)](#)
- [According to OFHEO, Fannie and Freddie were adequately capitalized on September 30th \(p.16\)](#)
- [Notes from Capitol Hill \(p. 16\)](#)
- [FASB approves January release of guidance on mortgage exception to derivatives rules \(p. 17\)](#)

Fannie Mae

- [Fannie Mae's mortgage portfolio shrank at an annualized rate of 5.7% in November \(p. 18\)](#)
- [NYSE gives Fannie Mae a deadline on filing its 2005 Annual Report \(p. 18\)](#)
- [Fannie Mae's growing foreign investor base fuels higher valuations of the company's securities \(p.18\)](#)

Freddie Mac

- [Freddie Mac's retained portfolio down 0.2% annualized in November \(p. 19\)](#)
- [Freddie Mac announces voluntary delisting from NYSE Arca \(p. 19\)](#)
- [Freddie Mac announces the Counseling Hotline will be made permanent \(p. 19\)](#)

Federal Home Loan Banks

- [Federal Housing Finance Board withdraws its proposal to increase the FHLBs' retained earnings \(p. 20\)](#)
- [On the eve of his retirement, FHLB-Indianapolis president Heger says the FHLBs should consider mergers if they find themselves in financial trouble \(p. 21\)](#)
- [FHLB of Cincinnati announces changes in management organization and promotions \(p. 22\)](#)
- [FHLBs announce board election results \(p. 23\)](#)
- [FHLBs announce their 4th quarter dividend rates \(p. 23\)](#)

Farm Credit System / Farmer Mac

- [FCS Rural America Bonds a back-door method to "stretch the \[legal\] boundaries" of FCS lending \(p. 24\)](#)
- [Leland A. Strom joins the FCA board of directors \(p. 25\)](#)

Postal Service

- [President Bush signs Postal Reform into law \(p. 26\)](#)
- ["Full privatization \[of the USPS\] is, or ought to be, the way of the future..." \(p. 26\)](#)
- [Passage of postal reform legislation will have no impact on the USPS's plans to increase postal rates in 2007 \(p. 28\)](#)
- [Senate confirms Jim Bilbray to serve on the USPS Board of Governors \(p. 28\)](#)

TVA

- [New leadership TVA makes its mark in 2006 \(p. 29\)](#)
- [TVA pays \\$10.5 million in executive bonuses and \\$40 million in employee performance bonuses \(p. 30\)](#)

Major Events

OFHEO's claw back: Agency sues three former Fannie executives for \$215 million

The scandal behind the scandal

Is OFHEO's lawsuit "*fair*"?

Fannie Mae's former execs may need Steven Oberfest's services

Raines is singing a different tune today...

OFHEO's claw back: Agency sues three former Fannie executives for \$215 million

- OFHEO has filed 101 criminal charges against Fannie Mae's former chairman and CEO Franklin Raines, former vice chairman and CFO J. Timothy Howard, and former SVP and controller Leanne Spencer, for their roles in the company's overstatement of profits by \$6.3 billion. Through the charges, the agency seeks to retrieve at least \$115 million in bonuses and civil fines totaling at least \$100 million from Fannie's former executives. Of the 101 charges filed, 79 involve Raines, 89 involve Howard and 73 involve Spencer. In addition to recovery of bonuses and payment of fines, OFHEO is seeking to have the three former executives barred from working for Fannie Mae or Freddie Mac; seeking to have the three executives waive their right to sue Fannie; seeking to restrict their employment with any other regulated financial institution; and seeking reimbursement of legal fees. [Through September 30, Fannie Mae has paid \$3.9 million of Raines' legal fees and \$3.2 million for Howard's legal fees; the company has not disclosed its payment of Spencer's fees.]
- "Mr. Raines, Mr. Howard and Ms. Spencer knowingly and ... recklessly engaged in misconduct and safety and soundness violations that caused substantial and ... material harm and loss," said OFHEO in a statement. "Such harm was the result of a pattern of misconduct, encompassing both the individual and collective action of these individuals." OFHEO director James B. Lockhart, III said, "The 101 charges [filed] reveal how the individuals improperly manipulated earnings to maximize their bonuses, while knowingly neglecting their accounting systems and internal controls, misapplying over 20 accounting principles, and misleading the regulator and the public. The Notice [of Charges] explains how they submitted six years of misleading and inaccurate accounting statements and inaccurate capital reports that enabled them to grow Fannie Mae in an unsafe and unsound manner. The misconduct cost the Enterprise and shareholders many billions of dollars and damaged the public trust." In a conference call with the media, Lockhart added, "We believed as an agency that these three individuals, separately and together, did serious harm to the company."

There is a long list of charges that show they allowed this company to grow out of control.”

- From 1998 through 2004, Fannie Mae paid Raines \$91 million, with more than \$52 million tied to meeting EPS targets. Over this period, Howard was paid \$30.85 million of which only \$3.5 million was salary and Spencer was paid \$7.3 million of which only \$1.67 million was salary.
- OFHEO general counsel Alfred Pollard said that the agency may bring similar charges against both current and former executives. He added that OFHEO decided to file its “Notice of Charges” against the three former executives now because a statute of limitations law might have stymied the agency from pursuing them after the end of 2006. The filing sets forth a complex legal process that could take years to resolve. The Office of Personnel Management will assign the case to an administrative law judge from HUD or another federal agency, who will oversee hearings to examine these charges. Pollard said OFHEO will ask the judge to fine the former executives \$100,000 a day for “knowing” they engaged in violations that caused substantial harm to Fannie; if that fails, the agency will ask for a ruling that they engaged in “reckless conduct,” which carries a \$10,000 a day fine. [Some of the violations outlined in the Notice of Charges occurred over a five year period.] The judge will determine remedies in the case and recommend action to OFHEO’s director. Lockhart may accept, modify, or set aside the judge’s recommendation. If a defendant disagrees with the findings, he or she may appeal the decision to a federal court for review.
- The defendants’ lawyers accused federal regulators of being “fatally biased” in filing the charges, painting OFHEO’s legal announcement as a politically ulterior attempt to encourage Congress to exercise more authority over the federally chartered mortgage group. Kevin Downey, Raines’ attorney, called OFHEO’s allegations “false” and asked Lockhart to recuse himself “immediately and completely from any further regulatory action affecting Mr. Raines,” according to an *Associated Press* report. Downey added that Lockhart is a “fatally biased regulator [who is using] Raines as a prop in the interests of” persuading Congress to pass GSE regulatory reform legislation. Downey also told reporters that OFHEO should allow the defendants to challenge the agency’s findings and proposed remedies immediately in federal court, rather than going through the administrative law procedure. “We don’t want the same person [OFHEO director Lockhart] to be the prosecutor, the judge and the politician ...having already announced publicly what his conclusions are,” said Downey. Raines’ attorney has also asked a federal judge to order OFHEO to remove the confidential designation on more than 300,000 pages of the agency’s documents, which Downey claims “disproves” that Raines manipulated the company’s accounting. [The confidentiality designation precludes Raines and his legal team from publicly discussing the contents of OFHEO’s documents.] Steven Salky, Howard’s attorney with Zuckerman Spaeder LLP, told the *Associated Press* the allegations are a “politically motivated attempt to rewrite history,” and said he’s “eager” to refute the government’s charges. David Krakoff, Spencer’s attorney at

Mayer Brown Rowe and Maw LLP, said, “We look forward to disproving the politically motivated claims brought by OFHEO.”

- American Enterprise Institute Fellow Peter Wallison rejected out-of-hand the defendants’ lawyers claims that OFHEO’s charges are politically motivated. “Anyone who knows Jim Lockhart, the head of OFHEO, knows that this is an absurd charge,” said Wallison. “If that’s all they have with which to defend their clients,” he said, “[then] their clients should be very worried.” Wallison added that OFHEO’s charges could strengthen class-action suits and provide additional insight to federal criminal investigators.
- In response to the defendants’ lawyers’ comments, Lockhart told reporters he has no intention of recusing himself from the litigation and stressed that OFHEO is moving ahead with the case against Raines and the others. “We have to take this action. We have no choice, really,” said Lockhart. “We have to send a message to management of these two companies, both present and previous, that this kind of activity cannot be allowed.” Lockhart added, “The allegations that are in [the Notice of Charges] are widespread and they’re based on a two-year study, all of which were done before I arrived here [at OFHEO]...”
- In a December 20th editorial, the *Wall Street Journal* wrote, “...[I]t’s revealing of Mr. Raines’s view of [OFHEO’s] proper role that he and his legal team believe that [the regulator’s] trying to investigate and penalize Fannie and Freddie’s misdeeds is a conflict of interest for the [OFHEO] director. No wonder Fan and Fred got away with accounting fraud for so long. ... The charges against Mr. Raines & Co. should remind everyone just how much corner-cutting and political manipulation the two companies were allowed to get away with for so many years.”
- Henry Hu, the Allan Shivers chair in the law of banking and finance at the University of Texas Law School, said the alleged misconduct by Raines, Howard and Spencer, if true, would be “one of the largest frauds in financial history.” He added, “These executives are paid according to private standards, but there’s federal backing. ...I think it’s perfectly legitimate [for OFHEO] to try to get the money. ...There were sure a lot of zeros attached to what Raines got.”
- In a December 31st article appearing in the *Chicago Tribune*, Andrew Leckey wrote, “...[OFHEO’s] contention is that bonuses paid on phony results should be considered invalid. *Picky, picky*. [Emphasis added.] The [Fannie Mae] execs, through their lawyers, have responded that allegations against them are ‘a work of unsubstantiated fiction’ and are giving every indication they’ll put up a fight that means nobody will get that money anytime soon.” OFHEO’s lawsuit against Fannie’s three former executives also made *TheStreet.com*’s “Five Smartest Things on Wall Street” for 2006. Colin Barr wrote, “Thanks to a diligent regulator, the geniuses who led Fannie Mae (FNM) into accounting quicksand will have their day in court... [OFHEO] want[s] to slap Raines and his buddies with civil penalties exceeding \$100 million -- and to force them to pay back some \$115 million in bonuses. That seems harsh, until

you consider that it was on Raines' watch that Fannie overstated its profit by a staggering \$6.3 billion. The defendants' lawyers were predictably petulant, claiming their clients didn't know the accounting was all wrong. One called the allegations 'a work of unsubstantiated fiction.' Of course, the same has been said of the Raines-era Fannie's books." (*Chicago Tribune*, Andrew Leckey, 12/31/06; *TheStreet.com*, Colin Barr, 12/29/06; *Wall Street Journal*, James R. Hagerty and Damian Paletta, 12/19/06; *Washington Post*, David S. Hilzenrath, 12/19/06; *Washington Post*, David Hilzenrath, 12/20/06; *National Mortgage News*, Brian Collins, 01/01/07; *New York Times*, Eric Dash, 12/19/06; *Reuters News*, Patrick Rucker, 12/18/06; *MarketWatch*, Greg Morcroft, 12/18/06; *Accountingweb.com*, 12/20/06; *Mortgage News Daily*, 12/31/06; *Bloomberg News*, James Tyson, 12/18/06; *New York Sun*, Matthew Chayes, 12/19/06; *Bureau of Financial News*, Richard Cowden, 12/19/06; *Wall Street Journal*, 12/20/06; *Washington Post*, David S. Hilzenrath, 12/20/06; *Washington Post*, 12/22/06; *Dow Jones Newswires*, Damian Paletta, 12/21/06; *Washington Post* 12/22/06)

The scandal behind the scandal

- On MSNBC on December 19th, Tucker Carlson said "[Fannie Mae's] executives are accused of inflating the company's earnings in order to justify their bonuses. If it's true, it's a scandal. But what is even more scandalous is the fact that Franklin Raines made \$91 million in the first place, working for a quasi-government organization. Raines didn't invent Fannie Mae. He didn't found the federally-guaranteed mortgage concept. What did he do to deserve \$91 million? No one seems to know. No one seems to care. It just is assumed that executives who run huge organizations deserve huge compensation packages. But that should not be assumed. Ninety-one million for six years of corporate caretaking isn't fair, it's greedy and ultimately it's destabilizing for any society that allows it. There aren't any revolutions brewing in this country, but keep up that sort of nonsense and there soon will be. That's my prediction" (*MSNBC*, Tucker Carlson, 12/19/06; 18:01:02)

Is OFHEO's lawsuit "fair"?

- On Bloomberg News' December 19th edition of *Morning Call*, former SEC Chairman Arthur Levitt answered questions about OFHEO's efforts to recover bonuses from members of Fannie Mae's former management team. The Bloomberg reporter asked Levitt, "What do you make of this?" Levitt responded, "It's one of the rare times that a government agency has ever done something like this. It's called a 'claw back.' I think that we will see a good deal more of this. And, I think that we'll see it in the private sector where executives have been paid tremendous bonuses based upon earnings that really turn out with restatements to be totally erroneous. I think that you're going to see boards of directors going back to those executives and getting back really what really ill-gotten gains. Whether the government will succeed with Frank Raines remains to be seen."

- The reporter asked, “Do you think that they’ll be able to succeed?” Levitt responded, “I think that there is a fair chance that there will be a settlement as there usually is in cases of this kind.”
- The reporter asked, “*Is it fair to be doing this you think?*” [Emphasis added.] Levitt replied, “Yes, I do. I think that if it can be proven that an executive actively participated in one way or another in cooking the books or doing something that alters the results of the company in way which increases his money, then, very definitely, that belongs to shareholders.”
- The reporter asked, “Is it safe to say that this would set a major precedent and certainly change the way be the way that corporate executives look at their company and maybe bring about more governance, if you will?” Levitt responded, “I think that it is safe to say that it is very unusual for a government agency to be doing this. But the same tendency has been going on throughout Corporate America, and the threat of the claw back is very much in the air. We’ll see much more of it.”
- The reporter then asked why OFHEO filed this lawsuit, since a federal agency has rarely, if ever, taken such action. Levitt replied, “I think that there is great public pressure, particularly on Fannie Mae because it has been so controversial. Congress has been involved in it. Politics have been involved in it. You have high profile individuals and the government has decided this has gone far enough and they’re going to take this action. Will it succeed? This is going to take months and probably years to play out.” [Note: In 1993, President Bill Clinton appointed Arthur Levitt to serve as the SEC Commissioner and reappointed him to serve a second five-year term in May 1998. Levitt left the Commission in February 2001.] (Bloomberg Television News Morning Call, 12/09/06, 07:55:24 a.m.)
- On December 31st, *New York Times*’ reporter Gretchen Morgenson awarded “THE FOLLOW THE MONEY AWARD” to “James B. Lockhart III, the director of [OFHEO], who sued Franklin D. Raines, the former chief executive of Fannie Mae, ...to recover about \$85 million in bonuses he received but did not earn. After [OFHEO] spent more than two years dissecting the giant accounting fraud at Fannie Mae, the company had to reduce its earnings from 2001 to 2004 by \$6.3 billion. By suing Mr. Raines and two other executives, ...Lockhart hopes to get back some of the bonuses generated by the fraud. Congratulations, Mr. Lockhart. Perhaps your suit will encourage similar actions at other companies.” (*New York Times*, Gretchen Morgenson, 12/31/06)

Fannie Mae’s former execs may need Steven Oberfest’s services

- The December 19th headline on OFHEO’s lawsuit against Fannie Mae’s former executives on www.dealbreaker.com read: “Former Fannie Mae CEO, CFO, and Controller May Need To Procure The Services of Steven Oberfest*” The article’s footnote read, “[Oberfest is] Founder of Incarceration Optimization Program

International, which offers a 100-hour, \$20,000 course that instructs mainly white-collar criminals on the finer points of prison etiquette.

- [Oberfest's company in fact does exist. According to *www.Supermogel.com*, "Steven Oberfest was working as a personal trainer in New York City four years ago, when a client's friend was convicted of a nonviolent crime and asked him to train her to defend herself. Oberfest said, 'I thought, "Why not? This could be a business.'" ' And with that first trainee, he founded his company. 'Prison time for someone who lives in a penthouse on Park Avenue?' said Oberfest with a laugh. 'You might as well send them to the moon.' His timing couldn't have been better: ... With a limited number of federal prison beds, convicted white collar criminals face the possibility of serving time with violent offenders.]" (*www.Dealbreaker.com*, Bess Levin, 12/19/06, 08:15 AM; *www.supermogul.com/2006/12/never_pick_up_the_soap_and_oth.php*)

Raines is singing a different tune today...

- In Fannie Mae's 2002 Annual Report, Fannie Mae CEO Franklin R. Raines wrote, "As a CEO, one of the most offensive things about the corporate scandals that emerged recently was to hear CEOs claim that they did not know, they could not know, and they could not be expected to know about the activities that brought down their companies." [*Amen.*] (*Washington Post*, David S. Hilzenrath, 12/19/06)
- In the December 10th *Baltimore Sun*, Jay Hancock wrote, "Frank Raines resigned under pressure two years ago as chairman and chief executive officer of Fannie Mae. ... Raines says he should be accountable for the billions in overstated earnings and shareholder losses at Fannie Mae when he was running the joint. He just doesn't act like it. Another executive would forthrightly apologize over the debacle at the mortgage-finance giant. Another executive would express shame at overseeing the bogus books even if, as Raines maintains, he had no knowledge they were fake. Another executive would forgo much of an annual pension of \$1.2 million. Another executive would disgorge tens of millions in pay that was tied to fictitious profits. But Raines has shown no sign of doing any of those things. He should be ashamed of that, too."
- "Last week, we got the best picture yet of the Fannie damage, although it is far from complete. From 2001 through the first half of 2004, [Fannie Mae] overstated profits by \$6.3 billion. That's less than what was previously estimated, but it still represents one of the biggest accounting breakdowns in history. Most Americans don't especially mind seeing business chieftains rewarded for success. We don't begrudge Bill Gates and Warren Buffett their billions. Reward for failure, however, kind of ticks us off."
- "... This is failure of a high order, and Raines has been rewarded on the same scale. He began collecting a lifetime monthly pension of \$100,000 last year. From the late 1990s through 2003, he made \$90 million, according to regulators, of which more than half was reward for fairy-tale profits. Last month, Fannie paid him an additional

\$2.6 million to partly settle claims that he was owed even more. The earnings were fake. Raines' pay wasn't, and it's still in his bank and brokerage accounts. Even if he had no clue that the books were bad, he should disgorge buckets of money. He was in charge. Tying his pay to profits was the board's way of saying: 'You are responsible for earnings, no matter what happens.' "

- "On Feb. 23, Raines' lawyer, Robert B. Barnett, issued a statement that said, in part: 'Mr. Raines strongly believes that, as the leader of Fannie Mae, he should be accountable for what happened within the organization, regardless of his personal involvement or fault. He does not disagree with the ... statement [in an internal report] that "he was ultimately responsible for the failures that occurred on his watch." ' But true accountability and responsibility come with actions and consequences, of which there have been few. Raines resigned under pressure two years ago, but that's about it..." (*Baltimore Sun*, Jay Hancock, 12/10/06)

Fannie Mae sues KPMG for \$2 billion, while KPMG plans to counter-sue the GSE

- On December 13, Fannie Mae filed a lawsuit against KPMG, its former auditor for 35 years, alleging negligence, malpractice, and breach of contract, which resulted in one of "largest accounting restatements in history." According to Fannie, the auditor approved "at least 30 accounting policies and practices" which weren't consistent with GAAP for audit years 2001 through 2004. Moreover, KPMG engaged in a "check the box" approach to Fannie Mae's audits, "failing to exercise professional judgment and independent scrutiny." Through the suit, Fannie Mae is seeking at least \$2 billion in damages, including more than \$1 billion in expenses that the company has incurred to recreate and correct historical financial statements which KPMG "negligently approved."
- In a statement, OFHEO director James B. Lockhart, III, said, "Fannie Mae's filing ... of a complaint against KPMG alleging malpractice, breach of contract and negligence for its failures in providing advice and services to the Enterprise and for its role in contributing to billions of dollars in direct damages and other harm to the Enterprise is appropriate and consistent with the findings of OFHEO's Special Examination reports [which were highly critical of KPMG's services to Fannie Mae]."
- A KPMG spokesman told reporters that his firm will try to move the suit from D.C. Superior Court to the U.S. District Court for the District of Columbia, which is host to other lawsuits related to Fannie Mae's accounting restatement. "The issues involved in the lawsuit ... by Fannie Mae are already pending in federal court in Washington, D.C. Accordingly, we will remove this suit to the same court, where we intend to pursue our own claims against Fannie Mae," said the spokesman.
- However, some legal experts question Fannie's claims. James Cox, a professor of corporate and securities law at Duke University Law School, said, "I would be blown

over that somehow Fannie Mae had out-of-pocket costs of \$2 billion, or \$1 billion, resulting from restatements,” Cox, a former Fannie Mae stockholder, said the GSE will have a difficult time proving that it was harmed more than investors, who bought Fannie Mae shares at inflated prices based upon the company’s overstated earnings. Cynthia Williams, a law professor at the University of Illinois College of Law, agreed. Fannie Mae blaming its own misstatements on KPMG is unusual, said Williams. You have to ask: ‘Where were they?’ ” (*Washington Post*, David S. Hilzenrath, 12/13/06; *Bureau of National Affairs*, R. Christian Bruce, 12/13/06; *Wall Street Journal*, Damian Paletta, 12/13/06; *OFHEO Press Release*, 12/12/06; *American Banker*, Kate Berry, 12/13/06; *Associated Press*, 12/12/06)

OFHEO determines that Fannie Mae was significantly undercapitalized
for 2002 and 2003

- As a result of Fannie Mae’s restatement of financial results for years 2002-2004, OFHEO has determined that Fannie Mae was “significantly undercapitalized” during 2002 and 2003. In 2002, Fannie Mae’s restated core capital was \$20.4 billion, \$7.3 billion below its minimum capital requirement of \$27.7 billion. Similarly, Fannie Mae’s restated core capital of \$27 billion in 2003, was \$4.9 billion below its minimum capital requirement of \$31.8 billion. “It should also be noted that [the GSE’s] restatements focused only on 2002, 2003, and 2004, and that Fannie Mae could have been significantly undercapitalized for some time prior to 2002,” said OFHEO. While no additional special action is needed at this time since Fannie Mae is complying with its Consent Agreement, an OFHEO spokeswoman did not rule out other action. “This is a continuing matter,” said the agency’s spokeswoman. (*Bureau of National Affairs*, 12/29/06)

Freddie Mac expects \$550 million loss for the 3rd and 4th quarters of 2006

- Due to lower interest rates in the second half of 2006, Freddie Mac said it expects a \$550 million loss for the third quarter of 2006, compared to net income of \$880 million for the third quarter of 2005. Freddie Mac attributed its sharp fall in earnings to lower returns on its credit guarantee business and declines in the value of derivatives used to hedge the company’s portfolio, which resulted from the 50 basis point decline in long-term rates during the period, prompting borrowers to refinance their mortgages. By the “fair value” measure, Freddie Mac said its financial performance was “unchanged” in the third quarter. The company also said it expects a similar loss of roughly \$550 million for the fourth quarter of 2006, compared to net income of \$684 million for the fourth quarter of 2005. For the nine-months ended September 30, 2006, Freddie Mac reported net income of \$2.5 billion, 78% higher than the company’s net income of \$1.4 billion for the corresponding period in 2005.
- Freddie Mac chairman and CEO Richard F. Syron said, “While our quarterly results reflect the volatility we see quarter-to-quarter in response to movements in interest

rates, we remain encouraged with the underlying progress of Freddie Mac's business. We face a challenging market environment due to continued tight spreads. However, our credit guarantee portfolio continues to grow, funding levels remain highly attractive, key interest-rate and credit risk measures are solid and our capital levels are strong."

- During the third quarter, Freddie Mac repurchased 32.7 million shares at an average price of \$61.06 per share for a total repurchase of approximately \$2 billion. The company also plans to complete the issuance of previously-authorized preferred shares with an additional \$500 million by March. The company's credit guarantee portfolio grew to approximately \$1.5 trillion as of November 30, 2006 for an annualized growth of 11%. Freddie Mac estimates its share of GSE mortgage securitizations was approximately 43% in November, down from 45% in November 2005.
- Freddie Mac plans to release results for the fourth quarter and fiscal year 2006 by March 31, 2007. The company said it will not begin reporting quarterly results for 2007 until the second half of the year. However, that does not necessarily mean that the 2007 reports will be made "on time," according to company spokesman Michael Cosgrove. In an investor conference call, Syron told he expected "there would be a discussion" with OFHEO about Freddie Mac's growth limits, once the company had completed its accounting overhaul. Syron added, "There's no question that we still have a great deal to do, but I'm confident that we're headed in the right direction." [In December, OFHEO said, "Significant work remains before Freddie Mac become a timely financial filer and corrects the evident operational weaknesses."] Syron also noted that while passage of GSE regulatory reform remains up in the air, "there does appear to be movement towards a compromise."
- Prudential Equity Group analyst Mathew Park, said "GAAP accounting is causing quarter-to-quarter volatility that most overseers would argue is not reflecting the reality of economics. But we don't have any alternative measure to filter that out." Park estimated that the company's quarterly earnings on a "non-GAAP, economic basis" were about \$600 million. Friedman, Billings analyst Paul Miller said, "The big issue for me is that their mortgage and debt spreads continue to remain tighter and they are getting tighter -- and that is their business." Moreover, Miller pointed out that the Freddie Mac's delayed return to timely reporting could take another year or two, which in turn delays the company's ability to return as much as \$10 a share in excess capital to shareholders, once OFHEO lifts Freddie's 30% surplus capital requirement. In an analyst report issued after the earnings call, Miller maintained his "market perform" rating for Freddie and a \$65 price target.
- Credit Suisse analyst Moshe Orenbuch doubts that Freddie would return to "timely financial reporting" before 2008. In a January 8 research note, Orenbuch wrote, "It appears that deficiencies still exist in [Freddie Mac's] closing process." Freddie revised its first-half net income estimates upward by about \$300 million, he noted, after submitting capital levels last year to OFHEO. Overall, he said, Freddie appears

to be on target to reach full-year profitability objectives. “Fair-value results, which amounted to 14% annualized year-to-date, are likely to achieve the lower end of management’s targeted range of low- to mid-double-digit returns in 2006,” he wrote in the research note. (*Freddie Mac Press Release*, 01/05/06; *Associated Press*, Marcy Gordon, 01/05/07; *MarketWatch*, Robert Schroeder, 12/05/06; *Washington Post*, David S. Hilzenrath, 01/06/07; *TheStreet.com*, 01/05/07; *American Banker*, William Launder, 01/08/07)

OFHEO directs Fannie and Freddie to follow the nontraditional mortgage risk policy

- OFHEO director James B. Lockhart, III has directed Fannie Mae and Freddie Mac to immediately take action to support the practices outlined in interagency guidance on nontraditional mortgages, issued on October 4th. The guidance outlines how financial institutions can offer nontraditional mortgage products in a safe and sound manner, which clearly discloses the benefits and risks of these products to borrowers. “OFHEO supports what the banking regulators have issued, and we have taken steps to ensure that Fannie Mae and Freddie Mac incorporate the principles of that guidance into their risk management and business practices,” said Lockhart. “This will enhance the overall level of underwriting standards, risk management practices and consumer protection in the mortgage market.” In letters to the GSEs, Lockhart added, “Adoption of this guidance by the two government-sponsored enterprises should serve to enhance the overall level of underwriting standards, risk management practices and consumer protection throughout the mortgage market.” Lockhart directed both companies to update him by February 28th on the progress that they have made in developing policies, consumer credit quality standards and capital provisions in line with the guidance.
- Fannie Mae said it supports prudent lending practices and will be talking to its customers to fully understand the impact of the policy. On December 29, Fannie also announced a tightening of its underwriting standards. Effective January 30, borrowers must be qualified at “a fully-indexed rate that assumes a fully-amortizing repayment schedule” to qualify for a loan to be purchased by Fannie Mae. The company is also eliminating its “InterestFirst” interest-only loan product and reclassified it as a loan feature to be used with other loan products.
- These new underwriting standards, once implemented, will impact Fannie’s and Freddie’s purchases of interest-only and payment options mortgages, as well as their securitizations of nontraditional mortgages and their purchases of IO and PO adjustable rate mortgages. According to a December 15th report by Friedman Billings Ramsey (FBR), bonds secured by non-traditional mortgages may “weaken” in 2007, as Fannie and Freddie cut their purchases of these loans. According to FBR, Fannie and Freddie bought \$221 billion in non-agency securities in 2005; assuming all of the purchases were subprime mortgage bonds, then the GSEs purchased 37.2% of subprime mortgages’ total new volume in 2005, said FBR. “Spreads of sub-prime securities may widen unless the origination of sub-prime loans in 2007 falls in

concert.” (*US Fed News*, 12/13/06; *Dow Jones International News*, Damian Paletta, 12/13/06; *National Mortgage News*, 12/01/06; *Bloomberg News*, Jody Shenn, 12/20/06; *MortgageWire*, 12/29/06)

Fannie Mae and Freddie Mac

House Financial Services chairman Frank says
GSE regulatory reform bill will be passed by the April recess

- House Financial Services chairman Barney Frank (D-MA) said he expects the House of Representatives to pass a GSE regulatory reform bill by the April recess. “I think we should be able to get it out of the House before the April break,” Frank told reporters. In a speech to the National Press Club, Frank said, “We will increase the regulation. We will not put any absolute limitation on the size (of the GSEs’ portfolios), and we will take a chunk of the money [5% of Fannie Mae’s and Freddie Mac’s profits] and put it into affordable housing.” In a December 11 speech at a housing summit sponsored by Office of Thrift Supervision, Frank said he had reached “a reasonable framework” with Treasury officials for GSE regulatory reform legislation. While not providing any details, Frank said, “I think we are about to put this thing together. We have enjoyed working with [Treasury Secretary Henry] Paulson.” [A January 5th Special Supplement to the *GSE Report*, provides an analysis of the GSE regulatory reform legislation compromise, which is available at www.gsereport.com.] (*Dow Jones Newswires*, Damian Paletta, 01/03/07; *Dow Jones International News*, Damian Paletta, 12/11/06)
- *National Mortgage News* reports that the National Association of Home Builders and National Association of Realtors, close allies of Fannie Mae and Freddie Mae, are making favorable comments about the tentative agreement which has been reached by Frank and Treasury officials on GSE reform. NAHB’s CEO Jerry Howard told *NMN*, “We are fine with the whole [GSE] package,” including provisions related to the approval process of new GSE products and programs which makes sure that the GSEs don’t overstep their [charter] boundaries. “Howard added, “At the same time, we think it is a quick-enough process to allow them to be nimble in the marketplace.” While NAR is withholding comment on the entire package, the trade group’s spokeswoman Mary Trupo said, “We think it is moving in the right direction.” (*National Mortgage News*, 12/18/06)
- While Representative Frank and the Bush administration appear to be close to a final deal on GSE regulatory reform, it remains unclear if the bill can pass muster with the Senate Banking Committee. Sources told the *American Banker* that Senate Republicans fear that Treasury Secretary Paulson has compromised too much and Senate Democrats may press for more changes. While some lobbyists say they are

optimistic, they remain wary of predicting victory. “The administration, at least to some degree, seems to have come around, and we’ll see whether that helps break all the final logjams... Whether they can get all the way there, who knows for sure?” said Robert Davis, EVP of government relations for America’s Community Bankers. (*American Banker*, Stacy Kaper, 12/28/06)

Fannie Mae spends \$10.48 million in 2006
to lobby Congress and to block passage of GSE regulatory reform legislation

- According to *PoliticalMoneyLine*, Fannie Mae spent \$5.28 million lobbying Congress in the first half of 2006, making it the biggest spender among financial services firms. Fannie’s expenditures exceeded by \$80,000 what it spent in the second half of 2006, bringing the GSE’s total lobbying expenses to \$10.48 million in 2006. In a December 14th statement, Senator Chuck Hagel (R-NE) said “In another astounding story in [the] *Washington Post*, we learn that Fannie continues to spend record levels of money on lobbying Congress... At the same time, Congress continues to fail to enact meaningful GSE reform. How does this record multi-million dollar lobbying further Fannie’s statutory housing mission?” (*Washington Post*, 12/14/06; *US Fed News*, 12/14/06)
- *An American Banker* reporter asked Representative Jim Leach (R-IA), “If you could go back and change anything, what would it be?” Leach responded, “The country has to be very careful about the advantageous empowerment of institutions such as GSEs....” Leach, who was defeated in the November election, served more than 30 years in Congress including six as Banking Committee chairman. (*American Banker*, 12/13/06)

Chairman Frank envisions *larger* role for Fannie and Freddie

- During a January 3rd appearance at the National Press Club, incoming House Financial Services Chairman Barney Frank said, “...One of the things that many of us [in Congress] are going to be arguing for is some forbearance by lenders, so you don’t get excessive [mortgage loan] foreclosures. If you sell all of this mortgage stuff into the secondary market, forget about forbearance. The secondary market can’t do forbearance. Allowing people who are in trouble a little extra time can only come from an entity that holds the mortgages. I can ask Fannie Mae, Freddie Mac to show forbearance. I can go ask the secondary market to do it, but they won’t pay any more attention to me than Dick Cheney does. So the answer is we will increase the regulation and increase. ...I want to keep Fannie Mae and Freddie Mac in business. People said they get too many advantages, borrow more money more cheaply because of various perceptions of involvement with the government. The stockholders make too much money. Too much profit accrues to them. Let’s cut back on their profit. My answer is no, let’s leave them the profit, but let’s take a chunk of it and put it in to affordable housing. That’s what the House did. That’s our bargain. Let capitalism

flourish. Let the market flourish, but take a percentage of this, 5%--not a huge amount of the profit—and put it into affordable housing.” (*CSPAN2*, 01/05/07, 10:46:57).

- In an interview with *CQ Weekly*, Frank said he wants to push his party to use governmental leverage to provide affordable housing as a means to bridge the widening gulf of income disparity in the United States. According to *CQ Weekly*, “A new approach to housing policy can be a hallmark of the Democrats’ efforts to redistribute wealth, he says, and at the same time bolster economic growth. To this end, he said he would propose constructing more low-cost housing units, increasing aid to renters and buyers, and creating an affordable housing fund financed by ...Fannie Mae and Freddie Mac.” (*CQ Weekly*, Michael R. Crittenden, 12/11/06)
- In a December 20 editorial, the *Wall Street Journal* wrote, “...[T]here’s no doubt that with Barney Frank wielding the gavel in the House Financial Services Committee, Fannie Mae and Freddie Mac will have a pal on Capitol Hill. Mr. Frank is already talking about expanding the companies’ operations (and thus taxpayer exposure to any financial accident). ...Few big businesses inspire the Massachusetts liberal’s regulatory forbearance the way Fannie and Freddie do. This is ironic, because the fact that the two companies are government-sponsored and hold an implicit government guarantee on their debt means they deserve more scrutiny than the average private company. The companies are playing in effect with House money.”
- “Fannie’s friends on Capitol Hill ran out the clock on a stronger oversight bill in the GOP Congress. And with Democrats back in charge, Treasury Secretary Hank Paulson is now trying to negotiate a compromise. One of Mr. Frank’s demands is the creation of a new ‘affordable housing fund’ that the mortgage giants would finance -- a several-hundred-million-dollar Fan-and-Fred **tax** to dole out to such partisan liberal outfits as Acorn. [Emphasis added.] Whether funded as a percentage of profits or revenues, such an annual patronage bonus would give Congress one more political incentive to see the siblings grow.”
- If Mr. Paulson is going to agree to such a political slush fund, he had better get something good in return. And the crucial regulatory point is that Mr. Lockhart and his successors have enough power to limit the growth of Fan and Fred’s mortgage-backed securities portfolios. Built with subsidized borrowing, these MBSs are the source of the companies’ systemic risk and were a main reason for their accounting woes. The companies still have more than \$1 trillion worth of MBSs on their books. [OFHEO’s] charges against Mr. Raines & Co. should remind everyone just how much corner-cutting and political manipulation the two companies were allowed to get away with for so many years..” (*Wall Street Journal*, 12/20/06)

According to OFHEO, Fannie and Freddie were adequately capitalized on September 30th

- Fannie Mae and Freddie Mac were “adequately capitalized” on September 30, said OFHEO in its quarterly review of the GSEs’ capital. At September 30, Fannie Mae’s total capital of \$41.8 billion exceeded its risk-based capital requirement (\$22.5 million) by \$19.3 billion. Fannie Mae’s core capital of \$42.0 exceeded OFHEO’s directed capital requirement of \$37.7 billion by \$4.3 billion. On September 30, Freddie Mac’s total capital of \$37.2 billion exceeded its risk-based capital requirement (\$14.9 billion) by \$22.3 billion. Freddie’s core capital of \$36.8 billion exceeded OFHEO’s directed capital requirement (\$33.8 billion) by \$3.1 billion. (*Dow Jones Commodities Service, 12/28/06*)

Notes from Capitol Hill

- Minority leader Mitch McConnell (R-KY) announced that Senators Richard Shelby (R-AL), Bill Bennett (R-UT), Wayne Allard (R-CO), Mike Enzi (R-WY), Chuck Hagel (R-NE), Jim Bunning (R-KY), Mike Crapo (R-ID), John Sununu (R-NH), Elizabeth Dole (R-NC) and Mel Martinez (R-FL) have been assigned to the Senate Banking Committee. (*Press Release from Senator Mitch McConnell, 12/13/06*)
- By unanimous consent, the Senate approved the following nominees to serve as senior Treasury Department officials: Phillip Swagel, assistant secretary for economic policy; Anthony Ryan, assistant secretary for financial markets; Michele Davis, assistant secretary for public affairs; Eric Solomon, assistant secretary for tax policy; and Robert Hoyt, Treasury general counsel. On December 11, the new Treasury officials were sworn in by Treasury Secretary Henry M. Paulson, Jr. (*Bureau of National Affairs, 12/12/06*)
- House Financial Services Committee Chairman Barney Frank has chosen James Segel as his special counsel. Segel, a Massachusetts lawyer who has known Frank since they were undergraduates at Harvard 40 years ago, also served with the chairman in the Massachusetts state legislature and managed Frank’s first Congressional race in 1980. Segel said, “This is a unique opportunity to work with a man who I highly respect and who now is in a position to create and fulfill an agenda that will vitally affect both Massachusetts and the nation. I look forward to starting.” (*American Banker, 21/21/06*)
- HUD Secretary Alphonso Jackson said he has no plans to resign, despite speculation that he was looking for a job to lead a university. “I’m as surprised as you with all this speculation,” Jackson told members of the press. “I am here at the pleasure of the President, and we’ve got a lot of work to get done, and I expect to be on the job the next two years if the President wants me to stay.” Jackson added that he expects to have good relations with House Financial Services chairman Barney Frank (D-MA). He said, “I have the utmost respect for Chairman Frank. We will have disagreements,

but he is the chairman. If he so insists that things be done, I will do them. There is no question about it.” (*Dow Jones Newswires*, Damian Paletta, 12/22/06; *Reuters*, Patrick Rucker, 12/22/06)

FASB approves January release of guidance on mortgage exception to derivatives rules

- On December 20, the Financial Accounting Standards Board approved for issuance in January a new guidance on derivatives intended to offer a narrow exception to current accounting rules for certain asset-backed securities under FASB 133. According to the *Bureau of National Affairs*, “The exception would free banks and other players in the securitizations market from having to “bifurcate” derivatives that are part of the instruments, such as collateralized mortgage obligations, under FASB No. 133. The derivative would not have its changes in fair value affect profit and loss.” (*Bureau of National Affairs*, Steve Burkholder, 12/21/06)

Fannie Mae

Fannie Mae's mortgage portfolio shrank at an annualized rate of 5.7% in November

- In November, Fannie Mae's mortgage portfolio shrank at a 5.7% annualized rate to \$717.4 billion, the lowest level in a year. The company's portfolio purchases of \$13.9 billion were more than offset by \$6.3 billion in sales and \$11.2 billion in liquidations. During the month, Fannie Mae entered into contracts to buy \$8.6 billion in mortgages, up slightly from October. According to FNT Financial analyst Jim Vogel, the company's reports "show a rationale approach for a capped portfolio -- replace most roll off, buy selectively to improve margins, sell on strength, and maintain buying capacity in case bargains appear." The GSE's issuance and guaranteeing of MBS continued to grow with its outstanding MBS increasing 12.2% annualized to \$1.77 trillion. Fannie Mae's duration gap averaged zero months in November, unchanged from October. (*Reuters*, 12/22/06; *Monthly Summary*, Fannie Mae, November 2006)

NYSE gives Fannie Mae a deadline on filing its 2005 Annual Report

- Fannie Mae has until March 15, 2007 to file its 2005 Annual Report with the New York Stock Exchange (NYSE). However, the Exchange will permit the company to continue trading after the March 15 deadline, if Fannie Mae complies with additional listing requirements in the interim. If the Annual Report is not filed by December 31, 2007, the NYSE said that Fannie Mae shares face delisting. Company CEO Daniel Mudd said that Fannie plans to deliver its 2005 audited financial statements by September 2007. (*Associated Press*, 12/12/06; *Dow Jones Newswires*, Bhattiprolu Murli, 12/12/06)

Fannie Mae's growing foreign investor base fuels higher valuations of the company's securities

- Speaking at the December 12th Lehman Brothers 2006 Mortgage and Specialty Finance Conference, Peter Niculescu, Fannie Mae's executive vice president of capital markets, said that the GSE's growing base of foreign investors has increased valuations of the GSE's securities. As a result of an increase in international demand, Niculescu said, "A fairly significant volume of what we do here is going abroad." For example, Asian investors' purchase of the GSE's noncallable benchmark securities increased from 15.2% in 2001 to 28.7% in 2005. That trend continues in 2006 in which Fannie Mae saw "an increase in bullet demand from Asia, he added. Although the percentage of European investors fell from 11.2% in 2001 to 6.2% in 2005, overall foreign investors represented 39% of total investors in 2005, up from

34.4% in 2001. “Increasingly, our mortgage-backed securities are going abroad as well,” said Niculescu. “It explains part of the richness you see in mortgage-backed securities today and in the last couple of years.” (*Dow Jones Newswires*, Marine Cole, 12/12/06)

Freddie Mac

Freddie Mac’s retained portfolio down 0.2% annualized in November

- In November, Freddie Mac’s retained mortgage portfolio fell by \$112 million to \$704.3 billion for an annualized decline of 0.2%. Under GAAP, the company’s holdings totaled approximately \$704.8 billion. Year-to-date, the company’s retained portfolio declined by an annualized 0.9%. “Freddie’s portfolio balance was unchanged for the third month in a row,” said FTN Financial analyst Jim Vogel. “Purchases were quiet as were sales, just keeping up with the continued high prepayment rate on existing assets, 26%.” Freddie’s duration gap averaged zero months in November, unchanged for the past 12 months. (*Dow Jones Newswires*, Cynthia Koons, 12/22/06)

Freddie Mac announces voluntary delisting from NYSE Arca

- On December 14, Freddie Mac announced that it is voluntarily withdrawing its common stock listing on NYSE Arca, formerly the Pacific Exchange. The company made this move to eliminate duplicative administrative requirements following the NYSE Group’s takeover of the electronic exchange’s parent company, Archipelago Holdings. (*Freddie Mac Press Release*, 12/14/06; *Associated Press*, 12/14/06)

Freddie Mac announces the Counseling Hotline will be made permanent

- Freddie Mac announced that its one-year old pilot program for a telephone counseling hotline provided by Consumer Credit Counseling Services will be made permanent to help the company reach borrowers on the verge of losing their homes. “We have created a [telephone] number that is sent to delinquent borrowers after 45 days,” said Brad German, Freddie Mac’s director of public relations. “The idea is that counselors are less threatening than lenders. ... The hotline has increased contact rates of people who decline contact with lenders by 25 percent. This is more contact than we would have otherwise had.” (*DSNews.com*, Payton Oldham, 01/03/07)

Federal Home Loan Banks

Federal Housing Finance Board withdraws its proposal
to increase the FHLBs' retained earnings

- On December 22, the Federal Housing Finance Board significantly scaled back a proposed rule which would have required the FHLBs to retain more of their earnings as capital and restrict and payment of dividends and issuance of stock. After receiving approximately 1,100 comment letters on its March proposal, the Finance Board tabled its new retained earnings policy until a later date and implemented a policy, prohibiting the FHLBs from issuing any new excess stock to members, if the Bank's stock exceeded more than 1% of total assets. The Board also finalized a provision of the proposed rule, requiring that the FHLBs declare and pay dividends only out of known income. These modest changes to the FHLBs' capital rules aren't expected to have any significant immediate impact on any of the Banks. The Finance Board plans to revisit its retained earnings proposal, possibly in the coming year, in which it would take a more risk-focused approach that would apply different requirements based upon the risk at each individual FHLB. Finance Board chairman Ronald Rosenfeld said, "We have taken an important step in fulfilling our statutory responsibility regarding the prudential operation of the Banks. Excess stock has been at the root of significant safety and soundness issues at several Banks and presents mission issues for other Banks."
- "The overall effect [of the Finance Board's new capital rules] on the credit profiles of the FHLBs will be benign, since the rule will discourage the accumulation of burdensome excess stock overhangs, without requiring that stock in excess of 1% be repurchased within a fixed period, and also without prohibiting the FHLBs from paying cash dividends," wrote S&P analysts in a January 3rd report.
- Banking industry representatives quickly issued statements, applauding the Finance Board's move. "We think this is a good thing and we want to commend the Finance Board for taking members' comments to heart," said FHLB-Cincinnati. Spokesman John Byczkowski. "We are pleased to see that the final rule on restricting excess stock will not require Bank System members to reduce the excess stock they already own," said Diane Casey-Landry, president of America's Community Bankers. "In scrapping its controversial one-size-fits-all proposed rule, the Federal Housing Finance Board did the right thing for the nation's community banks and the communities they serve," said Camden Fine, president of the Independent Community Bankers of America.
- Rosenfeld acknowledged the proposed rule was "flawed." He told reporters, "It's a reflection of the quality and maturity of this board that we want to produce rules and regulations that are appropriate and well thought out and that reflect the best thinking

that we could possibly have on the subject. We're not rushed to do anything." Rosenfeld defended the reasoning behind the proposal and the final rule, which he said was to increase the safety and soundness of the FHLB System. (*Dow Jones Newswires*, Damian Paletta, 12/22/06; *Federal Housing Finance Board Press Release*, 12/22/06; *American Banker/MortgageWire*, Steven Sloan, 01/05/07)

- At the December 22 meeting, the Finance Board also voted to reappoint 25 public interest directors remaining on the board of the FHLBs for an additional one year, commencing on January 1, 2007. By appointing these directors to fill vacant appointed directorships with one year remaining in the terms, the Board was able to preserve a core of 25 experienced appointed directors at the FHLBs. Chairman Rosenfeld said, "While corporate governance is enhanced by well-qualified public interest directors or 'outside directors,' I believe that a better practice would be for the regulator not to appoint directors to the entities that it regulates. As I had testified earlier, while the Congress was engaged in a worthy GSE reform debate, which may have affected the directorship structure, I did not believe it appropriate to act in a manner that might preempt the Congress. Because the Congress has adjourned without resolving the GSE debate, it is imperative that we act to appoint public interest directors to the Banks, and immediately begin the process for appointing persons who have the requisite skills and experience to be a public interest director of an enterprise as complex and important to the nation's housing finance as a Federal Home Loan Bank." (*Federal Housing Finance Board Press Release*, 12/22/06)
- In a December 15th letter to the Finance Board, incoming House Finance Services Committee chairman Barney Frank (D-MA) and capital markets subcommittee chairman Paul Kanjorski (D-PA) urged the agency to make full, three-year appointments for public interest directors to the FHLBs. They wrote, "We encourage the Finance Board to begin its process by making the three-year appointments required by statute. ...As you know, we also expect to revisit legislation in the next Congress that would reform the regulation and operations of [GSEs] and would strongly discourage the Finance Board from using that fact as a basis for refusing to comply with its statutory obligations to name all the required public-interest directors." (*American Banker*, Steven Sloan, 12/19/06)

<p>On the eve of his retirement, FHLB-Indianapolis president Heger says the FHLBs should consider mergers if they find themselves in financial trouble</p>

- In an interview with *American Banker*, Martin Heger, the out-going president of the FHLB-Indianapolis, said he believes that the FHLBs' executives should consider mergers if they find themselves in financial trouble. "All the [FHLBs] have got to be willing in the future to listen to discussions related to the merger of a bank," said Heger. "That's just prudent management." He also said the FHLBs should give the troubled mortgage purchase programs a second chance.

- Heger, 61, and the Indianapolis Bank's board of directors began exploring merger opportunities with other FHLBs in March, after the Bank was dealt a series of blows, including the July decision by National City Corp., one of the bank's largest members, to move its charter to Cincinnati. During the first nine months of 2006, the Bank's advances fell 11%, the biggest decline of any FHLB. The situation appeared so severe that the Bank's board entertained the possibility of merger. "We looked at it seriously," Heger said. "We visited our regulator. We talked to a few other Federal Home Loan banks. But in the final analysis, I think the board felt we still had some upside potential, and that it was in our interest, and our members' best interest, to remain independent."
- Heger believes the Indianapolis Bank has a solid future, in part because of its mortgage purchase program which he believes is critical to the FHLB System's future. "This potential for the Home Loan Bank System in terms of housing hasn't been reached, because we haven't been able to, I think, truly take advantage of what these mortgage purchase programs could offer." Heger said the FHLBs need the programs to move beyond their traditional advance business and remain competitive. "You have to have more than advances to really serve the members and citizens of this country," he added. Heger believes that the mortgage purchase programs would have a better chance of survival, if Congress passes GSE regulatory reform which creates a single regulator for Fannie Mae, Freddie Mac and the FHLBs. "Competition usually brings better pricing and better service," he said. "The reality is we are one of three entities dedicated to providing housing to this country."
- Heger said made his decision to retire at year-end, after the Bank offered an early retirement plan to roughly 20 employees to achieve significant savings in operating expenses. Regardless of the bumps that the Bank has experienced, Heger remains confident that the FHLB-Indianapolis will remain successful. "With the team we've got together and the reductions we've got in place on the way to reduce costs, we have a future." (*American Banker*, Steven Sloan, 12/31/06)

FHLB of Cincinnati announces changes in management organization and promotions

- The FHLB-Cincinnati's board of directors approved management promotions and changes in the organization of its management, as part of a broader effort to consolidate the management of the Bank's Mission Asset Activity and to strengthen its risk management. The board promoted Arthur S. Howell to EVP, Mission Asset Activity; Carole L. Cossé to SVP and CFO; Steven J. Sponaugle to SVP and Chief Risk Officer; Maura H. Wolf to VP and Treasurer, and Donald R. Able to Principal Financial Officer. (*FHLB-Cincinnati Press Release*, 01/02/07)

FHLBs announce board election results

- The FHLB-Cincinnati's board of directors has elected Carl F. Wick to serve as its chairman and Richard C. Baylor as its vice chairman. Wick is the principal/owner of Wick and Associates Business Consulting. In 1994, he retired from NCR Corporation following a 28-year career as Director of Engineering Human Resources. Wick also serves as the Bank's representative to the Council of Federal Home Loan Banks. Baylor is chairman, president and CEO of Camco Financial Corporation, a \$1.1 billion financial services company with offices in Ohio, Kentucky and West Virginia. Baylor currently chairs on the FHLB-Cincinnati's Asset/Liability Policy Committee and is a member of the Audit and MPP Committees. (*FHLB-Cincinnati Press Release, 12/26/06*)
- The FHLB-Dallas announced that Ty Abston has been elected as a director for the Bank for a three-year term commencing January 1. Abston serves as president and CEO of Guaranty Bond Bank in Mt. Pleasant, TX. The Bank also announced that its board of directors has elected Lee R. Gibson to serve as chairman and Mary E. Ceverha to continue to serve as vice chairman. Gibson serves as EVP and CFO of Southside Bank, Tyler, TX. Ceverha is a community development representative on the board and former commissioner of the Dallas Housing Authority. (*FHLB-Dallas Press Release, 12/07/06; FHLB-Dallas Press Release, 12/22/06*)

The FHLBs announce their 4th quarter dividend rates

- The FHLB-Atlanta's board of directors approved an annualized dividend rate of 5.90% for the fourth quarter, applicable to capital stock held from October 1 – December 31, payable on January 2. (*FHLB-Atlanta Press Release, 12/19/06*)
- The FHLB-Dallas declared a dividend in the form of capital stock for the fourth quarter at an annualized rate of 5.25%, which approximates the average federal funds rate for the third quarter of 2006. The dividend, applied to the average capital stock held from July through September 30, was paid on December 29. The Bank also announced plans to repurchase the portion of members' stock identified as surplus stock [defined as the amount of capital stock held by a member that exceeds 110% of its minimum investment requirement] on January 31, 2007. (*FHLB-Dallas Press Release, 12/19/06*)
- The FHLB-Des Moines's board of directors approved a cash dividend of 4.25% per annum for the three months ended November 30, which was credited to members' accounts on December 22. (*FHLB-Des Moines Press Release, 12/15/06*)

Farm Credit System / Farmer Mac

FCS Rural America Bonds a back-door method
to “stretch the [legal] boundaries” of FCS lending

- In the December issue of *Farm Credit Watch*, Bert Ely wrote, “Last year, the Farm Credit Administration (FCA) authorized two FCS banks and the associations they fund to invest in Rural America Bonds, or RABs. The FCA then stretched the definition of permissible FCS investments to encompass RABs. In fact, RABs represent a back-door way by which an FCS association can provide credit to a borrower the association cannot legally lend to, either because the loan lies beyond the FCS’s lending authority or the borrower is located outside its FCA-assigned territory. Here is how one well-placed source characterized the real purpose of RABs -- if the FCS cannot legally make a loan, structure it as a RAB.”
- “An excellent example of a loan disguised as a RAB was trumpeted recently by an FCS association. The October 2006 issue of the *Leader*, published by ArborOne Land and Home..., ran an article, headlined ‘ArborOne Completes a First-ever Health Facility Loan.’ Note the word ‘loan’ in the headline and keep in mind that the FCS does not have the statutory authority to finance health-care facilities. The body of the article states that ‘while the health facility loan is a first in the nation for a member of the [FCS], it also reinforces ArborOne’s expanding role within rural communities.’ ArborOne unambiguously saw this credit extension as a loan, and unlike any loan any FCS institution has ever made. The article went on to report that ArborOne had partnered with an investment banking firm ‘and other [FCS] associations across the nation to make a new \$16 million health care facility a reality’ in St. James, Minnesota. *FCW* has learned that this loan actually was structured as a bond, with 90% of it backed by a USDA loan guarantee. Almost certainly, this bond has been categorized as a RAB and classified on ArborOne’s balance sheet as an investment, not as a loan. ArborOne, headquartered in Florence, South Carolina, had total assets of \$489 million on September 30, 2006, including \$137 million of investments, and serves just 12 South Carolina counties.”
- “In disclosing this investment, ArborOne posed a very interesting question: ‘Why would ArborOne, a longstanding member of the [FCS] -- an organization devoted to lending to financing agriculture -- be involved in helping to build a health care facility?’ According to Jack Shuler, ArborOne’s CEO, ‘the reason is a broadened scope of business interests.’ Shuler also stated that ArborOne can ‘serve more people in more ways by opening new doors and stretching our boundaries.’ In effect, Shuler readily admitted that ArborOne stretched the ‘boundaries’ by making a loan an FCS institution cannot lawfully make and doing so outside its FCA-assigned territory, for Florence is 1,300 miles from St. James. Out-of-territory lending was the intent of the FCA’s National Charters proposal a few years ago, which opposition from within the

FCS helped to kill. Do RABs represent a new form of out-of-territory lending within the FCS?” (*Bert Ely’s Farm Credit Watch*, Bert Ely, December 2006)

- In a December 20 article the *Illinois Farm Bureau’s Farm Week*, Glen Semple, Farm Credit Services vice president, also touted the value of the three-year pilot program for RABs, which will allow FCAs to fund agricultural and rural community business projects, which the lenders had previously been prohibited by law from financing, said Semple. Under the RAB program, FCAs may buy bonds issued by eligible for-profit businesses and non-profit organizations, with the exception of religious and gambling organizations, in rural areas with populations of fewer than 50,000. Semple said the bond program could help meet the needs of rural areas, such as financing independent or assisted living facilities for the elderly, fire stations and major fire equipment purchases, waste-water or water treatment facilities, community buildings, local government facilities, industrial development parks, and rural drainage district projects. While the bond program is being offered for three years, Semple is hopeful that the program would demonstrate its value to rural communities. “The idea is if we can show we can be a positive force, this [program] could be extended” by law, said Semple. (*Illinois Farm Bureau’s Farm Week* , Kay Shipman, 12/20/06)

Leland A. Strom joins the FCA board of directors

- On December 14, Leland A. Strom was sworn in as the newest member of the Farm Credit Association. On December 9, the U.S. Senate confirmed Strom’s nomination for a term that expires on October 13, 2012. Strom, the owner and manager of a family farm in Illinois, has served on the Illinois Farm Bureau, the board of County Mutual Funds Trusts, and on the Federal Reserve Bank of Chicago’s Advisory Council on Agriculture, Labor and Small Business. He also was director for his local Farm Credit Association for more than 25 years and served nine years on the board of AgriBank, FCB. (*Farm Credit Administration Press Release*, 12/15/06)

Postal Service

President Bush signs Postal Reform into law

- On December 20, President George W. Bush signed into law the landmark postal reform legislation, providing the first modernization of the Postal Service in more than 30 years. At the signing ceremony, President Bush observed that the legislation would accomplish the paramount objective of ensuring that the guaranteed continuation of universal mail service by the USPS, with rate stability and price predictability.
- President Bush also issued a December 20 Signing Statement, which clarifies several points in the new postal reform law. The statement takes issue with the statute's attempt to limit the field of individuals from which the president can choose appointees for the Postal Commission. As set forth in other signing statements, the President said that the executive branch will submit reports to Congress as it deems fit, not as dictated by law. The postal reform legislation specifically requires the Postal Service to report to Congress and the GAO with a strategy for how it plans to restructure the USPS's infrastructure to reduce excess capacity. According to the statement, the executive branch would "construe" such provisions "in a manner consistent with the constitutional authority of the President ... as the President shall judge necessary and expedient." The statement also insisted that officers and agencies within the executive branch shall not be authorized to institute proceedings in federal court against the Postal Regulatory Commission. Another provision reiterated the State Department's authority over the USPS with regards to international treaties. A final provision noted the executive branch's right to open "an item of a class of mail otherwise sealed against inspection ... in a manner consistent ... with the need to conduct searches in exigent circumstance." This statement reiterates provisions in the law providing for the procedure under which the federal government can legally open mail. The statement does not alter the law in this area, nor did Congress attempt to change the law. (*Bureau of National Affairs*, Derrick Cain, 12/22/06; *NAPUS*, 12/22/06)
- According to the Association for Postal Commerce, Ann Fisher, "chief postal guru" for Senate Government Reform and Homeland Security chairwoman Susan Collins, has joined the staff of the Postal Regulatory Commission. (*Postcom*, 01/06/07)

"Full privatization [of the USPS] is, or ought to be, the way of the future..."

- "In a December 26 editorial, the *Wall Street Journal* wrote, "What if Congress voted to reform a huge government service, and nobody cared? Well, lawmakers did just that with the U.S. Postal Service in the dying days of the 109th Congress -- by voice vote, no less -- and the action attracted nary a whit of attention. Twenty years ago

such an effort would have meant a brutal public brawl, but President Bush signed the measure with little fanfare last week. There's a lesson here about the luck of technology in transcending otherwise immovable government monopolies."

- "The new law itself caps future postage increases at the rate of inflation, a definite boon to the bulk mailers who constitute most of the Postal Service's customer base these days. But the average rate of postage increase since the last major reform in 1971 works out to the inflation rate in any case. A long period of no change followed by successive leaps to catch up have only made people think the price hikes were extraordinary. The law also helps put the post office's pension house in order, but mainly by sloughing off to Treasury a chunk of its obligations estimated at \$27 billion over the next few decades. Like other government workers, postal employees who are also veterans have enjoyed extra pension benefits because their time in the armed forces has been included in their length of service when calculating retiree benefits. The feds will now directly shoulder the extra expense incurred thanks to that Congressionally mandated arithmetic."
- "The bill also ...well, nothing. The USPS keeps its monopoly on first class mail delivery, meaning that private carriers like FedEx and UPS are still prevented from competing with the post office on price, and consumers either use the monopoly or pay \$10 to send a letter. The USPS also keeps its army of (unionized) workers, and what an army it is. A postal spokesman told us 700,000 work for the service, while a 2003 report from a Presidential commission on postal reform put the number at 854,376. Either figure easily makes the mail service the second-largest civilian employer in the country, between Wal-Mart and McDonald's, and the fourth largest civilian employer in the world."
- Real reform would entail more political bloodletting to privatize the Postal Service and shed some of its unwieldy workforce. There have already been a few steps in a more rational direction; up to 90% of the USPS mail that travels by air travels on FedEx planes under contract these days. And postal inspectors have stopped their practice, especially egregious during the 1990s, of harassing business owners for using private carriers.
- "But full privatization is, or ought to be, the way of the future. Germany did it several years ago with great success when the government stripped Deutsche Post of its monopoly and started selling shares in the enterprise. DP has since become a major player in the global logistics market, acquiring DHL along the way. While Congress was passing its postal 'reform,' the EU announced its plan to explore eliminating national postal monopolies entirely. Deutsche Post could soon offer more than 50% of its stock to the public. It says something when the U.S. trails even Germany in reforming outdated government monopolies. One lesson is how difficult it is to reform any part of government once it becomes a political fixture. The Postal Service has one big thing going for it: the lobbying power of its unions, members of which inhabit every ZIP Code in the country. Like the steelworkers union, they will ride their sinecures into economic irrelevance."

- “Fortunately for the private economy, the Postal Service was not allowed to monopolize parcel service or electronic communication, and thus technological progress long ago allowed anything truly vital to be sent by FedEx or fax or email. Which is another reason so few people cared about this marginal Beltway ‘reform.’”(*Wall Street Journal*, 12/26/06)

Passage of postal reform legislation will have no impact
on the USPS’s plans to increase postage rates in 2007

- In December 15th statement released by the USPS, the agency said, “We’ve been asked if the recently passed Postal Reform legislation will have any effect on the current proposed pricing change. It will not. We are still on target for a May 2007 implementation of new prices and mailing standards. We’ll have our revised mailing standards Federal Register published in early January 2007.” (*Postcom*, 12/15/06)

Senate confirms Jim Bilbray to serve on the USPS Board of Governors

- The Senate has confirmed former Nevada Representative Jim Bilbray was confirmed by the Senate to serve on the Board of Governors of the U.S. Postal Service until the end of 2015. Bilbray, 68, was nominated by President Bush to complete the remainder of a term that expired December 8, and then serve a new nine-year term. (*Postcom*, 12/12/06)

TVA

New leadership TVA makes its mark in 2006

- In March 2006, an expanded, part-time, nine member board of directors were sworn in to guide the Tennessee Valley Authority, led by Bill Sansom, a hard-nosed businessman with no previous experience with electric utilities. “I never thought I would be sitting here, so no I didn’t have an agenda coming in,” said Sansom in an interview with Associated Press. “It didn’t take long, though, to figure out what you needed to do.” After taking the reins, the politically connected group of businessmen, bankers, a church leader and a public relations executive immediately made an offer to let six Kentucky power distributors, who had served notice that they were leaving the TVA system in search of cheaper rates, remain at no extra cost. This offer was suggested and supported by representatives of TVA’s 152 other distributors in a show of unity. The Bowling Green cooperative, the largest of the six, accepted and the others are pending. The board also adopted a controversial new land policy banning the sale of TVA’s remaining 293,000 acres of protected shoreline to residential developers, after receiving more than 5,000 public comment letters. Before passing the policy, the board debated the option of disposing of the property and pay off some of the agency’s debt. Ultimately, the board voted 8-1 on November 30 to make permanent the temporary moratorium on land sales for private development. The Board’s actions, along with its approval in July of TVA’s first electric rate cut since 1988 in July after two rate jumps in the past fiscal year, portend a new cooperation with distributors and the public.
- Other big moves are in store for TVA in 2007, said Sansom. The board expects an engineering study under way will likely support the completion of a second reactor at the Watts Bar Nuclear Plant in Tennessee to increase the utility’s capacity to meet peak power demand. The utility continues negotiations on an agreement which, for the first time, could give distributors an ownership stake in a TVA power plant. [In 2006, TVA also opened the door to sharing a plant with Southern Co., another power provider.] The board is crafting a new strategic plan for the utility, which will consider power demand, pricing, financing and generation needs for the decade ahead. Sansom said he is less concerned about cutting TVA’s \$25 billion debt, a priority of the utility’s past boards, than being able to deliver low-cost, reliable, “clean” electricity to TVA’s 8.7 million consumers. “Yes, I wish it was \$10 billion less debt. It would be a whole lot easier,” Sansom said. “[But] if the lights are out and you don’t have any debts, that’s not pretty.” Instead, his mantra for TVA is “rates, rates, rates.” (*Associated Press*, Duncan Mansfield, 12/28/06; *Associated Press*, 01/01/07)

TVA pays \$10.5 million in executive bonuses and
\$40 million in employee performance bonuses

- In 2006, TVA paid \$10.5 million to 143 executives and \$40 million in performance bonuses to the agency's 12,000 employees. Tom Kilgore, the utility's president and new CEO received a combined compensation package of nearly \$1.6 million.
- The recently departed CFO Mike Rescoe also received a \$1.6 million severance package in 2006. Rescoe joined TVA in 2003 with a contract that provided for a two-year salary and bonus guarantee if his position were reduced or eliminated. When Kilgore was promoted to be the agency's president, he asked Rescoe to resign, triggering the golden parachute payment. Representative Zach Wamp (R-TN) called the payment "egregious" He added, "Paying that much money to someone who is not even staying at TVA leaves a very sour taste in the mouth of ratepayers who were hit with two rate increases from TVA in the past year. TVA needs to be competitive with other utilities, but it also needs to recognize that it is a special, quasi-government agency with a unique mission." Former TVA chairman Glenn McCullough said, "The situation we're in now is unfortunate. But that is how the contract with Mr. Rescoe was structured. You have to pay a competitive compensation package to ensure you have the best people running a \$9 billion-a-year corporation like TVA." (*Associated Press*, 12/16/06; *Associated Press*, 12/19/06; *UPI*, 12/21/06)

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