

# The **GSE** REPORT™

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## Major Events

OFHEO director Lockhart warns that Fannie and Freddie “unfortunately have very, very large problems [which] ...are massive and they’re ongoing”

- In a January 18 meeting with reporters, OFHEO director James B. Lockhart, III said that Fannie Mae and Freddie Mac “unfortunately have very, very large problems.” He added, “They have a long way to go; there are still significant worries.” He also noted that Fannie Mae had a loss in the third quarter, but did not specify the amount of the loss. Although Fannie has not reported its financial results for the third period, Jim Vogel, an analyst at FTN Financial Capital Markets, estimates that the company lost approximately \$400 million. Lockhart said that the financial results for both Fannie Mae and Freddie Mac will continue to be volatile from quarter to quarter. He also expressed frustration with Fannie Mae’s and Freddie Mac’s pace of reform. “It’s taking these companies five years to fix themselves,” said Lockhart. “To me, that’s unbelievable any public company takes that long.”
- Lockhart said he will continue to push for the passage GSE regulatory reform legislation in Congress. “We need to ensure that these kinds of problems which are costing these companies billions and billions of dollars don’t reoccur in the future,” said Lockhart. “And in particular, we need to prevent these companies from growing out of control again as they did in the early 2000s.” He reiterated that the GSEs’ portfolios are still too large. “I think the portfolios need to be right sized, and I’m not sure they are right-sized now,” said Lockhart. “They represent too much risk. ...We need to be able to have the power to establish a regulation on the size and growth of the portfolios and relate that to mission and risk.” He said his agency is satisfied that draft language being considered for a GSE reform bill would address the administration’s concerns about restricting the growth of Fannie and Freddie. Lockhart is hopeful that Congress will enact GSE regulatory reform legislation this year. “I’m pretty optimistic, but I’ve been pretty optimistic for a while,” he added.
- Lockhart also said that OFHEO needs a bigger budget to supervise Fannie Mae and Freddie Mac. His agency is operating on a budget of \$60 million this year, the same budget it had last year. Lockhart said his agency needs a budget of \$67.5 million of which \$5.6 million would be expended on litigation costs. “When you compare those numbers to the billions of dollars that these companies are taking to remediate their problems, you can see there is a disparity there,” he added. (*Dow Jones Newswires*, Damian Paletta, 01/19/07; *Dow Jones Newswires*, Damian Paletta, 01/18/07; *MarketWatch*, Robert Schroeder, 01/18/07; *CQ Today*, Michael R. Crittenden, 01/18/07; *Associated Press*, Marcy Gordon, 01/18/07)

Former Fannie Mae CEO Franklin Raines accuses  
OFHEO director Lockhart of being hopelessly biased against him

- In a filing with a federal appeals court, former Fannie Mae chairman and CEO Franklin Raines said that OFHEO director James B. Lockhart, III is hopelessly biased against him and asked the U.S. Court of Appeals for the District of Columbia Circuit to bar Lockhart from making the decision in OFHEO's administrative proceeding against Raines. "Director Lockhart has prejudged the charges against Mr. Raines and cannot serve as an impartial decision maker that due process requires," states Raines' filing. "...[B]ecause it is apparent that bias against Mr. Raines pervades the agency," the case should be moved from OFHEO to federal court. According to the motion, Lockhart has made a host of critical comments about Raines, including a statement on *The Newshour with Jim Lehrer* that much of Raines's income during his tenure as Fannie's CEO was "basically fraudulently attained." Raines claims that Lockhart is motivated to bring the charges against him because the Director wants Congress to enact GSE regulatory reform legislation. (*Associated Press*, Marcy Gordon, 01/17/07; *Washington Post*, David S. Hilzenrath, 01/22/07)
- Under statute, OFHEO's 101 criminal charges against Raines, former CFO J. Timothy Howard, and former SVP and controller Leanne Spencer will be heard by an administrative law judge, who will make a nonbinding recommendation on whether the charges should stand. Lockhart may accept, modify or set aside the judge's recommendations. If the defendant(s) disagrees with the findings, he or she may appeal the decision to a federal court for review. (*Wall Street Journal*, James R. Hagerty and Damian Paletta, 01/19/07)
- In response to Raines' appeal to a federal court to remove the OFHEO director from the agency's pending lawsuit against Fannie Mae's former executives, Lockhart told reporters that "the charges stand for themselves." He added, "[OFHEO] effectively did a very thorough job in the examination [of the former executives]," but would not respond to Raines' implication that the suit was politically motivated. (*Market News International*, Margaret Chadbourn, 01/19/07)

Ken Duberstein resigns from Fannie Mae's board of directors

- On January 12, Kenneth M. Duberstein submitted his resignation from Fannie Mae's board of directors effective February 15<sup>th</sup>. Duberstein, a Republican consultant and chief of staff for President Ronald Reagan from 1988 to 1989, has served as a director at Fannie Mae since 1998 and his lobbying firm has worked for the company in years past. Duberstein was one of the few remaining directors from the "Raines era" at Fannie Mae. (*Dow Jones Newswires*, Ed Welsch, 01/12/07; *MortgageWire*, 01/18/07)

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

Financial Services chairman Barney Frank predicts passage of GSE reform by April 2<sup>nd</sup> – but changes to conforming loan limits remain a “sticky issue”

- The House of Representatives can pass GSE regulatory reform legislation before April 2 when Congress adjourns for its spring break, predicts House Financial Services chairman Barney Frank (D-MA). Essentially, the bill will be similar to that passed by the House in the last Congress on a vote of 331-90, except for improvements worked out with Treasury officials in December, said Frank. He told reporters that the House bill would also include an increase in GSEs’ conforming loan limit, allowing Fannie and Freddie to purchase loans in high cost markets at 150% of the current loan limits (\$625,500). The proposed change to loan limits appears to be the last primary obstacle to passing GSE regulatory reform legislation. Frank argues that this provision is critical to the bill and has threatened to kill the legislation without it. However, the White House remains reluctant to support a higher conforming loan limit. According to sources, Senate Republicans argue that the Bush administration has already gone too far in compromising with Frank and are reluctant to agree to a change in the loan limit provision.
- Supporters of the loan limits provision are unsure if they will prevail. “We have miles to go before we sleep,” said Jerry Howard, CEO of the National Association of Home Builders. “From our perspective, the more money you get into the housing system, the better. We think it’s important for Fannie and Freddie to play in these high cost areas,” Howard added. Other observers insist the provision must be in the bill. “If there is no conforming loan increase, there will not be a bill, said Judy Kennedy, CEO of the National Association of Affordable Housing Lenders. The provision has ample political support from other trade groups, including the National Association of Realtors. “We are anxious to work with Congress to make this a higher priority,” said Gerald Giovaniello, NAR’s chief lobbyist, who acknowledged that the Senate Banking Committee will probably have to resolve this issue. “They will have to work that out,” said Giovaniello.
- The loan limit provision is meeting stiff opposition from the banking industry, which argues that the private sector is already providing sufficient funding for the jumbo mortgage market. “Our view is that an increase in the loan limit for high-cost areas is unnecessary,” said Paul Leonard, VP of government affairs at the Financial Services Roundtable. “The mission of the GSEs is to support the secondary market for low- and moderate-income homebuyers. Focusing on high-cost areas and allowing an increase is not consistent with that mission.” In letters sent to Congressional members in July 2005, America’s Community Bankers, the Association of Financial Guaranty Insurers, the Consumer Mortgage Coalition, and the Financial Services Roundtable urged Congress to reject calls for raising the conforming loan limit. With

Democrats now in control of Congress, some industry representatives are seeking compromise on the issue. “We are going to look for common ground, said Robert Davis, EVP and manager of government relations at ACB. “We are looking to not have this as a point of serious contention going forward.” Joe Pigg, senior counsel at ABA, said “As community banks have been able to use Fannie and Freddie for the secondary market, there’s more interest into expanding into these [jumbo mortgage] loans.” While the banking industry’s resistance may be weakening, there is no sign yet of a softening in the Senate on this issue, where Republicans previously opposed raising the conforming loan limit. “Senator Shelby (R-AL) seems opposed [to the conforming loan limit provision] and I don’t expect that to change,” said Pigg.

- Senate Banking Committee chairman Chris Dodd (D-CT) said that passing GSE regulatory reform bill is an “early priority” for his committee this year. Dodd told *Dow Jones Newswire*, “I liked [Barney Frank’s] bill in the last Congress. He added, “I’m anxious to see [what agreement Frank and Treasury officials have reached].” He acknowledged, however, that there are still some “ticklish” details that need to be resolved, but said he is confident that all sides were moving forward. “We’re headed in the right direction,” said Dodd. “I think things are going well.”
- The Bush administration’s position on the “ticklish” loan limit provision is unclear. In a January 18<sup>th</sup> meeting with reporters, OFHEO director James B. Lockhart, III said the provision would likely affect 10 or 11 markets, primarily in California and some suburbs in New York City. He said he is studying the proposal and its potential impact and plans to present his findings to the White House and Congress. Although he has not taken a position on the issue, Lockhart appeared to be sympathetic to Treasury’s position. “Certainly there is an argument that can be made that providing mortgages over \$417,000 is well away from the affordable housing missions [of Fannie and Freddie],” said Lockhart.
- Critics argue that allowing Fannie Mae and Freddie Mac to buy larger mortgages, secured by more expensive homes would encourage the GSEs to buy few mortgages for affordable housing. “Once we say they are permitted to do these things, we give a signal that they don’t have to put as much of an effort in affordable housing,” said AEI senior fellow Peter Wallison. “[If Congress approves the loan limit provision,] it only reflects the fact that Fannie and Freddie still have the political power they had before the [accounting] scandals.” (*National Mortgage News*, 01/15/07; *American Banker*, Steven Sloan, 01/09/07; *Dow Jones Newswires*, Damian Paletta, 01/19/07; *National Mortgage News*, 01/08/07; *Dow Jones Newswires*, Damian Paletta, 01/08/07)

- In a speech to the Chartered Financial Analysts of St. Louis, William Poole, president of the Federal Reserve Bank of St. Louis, addressed his concerns about the risks posed by the housing GSEs and discussed steps that need to be taken to alleviate the GSEs’ systemic risks. Poole said, “One of the Federal Reserve’s most important responsibilities is maintenance of financial stability. The job obviously, and sometimes dramatically, encompasses crisis response. However, the very existence of a crisis, when one occurs, often demonstrates a failure of some sort, on the part of the firms involved, the government or the Federal Reserve.”
- “...Not long after coming to the St. Louis Fed in 1998, I became interested in Government Sponsored Enterprises, or GSEs. My interest arose when I began digging into aggregate data on the financial markets and discovered how large these firms [Fannie Mae, Freddie Mac and the 12 FHLBs] are. ...Using information as of Sept. 30, 2006—the latest available as of this writing—these 14 firms have total assets of \$2.67 trillion; given their thin capital positions, their total liabilities are only a little smaller. Just two firms—Fannie Mae and Freddie Mac—account for \$1.65 trillion of the assets, or 62 percent of all housing GSE assets. Moreover, Fannie Mae and Freddie Mac have guaranteed mortgage-backed securities outstanding of \$2.82 trillion. Thus, the housing GSE liabilities on their balance sheets and guaranteed obligations off their balance sheets are about \$4.47 trillion, which may be compared with U.S. government debt in the hands of the public of \$4.83 trillion.”
- “In what follows, I’ll confine most of my comments to Fannie Mae and Freddie Mac, where the largest issues arise. My purpose is to make the case once again that failure to reform these firms leaves in place a potential source of financial crisis. Although there is pending legislation in Congress, a major restructuring of these firms and genuine reform appear to be as distant as ever.”
- “My initial curiosity about the GSEs was stoked simply by the size of these firms. As I investigated further, I became concerned about their thin capital positions and the realization that if any of them got into financial trouble the markets and the federal government would look to the Federal Reserve to deal with the problem. As I worked through the issues, I began to speak on the subject; my first such speech was in October 2001...”
- “Today I want to look back over the past few years to summarize a few of the changes that have occurred at the GSEs and in the regulatory environment they face. ...[T]hese have been event-filled years for the GSEs, primarily because of disclosures of accounting irregularities at Fannie Mae and Freddie Mac. Although these firms stopped growing when the irregularities were disclosed, ...once they get their houses in good order they will likely resume rapid growth because of the special advantages they enjoy in the marketplace from their ties to the federal government. I remain

hopeful that Congress will eventually pass meaningful GSE reform legislation. Private-sector financial firms ought to have an intense interest in reform legislation. Still, given that there seems to be so little appreciation of the importance of the GSE issue, where do they—and we—go from here? ...”

- “Although the housing GSEs are less obscure than they used to be, they are not much discussed in recent months. A year ago I would have noted that it was not unusual to find stories about the GSEs on the front pages of major financial newspapers. They were the subject of substantial debate in Congress and among financial-policy experts. They had escaped from obscurity, primarily because of publicity in recent years over their accounting irregularities. But today they seem to be returning to obscurity.”
- “For Fannie Mae and Freddie Mac, the two stockholder-owned housing GSEs, history can be divided into two distinct eras—before June 2003 and after. June 9, 2003, was the day the board of directors of Freddie Mac announced discovery of significant accounting irregularities. The stock prices of both Freddie Mac and Fannie Mae plunged, as investors immediately realized that something might have gone terribly wrong with both GSEs. Subsequent investigations by private experts and public authorities confirmed the fears of many investors and financial supervisors. These giant, fast-growing firms had poor accounting systems and financial controls. Because it is important for my analysis later, keep in mind these facts: First, the effect of disclosure of accounting irregularities at Freddie Mac on June 9, 2003, led to a decline of 16 percent in Freddie’s stock price and 5 percent in Fannie’s stock price that day. However, ...the effect of these disclosures on the mortgage market was negligible. Similarly, when Fannie’s accounting irregularities were disclosed on Sept. 22, 2004, its stock fell by 6.5 percent that day and by a total of 13.5 percent over a three-day period; the mortgage rate was again unaffected.”
- “Fortunately for financial stability, the accounting irregularities at Freddie Mac had been designed, as we later learned, to understate earnings by a total of about \$9 billion over a period of years. Thus, there was no question of Freddie Mac defaulting on any of its obligations and immediately unleashing unpredictable effects on its counterparties or the financial system. In 2004, we learned that Fannie Mae’s accounting was revealed to be faulty. In December 2006, Fannie restated its earnings for 2002, 2003 and the first half of 2004, revealing that it had *overstated* its earnings by a total of about \$6 billion.”
- “The stunning accounting irregularities at Freddie Mac and Fannie Mae served as wake-up calls both to the GSEs themselves and to the supervisory and legislative communities. Freddie Mac fired virtually all of its top-level management immediately in June 2003, and then, a few months later, fired the new CEO [the company’s former CFO] it had hired to replace the original disgraced CEO. Barely a year and a half later, Fannie Mae ejected its own top managers, who had repeatedly declared that, unlike Freddie’s, its own books were clean. ...Hundreds of millions of shareholder dollars were committed to rebuilding accounting and control systems at

both firms. Both firms agreed to restate earnings for the past few years; so massive was this undertaking that neither firm is current on its financial reporting. Freddie did release its annual report for 2005 but, according to its press release of Jan. 5, 2007, may revise its results materially for the first nine months and the third quarter of 2006. Nor is Fannie filing current reports. In December 2006, Fannie filed its Form 10-K for 2004 with the SEC. Currently, investors in common stock or debt obligations issued by both companies rely on partial and incomplete information subject to material revision.”

- “The GSE accounting scandals constituted a rude awakening for OFHEO and Congress. OFHEO was caught napping at Freddie Mac but, to its credit, then identified Fannie Mae’s shortcomings on its own. Once alerted to the problems, OFHEO’s tenacious investigations into wrongdoing at both Freddie Mac and Fannie Mae spurred investigations by the Securities and Exchange Commission and the Department of Justice. Congressional hearings were held, and GSE reform legislation was passed in oversight committees of both houses of Congress in 2004 and 2005, although no final legislation has been enacted as of this time...”
- “Meanwhile, the Federal Home Loan Banks—the ‘other housing GSEs’—were enduring accounting and control crises of their own. Two of the 12 FHLBs signed written regulatory agreements in 2004 with their supervisor, the Federal Housing Finance Board (FHFB), to rectify portfolio risk-management deficiencies. Then, in 2005, 10 of the 12 FHLBs failed to meet their agreed deadline to register their stock with the SEC. Like Fannie Mae and Freddie Mac, all of the Federal Home Loan Banks restated their earnings for recent years; all have now returned to timely filing of accounting statements.”
- “So where do we stand? I would characterize the current situation as a period of uneasy waiting. The GSEs have grown much more slowly and they have been more reticent in public in recent quarters than they had been during the pre-2003 decade. It appears that they want to pursue a low-key strategy while memories of their accounting and control failures gradually fade. Their aim, apparently, is to return to the environment before heightened scrutiny arose in 2003.”
- “Although I think much more needs to be done, it would be a mistake to believe that nothing useful was done after severe accounting problems surfaced in June 2003. In general terms, the most important achievement is a much broader and better-informed discussion of the risks to financial stability posed by the GSEs. We were fortunate that the GSE accounting and governance scandals did not threaten the immediate solvency of the enterprises and that the problems surfaced when the economy and financial markets were strong.”
- “I will point to six major contributions to the public investigation into, and debate about, the risks posed by the GSEs. There have been other contributors, to be sure, but this list provides what I think is a good overview of the issues and what we have learned so far: (1) A 2003 study by Dwight Jaffee of interest-rate risks run by the

GSEs; (2) A 2003 study by OFHEO of the potential systemic risks posed by the GSEs; (3) A series of testimonies and speeches by Federal Reserve Board Chairman Alan Greenspan; (4) A series of research papers prepared by Federal Reserve System staff members; (5) The results of a Federal Reserve ad-hoc study group investigating counterparty exposures and risks in the OTC interest-rate derivatives markets; [and] (6) An economic-capital analysis of Fannie Mae and Freddie Mac prepared by Kenneth Posner, an equity analyst at Morgan Stanley.” [The Federal Reserve Bank of St. Louis’ web site provides a summary of each of these items in the appendix of Poole’s speech at [http://stlouisfed.org/news/speeches/2007/01\\_17\\_07.html](http://stlouisfed.org/news/speeches/2007/01_17_07.html).]

- “...Considering these results as a whole, we have learned a great deal in recent years about the way the GSEs operate; the risks they are taking and how they attempt to manage them; and what effects the GSEs have on financial markets during normal times as well as during periods of market turbulence. Armed with this knowledge, lawmakers and policymakers are in a much better position to make needed improvements in the statutory and regulatory environment in which the GSEs operate.”
- “I continue to believe that the nation would be well-served by turning the GSEs into genuinely private firms, without government backing implied or explicit. If they bolster their capital, they can function perfectly well as purely private firms. A key issue for many is whether privatizing Fannie and Freddie would raise mortgage rates paid by borrowers. We now have some solid evidence on how the mortgage market would function if the housing GSEs became fully private firms. A careful econometric investigation by three economists at the Board of Governors last year reached this conclusion: ‘We find that GSE portfolio purchases have no significant effects on either primary or secondary mortgage rate spreads.’ Put another way, the 30-year mortgage rate fluctuates in tandem with the rate on 10- year Treasury bonds, and the spread over the Treasury rate is not affected by portfolio purchases by Fannie and Freddie.”
- “Another approach to acquiring evidence on the effects on the mortgage rate of mortgage purchases by Fannie and Freddie is to examine what happened when their portfolios stopped growing in the wake of disclosures of accounting irregularities. Those disclosures led OFHEO to impose 30-percent temporary surcharges on the firms’ required minimum capital levels. Freddie Mac’s capital surcharge was imposed in January 2004, while Fannie Mae’s capital surcharge became effective in September 2004. To meet the higher capital ratio, the two firms had to do some combination of raising new capital and reducing their portfolios. The retained portfolios of mortgages and mortgage-backed securities held by Fannie and Freddie grew strongly in the years preceding the OFHEO orders. ...[A]t the end of 2003 they held 22 percent of outstanding mortgages on 1-4 family properties. Net growth of their retained portfolios then stopped; over the course of both 2004 and 2005, their total portfolios of mortgages and mortgage-backed securities fell slightly. In 2006, their retained portfolios continue to decline and by the end of the third quarter their portfolios were below year-end 2005. Meanwhile, the total market continued to

expand. The combined market share of Fannie and Freddie fell from 22 percent at the end of 2003 to 14 percent at the end of the third quarter of 2006.”

- “What happened to the mortgage spread when the GSEs stopped accumulating ever larger portfolios? Nothing. Because fixed-rate mortgages are subject to prepayment risk, whereas the 10-year Treasury bond is not, there is a degree of variability of the mortgage spread. But if the cessation of the GSEs’ portfolio growth had made a difference, it surely would have shown up in the data. The annual average of the spread in 2003, before the OFHEO orders that restricted Fannie and Freddie’s portfolio growth, was 180 basis points; the spread was 157 basis points in both 2004 and 2005.”
- “Nor did we observe any sort of shock to the market when the accounting irregularities at Freddie were disclosed in June 2003. The spread was 196 basis points in May 2003, 198 basis points in June and 196 basis points in July. Consider also January 2004, when OFHEO imposed a capital surcharge on Freddie. That month, the mortgage spread was 159 basis points. The month before the spread was 161 basis points; the month after, 156 basis points. The OFHEO order applying to Fannie came in September 2004. That month the spread was 163 basis points; the month before, 159, the month after, 162.”
- “Toward the beginning of my remarks I noted that disclosure of the accounting irregularities did affect the stock prices of the two firms. Now we see that there was no effect on the mortgage market. The issue, clearly, is the profitability of the firms and not effects on the mortgage market. The effects of problems at Fannie and Freddie on the mortgage market have been minimal because the market contains many competent and well-capitalized competitors that can readily pick up the slack when other players stumble.”
- “Financial firms throughout the economy ought to have an intense interest in reforming the GSEs. One reason is simply that banks and other financial firms, and many nonfinancial firms, hold large amounts of GSE obligations and GSE-guaranteed mortgage-backed securities. I believe that many risk managers simply accept that GSEs are effectively backstopped by the Federal Reserve and the federal government without ever thinking through how such implicit guarantees would actually work in a crisis. The view seems to be that someone, somehow, would do what is necessary in a crisis. Good risk management requires that the ‘someone’ be identified and the ‘somehow’ be specified. I have emphasized before that if you are thinking about the Federal Reserve as the ‘someone,’ you should understand that the Fed can provide liquidity support but not capital. As for the ‘somehow,’ I urge you to be sure you understand the extent of the president’s powers to provide emergency aid, the likely speed of congressional action and the possibility that political disputes would slow resolution of the situation.”
- “There is a long-run issue that goes beyond that of today’s systemic risk. The fact is that it is very profitable for a firm to be able to borrow at close to the Treasury rate,

lend at the market rate and hold little capital. That is why the promise of constraints on the portfolio growth at Fannie and Freddie had a significant effect on their stock prices. Any firm with such a privileged position will want to extend its scope of operations. Over the past 15 years, Fannie Mae and Freddie Mac have grown much more rapidly than has the stock of mortgages outstanding and as a consequence now hold or guarantee a large fraction of U.S. home mortgages. They held in their portfolios 5 percent of 1-4 family mortgages at the end of 1990, the share peaked at 22 percent at the end of 2003, and, at the end of the third quarter of 2006, the share was 14 percent. Given the powerful incentive Fannie and Freddie have to grow, the systemic risk they pose to the economy will also grow.”

- “Once their current accounting problems are fully resolved, Fannie and Freddie will want to resume their growth. It is simply very profitable to be able to borrow at close to the Treasury rate and invest in mortgages while holding minimal capital. Banks maintain capital ratios double or more the ratios that Fannie and Freddie maintain. Banks pay deposit insurance premiums to the Federal Deposit Insurance Corporation whereas Fannie and Freddie pay no insurance premiums. Assuming that the implied guarantee would, in a crisis, lead to a federal bailout, U.S. taxpayers bear the risk while the shareholders and managements of Fannie and Freddie enjoy the profits. This situation encourages these firms to grow vigorously.”
- “These two firms, however, cannot meet their growth targets in the long run if they confine their operations to conforming home mortgages. Their interest in increasing the conforming mortgage limit is clear. Moreover, in my opinion it is inevitable that they will look for ways to extend their operations into new areas. They have that clear incentive because of the implicit federal guarantee they enjoy. For them to extend their operations into market segments already well served by existing private firms will not enhance the efficiency of mortgage markets or reduce costs to mortgage borrowers.”
- “There are two possible ways to constrain the operations of the GSEs to areas with a clear public purpose. One is to end the implied federal guarantee so that Fannie Mae and Freddie Mac compete on an equal basis with other fully private firms. The other is to place restrictions on the size of their owned portfolios if they retain their privileged position. Their owned portfolios should be limited to mortgages held temporarily in the process of securitization.”
- “Absent complete privatization, or on the way to it, Congress should strengthen the powers of OFHEO or a successor regulator. OFHEO has weaker powers than provided by law to the federal bank regulators—the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation. The GSE supervisory framework remains fragmented and weak, as the GAO has pointed out on numerous occasions. Thus, structural change of the GSEs and their supervision should be at the top of the reform agenda. There is a glaring need for legislation to clarify the bankruptcy process should a GSE fail. At present, there is no

process and no one knows what would happen if a GSE is unable to meet its obligations.”

- “Freddie Mac and Fannie both got into trouble with accounting irregularities in part because of the complexities under GAAP rules of accounting for derivatives positions and rules determining which assets should be reported at market and which should be reported at amortized historical cost. Sound risk management practices require that GSE managements base decisions on market values, or estimates as close to market as financial theory and practice permit. The reason is simple: Fannie Mae and Freddie Mac pursue policies that inherently expose the firms to an extreme asset/liability duration mismatch. They hold long-term mortgages and mortgage-backed securities financed by short-term liabilities. Given this strategy, they must engage in extensive operations in derivatives markets to create synthetically a duration match on the two sides of the balance sheet. These operations expose the firm to a huge amount of risk unless the positions are measured at market value.”
- “Almost all the assets and liabilities of the GSEs are either traded actively in excellent markets or have values that can be accurately measured by prices in such markets. For this reason, the financial condition of the GSEs ought to be measured through fair-value accounting and such accounts ought to be the principal yardstick of condition and performance.”
- “Since the GSE accounting scandals emerged in mid-2003, one thing has remained rock-solid: The GSEs have continued to borrow at yields only slightly higher than those of the U.S. government, and noticeably lower than those available to any other AAA-rated private company or entity. In other words, despite the vast recent accumulation of knowledge about the significant risks run by the GSEs, as well as their inability (or unwillingness) to manage these risks, investors in GSE debt securities appear unmoved. Upon reflection, the lack of market discipline evident during this crisis period is striking—like a dog that did not bark. This fact indicates to me that there still is a significant problem with the GSEs that needs to be fixed.”
- “The obvious answer to why the dog did not bark is that the so-called ‘implicit guarantee’—that is, the belief by investors that the U.S. government would not allow the GSEs to default on their debt obligations—has not been removed. Indeed, the talk of increased GSE regulation and the failure of structural-reform legislation to become law may actually have reinforced the belief of many that, overall, the government is perfectly happy with the situation as it is. The GSEs remain politically powerful, if less strident than they were a few years ago.”
- “Three essential reforms are needed to eliminate the GSEs’ threat to financial stability. First is a limit on their portfolio growth; second is an increase in their minimal required capital; third is satisfactory bankruptcy legislation so that, should the worst happen, federal authorities can deal with the problem in an orderly way.”

- “Freddie Mac apparently does not expect any significant increases in constraints on its operations. Funds that could have been used to build capital to better protect taxpayers have instead been used to increase common stock dividends. Freddie set a quarterly dividend of \$0.22 in the fourth quarter of 2002 and has increased the dividend every year since. As of the fourth quarter of 2006, the dividend stands at \$0.50 per quarter, more than twice its level four years earlier. Fannie Mae cut its dividend in half in early 2005 to build capital, but I’ll hazard a guess that once it starts issuing regular financial statements the company will increase its dividend rather than build capital further.”
- “I began this speech noting that the Federal Reserve has a responsibility to maintain financial stability. That responsibility includes increasing awareness of threats to stability and formation of recommendations for structural reform. I do not believe that a GSE crisis is imminent. However, for those who believe that a GSE crisis is unthinkable in the future, I suggest a course in economic history.” (*Prepared Remarks by William Poole, President of the Federal Reserve Bank of St. Louis, 01/17/07*)

<p>The revised language of H.R. 1461 is “workable” and will achieve the goal of restricting the GSEs’ portfolios</p>
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- In the January 12<sup>th</sup> issue of *American Banker*, American Enterprise Senior Fellow Peter Wallison wrote, “Just after Thanksgiving, draft revisions to the House GSE legislation (H.R. 1461) began to circulate on Capitol Hill. The new language reflected a purported agreement between the Treasury Department and Rep. Barney Frank, the incoming chairman of the House Financial Services Committee, and set off alarm bells around Washington. For those who have fought for six years to rein in the government-sponsored enterprises Fannie Mae and Freddie Mac, the administration’s compromise - if that’s what it is - was a bit of a shock. The language amended the original House bill, which when passed was worse than no bill at all, and did not use the term ‘systemic risk’ in connection with the legislation’s key issue: whether the new regulator would have authority to control and reduce the size of the GSEs’ mortgage portfolios.”
- “The compromise had some laudable provisions. It contained relatively strong language on the important question of new products, giving the regulator the authority to determine whether a GSE initiative is in fact a new product. In addition, the language would eliminate the president’s authority to appoint any GSE directors, thus reducing the apparent connection between the government and the enterprises. Finally, and most important, the language would give the new regulator the authority to raise minimum capital levels for the enterprises above the level now required by statute - a powerful tool to assure their safety and soundness.”
- “But the key issue associated with any reform legislation was always the question of the new regulator’s authority with respect to the GSEs’ portfolios. Those of us who

saw this as the principal reason for any new regulatory legislation had always argued that the enormous size of the portfolios - which had reached \$1.5 trillion before Fannie and Freddie ran into accounting problems - created a risk to the stability of the entire U.S. economy (hence 'systemic') and not simply the risk of a taxpayer bailout. Our view was that the regulator would need authority to curb the source of systemic risk—i.e., the size of the portfolios—before any GSE legislation would be satisfactory.”

- “In avoiding any reference to systemic risk, does the compromise language meet this test? **My conclusion is that the language is workable for controlling the portfolios and thus deserves the support of those who have sought this goal.** [Emphasis added.] The relevant provision begins, ‘The director shall, by regulation within 180 days, establish standards by which the portfolio holdings, or rate of growth of the portfolio holdings, of the enterprises will be deemed to be consistent with the mission and the safe and sound operations of the enterprises.’ It then lays out seven elements that the director ‘shall consider,’ including ‘the need for the portfolio in maintaining liquidity or stability of the secondary mortgage market,’ ‘the need for an inventory of mortgages in connection with securitizations,’ ‘the need for the portfolio to directly support the affordable housing mission of the enterprises,’ and ‘any potential risks posed by the nature of the portfolio holdings.’”
- “Together, these statutory elements leave the decision on the portfolios firmly to the director’s discretion. In other words, the language gives the director the necessary authority, if he chooses to use it. And if one believes, as I do, in the good judgment and steadiness of OFHEO Director Jim Lockhart - whom I assume will be appointed by the president as the director of the new regulator - this language would produce the right result for the economy and the taxpayers.”
- “I have come to this conclusion for several reasons. First, it is important to understand that the danger of systemic risk always rested on the possibility that problems with the portfolios would initially have to impair the ‘safe and sound operation’ of the enterprises. Thus, if the director were to conclude that the portfolios could impair the GSEs’ safe and sound operation, he would be making a judgment that would have been necessary, in any event, to a finding of systemic risk. In fact, the standard in the compromise language would be lower than a systemic risk standard, because the director is not required to conclude that an impairment of the safe and sound operation of the enterprises would likely produce a systemic result. Thereafter, each of the items the director must consider should not pose difficult conceptual or factual hurdles if he believes that standards are necessary to control the size of the portfolios.”
- “It’s reasonably clear, for example, that the portfolios are not necessary to maintain the ‘liquidity or stability of the secondary mortgage market.’ To the extent that the enterprises create liquidity or stability in the secondary market, they do it by acquiring mortgages from originators. Whether they hold those mortgages in portfolio, or securitize and sell them, should have no effect on the secondary market.

That has been clear recently, as Fannie and Freddie have been reducing their portfolios and emphasizing securitization, with no noticeable change in the secondary market. Similarly, in addressing the factors that must be considered in connection with regulating the portfolios, the director could readily find that the GSEs' enhanced use of securitization would not require a large inventory of mortgages, would as easily support their affordable housing mission as acquiring for portfolio, and would avoid the potential risks - particularly interest rate risk - inherent in holding large portfolios of mortgages."

- "Accordingly, while the regulator's enforcement authority must be enhanced, and there is still language to be negotiated on major issues - especially on the affordable housing fund - the fact that the compromise would give the regulator sufficient authority to control or reduce the GSEs' portfolios clears the way for a bill the president should sign." (*American Banker*, Peter Wallison, 01/12/07)
- [*Editor's Note*: Since 2000, Peter Wallison has critically appraised the activities of Fannie Mae and Freddie Mac and analyzed the GSEs' relation to the housing sector and economy as a whole. Together with AEI resident fellow Alex J. Pollock, Wallison has written (or co-authored) three books concerning Fannie Mae and Freddie Mac and the risks that they pose; written eight articles on Fannie and Freddie in *Financial Services Outlook*, AEI's monthly newsletter; testified before Congress on four occasions about Fannie Mae, Freddie Mac and the FHLBs; delivered six public speeches on the housing GSEs; hosted 24 AEI conferences on GSE-related issues; published 34 articles and opinion editorials in national newspapers and magazines; and worked with the Shadow Financial Regulatory Committee on the issuance of 15 statements related to GSE issues.]

House Financial Service Committee chairman Frank readies an ambitious agenda of making more affordable housing available to lower-income Americans

- On January 10, Financial Services chairman Barney Frank (D-MA) held a news conference at the National Press Club to discuss his ambitious agenda on making housing more affordable to lower-income Americans. Frank's goal is the establishment of a multi-million dollar national housing trust fund, which would fund the production, rehabilitation and preservation of housing for low income Americans (with incomes less than 30% of their state or area median). Acknowledging that there will be "some problems in funding brand new programs," Frank said the fund could initially rely on the revenue generated from Fannie Mae's and Freddie Mac's affordable housing fund, created through a 5% tax ("\$500 to \$600 million") on the companies' profits to be created through passage of GSE regulatory reform. Frank said, "[W]e do hope to at least have, by the middle of this year, that Fannie Mae and Freddie Mac piece, which will begin to generate money that we'll use for affordable housing." Given the pay-as-you-go budget constraints, Frank is also focused on generating revenues and/or savings from within housing programs to pay for new proposals and is recruiting industry allies to help advance his agenda.

- Shelia Crowley, president of the National Low Income Housing Coalition, said, “[The GSE piece is] roughly \$500 million a year, which is a good amount of money, but it doesn’t get us where we need to get for a national housing trust fund. Working within the current budget framework, there isn’t really much room to maneuver. A housing trust fund is really based on finding new revenue sources. In the housing area, there has been a lot of money made ... and we would like to see some of that go back into the trust fund.” According to *CongressDaily*, “Additional revenue options include proposals to garnish surpluses in the Federal Housing Administration program, revamp the mortgage interest tax deduction and tap the mortgage-backed securities market, though some of those proposals could meet resistance from some housing industry lobbyists.” (*CQ Transcripts*, Representative Barney Frank holds a news conference at the National Press Club on Homeless, 01/10/07; *National Journal’s CongressDaily*, Bill Swindell, 01/16/07; *National Journal’s CongressDaily*, Bill Swindell, 01/10/07)
- In a January 12 meeting with House Speaker Nancy Pelosi (D-CA), the United States Conference of Mayors delivered their 10-point plan titled *Strong Cities, Strong Families for a Strong America*. According to the Mayors’ plan, “The mayors support an affordable housing fund to be administered by the Government Sponsored Entities (GSEs), (not by HUD or state housing agencies) funded at least 5 percent of their profits, with local government projects eligible to be assisted.” (*PR Newswire*, 01/12/07)

Capitol Hill Notes
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- On January 11<sup>th</sup> during an interview on the *Imus in the Morning* radio show, Senate Banking Committee chairman Christopher Dodd formally announced that he is running for president of the United States in 2008. Dodd said “I want to skip this exploratory phase a lot of people go through and become a full-fledged candidate for the presidency. ...I realize I’m a dark horse in all of this. I’m not as well-known as some of the other candidates running ...So I decided to get out of the bleachers and onto the arena floor.” (*CQ Today*, Rachel Kapochunas, 01/11/07)
- Representative Ron Paul, the ranking Republican on the House Financial Services Committee’s monetary policy subcommittee, announced that he is forming an exploratory committee in contemplation of running for the Republican nomination in 2008. (*American Banker*, Barbara Rehm, Stacy Kaper, and Steven Sloan, 01/16/07)
- The House Republican Conference announced committee assignments to the Financial Services Committee, which include ranking member Spencer Bachus (R-AL), Richard H. Baker (R-LA), Deborah Price (R-OH), Michael N. Castle (R-DE), Peter King (R-NY), Edward R. Royce (R-CA), Frank D. Lucas (R-OK), Ron Paul (R-TX), Paul E. Gillmor (R-OH), Steven C. LaTourette (R-OH), Donald A. Manzullo (R-IL), Walter B. Jones (R-NC), Judy Biggert (R-IL), Christopher Shays (R-CT),

Gary G. Miller (R-CA), Shelley Moore Capito (R-WV), Tom Feeney (R-FL), Jeb Hensarling (R-TX), Scott Garrett (R-NJ), Ginny Brown-Waite (R-FL), J. Gresham Barrett (R-SC), Rick Renzi (R-AZ), Jim Gerlach (R-PA), Steven Pearce (R-NM), Randy Neugebauer (R-TX), Tom Price (R-GA), Geoff Davis (R-KY), Patrick T. McHenry (R-NC), John Campbell (R-CA), Adam Putnam (R-FL), Marsha Blackburn (R-TN), Michele Bachmann (R-MN), and Peter J. Roskam (R-IL). (*Bureau of National Affairs*, 01/11/07)

- Bachus announced that Representative Deborah Pryce (R-OH) will serve as the Ranking Member of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee for the 110<sup>th</sup> Congress. Representative Richard Baker (R-LA), who previously served as chairman of the subcommittee, will remain on the panel, even though he did not retain his subcommittee role. “He plans to remain on the committee and remain active on the issues,” said Baker’s spokesman Michael DiResto. Others selected by Bachus to serve as ranking subcommittee members include Representative Paul Gilmore (R-OH) on the subcommittee on financial institutions and consumer credit; Representative Ron Paul (R-TX) on the subcommittee on domestic and international monetary policy, trade and technology; Representative Judy Biggert (R-IL) on the subcommittee on housing and community opportunity; and Representative Gary Miller (R-CA) on the subcommittee on oversight and investigations. (*Dow Jones Newswires*, Siobhan Hughes and Damain Paletta, 01/10/07)
- Representative Spencer Bachus (R-AL) has announced the Republican staff members of the House Financial Services Committee, which include Larry Lavender as Staff Director; Jim Clinger as Chief Counsel; Warren Tryon as Deputy Staff Director; and Richard Cross as Communications Director. (*Representative Spencer Bachus Press Release*, 01/19/07)
- Senator Chris Dodd (D-CT) has chosen Roger Hollingsworth to be a senior advisor to the Senate Banking Committee. Previously, Hollingsworth was a Banking Committee aide to former Senator Jon Corzine (D-NJ) and was a banking and housing legislative assistant to Senator Charles Schumer (D-NY). (*American Banker*, Barbara A. Rehm, Stacy Kaper, and Steven Sloan, 01/16/07)
- The House Budget Committee voted to recommend the appointment of Peter R. Orszag as director of the Congressional Budget Office. Orszag, a Brookings Institution economist and former Clinton administration adviser, has written extensively on Social Security and other issues and has been a sharp critic of President Bush’s tax cuts and his proposals to establish private investment accounts within Social Security. Speaker Nancy Pelosi (D-CA) and the Senate’s president pro tempore, Robert C. Byrd (D-WV) will jointly make the final CBO appointment. (*CQToday Midday Update*, 01/18/07)

## Basel II capital rule's impact on GSEs

- According to a recent study released by the Mortgage Bankers Association, competition between large commercial banks and Fannie Mae and Freddie Mac could heat up if regulators implement the proposed Basel II international risk-based capital standards. According to new research by Professor Mark J. Flannery at the University of Florida, Basel II could lower banks' capital requirements for mortgage portfolios to nearly the same levels as the GSEs, if the larger banks use the "advanced internal ratings based" approach. "This would mean that the GSEs would confront more competition for their mortgage guarantee business," said Flannery. If Basel II puts banks on level ground with the GSEs, more institutions would focus on the conforming market, he said. "This adds to the areas where banks will be competitive." In response to the tougher competition, the GSEs would be pressured to lower their guarantee fees which they charge to back the mortgages they purchase, according to Flannery. (*National Mortgage News*, 01/15/07; *American Banker*, Steven Sloan, 01/10/07)
  
- In a January 19 Letter to the Editor in the *American Banker*, William R. Maloni, Fannie Mae's former senior vice president for government and industry relations wrote, "It seems that the Basel II overseers may soon lay to rest a dispute - between the GSEs and their opponents, including many commercial banks - which has rumbled around for years. If, as you reported ['Study on Basel II and GSE Competition,' Jan. 10], Basel II lowers the capital requirements on bank-backed mortgage securities to that of the Fannie Mae and Freddie Mac MBS, it would seem to be a tacit admission by the regulators that GSE mortgage-backed securities - and the capital backing them - has been the correct mix, and that bank issuers have demanded too much capital for the lesser risk that issuers and investors face. Leave it to the responsible Basel to conclude that investors in bank-issued MBS were holding too much capital, while investors in Fannie and Freddie MBS were holding just the right amount of capital. That's a comment both about the asset and the issuers. This 'correction' also should cause commercial banks - which long have led the charge (no pun intended) against GSE regulatory capital - to quiet down and back off their claim, wrongly made, that Fannie Mae and Freddie Mac, themselves, are too thinly capitalized." (*American Banker*, William R. Maloni, 01/19/07)

## UBS anticipates limited debt issuance by Fannie and Freddie in 2007

- UBS analysts expect to see limited growth in GSE debt issuance in 2007, along with a continuation of tightening of spreads in the mortgage market. The analysts believe that Fannie Mae and Freddie Mac will become more active traders in the MBS market, as the companies focus on "total return and relative value" investing. UBS expects to see little change in MBS holdings with banks currently owning 23% of MBS outstanding and the GSEs owning 21%. Over the past two years, Fannie and Freddie have shed approximately \$203 billion of agency MBS and have added about

\$67 billion on non-agency MBS, according to UBS. “We expect for this trend to continue,” said Laurie Goodman, co-head of fixed-income research at UBS Global. “Fannie Mae and Freddie Mac now have most of their portfolios available for sale.” (*National Mortgage News*, 01/15/07)

## ***Fannie Mae***

OFHEO expects Fannie Mae to “resolve” its internal probe of executives by the end of February
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- OFHEO director James B. Lockhart, III said his agency is negotiating with Fannie Mae on how best to discipline the company’s current executives tied to its accounting scandal and said it would be “reasonable” to expect his agency to decide on disciplinary action by the end of February. “There was some recommendations about some individuals [at Fannie Mae], and we are discussing with the board some of the recommendations,” said Lockhart. “We hope to have an agreement and some actions taken by the end of February.” He did not identify the individuals that Fannie Mae might seek money from and said “many” of the officials would not be named publicly. “My sense is that many of them will not be made public because these are people that are not in the top five that you see [at Fannie Mae],” Lockhart added. A spokesman for Senator Chuck Hagel (R-NE) said the Senator is anxious to hear what OFHEO’s decision will be regarding Fannie Mae’s current management and their multi-million dollar executive bonus packages. (*Dow Jones Newswires*, Damian Paletta, 01/18/07; *Reuters*, 01/08/07)
- On January 8, OFHEO denied *Reuter’s* December 20<sup>th</sup> Freedom of Information Act request for a copy of the report on the executives’ role in Fannie Mae’s accounting scandal and the agency’s report on the company’s lobbying efforts. Lockhart said the two reports may never be released. “This is privacy information [regarding the report on the executives],” he said. “These are individuals who are potentially being disciplined...People more buried in the organization, I’m not sure its appropriate to release that information.” With regard to OFHEO’s report on Fannie Mae’s lobbying, the agency declined the FOI request, claiming that the report was privileged information since it was produced as part of its examination of the company. Lockhart said that report largely addressed “a set of best practices across the board” but did not address Fannie’s past actions. “This company is in the process of implementing these best practices and we will examine them against those practices,” said Lockhart. (*Reuters*, 01/11/07; *Reuters*, 01/08/07)
- Senate Banking Committee member John Sununu (R-NH) urged OFHEO to release its report on Fannie Mae’s lobbying efforts. He told *Reuters* that it would be

appropriate for OFHEO to release the report because of Fannie Mae's benefits from the federal government. "It is absolutely appropriate and responsible for [Fannie's] lobbying activities in Congress to be scrutinized carefully," said Sununu. According to *PoliticalMoneyLine*, Fannie Mae spent \$10.48 million lobbying Congress in 2006, in an effort to block passage of GSE regulatory reform legislation. (*Reuters*, 01/08/07)

#### Fannie Mae declares first quarter dividends

- On January 19<sup>th</sup>, Fannie Mae's board of directors declared a first quarter dividend on the company's common stock of \$0.40 per share, unchanged from the total common stock dividend paid in the fourth quarter of 2006. The Board also declared dividends on the company's preferred stock in accordance with the terms of the preferred stock, and approved the redemption of all outstanding shares, with an aggregate stated value of \$700 million, of the company's Variable Rate Non-Cumulative Preferred Stock, Series J. (*Fannie Mae Press Release*, 01/19/07)

#### Fannie Mae closes its largest ever single-asset loan acquisition: \$325 million

- During 2006, Fannie Mae closed a \$325 million loan for a 140-building multifamily complex in Queens, New York, with Median Capital Group. According to Meridian, the transaction "made investment history" as Fannie Mae's largest-ever single asset loan acquisition. (*BusinessWire*, 01/08/07)

#### Fannie Mae's tentacles extend to the Pennsylvania Housing Finance Agency's board of directors

- Dr. Howard B. Slaughter, director of Fannie Mae's Pittsburgh Community Center, has been appointed to the Pennsylvania Housing Finance Agency's board of directors. At Fannie Mae, Slaughter is responsible for overseeing affordable housing investments for a six county area in Pennsylvania. He also serves on the board of directors for the Urban League of Pittsburgh. (*DSNews.com*, Payton Oldham, 01/08/07)

## ***Freddie Mac***

The suspense continues...

- In a January 18 interview, OFHEO director James B. Lockhart, III said that Freddie Mac had given him a timeline of when it would finally split the titles of chairman and chief executive officers, titles currently held by Richard Syron. When asked if he knew when the titles would be split by Freddie Mac, Lockhart said, “Yes I do, but I’m not going to tell you.” (*Dow Jones Newswires*, Damian Paletta, 01/19/07)

Freddie Mac doubles its offering of preferred stock to \$1.1 billion

- On January 9, Freddie Mac increased its newly offered \$500 million of fixed-rate non-cumulative perpetual preferred stock to \$1.1 billion. The \$44 million of preferred shares were offered at \$25 per share with a dividend rate of 5.57%. Freddie Mac will have the option to redeem all of part of the 44 million shares offered on or after December 31, 2011 for \$25 a share plus accrued dividends. Fitch Ratings assigned an ‘AA-’ rating to the offering, which was sold through a syndicate of dealers headed by Goldman, Sachs & Co. and JPMorgan. The company plans to issue the shares on January 16, subject to the satisfaction of customary closing conditions. Freddie Mac plans to use the offering proceeds to repay debt, purchase mortgage-backed securities and redeem all of the preferred shares currently outstanding of its 6.14% non-cumulative preferred stock issued in June 1997. (*Baltimore Business Journal*, Neil Adler, 01/11/07; *BusinessWire*, 01/11/07; *PR Newswire US*, 01/10/07; *Freddie Mac Press Release*, 01/10/07)

Freddie Mac re-organizes its multi-family division

- Freddie Mac has reorganized its multi-family division in an effort to focus more time and attention on customer needs and to streamline operations. Effective January 31, Mitchell Kiffe will lead the division’s production and sales, which is responsible for deal negotiation, price quotes, and commitments. Kim Griffith will head up affordable sales and investments department, which negotiates deals, price quotes and commitments for the “affordable business.” Mike McRoberts will be in charge of Freddie Mac’s new multifamily underwriting department, which handles credit decisions. Daryl Hall will remain head of asset management, supporting the company’s increased focus on new and specialty products. Freddie Mac has also created the offerings and customer management department to address customer business needs. The company has also created a new business management department to support new product development and customer compliance management. According to Mike May, Freddie Mac’s senior vice president of multifamily sourcing, “The reorganization ...mak[es] us even more customer-

focused, efficient and creative in meeting customer needs and the demands of a changing market. The changes establish a single point of accountability and enable the entire organization to work better as a team.” (*Freddie Mac Press Release*, 01/09/07)

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

Federal Housing Finance Board unanimously approves procedures for making appointments of public-interest directors to the FHLBs’ boards

- The Federal Housing Finance Board unanimously approved an interim final rule, setting forth new procedures for appointing public-interest directors at the FHLBs. The procedures require the FHLBs to submit the names of candidates for the posts by March 31, which the agency will review and approve or veto. To ensure that the agency has a healthy slate of candidates, each FHLB will be required to nominate twice as many directors as there are vacant seats. The new procedures end the Finance Board’s practice of naming the public-interest directors, which were often based on political patronage. Finance Board chairman Ronald Rosenfeld said the search for public interest directors “will be best executed by each individual bank.” Although the procedures were issued as a final rule, the Finance Board will accept public comments for 30 days after publication of the rule in the *Federal Register*. Public comments will be considered in promulgating the final rule.
- In an interview with *American Banker*, Rosenfeld defended his earlier refusal to appoint public interest directors to the FHLBs. “There’s a law that says we shall appoint,” said Rosenfeld. “We believe that that law has within it a certain latitude as to when you appoint.” After Congress adjourned in December without passing a GSE regulatory reform bill, Rosenfeld said he felt compelled develop these new procedures. “Even our belief has limitations of reasonableness,” he said. “We think the concept of reasonableness ended when Congress did not, this past session, enact legislation.” (*American Banker*, Steven Sloan, 01/19/07)

Federal Housing Finance Board terminates its supervisory agreement with the FHLB-Seattle

- On January 12<sup>th</sup>, the Federal Housing Finance Board terminated its Written Agreement with the FHLB-Seattle, following the Bank’s full compliance with the terms of the agreement and the significant progress that the Bank has made in implementing its business and capital management plan. “The Seattle Bank’s Board of Directors and staff are delighted with this very positive news from the Finance Board,” said the Bank’s president and CEO James E. Gilleran. “We are extremely

pleased with the progress we've made in our business turnaround. Everyone at the Seattle Bank has worked very hard to meet the objectives of the agreement, and we appreciate the ongoing support of our member banks, our Board of Directors, and our staff during this significant business transition." On December 10, 2004, the Bank's board of directors entered into the regulatory agreement, which required the Bank to develop a new business and capital plan which simplified its business model, reduced the Bank's interest-rate risk, and improved its profitability. The termination of the Written Agreement does not affect the resolutions passed by the Bank's board of directors that restricts repurchases of Class B stock and limits dividends to 50% of year-to-date GAAP net income, except with the prior written approval of the Finance Board's Director of the Office of Supervision. The Finance Board's action to terminate its agreement with the FHLB-Seattle leaves the FHLB-Chicago as the only Bank still operating under a written agreement.

- The FHLB-Seattle announced that it resume paying dividends – albeit a small one–of \$0.10 share dividend [for a total of \$2.2 million] for the third quarter. The dividend represents a payout ratio of 24.2% of the Bank's third quarter net income of \$9.1 million. (*Business Wire*, 01/12/07; *American Banker*, Steven Sloan, 01/17/07; *Banking Wire*, 01/09/07)

#### FHLB-Indianapolis announces 4<sup>th</sup> quarter dividends

- The FHLB-Indianapolis' board of directors declared cash dividends on B-1 stock at an annualized rate of 5% and a dividend on B-2 stock at an annualized rate of 4.0% for the fourth quarter, payable January 23. (*PrimeZone Media*, 01/16/07)

#### FHLBs announce board election results

- The FHLB-Dallas announced that Gary Blankenship, chairman and CEO of Bank of the West [Irving, TX], was elected to the board of directors to serve a three-year term. (*Dallas Morning News*, 01/12/07)
- The FHLB-San Francisco board of directors has selected W. Douglas Hile and Reginald Chen to fill open seats on the board. Hile, chairman and CEO of Meridian Bank, NA [Wickenburg, AZ], will fill the vacant Arizona seat for a term ending December 31, 2007. Chen, the treasurer of Citigroup's Consumer Lending Group and Vice President of Citibank, N.A., will fill the vacant Nevada seat for a term ending December 31, 2008. (*BusinessWire*, 01/11/07)

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

FCA extends comment period on proposal  
to broaden the Farm Credit System's lending authority

- The Farm Credit Administration has extended the comment period from December 15<sup>th</sup> to February 26 concerning a proposal to broaden the Farm Credit System's lending authority to include making loans to a broader range of firms that market or process farm products. Under the current rules, a marketing or processing company can borrow from a FCS lender only if it is owned by a farmer or if farmers own more than 50% of the company. FCA's proposal would allow FCS lenders make loans to companies in which farmers own 50% of the voting stock but not 50% of the total stock; farmers control the management but own less than 50% of the stock; and farmers own at least 25% of the voting stock and provide at least 20% of the raw materials for its operations. "[The proposal] is not designed as a grand expansion of the lending authority," said Gary K. Van Meter, deputy director of the office of regulatory policy at FCA. "It is simply trying to meet the farmers' needs in light of how they structure their operations."
- The Community Bankers of America, the Independent Community Bankers of American and the American Bankers Association are urging their members to write letters opposing the plan, which they argue strays from the Farm Credit System's mission. "Our plan will be to provide our membership with information that will help them understand the implications of this proposed rule," said John M. Blanchfield, the director of the ABA's Center for Agricultural and Rural Banking. "This extension will give us the opportunity to do that education for sure." Mark K. Scanlan, the director of agricultural finance at the ICBA, said, "A number of bankers are going to be interested in learning more details about it." (*American Banker*, Ben Jackson, 01/17/07)

Farm Credit System Financial Assistance Corporation  
takes 17 years to bail out the Farm Credit System

- On January 11, the Farm Credit Administration's board of directors approved the dissolution of the Farm Credit System Financial Assistance Corporation (FAC), which was formed in 1988 to provide capital to financially-troubled FCS institutions. Pursuant to statutory requirements, the FAC repaid its financial obligations in June 2005 and received its final audit in September 2005. The FCA board determined that FAC had completed its statutory mission, complied with applicable laws and regulations, and operated in a safe and sound manner. In response to a certified resolution of the FAC board of directors, the FCA board cancelled the FAC charter as of December 31, 2006. (*US Fed News*, 01/11/07)

## *Postal Service*

### Congress delivers on postal reform

- In a January 8<sup>th</sup> IRET Congressional Advisory on Postal Reform, the Institute for Research on the Economics of Taxation wrote that Congress passed “significant” Postal Service legislation with its passage of the Postal Accountability and Enhancement Act in December. According to IRET, “The new law gives the Postal Service greater flexibility to adjust postal rates, a power it had long sought; broadens oversight on non-rate issues by its regulator, now called the Postal Regulatory Commission; and resolves two issues regarding the Postal Service’s pension contributions. The pricing discretion ...comes with the restriction that rates on market-dominant products are not to increase faster than the consumer price index. Mailers hope the rate cap will hold down future rate increases, and the Administration hopes the cap will promote financial discipline at the government-owned agency.
- “...Unfortunately, the legislation does little to relax Congressionally imposed requirements that push up the Service’s labor costs. Rate-cap regulation is not a magic bullet. It would work much better if it were coupled with labor compensation reform.
- “Congress has decided to transform the Postal Service’s regulator from mainly a rate regulator to a full-fledged regulator, extending its oversight into areas such as service standards, in order to provide a check on the Postal Service’s increased discretion. The regulator has shown itself to be highly competent in the past. The rules it develops in coming months and years to carry out its expanded responsibilities will help determine the new law’s effectiveness.”
- “...Privatization and de-monopolization were not on the table in 2006. Congress will be loathe to consider these changes as long as the Postal Service delivers reasonable service at affordable prices. Congress wisely understood that the Postal Service should concentrate on its core mission and not wander into unrelated markets. The Postal Accountability and Enhancement Act removes the Service’s authority to introduce new non-postal products.” (*IRET Congressional Advisory*, Advisory No. 216, 01/08/07)

### Postal issues are on the agenda for the 110<sup>th</sup> Congress

- According to postal insiders, postal issues remain on the agenda for the 110<sup>th</sup> Congress “[Congress will] be tracking very closely how the [postal reform] bill is implemented, as well as how the Postal Regulatory Commission is working,” said Jerry Cerasale, Direct Marketing Association senior vice president of government

affairs. In December, Representative Henry A. Waxman (D-CA), the chairman of the House Government Reform Committee, announced a new subcommittee covering the federal workforce, postal service and District of Columbia. “The [postal service] subcommittee is a good thing because it means more attention will be paid to postal issues,” said Bob McLean, executive director of the Mailers Council. “Even though we got reform, there are other postal issues we hope Congress will look into during the session,” including oversight of postal operations, the rate case, and service standards.

- Sen. Joseph I. Lieberman, (I-CT) is chairman of the Senate Homeland Security and Governmental Affairs Committee, which oversees the USPS. While no agenda has been announced, McLean said it’s been a long time since the Senate has held a general postal oversight hearing, “so we should expect one sometime very soon.” Senator Susan Collins (R-ME), the committee’s previous chair, was interested in the issue of delivery standards and the need for new service performance measurement systems. “Our hope is that Senator Lieberman will continue to follow this issue closely,” said McLean. Collins requested a GAO report on the issue of delivery standards in the 109th Congress, and that “the report is under way,” said McLean. (*DMNews.com*, Melissa Campanelli, 01/11/07)

#### APWU members approve contract with USPS

- On January 18, APWU members ratified a new four-year contract with the USPS, which runs through November 20, 2010 and affects approximately 272,000 Postal Service employees. The contract approves retroactively a 1.3% increase in salary effective November 25, 2006. On February 16, 2008, all eligible employees will receive a one-level upgrade. And, on November 21, 2009, eligible employees will receive a 1.2% increase in salary. The contract also contains a continuation of cost of living adjustments at current levels twice a year. (*DMNews.com*, Melissa Campanelli, 01/17/07)

#### It’s a changing world...

- According to the *Washington Post*, the nation’s three largest newspaper publishers are gearing up to sell advertising jointly on the newspapers’ Web sites, believing that their survival depends on seizing new online revenue from national advertisers. Circulation is declining at major papers across the country as readers increasingly find news online and elsewhere. (*Washington Post*, Frank Ahrens, 01/16/07)
- According to *Seeking Alpha*, “Netflix ...plans to spend \$40 million this year to build out its digital movie-rental business. That’s on top of the \$5 to \$10 million spent last year.” Why? Well, according to the CEO: ‘In aggregate, we’re looking at a \$300

million postal bill. As we switch to an online format, that's savings that we can recognize.” (*Association for Postal Commerce*, 01/17/07)

USPS delivers 46% of the world's mail

- The US Postal Service delivers more than 46% of the world's mail volume—some 213 billion letters, advertisements, periodicals and packages a year—and serves 10 million customers each day at 37,000 retail locations nationwide. (*Alliance of Nonprofit Mailers*, 01/18/07)

When you thought you'd heard it all...

- According to the *Baltimore Examiner*, “Taxpayers across the United States might have to dole out \$100 million to postal police for overtime they never worked, thanks to a decision by a federal arbitrator in Baltimore. Everything about the case is ridiculous, including the decision. A union representative said earlier this month the back pay for Baltimore postal police will be about \$2.6 million.” (*Baltimore Examiner*, 01/17/07)
- As the 2006 tax season approaches, the federal government is still trying to recover nearly \$3 billion from 450,000 active and retired federal employees who failed to file income tax returns in 2005. The federal agency with the highest number of delinquent taxpayers is the USPS, where 56,652 employees owe more than \$320 million in unpaid taxes. (*WTOP 103.5 FM*, Mark Segraves, 01/17/07)

## TVA

Senator Lamar Alexander and Representative Bud Cramer elected co-chairmen  
of the TVA Caucus for 110<sup>th</sup> Congress

- Senator Lamar Alexander (R-TN) and Representative Bud Cramer (D-AL) were elected co-chairmen of the bicameral, bipartisan TVA Caucus for the 110<sup>th</sup> Congress. The caucus, made up of senators and representatives from the seven states served by TVA, addresses issues that affect the TVA region. Alexander said, “My goal is to help create an environment in which the new TVA board can develop a strategic plan that will provide ratepayers in the Tennessee Valley with reliable, low-cost, clean electric power for years to come.”
- Cramer said, “I am excited about this opportunity to lead this group of Senators and Representatives who are passionate about a successful future for TVA and the

communities they represent. TVA can be a valuable partner with our communities in North Alabama and across the region. Not only do we depend on them for affordable utilities, environmental research, and management of the Tennessee River, but TVA also plays a key role in helping recruit new industries to our region. This responsibility is one, which I believe additional emphasis should be placed. I look forward to working with the leadership at TVA to ensure our area's economic vitality."

- Cramer is sharply critical of the utility's recent decision to bar the sale of the agency's 293,000 acres of protected shoreline to private entities. "I've had a problem with their land use policy," said Cramer. "I've felt like it's been too restrictive. TVA's charter is [to stimulate] economic development. TVA's got to be flexible when it comes to economic development. I'm not sure this land use policy they finally enacted is flexible enough. ...I'm not sure the new board and the new CEO, Tom Kilgore, are taking economic development as seriously as they should." Cramer also is concerned that the utility is reverting to a bureaucracy that considers itself unaccountable to the public—and specifically Congress. "With TVA's new board structure, where I turn to get my answers is unclear," said Cramer. "I've not been getting clear, direct answers from TVA. I was particularly frustrated with TVA my first few years here [beginning in 1991] because it seemed to be a bureaucracy that didn't think it was accountable to anyone. I'm wondering now if TVA thinks it's even accountable to Congress." He said that he plans to implement a schedule of regular meetings with the TVA board, where he will address his concerns about the TVA land use policy, the utility's storage of nuclear waste and its lock system, and TVA's rate structure. "I told the caucus before it elected me that I'd be, to a certain extent, a thorn in TVA's side," said Cramer. (*US Fed News*, 12/11/07; *The Decatur Daily News*, Eric Fleischauer, 01/12/07)
- In a January 12 editorial, the *Decatur Daily* [AL] wrote, "[Cramer]... put TVA on notice that the federal agency that dates to the Great Depression isn't about to abandon its core mission. As the new co-chairman of the Tennessee Valley Authority Caucus, he plans to hold members of the expanded board accountable for continued economic development in the seven-state region. The congressman already has an appropriate agenda. He wants to revisit TVA's controversial land-use policy, the issue of nuclear waste stored at Browns Ferry and the antiquated locks on the Tennessee River. Go get 'em, Mr. Congressman." (*The Decatur Daily*, 01/14/07)
- In a January 15<sup>th</sup> editorial, *TimesDaily.com* wrote, "Thumbs up to the election of U.S. Rep. Bud Cramer [D-AL] of Huntsville, as co-chairman of the [TVA] Caucus... Cramer's north Alabama district includes some of TVA's most important facilities, including Browns Ferry nuclear plant. A long-time critic of some of TVA's management practices, Cramer said Congress still has oversight over TVA and that he is 'going to rattle TVA's cage.' That's tough talk, and maybe a bit too threatening, but he is right in his assessment of TVA's lack of foresight in redeveloping portions of the Muscle Shoals Reservation for industrial and research use. ...We think Cramer

will be an important advocate for the Shoals area in this caucus.” (*TimesDaily.com*, 01/15/07)

TVA is seeking to expand its energy capacity 50% to meet growing demand

- In a January 9<sup>th</sup> speech to the Huntsville [AL] Rotary Club, TVA board member Howard Thraikill said the agency is will have to expand its power capacity 50% to meet demand over the next 20 years at a cost ranging from \$20 billion to \$30 billion. On average, TVA’s rates are about \$0.02 per kilowatt hour cheaper than the national average, said Thraikill. “We are focused on rates,” he added, stressing the utility’s historic mission of providing low-cost power in the Tennessee Valley. In April or May, TVA hopes to complete its restart of Browns Ferry Unit 1 at a cost of \$1.8 billion. Within four years, TVA has committed the expenditure of \$29 million to start the Watts Bar Unit 2 reactor, said Thraikill. In the future, he predicted that TVA will focus on power generation through “nuclear and clean coal” under tighter environmental regulations, which address green house gases and require more power generation through renewable sources of energy. (*The Huntsville Times* [AL], Brian Lawson, 01/10/07)
- TVA’s new board of directors, led by CEO Tom Kilgore, are exploring the possibility of entering into partnerships with TVA distributors in the purchase of additional power plants to expand the utility’s power capacity. “There ought to be some type of ownership of power producing assets in the valley by the people, not just the federal government,” said Jack Simmons, president and CEO of the Tennessee Valley Public Power Association, an association of TVA’s 159 distributors. “It’ll create a stronger bond between distributors and TVA,” Simmons added. TVA spokesman John Moulton said that management’ talks with TVA distributors about partnerships “are still very preliminary” but could help the agency add more generation without increasing its debt. “We are interested in working with our distributors in partnerships where they could contribute financially to new generation and be a partner with us in future power plants,” Moulton said. (*Chattanooga Times Free Press*, Jason M. Reynolds and Dave Flessner, 01/20/07)

Three power distributors elect to rescind their notices of termination with TVA

- Three of the six power distributors who had given notice to terminate their power contracts with TVA have withdrawn the notice and are returning to their standard TVA power contracts without paying additional costs. “We are very pleased that ...Warren Rural Electric Cooperative [Bowling Green, KY], Duck River Electric Membership Corp. [Shelbyville, TN], and Glasgow Electric Plant Board [Glasgow, KY] have chosen to remain with TVA,” said Ken Breeden, TVA executive vice president of customer relations. The three Kentucky-based TVA power distributors that chose not rescind their notices of contract termination include Paducah Power System with 22,586 customers; Princeton Electric Plant Board with nearly 4,000

customers; and Monticello Electric Plant Board with 3,500 customers. New TVA chairman Bill Sansom and the utility's president Tom Kilgore personally lobbied each of the distributors with the no-added-cost offer to rescind the termination notice, proposed by the Tennessee Valley Public Power Association. (*US Fed News*, 01/11/07; *Associated Press*, 01/09/07; *Associated Press*, 01/11/07)

TVA looks for lower cost office space in Chattanooga, TN
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- TVA has announced plans to relocate more than 2,500 employees in Chattanooga to less expensive office space, if its current landlord doesn't reduce the utility's rental rates. The agency will accept competitive offers for office space through January 19, said TVA spokesman John Moulton. Although the utility won't disclose the terms of its existing lease, TVA officials said the agency is now paying twice the market rate for office space in Chattanooga and only needs 66% of its 1.1 million square feet it currently leases through the 25-year lease it signed in 1986. (*Chattanooga Times*, Dave Flessner, 01/11/07; *Associated Press*, 01/13/07)

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