

# The **GSE** REPORT™

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## ***Major Events***

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### Spillover

### Contagion...

- “The subprime virus has gone global,” says *Financial Times*'s ‘Lex’ Blog. “Starting as a localized outbreak in the U.S. market for risky subprime mortgages, it has spread into the supposedly safer “Alt-A” tier and even into prime mortgages. Meanwhile, it has crossed into other loan species – particularly leveraged lending, where ballooning spreads have rattled the market and left banks holding big chunks of debt.”
- “The sharp credit market reversal has in turn prompted a flight from risk. Stocks have slumped, especially financials, and Treasury yields have fallen. A number of credit hedge funds, carriers of the virus, have blown up around the world – even some without subprime exposure. Those with bad leveraged bets face falling collateral values, tighter lending from prime brokers and illiquidity in some assets. That is probably exacerbated by investors seeking redemptions after two Bear Stearns funds blew up in June. That can force a fire sale of assets or a redemption freeze and more fear.”

- “That does not necessarily signal Armageddon. The credit markets needed to cool down. While there is a chance that a vicious circle develops, overall it is healthy that investors have rediscovered risk. And some institutions are making hay – witness Deutsche Bank’s results on Wednesday.”
- “The question is whether the contagion, which started in U.S. housing, spreads back from financial markets into the real economy. This is a real concern. The availability of credit has declined significantly for risky borrowers, which accounted for about a third of house purchases last year, according to Deutsche. The removal of marginal buyers will affect house prices, as will forced selling because of defaults. Even for prime borrowers, mortgage rates have not fallen with Treasury yields in recent weeks. House prices are likely to come under more pressure. That could be a drag on consumption and further damp US growth. It is probably manageable, with companies well-financed overall and the global economy still buoyant. But it does not leave much margin for error if the long-stable US employment picture finally starts to worsen.” (*Financial Times ‘Lex’ Blog*, 08/01/07)
- In his August 2007 *Investment Outlook*, William H. Gross, manager of the \$103 billion PIMCO Total Return Fund wrote, “...[T]he sudden liquidity crisis in the high yield debt market is just the latest sign that there is a connection, a chain that links all markets and ultimately their prices and yields to the fate of the U.S. economy. The fact is that several weeks ago, Moody’s and Standard & Poor’s finally got it into gear, downgrading hundreds of subprime issues and threatening more to come. ‘Isolationists’ would wonder what that has to do with the corporate debt market. Housing is faring badly but corporate profits are in their prime and at record levels as a percentage of GDP. Lenders to corporations should not be affected by defaults in subprime housing space, they claim. Unfortunately that does not appear to be the case.”
- “As Tim Bond of Barclays Capital put it so well a few weeks ago, ‘it is the excess leverage of the lenders not the borrowers which is the source of systemic problems.’ Low policy rates in many countries and narrow credit spreads have encouraged levered structures bought in the hundreds of millions by lenders, in an effort to maximize returns with what they thought were relatively riskless loans. Those were the ABS CDOs, CLOs, and levered CDO structures that the rating services assigned investment grade ratings to, which then were sold with enticing LIBOR + 100, 200, 300 or more types of yields. The bloom came off the rose and the worm started to turn, however, when institutional investors – many of them foreign – began to see the ratings downgrades in ABS subprime space. Could the same thing happen to levered structures with pure corporate credit backing? **To be blunt, they seem to be thinking that if Moody’s and Standard & Poor’s have done such a lousy job of rating subprime structures, how can the market have confidence that they’re not repeating the same structural, formulaic, mistake with CLOs and CDOs?** [Emphasis added]. That growing lack of confidence – more so than the defaults of two Bear Stearns hedge funds and the threat of more to come – has frozen future

lending and backed up the market for high yield new issues such that it resembles a constipated owl: absolutely nothing is moving...”

- “...The mistrust of rating service ratings, the constipation of the new issue market and the liquidity to hedge the obvious in CDX markets has led to current high yield CDX spreads of 400 basis points or more and bank loan spreads of nearly 300. The market in the U.S. seems to be looking towards this week’s large and significant placing/pricing of the Chrysler Finance and Chrysler auto deals to determine what the new level for debt should be. In the U.K., a similarly large deal for BOOTS promises to be the bell cow for European buyers. But the tide appears to be going out for levered equity financiers and in for the passive owl money managers of the debt market. And because it has been a Nova Scotia tide, rising in increments of ten in a matter of hours, it promises to have severe ramifications for those caught in its wake. No longer will double-digit LBO returns be supported by cheap financing and shameless covenants. No longer therefore will stocks be supported so effortlessly by the double-barreled impact of LBOs and company buybacks. **The U.S. economy in turn will not benefit from this tidal shift and increasing cost of financing. The Fed tightens credit by raising short-term rates but rarely, if ever, have they raised yields by 150 basis points in a month and a half’s time as has occurred in the high yield market.** [Emphasis added.] Those that assert that this is merely an isolated subprime crisis should observe very closely the price and terms that lenders are willing to accept with Chrysler finance this week. That more than anything else may wake them, shake them, and tell them that their world has suddenly changed. High yield lenders, perhaps if only in their frozen, frightened passivity, are signifying that the wealth must be redistributed, that the onerous oppressive tax in the form of low yields must change, and that finally enough is enough!” (*Investment Outlook*, William H. Gross, August 2007)

#### Lenders make “very major changes” to home loan standards and mortgage offerings

- Some of the nation’s largest lenders, including National City Corp., Wachovia Corp., and Wells Fargo are raising their rates and imposing stricter standards, as slumping demand in the mortgage bond market chokes off funding and the federal regulatory guidance on lending practices are implemented. According to Friedman Billings Ramsey portfolio manager Michael D. Youngblood, about \$11.2 billion of non-agency mortgage bonds were sold in July, down 73% from the \$41.6 billion in June and down 87% from the monthly average of \$86.6 billion this year.
- With investors losing their appetite for a broad range of the more risky mortgages, lenders are being forced to stop offering subprime and Alt-A mortgages. NatCity has stopped buying second mortgages from other lenders and making some stated-income loans. Wachovia has stopped making Alt-A mortgage through brokers. According to a company statement, Wells Fargo is curtailing its exposure to Alt-A loans and making “day-to-day decisions on the pricing and availability” of Alt-A loans made through brokers. This move follows Wells Fargo’s recent decision to stop its retail

offering of 2/28 loans. Other big lenders, including Countrywide Financial, Washington Mutual, Merrill Lynch's First Franklin and H&R Block's Option One Mortgage, have also announced that they will stop making 2/28s. Credit Suisse Group (CSG) told lenders that sell its loan products that "until further notice" CSG no longer wants any subprime loans, second mortgages, option ARMS, or ARMs with only two-or three-years of introductory fixed rate. American Home Mortgage Investment Corp., an Alt-A and prime loan lender, announced that it would cease most operations and slash its workforce from more than 7,000 to about 750 on August 3<sup>rd</sup>, as lenders and investors pulled the plug on at least \$750 million of home loans promised by American Homes to thousands of now stranded borrowers. "The credit crunch is here," said Keith Shaughnessy, president of Foundation Mortgage Corp., Littleton, MA. (*Reuters*, 07/24/07; *Dow Jones Newswires*, 08/01/07; *MarketWatch*, Laura Mandaro, 08/05/07; *Bloomberg News*, Kathleen M. Howley and Jody Shenn, 08/03/07; *Washington Post*, Jody Shenn and Bradley Keoun, 08/03/07)

- A letter written by IndyMac's chairman and CEO Mike Perry and posted on his company's website describes how the secondary mortgage market ground to a halt in late July:
  - "...Unfortunately, the private secondary markets ...continue to remain very panicked and illiquid. By way of example, it is currently difficult, at present, to trade even the AAA bond on any private MBS transaction. In addition, to give you an idea as to how unprecedented this market has become...I received a call from U.S. Senator Dodd this morning who seeking an understanding of 'what is really going on and how can I and Congress help?' I also have talked to the Chairman of Fannie Mae this morning and have traded calls with the Chairman of Freddie Mac (Fannie Mae's Chairman telling me that they are 'prepared to step up and help the industry')."
  - "Unlike past private secondary mortgage market disruptions, which have lasted a few weeks or so...our industry and Indymac have to be prudent and assume that this present disruption, which appears broader and more serious, might take longer to correct itself. As a result, we have seen just since yesterday, many major mortgage lenders announce additional product cutbacks...some leaving subprime, Alt-A, and other products altogether or restricting some products to only their own retail channel (and possibly wholesale) and significant, additional price widening."
  - "While we have very strong liquidity, a good amount of excess capital and there are no realistic scenarios that I can foresee that would impair Indymac's viability (thanks to our Federal Thrift structure), as I said on the earnings conference call yesterday...we cannot continue to fund \$80 to \$100 billion of loans through a \$33 billion balance sheet....unless we know we can sell a significant portion of these loans into the secondary market...and right now, other than the GSEs and Ginnie Mae....the private secondary market is not functioning."

- “As a result, Indymac like all major lenders, will continue to widen its pricing and tighten product and underwriting guidelines to ensure that a much greater percentage of our production qualifies for sale to the GSEs or through a GNMA security (we sold 40% to the GSEs in the 2nd quarter, up from 30% in Q107 and 19% in 2006, and we want to get it up to at least 60% asap). We are hopeful that private AAA MBS bonds begin to trade soon...and have encouraged the GSEs to step in and provide additional liquidity to the secondary markets (their primary role) for both these private securities and other loans. While this is an abrupt and uncomfortable change, it is a change that all of our competitors are making just as abruptly, if not more abruptly...so it should not result in one mortgage company having a competitive advantage over another...”  
(*IMBReport*, Mike Perry, 08/02/07)
- Bear Stearns CFO Samuel Molinaro said, “I’ve been out here for 22 years, and this is as bad as I’ve seen it in the fixed-income markets,” comparing the crisis to 1998, when hedge fund Long-Term Capital Management collapsed and Russia defaulted on its debt. Molinaro’s company has played a prominent role in the collapse of the subprime mortgage market, as two of Bear Stearns funds which were heavily invested in the subprime space have gone into bankruptcy, wiping out \$1.6 billion of investor capital and a third fund—the \$900 million Asset Backed Securities Fund with less than 0.5% of its assets in securities linked to subprime loans—suspended withdrawals after being overwhelmed with redemption requests. On August 4<sup>th</sup>, Bear Stearns’ stock plunged \$7.28 to \$108.35, nearly a two-year low, after Standard & Poor’s downgraded the company’s credit-rating outlook to negative, on concern that declining prices for mortgage-backed securities will reduce its earnings. On August 5<sup>th</sup>, Bear Stearns’ co-president and co-chief operating officer Warren Spector resigned. (*Reuters*, 08/03/07; *Los Angeles Times*, Tom Petrino, 08/05/07; *Wall Street Journal Online*, Kate Kelly and Dennis K. Berman, 08/05/07; *Bloomberg News*, Nick Baker, 08/04/07; *American Banker*, William Launder and Kate Berry, 08/02/07; *Bloomberg News*, Yalman Onaran, 08/01/07)
- Some experts believe that the crisis in the mortgage market could prompt action from Congress. “The chance of government intervention in the marketplace in response to current events has increased significantly,” said Andy Chow, portfolio manager at SCM Advisors LLC. Freddie Mac spokesman Doug Duvall said, “Congress is very focused on this issue. There’s a squeeze in the market right now and lenders are tightening their standards. But having a little more prudent underwriting isn’t a bad thing. It’s important to keep people in their homes and to make sure they buy homes they can afford.” Fannie Mae spokesman Brian Faith said, “[Fannie is] playing an active but prudent role in the effort to stabilize the secondary market. We will continue to work with our lender customers to provide additional liquidity where we can to help stabilize and support the market.” However, an individual close to Freddie Mac stressed that Fannie and Freddie aren’t just going to buy up non-conforming loans to bail out troubled players in the secondary market. (*Dow Jones Newswires*, 08/03/07; *MarketWatch*, Alistair Barr, 08/02/07)

- In an interview with the *New York Times*, Freddie Mac's chairman and CEO Richard F. Syron said that the speed and severity of the tighter credit terms are surprising, but perhaps necessary given the excesses in the market in recent years. Syron was wary of the calls by some mortgage industry officials that Freddie Mac and Fannie Mae step in to buy loans and securities that private investors will no longer purchase. "There are some loans that are in difficulty [because credit pools are drying up]," said Syron. "There are other loans that probably should never have been made and providing more liquidity will make that situation worse in the long term." (*New York Times*, Vikas Bajaj, Eric Dash and David Leonhardt, 08/04/07)

### Citigroup sees subprime losses at Fannie Mae and Freddie Mac

- According to a July 26<sup>th</sup> report by Citigroup, price deterioration in subprime mortgages has resulted in approximately \$4.7 billion of unrealized losses for Fannie Mae and Freddie Mac, representing about 6% of the GSEs' equity capital. Citigroup estimates that the two companies' retained portfolios contain \$182 billion of subprime bonds, almost all of which are rated triple-A, based on public disclosures by the GSEs and OFHEO. Citigroup analyst Brett Rose and Scott Peng estimated that Fannie's \$58 billion subprime mortgage portfolio has dropped \$1.5 billion in value, while Freddie Mac's \$124 billion subprime portfolio has declined \$3.2 billion in value. The Citigroup analysts added that the GSEs' paper losses won't necessarily be realized because prices may recover and that the two companies "can "easily ride out" the turmoil in the subprime mortgage market. "Given the long investment horizons and stable funding sources available to Fannie and Freddie, there is little reason to expect that they will realize these losses in the near term," wrote Rose and Peng. In a subsequent clarification, Citigroup said that there was no cause for alarm and the \$4.7 billion estimate probably overstates the amount of losses that ultimately will be realized.
- A Freddie Mac spokesman Michael Cosgrove disputed the \$3.2 billion loss estimate. "We think it's inaccurate, based on how they did the calculation." Freddie Mac uses third-party sources to value its holdings and hasn't seen "any material markdown of value," he added. A Fannie spokesman said that none of the company's mostly AAA-rated bonds in question have been downgraded by rating agencies. (*Reuters*, 07/27/07; *MarketWatch*, Alistair Barr, 07/27/07; *Wall Street Journal*, James R. Hagerty, 07/28/07)
- Subsequently, UBS AG analysts estimated the loss of \$1.34 billion this year on Fannie's and Freddie's subprime mortgage portfolio. "While no market decline is positive, we feel a market decline of this magnitude is not at a danger or alarming level," wrote the analysts. While Fannie Mae and Freddie Mac have been providing guarantees on mortgage bonds secured by loans from bad-credit borrowers or one with low downpayments this year, "[there aren't] any troubling credit trends," wrote

the analysts. Fannie and Freddie charge higher fees for taking on greater risks with these loans, they added. (*Bloomberg*, Jody Shenn, 08/01/07)

### As Countrywide Financial goes, so goes the mortgage sector

- In Sitka Pacific Capital Management's July letter to investors, SPCM wrote, "On the housing side of the equation, consider the following example. Countrywide Financial, the largest mortgage lender in the country, reported their second quarter results last week. Not only had earnings and revenue declined 33% and 15% respectively from 2006, but they disclosed that default rates on their prime mortgages (loans made to borrowers with good credit) had more than doubled in the past year from 2.2% to 5.5%. The rising default rate in the sub-prime arena, which had climbed to over 20% from 13% a year ago, was already well known. But the news that default rates are now climbing among prime borrowers suggests the effects of the housing decline are not staying contained within the sub-prime realm, as many had hoped. In fact, the data suggest the problems in sub-prime are only the beginning of a spreading default 'contagion' within the mortgage market."
- "Countrywide's CEO, Angelo Mozilo, was quoted during the earnings conference call as saying housing prices are falling 'almost like never before, with the exception of the Great Depression.' With the Dow and S&P 500 hitting all time highs in the past month and everything appearing rosy, this is hardly the assessment we would expect from the leader of the biggest mortgage lender in the country. Last Tuesday when Countrywide released their earnings and the news about the increased prime default rate hit the wires, the Dow declined more than 200 points. The market then continued to sell off and recorded its largest weekly loss since 2003, with major indexes down between 4%-7%. There is no doubt a stark contrast between the problems in the housing market, which have never occurred at this scale and not been accompanied by a recession, and the strength of stocks prior to last week's sell off. However, the rally over the past 6 months may have been based partly on the assumption that problems in the sub-prime mortgage market would not spread, resulting in a housing downturn that would not weaken the broader economy. The news on prime mortgage defaults from Countrywide may have shattered that assumption..." (*Sitka Pacific Capital Management's Letter to Investors*, July 2007)

### The Fed won't ride to the rescue of upset markets, says St. Louis Federal Reserve Bank President Poole

- In a July 31<sup>st</sup> speech at the University of Missouri, St. Louis Federal Reserve Bank president William Poole said that the financial markets understand that the central bank will not respond quickly to a typical financial market upset such as the stock market's sell off during the week of July 23<sup>rd</sup>. In cases of market turmoil, the best policy for the Fed is to be cautious and try to understand the reasons for the volatility, said Poole. The Fed should only act "in due time" if evidence accumulates that the

market upsets threaten to cause price stability or low unemployment, or when financial-market developments threaten market processes themselves, he added. “If the market believes that the Fed is always primed to adjust policy, then market participants will spend more time trying to second guess the Fed than trying to understand what is happening to business and household behavior,” said Poole. (*MarketWatch*, Rex Nutting, 07/31/04)

- “There is no such thing as ‘In Due Time,’ writes Mike Shedlock in *Mish’s Global Economic Trend Analysis*. “The Fed should not attempt to bail out the market place, ever, period. It is the repeated intervention over the years (otherwise known as the ‘Greenspan Put’) that puts an unnatural bid on the market and promotes speculative behavior. The foreclosures and the housing related blowups we see now are a direct result of the last party. The Fed managed to bailout lenders in the wake of a dotcom bust by slashing rates to 1%. What’s next? I suggest the biggest party has already been thrown. There is no conceivable bailout coming that is going to create jobs and encourage reckless spending like housing did. It’s the end of the line.”
- “...What the Fed doesn’t know is that few will be willing to put on those party hats when they next attempt to pass them out. Banks won’t lend to poor credit risks and good credit risks will have no reason to borrow in a world awash in overcapacity. Cheap labor enhances the problem and will make it impossible for many consumers to pay back debts. The party is over but a massive hangover is just starting.” (*Mish’s Global Economic Trend Analysis*, Mike Shedlock, 07/31/07)

Additional action is needed on subprime mortgage practices, says Fed Governor Kroszner

- In prepared remarks before a conference on minority banking, Federal Reserve Board Governor Randall Kroszner said that while regulation and market forces have changed subprime lending practices in federally supervised banks, “additional action” is needed. “We are all keenly aware that ongoing issues in the subprime market require additional action to address the very real and significant impact that rising delinquencies and foreclosures are having on individuals and communities,” said Kroszner. “Many of the most-worrisome practices are found in credit extensions by non-depository lenders and brokers, many of which are outside the supervisory scope of the federal banking agencies.” The Fed “has taken the lead” with other federal agencies in a pilot project reviewing nondepository lenders with significant subprime operations, he added. (*Dow Jones Newswires*, Brian Blackstone and Damian Paletta, 08/01/07)
- During a July 25<sup>th</sup> panel discussion at the Urban Institute, Sandra Braunstein, the Federal Reserve’s director of consumer and community affairs outlined the type of mortgage practices that the central bank is likely to ban in the subprime market. Braunstein said, “We have decided that [previous] guidance and the market’s self-correction, all that is not sufficient to take care of the issues that we’ve seen in the market. So we are in the process now of writing rules, under [the Home Ownership and Equity Protection Act], for unfair and deceptive acts and practices. Writing rules

is a major undertaking and it's something we don't go into lightly because we are the Federal Reserve - we do believe in free markets. But we felt that the situation deserved some additional regulation at this point in time." Specifically, the Fed plans to address certain prepayment penalties, the need for escrow accounts, and loans that require very little information to verify income. "We are definitely looking at prepayment penalties," said Braunstein. "Many of these subprime loans do not include escrows in the payment, and then the borrowers get hit with a large insurance bill or a tax bill and don't realize they are going to have that," she added. With regard to stated income loans, Braunstein said, "we are looking at that practice to see if there is something we can do about that." More generally, the Fed is looking "at the general concept of 'ability to repay,' to see what can be done about that," she said.

- The Federal Reserve also plans to overhaul the types of disclosures lenders are required to provide borrowers and appears likely to address deceptive advertising of these products, said Braunstein. "For instance, you see an ad that says 'Get out of debt'," she said. "But what they are doing is advertising loans. It seems a little contradictory. They mean 'Get out of your debt and get into our debt.'"
- Former Fed Governor Edward Gramlich, who also participated on the panel, praised the central bank's decision to address these lending practices. "It is a real sea change for the Federal Reserve to be doing this, but it is a marvelous package," said Gramlich. (*Dow Jones International News*, Damian Paletta, 07/25/07)
- During an August 3<sup>rd</sup> hearing by the Senate Banking Committee, the three nominees to the Federal Reserve Bank pledged to give consumer protection issues a prominent focus in their work on the board, if confirmed. The Committee heard testimony from Kroszner, who currently serves on the Fed and whose term expires on January 31, 2008; Elizabeth Duke, a senior executive vice president and COO of Townebank nominated to a term expiring January 31, 2012; and Larry A. Klane, the president of Capital One Global Financial Services, nominated to a term expiring January 31, 2010. The three nominees pledged strong support for consumer protection, particularly as mortgage market conditions continue to deteriorate.
- During the hearing Kroszner found himself on the defensive, as he tried to explain the Federal Reserve's management of the subprime mortgage crisis. When asked if the crisis is contained, Kroszner responded, "We're trying to make sure to reduce the amount of pain and keep people in their homes," noting that the Fed has released mortgage guidance dating to 1999. "With respect to the macroeconomy, the real economy does not seem affected by this," he added. Kroszner and Committee Chairman Chris Dodd (D-CT) disagreed on the extent of the damage from the ailing subprime market. While some say the damage is contained, Dodd said, "all evidence is to the contrary." Kroszner acknowledged that while the damage has not been contained with respect to individuals, the nation's overall economic fundamentals have not yet been affected. When asked by Dodd if the Fed could have done more to avert problems in the mortgage market, Kroszner argued that much of what has happened involved institutions outside the Fed's regulatory or enforcement power.

- Duke and Klane told the panel that the Fed could have done a better job. “I think, sitting here with hindsight, we can say very clearly that if the Fed had acted somewhat earlier, we might have had to some extent a better outcome,” said Klane.
- Dodd told reporters after the hearing that he has not set a date for the committee to vote on the nominees. (*American Banker*, Steven Sloan, 08/03/07; *Bureau of National Affairs*, R. Christian Bruce, 08/03/07)

### Mortgage madness

- In an August 3<sup>rd</sup> commentary in the *Wall Street Journal*, Lawrence Lindsey, former chief economic advisor for President George W. Bush, wrote, “The current troubles in the housing and mortgage markets virtually guarantee that some restructuring of the home finance industry will occur... Already there are a number of legislative proposals on the table, with important implications for the ability of young men and women to purchase homes and existing homebuyers to sell.”
- “One leading proposal is a bill called S. 1299, offered by Sen. Chuck Schumer of New York. Mr. Schumer is a senior Democrat on the Banking Committee and the third ranking member of his party in the entire Senate, so any proposal he makes should be taken seriously. His proposal represents a regulatory and litigious approach to mortgage market reform.”
- “The bill requires that each mortgage originator act with ‘reasonable skill, care, and diligence’ and in ‘good faith and fair dealing.’ It also requires that all loans are ‘reasonably advantageous to the consumer.’ ...[T]hey are also vague and ill defined legal requirements that open up the mortgage industry to endless litigation in an environment where juries comprised of homeowners must decide between families in the process of losing their homes and mortgage brokers, investment bankers and other financial intermediaries.”
- “Mr. Schumer’s bill makes the ultimate lenders legally responsible for ‘acts, omissions, and representations made by the mortgage broker.’ ...[I]n the modern mortgage market, the mortgage broker is unlikely to be under the employ or control of the lender. The mortgage may be ‘owned’ by someone who has never seen the borrower or the originator. So, anyone supplying money to the mortgage market may well be taking on uncontrollable and unquantifiable risk in the process.”
- “The legislation also prescribes some regulatory tightening that will block access to mortgages for some key segments of the population, or at least make those mortgages more expensive and less appropriate. The bill would require that all borrowers qualify for a mortgage at the fully indexed long term rate that would apply when a variable rate mortgage converts to its long term level.”

- "...The home mortgage industry has certainly been guilty of excesses in the past few years. It may be that Sen. Schumer's approach of restrictive regulation and turning the trial bar loose on the industry is the only way to reverse these excesses. But the cost of his approach to every existing homeowner and would be homeowner is potentially staggering."
- "We already have an excess supply of homes on the market, and credit standards have been toughened. Reductions in demand already have pushed total home sales existing and new down 15% in the last year. The Schumer bill would depress demand still further."
- "...Legislative proposals like the Schumer bill, which has a credible chance of becoming law, will have their effect long before they are enacted. They are setting the backdrop for decisions in the capital market on whether or not to supply loans for mortgage financing..." (*Wall Street Journal*, Lawrence B. Lindsey, 08/05/07)

Rating agencies: A lagging indicator

- On *Minayville.com*, John Succo wrote, "I asked a large broker firm to send over its smartest math person on Collateralized Debt Obligations (CDO) structuring. I wanted to know what I am missing: why is the market so sanguine in the face of deteriorating collateral values in the mortgage market? One of my firm's theses has been that, as the mortgage market deteriorates, investors holding CDOs as an investment would realize losses and this would feed into other risky asset classes. Why aren't losses being seen when the market is clearly deteriorating?"
- "The team that came over was headed by a very smart gentleman. He was very good at math and very straightforward. Working for a broker I was prepared for some sugar coating. I didn't get any. The answer is simple and scary: conflict of interest."
- "He explained that due to the many layers of today's complicated credit products, the assumptions used to dictate the pricing and outcome of CDO are extremely subjective. The process is so subjective in fact that in order to make the market work an 'impartial' pricing mechanism must exist that the entire market relies upon. Enter the credit agencies. They use their models, which are not sensitive to current or expected economic activity, but are based almost entirely on past and current default rates and cash flow to price the risk. This of course raises two issues."
- "First, it is questionable whether 'recent' experienced losses over the last few years really represent the worst of the credit market (conservative). But even more importantly, it raises a huge conflict of interest: the credit agency's customers are the very issuers of the tranches they rate. The credit agencies, therefore, need to compete for business based at least in part on the ratings they are willing to give these tranches. As a result, they will only downgrade when forced to by experienced losses; not rising default rates, not a worsening economy, but only actual, experienced

losses. Even more disturbing, they will be most reluctant to downgrade the riskiest tranches (the equity tranches) since those continue to be owned by the issuers even after the deal is sold.”

- “So even though the mortgage market has deteriorated substantially, mark-to-market losses by those holding the CDO paper have generally not been realized simply because the rating agencies have not changed their ratings for all the above reasons. Accounting rules only require holders of the paper to mark prices according to the accepted model, not actual prices. For example, below is a chart of the actual BBB minus tranche of the mortgage-backed securities pool from November ‘06 to present. Actual prices where traders can really buy and sell is substantially lower than where investors are marking their positions.” ([www.minyanville.com](http://www.minyanville.com), John Succo, 05/17/07)
- On a July 24<sup>th</sup> interview on CNBC, McGraw-Hill Cos. chief executive Harold McGraw said that his company’s subsidiary, Standard & Poor’s, started noticing problems with mortgage-backed securities two years ago, despite the fact that S&P started cutting ratings this year. McGraw explained, that the ratings agency started downgrading securities this year because it needed hard data to make that decision. “We’re just starting to get that data,” he said. “We actually were a little bit early on this one.” (*Dow Jones*, 07/25/07)

#### SEC eases stance on FAS 140 for loan servicers

- The SEC has said that loan servicers can use their discretion to modify securitized mortgages that may be nearing foreclosure. In a July 24<sup>th</sup> letter to lawmakers, SEC chairman Chris Cox said that such modifications would not be a violation of FAS 140. “The commission’s professional staff believes that, consistent with general agreement in practice, such loan modifications would not result in a requirement for entities to account for those securitized assets on their balance sheets,” wrote Cox, in response to a June 15 letter from Representative Barney Frank (D-MA) and 10 other lawmakers about this issue. In response, Frank released a statement saying, “I congratulate Chairman Cox and the SEC staff for their prompt response to my letter on FAS 140. This is a constructive approach that will allow mortgage lenders to provide help at the earliest possible moments to people who might otherwise be trapped in bad loans or forced into foreclosure.” (*American Banker*, Joe Adler, 07/27/07; *House Financial Services Press Release*, 07/25/07)

#### Subprime mortgage woes contained, as adjustments to repricing risk are made

- On August 1<sup>st</sup>, Treasury Secretary Henry Paulson reiterated that the market impact of the U.S. subprime mortgage fallout is largely contained and the global economy remains strong. Paulson attributed the recent volatility in global stock and currency markets to a repricing of risk and the unwinding of excesses in U.S. mortgage and leveraged buyout financing. “There’s a wake-up call, and there’s an adjustment to

this repricing of risk, but I see the underlying economy as being very healthy,” he told reporters. (*Reuters*, 08/01/07)

### Spillover

- In a July 30<sup>th</sup> editorial, the *New York Times* wrote, “By the end of last week, any lingering hope that the housing downturn would be contained had vanished. As this week begins, signs of contagion seem to be everywhere.”
- “Unnerved by mounting losses in mortgage- related investments, investors have started to shun tens of billions of dollars in corporate debt offers as well — and seem likely to go on doing so for months to come. That would stanch the flow of easy money that has fueled the leveraged buyout boom, which would, in turn, expose the extent to which stocks have also come to depend on cheap credit. Stocks took a dive last week because debt-driven buyouts had long boosted the share prices of targeted companies. Stocks have also benefited directly from easy money because public companies have borrowed heavily to buy back their own stock, a ploy to drive up earnings per share.”
- “The fallout of housing-related turmoil is also likely to extend beyond financial markets. Among the deals that faltered last week were the \$7.4 billion buyout of the Chrysler Group and the \$5.6 billion purchase of the Allison Transmission unit of General Motors. Unless investor capital is forthcoming, it could become increasingly difficult for the automakers to avoid bankruptcy. At the same time, the housing slump has also driven down analysts’ monthly forecasts for car and truck sales to levels not seen in nearly a decade.”
- “The double whammy of weakness in housing and in autos has already hit the chemical maker DuPont. Last Tuesday, the company was the Dow’s biggest loser, in part because of lackluster demand for a pigment used in house paint and lower paint sales to automakers.”
- “There is also growing evidence that housing woes are curtailing consumer spending, the mainstay of the economy. As home prices fall, home equity borrowing is drying up as a source of disposable income, while wages and salaries are hardly enough to cover many households’ consumer and mortgage debt, along with the rising costs of food, energy and other essentials. As a result, consumption ebbs.”
- “Officials at the Federal Reserve and the Treasury Department cannot manage these problems on their own. If the Fed wanted to reduce interest rates, for example — which financial markets are expecting in the wake of last week’s plunge — it would need cooperation from other central banks to ensure that lower American rates would not dangerously weaken the dollar, provoking inflation.”
- “Similarly, assurances that the economy will be fine, such as the one delivered on Friday by Treasury Secretary Henry Paulson Jr., ring hollow in the absence of an

international reporting framework to monitor the positions taken by globally active hedge funds. Otherwise, there's little reason to believe that government officials have all of the information they need to assess the risks to the financial system and the economy. To date, however, Treasury officials have played down the need for more monitoring."

- "Throughout the Bush years, international cooperation has been neglected. Last week's gyrations are another signal that the need to work with others cannot be safely ignored." (*New York Times*, 07/30/07)

#### House Financial Services Committee passes the Affordable Housing Trust Fund bill

- By a vote of 45 to 23, the House Financial Services Committee passed H.R. 2895, the National Affordable Housing Trust Fund of 2007 (NAHTF). According to the Committee's press release, the passage of this bill "will be the largest expansion in federal housing programs in decades, with a goal of producing, rehabilitating and preserving 1.5 million housing units over the next 10 years." The NAHTF would be funded by revenue "excesses" from the FHA mortgage lending surpluses, as set forth under FHA reform legislation (H.R. 1852) and an affordable housing assessment [tax] on Fannie Mae and Freddie Mac, as set forth under GSE regulatory reform legislation (H.R. 1427). Chairman Barney Frank (D-MA) said the bills will authorize a trust fund of approximately \$1 billion each year over a decade. In a series of roll call votes, the panel rejected five GOP amendments, including proposals that would have required merging the proposed trust fund into HUD's HOME program; barred lawmakers from seeking appropriations for the trust fund beyond those from the FHA and Fannie Mae and Freddie Mac funds; required all people living in public housing to show valid identification; required funding for the trust to be offset; and exempted contractors from the Davis-Bacon Act, which requires workers be paid wages and benefits equal to prevailing local wages.
- Representative Maxine Waters (D-CA), Chairwoman of the Housing and Community Opportunity Subcommittee, said, "The National Affordable Housing Trust Fund is a critical step forward toward a historic moment in affordable housing. As the affordable housing crisis in this country continues to worsen after years of neglect, we must move quickly to get the federal government back in the affordable housing production business. House Financial Services Committee Chairman Barney Frank (D-MA) added, "The growing shortage of affordable housing is one of the most serious social and economic problems facing our country. Given our severely constrained fiscal realities, we are today doing the best we can to address this - creating a low income housing trust fund that will be paid for in ways that do not draw from federal tax revenues." (*House Financial Services Press Release*, 07/31/07; *CQToday*, Libby George, 07/31/07)
- In a July 30<sup>th</sup> editorial, the *Washington Post* wrote, "The [National Housing Trust] bill differs from other federal housing development programs in its targeting of

America's lowest-income families and in its funding sources. New housing units will be built with grants from a National Affordable Housing Trust Fund, and contributions to this trust fund won't come from taxpayers. Instead, the trust will be funded by government-chartered enterprises Fannie Mae and Freddie Mac and by new revenue expected to reach the Federal Housing Administration upon passage of a related House bill."

- "The Bush administration has expressed opposition to the bill essentially because it wants more discretion over the spending of the FHA's expected increase in revenue. It has also said that the contributions from Fannie Mae and Freddie Mac—1.2 basis points, or 12 thousandths of 1 percent, of their total mortgage portfolios—create an undue burden on these companies. But neither company is publicly objecting to this requirement. Besides, these companies receive significant benefits from Congress in exchange for maintaining a mission that is meant to help low- and middle-income families."
- "The trust itself appears to be well designed, with requirements for matching funds from states and localities receiving grants and for construction of mixed-income housing developments to prevent the further ghettoization of America's poor. The bill has bipartisan support; we urge its passage." (*Washington Post*, 07/30/07)

House of Representatives votes to strip expansion of Farm Credit System powers from the 2007 Farm Bill
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- The House of Representatives approved by voice vote an amendment to scrap provisions that would have let the Farm Credit System expand its lending authority and powers from the Farm Bill Extension Act of 2007 (H.R. 2419). The amendment, sponsored by House Financial Services Chairman Barney Frank (D-MA) and minority leader Spencer Bachus (R-AL) struck out provisions which would have allowed the FCS to offer mortgages in towns of up to 6,000 and to any business related to renewable energy.
- After the House passed the Farm Bill, Agriculture Committee Chairman Collin C. Peterson (D-MN) was asked by reporters why he had stepped off the floor to take a phone call when the Frank/Bachus amendment came up for consideration by the House and why he didn't defend the challenge or even question the vote with a request for a roll call vote. Peterson responded, "It was probably a mistake... because [Frank] and I didn't have a serious in-depth talk about this issue. When we finally did get engaged...there just wasn't time to talk through it." He added, there was a sense that "the bankers already had the votes" to pass the amendment. Peterson said that he and Frank have agreed to hold joint hearings between one of the Banking subcommittees and the Farm Credit Subcommittee, in Washington and probably around the country, looking into the adequacy of credit to farmers and farm-related businesses, particularly ethanol plants.

- “[The passage of the amendment] is just one hurdle - it’s a big hurdle,” said Nicole Freeman, a lobbyist for America’s Community Bankers. “The Farm Credit System is the only GSE that currently directly competes with community banks and they compete by leveraging a huge tax advantage. There is no shortage of credit in rural America.” Floyd Stoner, the lead lobbyist for the American Bankers Association, said, “Obviously, the issue is not over. The Senate has yet to act. But a strong vote in the House will send a strong message to the Senate.” The American Institute of CPAs (AICPA) also applauded the passage of the Frank/Bachus amendment, which stripped language which would have allowed the Farm Credit System to offer accounting, tax and other financial services to its customers in addition to the usual loans. (*National Journal’s CongressDaily*, Jerry, Hagstrom, 07/27/07; *High Plains/Mid-West Ag Journal*, Sara Wyant, 07/30/07; *WebCPA.com*, 08/03/07; *American Banker*, Stacy Kaper, 07/27/07)
- In *Farm Credit Watch*, Bert Ely wrote, “There is an old saying, well known to farmers, ranchers, and ag lenders, about unworkable ideas: ‘that dog won’t hunt.’ Last Thursday evening, the House of Representatives agreed, by rejecting the HORIZONS provisions the FCS managed to get the House Agriculture Committee to include in the 2007 Farm Bill. This rejection occurred when the House, by an overwhelming voice vote, adopted an amendment knocking the HORIZONS provisions out of the Farm Bill...”
- “House members understood that the HORIZONS provisions in the Farm Bill would only expand the FCS’s off-farm lending while weakening farmer control of the FCS. Specifically, these provisions would have broadened the range of businesses which the FCS could lend to (in the guise of funding renewable energy sources), raised from 2,500 to 6,000 the population of communities in which the FCS can make home mortgages, weakened farmer-borrower control of FCS associations, and watered down the already minimal stock-purchase requirement for FCS borrowers. CoBank appears to be the only FCS winner in the Farm Bill as CoBank borrowers which are not cooperatives can become voting stockholders in CoBank. It is not known why CoBank wanted this provision, but perhaps it paves the way for CoBank to privatize itself.”
- “The House wisely retained a provision in the Farm Bill not sought by the FCS, an increase in FCS premium payments to the FCS Insurance Corporation (FCSIC), the FCS equivalent of the FDIC. This increase, estimated at \$378 million over the next five years, is intended to restore the FCSIC to its statutory minimum balance. The FCSIC has fallen short of its minimum balance requirement in recent years due to extremely rapid FCS loan growth.”
- “Two reasons stand out for why the House rejected the HORIZONS provisions. First, the FCS has never made a convincing case that there is an insufficient supply of off-farm credit in rural America. As Chairman Frank pointed out in the floor debate on the amendment, the Financial Services Committee had not previously been told ‘about a problem of a lack of availability of credit from the banking system for

alternative energy.’ The House Ag Committee, which tends to give the FCS what it wants, never demanded that the FCS make that case. Apparently, the FCS and its trade association, the Farm Credit Council (FCC), believed that simply asserting that there are unmet off-farm credit needs would carry the day in Congress.”

- “Second, former FCA Chairman Mike Reyna issued a powerful statement supporting the Frank-Bachus amendment. He noted that Congress tried to focus ‘the public benefits of [the FCS] by limiting the types of loans that the [FCS] can make as well as where and to whom these loans can be made. Unsatisfied with the wisdom of Congress, the [FCS] has applied relentless pressure in recent years on its regulator, the FCA, to grant ever broader lending authority’ to it. ‘As the immediate past Chairman of the FCA, I have directly experienced the [FCS]’s pressure to get the FCA to give the [FCS] what it wants’ [emphasis in the original]. It cannot be said with certainty what impact Reyna’s statement had on the House, but it was not insignificant.” [In a subsequent media interview, Reyna said he was speaking out on this issue was because it had “boiled up to the top” and that he was not paid by any banking interest to lobby on this issue.]
- “The FCC seems to have been blindsided by the House’s rejection of HORIZONS, stating that its defeat ‘was brought to you by the vitriolic and disingenuous opposition promoted by an entirely self-interested banking lobby.’ That statement provided absolutely no introspective insight by the FCC or the FCS as to why HORIZONS lost in the House. Ironically, the FCC invited the ‘congressional banking committees’ to engage in the debate over the cost and availability of credit in rural America. According to Chairman Frank, the Financial Services and Agriculture Committees plan to hold joint hearings on the availability of credit to finance alternative energy projects.
- “The HORIZONS battle, though, is far from over as it now moves to the Senate, where the Senate Ag Committee has yet to write its version of the 2007 Farm Bill. The FCS has not given up on getting its HORIZONS agenda plugged into the Farm Bill, for as the FCC stated, ‘Congress can make great progress toward meeting the changing needs of U.S. agriculture and rural America, and [the FCS] will continue to work with lawmakers to address these needs.’ However, the House’s resounding rejection of HORIZONS weakens the ability of the FCS to get the Senate to give it what it wants. If Congress does not include any HORIZONS provisions in the Farm Bill, the FCS will have suffered a major defeat, a defeat that should raise serious questions within the FCS about its future as a GSE.”
- “The House rejection of HORIZONS also should raise questions within the FCA about its advocacy of HORIZONS, which has reinforced the perception that the FCA is much more a cheerleader for the FCS than a regulator who puts the public interest ahead of the FCS’s parochial, self-serving interests. If the FCA continues to stretch the law by granting broader lending powers to the FCS while looking the other way at FCS lending abuses, it could be setting itself up for hearings by the House Financial Services and Senate Banking Committee to examine the growth in the FCS’s non-

farm lending. Not only did the HORIZONS dog not hunt, but a continued lax regulatory regime at the FCA is another dog that may not hunt much longer.” (*Farm Credit Watch*, Bert Ely, July 2007; *American Banker*, Ben Jackson, 08/02/07)

- In a July 28<sup>th</sup> editorial, the *Washington Post* addressed the “modest –and dubious— achievements” of the 110<sup>th</sup> Congress. *WaPo* wrote, “...Speaker Nancy Pelosi (D-CA) and her House leadership also deserve discredit for forcing through an irresponsible farm bill that renews an indefensible subsidy system. The legislation does include some necessary funding increases, in nutrition and conservation programs, for example, and a (high) income cap for subsidy payments. But it otherwise fails to significantly improve on the bad farm payments system designed in 2002. This farm bill might help a few Democratic lawmakers from predominantly agricultural districts, but it defrauds nearly everyone else in the country. ...[T]his is no accomplishment, and President Bush would be justified in vetoing the House’s version.” (*Washington Post*, 07/28/07)

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

Senator Dodd pledges to make up for lost time in the Senate Banking Committee this fall

- Frustrated with the Senate Banking Committee Chairman Chris Dodd's absence from Capitol Hill, consumer advocates, low-income housing proponents and banking lobbyists are anxious for to see the panel advance important legislation to the Senate floor. Dodd, a candidate for the 2008 Democratic presidential nomination, said he is not taking the criticism lightly and promised swift action from Banking when Congress returns in September. "The staffers intend to work through the recess," Dodd said. After the August recess, Dodd said his committee was aiming to mark up GSE regulatory reform legislation, an overhaul of FHA, bills extending the Terrorism Risk Insurance Act, blocking retailers from setting up their own banks and overhauling the flood insurance program. The committee is likely to consider a bill to require oversight of brokers—"an issue ...ready for legislation," said Dodd. But, he does not endorse any broader reforms, such as the creation of national anti-lending standard which is being pursued by House Financial Services leaders.
- While various groups welcomed the Senator's pledge of more action, some suggested that Dodd spend more time in Washington if he's going to deliver. "We think it's really important to get moving," said Sheila Crowley, president of the National Low Income Housing Coalition. "There's a lot that needs to get done on housing issues.. It depends on how much time he's going to put into it." Housing advocates were disappointed when the Committee cancelled its plans to markup an FHA reform bill and legislation bill to renew the nation's primary homeless assistance law. Observers said Dodd pulled the bills after running into trouble with ranking minority member Richard C. Shelby (R-AL). Citing the quest for bipartisan consensus for his lack of action, Dodd said, "So you spend a few extra days to work out the details," he said, adding that waiting is "the price you pay when you're trying to achieve that unanimity." He added, "I was disappointed that that we didn't get the FHA bill done...We got about 98% there and that would help [subprime borrowers] as well."
- "The general impression people have gotten is Dodd has been an absentee landlord for this committee," said one senior Republican aide. Dodd's staff argue that oversight and backroom negotiations often lead to more changes than legislation, as demonstrated by the Chairman's push to get the Federal Reserve Board to begin more aggressive enforcement action on mortgage lending. Dodd's efforts led to Federal Reserve Chairman Ben S. Bernanke announcement on July 24<sup>th</sup> that the Fed would more vigorously enforce existing consumer protection laws and launch a new campaign to crack down on predatory lenders. "Dodd gets good marks on oversight," said Travis Plunkett, legislative director for the Consumer Federation of America. "But the time for oversight is over, and the time is coming to legislate." (*CQToday*, Libby George, Martin Kady, II, and Michael R. Crittenden, 08/01/07; *American Banker*, Stacy Kaper, 08/02/07)

- The *Rapid City Journal* [SD] reports that Senator Tim Johnson's (D-SD) "encouraging recovery" from a brain hemorrhage makes it like that he will return to the Senate sometime after the August recess. Johnson's return to the Senate Banking Committee will provide the Democrats a one-vote majority on the panel. (*CQ Today Midday Update*, 07/25/07)
- In a July 23<sup>rd</sup> letter to Senate Banking Committee leaders, seven [banking] trade organizations asked urged the lawmakers to speed up action on GSE regulatory reform legislation. "We strongly encourage the Committee to continue its efforts on this important issue by holding a hearing as soon as possible, and by working toward the goal of sending completed legislation to the President this year, wrote the groups. The letter, signed by America's Community Bankers, American Bankers Association, American Financial Services Association, Consumer Bankers Association, Consumer Mortgage Coalition, Housing Policy Council, The Financial Services Roundtable, and Mortgage Bankers Association, reflects the anxiety that many advocates of GSE reform have had about the lack of progress on GSE reform in both the 109<sup>th</sup> and 110<sup>th</sup> Congress. (*Bureau of National Affairs*, Richard Cowden, 07/25/07)

GSE regulatory reform legislation must be a priority –now more than ever
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- In a July 29<sup>th</sup> editorial in the *Las Vegas Review-Journal*, J.C. Watts, chairman of FM Policy Focus, wrote, "Congress returned to Washington after the 4th of July holiday with a list of items to address before the August break, and I was hoping Government Sponsored Enterprise reform would be one of them. Let me tell you why."
- "America is facing a mortgage crisis, in part because the two companies charged with supporting affordable home ownership fell down on the job. According to the Center for Responsible Lending, more than 2 million families have lost or are about to lose their homes and millions of others are falling behind in their mortgage payments because of certain types of high-risk subprime mortgages. Fannie Mae and Freddie Mac ...have been instrumental in enabling the sale of these high-risk loans to consumers. As Jesse Jackson testified in February before the Senate Banking Committee, 'Fannie Mae is purchasing securities that include the very loans that are stripping working-class people of their precious home equity. ...In purchasing such securities and profiting from predatory loans, Fannie Mae is violating its public mission.'"
- "In April, *BusinessWeek* reported that Freddie Mac owns \$124 billion in securities backed by loans to risky borrowers, while Fannie Mae owns \$58 billion. Of course, this may just be the tip of the iceberg, and the two GSEs may have invested many more billions in the subprime market. Moreover, a large portion of the loans in question are disproportionately for mortgage refinances rather than for the purchase of homes, and the primary reason for such investments is not to increase home

ownership or to help families stay in homes, but to generate higher profits for the companies.”

- “Now that the foreclosure rate is accelerating and millions of families are at risk of losing their homes, Fannie Mae and Freddie Mac have come forward with pledges to help distraught homeowners. Given his company’s deep involvement in promoting and benefiting from the subprime market, it is hard to believe that Fannie Mae’s chief executive officer told the House Financial Services Committee that his company ‘gave up significant market share to our competitors’ by staying away from the purchase of subprime loans. He claimed that ‘our disciplined approach to the subprime market has helped to protect our company, our lenders and our borrowers from the turmoil.’”
- “Judy Kennedy, president and chief executive officer of the National Association of Affordable Housing Lenders, recently told Congress, ‘The market has evolved by adapting to what the GSEs will buy.’ While the GSEs may not have directly purchased the riskiest subprime loans, they clearly have not shied away from making significant purchases of mortgage-backed securities containing pools of subprime loans. Additionally, Fannie Mae and Freddie Mac set the terms and conditions for the purchase of these securities.”
- “Several years ago, Fannie Mae testified before Congress that the company’s accounting system was second to none. It wasn’t long after those words were spoken that federal investigators and other investigators hired by the company uncovered massive accounting problems that showed the company had vastly overstated its earnings. The bottom line - Fannie Mae’s accounting systems were a disaster from which the company has yet to fully recover.”
- “While problems in the accounting system affect the company and its stockholders, problems in the purchase of high-risk subprime securities have much wider and potentially more adverse impacts, including families at risk of losing their homes and broader turmoil in financial markets.”
- “Despite belated guidance on nontraditional mortgage loans recently issued by the GSE’s current regulator, the Office of Federal Housing Enterprise Oversight, a much stronger regulator is clearly needed. Under current law, the federal government does not have all the tools it needs to oversee these giant companies that have such a profound connection to America’s housing and financial markets and that, because of lax regulation, have enabled the current subprime meltdown.”
- “Given the GSE’s less-than-judicious participation in the subprime mortgage market, on top of their accounting and other problems, many in Congress agree that the companies must be subject to much stronger regulation.”
- “In April, the House took the first step in reforming federal oversight with bipartisan passage of comprehensive legislation. The issue is now before the Senate Banking

Committee whose chairman, Sen. Chris Dodd, has said passing legislation is a top priority. Clearly it is, now more than ever. I'm hoping that the Senate will move on this legislation to protect the American home buyer and the American taxpayer."  
(*Las Vegas Review-Journal*, J.C. Watts, 07/29/07)

"In your heart of hearts, you have no use for the housing GSEs"

- Following his speech on the need for GSE regulatory reform at the Exchequer Club, OFHEO Director James B. Lockhart, III drew some usually sharp questions from his audience during a Q&A session. The *American Banker* reported, "Kenneth Guenther, the former head of the Independent Community Bankers of America, said 'odds ... favor no legislation' this year, and bluntly suggested Republicans who want a stricter bill simply want to put the [GSEs] out of business. How much of this is 'a philosophical difference, meaning' that 'in your heart of hearts, you have no use for the housing GSEs,' ...Guenther asked ...Lockhart. After taking issue with ...Guenther's premise that Congress won't act this year, ...Lockhart assured the crowd that he was a believer. 'I wouldn't have taken this job if I thought the housing GSEs were not useful,' he said."
- *American Banker* added, "The next zinger came from Joe Pigg, a lobbyist for the American Bankers Association. Since OFHEO has supported putting the federal home loan banks under the same new GSE regulator, ...Pigg asked whether ...Lockhart would also support adding the farm credit banks to the mix. 'That would be a big challenge. I think we'll take it one step at a time,' ...Lockhart said. The [FHLBs] are 'much more closely aligned with Fannie and Freddie than the Farmer Mac banks.' But ...Lockhart did not rule it out, noting such consolidation could result from Treasury Secretary Henry Paulson's recent efforts to streamline financial regulation. 'It's my view that over time that might make sense.'" (*American Banker*, Steven Sloan and Joe Adler, 07/23/07)

Bush administration notes

- The Federal Reserve Bank of Chicago has named Charles Evans as its new president, succeeding Michael Moskow, who is scheduled to retire September 1<sup>st</sup> following a 13-year tenure. Evans, a 16-year Bank veteran who serves as head of its research department, will become a voting member of the interest rate policy committee of the Federal Reserve in Washington starting in September. Analysts believe that Evans, 49, will share Moskow's moderately conservative approach to interest rate policy on the Fed's Open Market Committee. "You're handing the baton to the guy who was very much influencing Mike's thoughts as to where monetary policy should go," said Diane Swonk, chief economist at Mesirow Financial. "To say there would be a change would be to say that Mike wasn't listening to him in the first place, which is ridiculous," she added. Anil Kashyap, a professor of economics and finance at the University of Chicago's Graduate School of Business and a consultant to the Chicago

Fed, said, “Charley brings an expertise that will allow him to be a player in monetary policy discussions [in Washington]. For the financial community in Chicago that doesn’t know him, they should understand that means there will be somebody from this region talking to people around here who is going to have a voice at the table. Monetary policy is going to be even more the main line of the [Fed’s] business.” (*Chicago Tribune*, Bill Barnhart, 07/31/07)

- On August 2, the Senate Budget Committee approved the nomination of former Representative Jim Nussle (R-IA) to become director of the Office of Management and Budget by a vote of 22-1. Despite the strong support for Nussle in the two committees with jurisdiction over Nussle’s nomination, a Senate vote will not occur at least until September when the Senate returns from its August recess. Senator Bernie Sanders (I-VT), who cast the only vote against the nominee, has placed a hold on Nussle’s nomination, along with one other (unnamed) lawmaker. On August 1<sup>st</sup>, Senate Majority Leader Harry Reid (D-NV) told reporters that Nussle’s confirmation “is not a guarantee.” At the White House, Bush spokesman Tony Snow urged the Senate to vote on Nussle’s nomination before the August recess, noting that the administration’s current director of OMB, Rob Portman, leaves the agency on August 3. “If Congress is talking seriously about budget matters, and they say they want to, they’ve got to have somebody to talk to,” said Snow. (*Bureau of National Affairs*, Ralph Lindeman, 08/03/07)
- With two senators’ “holds” preventing Senate action Nussle’s nomination to be the White House budget director, the Iowan could be a top prospect for a recess appointment, say observers. Although Majority Leader Harry Reid “confidently” predicted that President Bush would not fill any top jobs without Senate confirmation because he has “an agreement with the president,” a White House spokeswoman said that Reid was wrong. “We do not have an agreement,” said Emily Lawrimore. “We don’t ever comment on the potential for recess appointments.” Jim Manley, a spokesman for Reid, said, “If ... we see that the president still plans to recess [appoint] controversial nominees, Senator Reid (D-NV) may need to keep the Senate in pro forma session during the August break.” To block the President’s ability to make recess appointments, Reid could opt for a recess of a few days rather than the traditional month-long adjournment resolution. Democratic senators, most likely from Maryland, Virginia or other nearby states, would be asked to take turns convening the Senate briefly every few days. Minority Whip Trent Lott (R-MS) said he expects Reid and Bush to reach an agreement on this issue. “I assume there are recess appointments that can and should be made,” Lott added. (*CQ Today*, Bart Jansen, 08/02/07)

### Reward program for “on-time” mortgage payments is gaining traction

- Fannie Mae is expanding the availability of its “Timely Payment Rewards,” which allows borrowers with less-than-perfect credit qualify for an automatic rate reduction of up to 1 percentage point, based on the payment history of the customer’s 30-year mortgage. The program is gaining popularity as regulators crack down on subprime lending, said Thomas Smith, Fannie Mae’s senior product manager. To qualify for the automatic rate reduction, payments need only be made during the month—not by any particular date, Smith added. Freddie Mac offers a similar reward program. (*MarketWatch*, Gail Liberman and Alan Lavine, 07/23/07)

### Senate passes lobby reform bill by vote of 83-14

- Despite objections that a major lobbying bill did not go far enough to clean up Congress, the Senate passed the measure on August 2 by a vote of 83-14. The House passed the reform bill in identical form on July 31, by a vote of 411-8. Given that the bill passed by veto-proof majorities in both chambers of Congress, observers believe that the President will sign the legislation. Critics argued that the final bill gave too much authority to Reid and Democratic committee chairmen to determine which provisions will be considered earmarks. But, Democrats argued that the new legislation will provide legal definitions of and requirements for earmarks, along with a practical method to ensure earmarks are disclosed publicly. Specifically, earmarks are to be identified by the relevant committee chairman or Senate majority leader in each piece of legislation at least 48 hours before the bill is introduced on the floor. Senator Diane Feinstein argued that only the committee chairman would know which provisions were specifically requested by a lawmaker, which is the key factor in defining an earmark.
- Under the bill, lawmakers and other candidates would be required to report to the FEC every six months on campaign money they receive that is bundled by lobbyists registered under the Lobbying Disclosure Act. Reporting would be required for all bundling in excess of \$15,000 during a six month period. Lobbyists’ bundled contributions to a “leadership” political action committee or national political party will also be required to be disclosed. Lobbyists themselves would have to disclose in their LDA reports direct contributions to campaigns, presidential libraries, presidential inaugural committees, and/or entities controlled by or named for members of Congress.
- Under the bill, the practice of secret Senate “holds” on legislation would no longer be permitted. Instead, senators objecting to any measure on the floor would have to make the objection public in the Congressional Record within six session days of lodging the hold with the Senate leadership. Also, legislative conference reports will be available for public review on the Internet 48 hours before the vote.

- The legislation also would increase the frequency of LDA reporting, require lobbyists and lobbying organizations to certify that they have not provided gifts or travel to lawmakers in violation of congressional ethics rules, and increase penalties for violation of lobbying laws. The new bill would prohibit lawmakers from attending national political convention parties held in their honor and paid for by lobbyists or their clients. The bill would outlaw the so-called K Street project by prohibiting lawmakers and staff from attempting to influence employment decisions “solely” in exchange for political access. Also, members of Congress who are convicted of bribery, perjury and similar crimes would lose their congressional retirement benefits. (*Bureau of National Affairs*, Kenneth P. Doyle, 0803/07)
- Senator Tom Coburn (R-OK) said, “This [ethics and lobbying reform] bill is a landmark betrayal, not a landmark accomplishment. Congress had a historic opportunity to expose secretive pork-barrel spending but instead created new ways to hide that spending.” Coburn continued, “The new bill makes disclosure voluntary rather than mandatory. The new bill fires the Senate’s current referee – the nonpartisan Senate parliamentarian – and makes one team’s quarterback – the Majority Leader – the referee. During floor debate, the Senate parliamentarian directly contradicted Senate leaders and bill supporters when he confirmed that the Senate parliamentarian would be powerless to certify whether earmark disclosure requirements had been met. The bill also turns the tables on reformers by allowing earmark abuses to be protected by 41 votes rather than 67 votes.” (*Senator Tom Coburn Press Release*, 08/03/07)

<p>“Politicians don’t amount to much, but ideas do,” says Representative Ron Paul</p>
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- According to the *New York Times Magazine*, Representative Ron Paul (R-TX), the 10-term congressman [and member of the House Financial Services Committee] who is running for president “is particularly popular among the young and the wired. Except for Barack Obama, he is the most-viewed candidate on YouTube. He is the most ‘friended’ Republican on MySpace.com. Paul understands that his chances of winning the presidency are infinitesimally slim. He is simultaneously planning his next Congressional race. But in Paul’s idea of politics, spreading a message has always been just as important as seizing office. ‘Politicians don’t amount to much,’ he says, ‘but ideas do.’ Although he is still in the low single digits in polls, he says he has raised \$2.4 million in the second quarter, enough to broaden the four-state campaign he originally planned into a national one.” (*New York Times Magazine*, Christopher Caldwell, 07/22/07; *Associated Press*, Liz Austin Peterson, 08/03/07)

## ***Fannie Mae***

### Fannie Mae's retained portfolio grew at an annualized 7.3% in June

- Fannie Mae's retained mortgage portfolio grew by an annualized 7.3% in June to \$722.5 billion, after jumping 13.8% in May. The company's retained portfolio has fallen 0.5%, after shrinking 0.4% in 2006 to \$724.4 billion. In June, Fannie Mae's book of business, which included assets it guarantees or owns, rose 13.7% in June to \$2.67 trillion. The company's MBS and other guarantees rose at a compound annual rate of 14.1% during the month. Fannie Mae's conventional single-family mortgage delinquencies rate remained unchanged at 0.62% in May, the latest data available. During the month of June, Fannie's effective duration gap was plus 1 month. [Comparative duration figures for prior periods are not available because of changes which were made to the methods used to calculate the June figure.] (*Fannie Mae Monthly Summary*, June 2007; Lynn Adler, 07/27/07)

### Fannie Mae changes its bylaws governing the election of directors

- In some cases, Fannie Mae's new board members will need a majority, not just a plurality, of the votes cast to win under a recently amended bylaw. "Previously, the bylaws provided that a plurality vote of the stockholders was sufficient to elect directors under all circumstances," said Fannie Mae in an SEC filing. "As amended, the bylaws provide that ... each director must be elected by a vote of the majority of the votes cast for that director nominee. ... In an election in which the number of nominees for director exceeds the number of directors to be elected, directors will continue to be elected by a plurality of the votes cast." (*Reuters*, 07/23/07)

### Some charges dismissed against Fannie Mae's audit committee directors in lawsuit brought by institutional investors

- A group of shareholders, who opted out of a class action lawsuit against the company, saw many of their claims against Fannie Mae dismissed by U.S. District Court Judge Richard J. Leon on July 31<sup>st</sup>. The group, led by Evergreen Equity Trust and Franklin Managed Trust, had accused the company, its executives, and board members of violating numerous state and federal securities laws in connection with Fannie Mae's massive accounting scandal. Leon dismissed all but a few of the group's claims against Fannie Mae and dismissed allegations of wrongdoings against the insurance company Radian Guaranty Inc. and the members of Fannie's audit committee. The judge let stand some securities charges against the company and its former executives, along with insider trading allegations against the company's former CFO J. Timothy Howard. Leon's ruling does not affect the class action lawsuit against Fannie Mae, which is still pending. With many of the group's unique claims

dismissed, the shareholders could now be folded into the pending class action lawsuit. (*Associated Press*, Matt Apuzzo, 07/31/07; *Washington Post*, David S. Hilzenrath, 08/01/07)

Fannie Mae sets record in financing multifamily rental housing in the first half of 2007

- During the first six months of 2007, Fannie Mae participated in the financing of \$27.2 billion in multifamily rental housing through its lender and housing partners. “Fannie Mae’s record performance in the first half of this year was fueled by strong deliveries by our DUS lenders and a substantial increase in our seniors business,” said Phil Weber, senior vice president of Fannie Mae’s Multifamily division. The company’s DUS lenders delivered \$14 billion of the company’s total investment in multifamily housing. Fannie Mae also committed \$620.5 million in equity investments which qualify for LIHTC. (*Multi-Housing News*, Keat Foong, 07/31/07)

Fannie Mae will disclose third party origination statistics for its MBS this fall

- Fannie Mae announced it will provide third-party-origination statistics at the pool level for substantially all of its single-family mortgage-backed securities beginning with September 2007 issuances. By year-end, the company said it will expand the at-issuance TPO statistics to include all single-family MBS and will provide the same information for on-going disclosure. (*PRNewswire-First Call*, 07/31/07)

Fannie Mae alumni news

- The National Community Reinvestment Coalition has appointed James H. Carr to serve as the organization’s chief operating officer. Previously, Carr served as senior vice president for financial innovation, planning and research at the Fannie Mae Foundation and vice president for housing research at Fannie Mae. (*Mortgage Servicing News*, August 2007)

## ***Freddie Mac***

Freddie Mac is “committed to serving lower-income families and areas”

- In a July 26<sup>th</sup> speech before the National Urban League’s 2007 Annual Conference, Freddie Mac CEO Richard Syron said, “I want to talk today about something very important to the well-being of African Americans. Homeownership is a key to the American Dream. ...[A]ll too often, African Americans have been locked out of the dream of owning a home. ...I’m convinced the two great domestic challenges America faces in this century are race and inequality. And housing is where they come together. As reflected in the Urban League’s own Equality Index™, the highest barriers facing African Americans today tend to be economic. ...There is too little affordable housing in this country. And the unaffordability of housing overall – while color-blind in theory – in practice affects African Americans even more severely than others. Why? Consider this terrible disparity. In 2004, “median net wealth for homeowners was \$184,560 compared with only \$4,050 for renters and just \$2,600 for minority renters.” The economic barriers at work here transcend incomes. African Americans typically buy their first home later in life than whites. That’s partly because, on average, they inherit less wealth. The result is that African Americans have fewer years to build up their wealth through homeownership. That means less to pass on to their kids. And that’s another vicious cycle. At Freddie Mac, we’re working hard to make homeownership more affordable for African Americans. This is a big part of our mission and it’s one we take very seriously. We are also committed to serving lower-income families and areas.”
- “Of course, the biggest instability in housing today is in the subprime market. Here too, African Americans are disproportionately affected. And here too, Freddie Mac is playing a vital role. The subprime situation is causing pain at several levels. Thousands of adjustable-rate loans are resetting upward every week from their teaser rates. Families are finding the new rates unaffordable and many face potential foreclosure. Some neighborhoods – Detroit comes to mind – are already struggling with multiple foreclosures. All this results in empty homes, destroyed neighborhoods, and plummeting home values. And it erodes the family structure that is critical to healthy and stable communities.”
- “During the boom, most subprime borrowers could always refinance if they had to, using the equity built up in their homes. It’s when the market weakened that problems really came to light. This is the kind of uncertain market situation for which Congress designed the GSEs to come in and provide some stability. And that is what we’re doing. In February, Freddie Mac became the first secondary market participant to announce we won’t buy subprime mortgages that pose an unacceptable risk of excessive payment shock and possible foreclosure. In April, we followed up by announcing we will buy up to \$20 billion in mortgages that will give lenders more and better choices to offer subprime borrowers. Our products, the first of which came

onto the market last month, will limit payment shock by offering reduced adjustable rate margins, longer fixed-rate terms, and longer reset periods.”

- “The problems in subprime remind us of a basic truth. We need to broaden our focus from simply increasing homeownership – which will always be hugely important – to the broader concept of sustainable homeownership. That’s why Freddie Mac has provided leadership in three key areas. First, we realized that homebuyer education is crucial, so we developed an award-winning credit education curriculum called CreditSmart®. This is an important tool to help people assess, achieve and sustain homeownership. Second, we have long worked with our customers to combat predatory lending. For example, we refuse to invest in mortgages that require mandatory arbitration, or carry excessive costs or fees. Finally, we have been a leader over the years in foreclosure prevention. We’ve shown that appropriately underwritten workouts with eligible borrowers can lower the odds of home loss through foreclosure by more than two-thirds.”
- “We live at a time when inequality is growing alarmingly – a fact now acknowledged across the political spectrum. As the Urban League has emphasized, it’s not enough to raise black incomes: we need to raise black net worth. That makes homeownership more important than ever. Why? Because homeownership remains the best and biggest doorway into the middle class. Other investments can make you rich, no doubt. But owning that first home is what can get your kids into better schools, lower your income taxes, and begin to build your net worth. This is more than an economic issue, or an issue of housing policy. It is an inescapable issue of fairness if we are fully to redeem America’s promise. And it’s a test for this nation that I’m convinced we must not and will not fail.”
- “...Despite the obstacles I’ve mentioned, I am very optimistic about African American homeownership. And I believe it’s extremely important for African Americans to keep their eye on the prize of owning and keeping a home.” *(Prepared Remarks by Freddie Mac CEO Richard Syron, 07/26/07)*

Freddie Mac’s mortgage portfolio grew 1.2% (annualized) in June
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- Freddie Mac’s retained mortgage holdings increased at an annualized 1.2% in June, bringing the company’s growth in its mortgage portfolio to 2.3% for the year. Freddie’s net agreements to purchase home loan assets more than doubled in June to \$40.4 billion, as yield premiums on guaranteed mortgage bonds widened amid increased volatility in interest rates. The company’s total mortgage portfolio, including assets it guarantees or owns, rose 13.5% in June to \$1.95 trillion. [During the first six months of 2007, the amount of securities outstanding guaranteed by Freddie, Fannie or GNMA surged by a record \$240 billion, compared to \$143 billion for the first six months of 2006, wrote Robert S. Baum, a Citigroup, Inc. analyst in a July report.] The company reported that its single-family delinquency rate for all loans was 49 basis points in May, unchanged from April. In June, Freddie Mac’s

duration gap averaged zero months, unchanged from May. (*Freddie Mac Monthly Volume Summary*, June 2007; *Bloomberg News*, 07/24/07)

Freddie Mac extends streamlined financing benefits to acquisition loans

- Freddie Mac now provides quicker, streamlined financing for borrowers seeking acquisition loans for properties financed by the company. “This new product will help our Seller/Servicers close acquisition loans more quickly and leverage Freddie Mac’s portfolio advantages,” said Mitchel W. Kiffe, Freddie Mac vice president of production and sales. “That should be very attractive to borrowers seeking acquisition financing.” Freddie Mac’s Streamlined Acquisition Financing extends the Freddie Mac Streamlined Refinance product to those who have a contract to purchase Freddie Mac-financed properties, but requires that full standard underwriting due diligence be performed on the new borrower and principals. According to Kiffe, the Streamlined Acquisition Financing (1) reduces documentation and lower costs, which could include no appraisal, engineering report or environmental report.; (2) reduces property financial documentation; (3) provides a quicker loan review and approval in roughly half the time required to originate most new loans; and (4) provides the new borrower a portfolio retention incentive in an amount equal to up to 1% percent of the unpaid principle balance on Freddie Mac’s current loan with the existing borrower and third-party report waivers. (*Multi-Family Housing News*, Keat Foong, 07/31/07)

Freddie Mac announces \$500,000 investment in Year-Up,  
an information technology program for low income youths

- Freddie Mac has announced a \$500,000 investment over a two year period in Year-Up, a one-year intensive information technology training program for low-income young adults. Year-Up has offices in Boston, MA, Providence, RI and Washington, DC. Of the 31 students who have graduated from Year-Up in 2007, 85% of the graduates have full time jobs with an average salary of \$35,000. Freddie Mac’s investment will allow the organization to add 72 students to the program. (*Freddie Mac Press Release*, 07/30/07)

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

FHLBs report second quarter results
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- During the second quarter of 2007, the combined earnings of the 12 FHLBs fell 2.8% to \$628 million from the level recorded a year earlier, according to the FHLBanks' Office of Finance. During the period, the Banks' consolidated assets grew by only 2.0% to \$1.02 trillion, while advances were flat at \$640 billion, over the previous four quarters. The Banks' investments rose 9.1% to \$295 billion during the second quarter, while member mortgage assets declined 3.7% to \$94 billion from year-end. On June 30<sup>th</sup>, the FHLBs combined total capital of \$45 billion, representing 4.41% of total assets.
- On June 30, 2007, more than 99% of the Banks' securities, commercial paper, and mortgage-backed securities were rated AAA/Aaa or the short term-equivalent. Subsequent to June 30<sup>th</sup>, none of these ratings have been adjusted lower. On March 31<sup>st</sup> (the latest data available), the FHLBs held \$75.5 billion in private-label securities on March 31<sup>st</sup>, which are generally rated AAA. The Office of Finance said, "Each [FHLB] believes it has limited exposure to subprime loans due to its business model, conservative policies pertaining to advances collateral and investments, and low credit risk due to the design of its mortgage loan programs." (*FHLBanks Office of Finance Press Release, 07/31/07*)
- The FHLB-San Francisco reported a 13% increase in net income to \$144 million for the second quarter, reflecting primarily growth in net interest income and differences in fair value adjustments for the period. During the first six months of 2007, the Bank's assets fell 4% to \$234.6 billion from \$244.6 billion on December 31, 2006, primarily due to a 7% decline in advances to \$171.0 billion from \$183.7 billion. During the period, 109 member institutions increased their advances while 102 members decreased their advances. In addition, the Bank's interest-bearing deposits in banks decreased 11% to \$8.3 billion from \$9.3 billion. The Bank's dividend rate for the second quarter is 5.14% (annualized) compared to 5.22% for the second quarter of 2006. At June 30, the Bank reported total capital of \$9.95 billion, representing 4.29% of total assets. (*FHLB-San Francisco Press Release, 07/26/07*)
- The FHLB-Cincinnati reported a 14% increase in net income for the second quarter of 2007 to \$71 million, for an average return on assets of 0.34% and average return on equity of 7.11%. On June 30, the Bank's assets totaled \$83.1 billion, an increase of 2.1% from year end, while its Mission Assets, comprised of Credit Services and Mortgage Purchase Program, grew 7.9% during the six month period. The Bank's total capital was \$3.7 billion, representing 4.77% of total assets. Over the six month period, the Bank's regulatory capital decreased 1.8% or 70.1 million from December 31, 2006, primarily due to repurchases of non-member excess capital stock. (*FHLB-Cincinnati Press Release, 07/27/07*)

#### FHLB-Chicago appoints William Dodds to serve as a director

- The FHLB-Chicago’s board of directors has appointed William R. Dodds, Jr. to fill a vacant elective director seat for a term which ends December 31, 2008. Dodds, who is EVP and treasurer of The Northern Trust Co., Chicago, will also serve on the board’s Risk Management and Personnel and Compensation Committees. (*National Mortgage News Online*, 08/03/07)

#### Finance Board approves public service directors to serve on the boards of the FHLB-Cincinnati and FHLB-Atlanta

- The Federal Housing Finance Board has appointed Cleveland attorney Leslie Dolin Dunn to serve as a public interest director on the FHLB-Cincinnati’s board of directors for the remainder of a three year term that began on January 1, 2006. Dunn is the former Senior Vice President of Business Development, Secretary and General Counsel of Cole National Corp., a NYSE-listed company. Previously, she was a partner in the business practice at the law firm of Jones Day in Cleveland, OH. (*PrimeNewswire*, 07/26/07)
- Finance Board also has appointed M. Joy Drass, M.D. and LaSalle D. “Donney” Leffall, III to serve as public interest directors on the FHLB-Atlanta’s board of directors for the remainder of three-year terms which end on December 31, 2008. Drass is president of Georgetown University Hospital, where she is responsible for the overall strategic and operational direction of the 609-licensed bed, not-for-profit, acute care teaching hospital as well as the hospital’s 300-plus faculty practice. Previously, she held several medical staff leadership positions at Washington Hospital Center including vice president for Professional Services and associate medical director. Leffall is president of LDL Financial, a financial advisory and investment firm in Washington, D.C. From 2002 to 2006, Leffall held several executive management positions including president, chief operating officer, and chief financial officer of The NHP Foundation, a national nonprofit owner of affordable rental housing and provider of resident services for low- and moderate-income families. Previously, he was an investment banker in the mergers and acquisitions divisions of Credit Suisse First Boston and UBS. (*PR Newswire*, 08/02/07)

#### FHLB-NY implements its disaster program again

- On July 18<sup>th</sup>, the steam-pipe explosion in Manhattan forced the FHLB-New York to implement its disaster plan—again. “It was a bit of a shock,” said Al DelliBovi, the bank’s president, who was at the Bank, located two blocks from the explosion site

near Grand Central Station, at the time of the explosion. The Bank sent nearly 50 essential personnel to a backup office in Jersey City, while other employees worked from home. Previously, the Bank implanted its contingency plans in the aftermath of the 9/11 attacks and the blackout of 2004. “We’ve had to do this more than we would prefer,” said DelliBovi. The Bank resumed its normal operations the following week, including the board’s announcement of a 7.5% (annualized) dividend for the second quarter. (*American Banker*, Steven Sloan and Joe Adler, 07/23/07)

## ***Ginnie Mae***

### Senate’s FHA reform bill would reduce the minimum downpayment requirement

- *National Mortgage News* reports that the Senate Banking Committee’s leadership has drafted an FHA reform bill which would cut the FHA downpayment requirement to 1.5% and raises FHA loan limits. The draft bills provides FHA the authority to vary insurance premiums based on loan or property type, loan-to-value ratios, and other factors and to charge premiums up to 3%, an increase from the current limit of 2.25%. The bill stops short of allowing the FHA insurance program to charge premiums based upon credit scores, as proposed by the Bush administration. The bill also prohibits seller-funded downpayment assistance on FHA loans. (*National Mortgage News*, 07/30/07)

### House provision in HUD appropriation bills would prohibit the agency from implementing a rule blocking seller-funded downpayment assistance for FHA loans

- According to *National Mortgage News Online*, “The House has passed a [HUD] appropriations bill after inserting language that prohibits the department from implementing a rule that would block seller-funded downpayment assistance on [FHA-] insured mortgages. Representatives Maxine Waters (D-CA) and Gary Miller (R-CA) offered the amendment, approved by voice vote, so that downpayment assistance providers like Nehemiah and AmeriDream can continue to assistance low-income families to become homeowners. ...HUD recently proposed to ban seller-funded downpayment assistance, maintaining that it leads to inflated appraisals and high foreclosure rates on FHA loans. The HUD appropriations bill also increases FHA multifamily loan limits in high-cost areas and suspends for one year a cap on the number of reverse mortgages the FHA can insure.” (*National Mortgage News Online*, 07/26/07)

## *Proposed New GSE*

Bill introduced which would create the National Infrastructure Bank to use the full faith and credit of the federal government to finance infrastructure projects
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- On August 2, Senator Chris Dodd (D-CT), chairman of the Senate Banking Committee, and Senator Chuck Hagel (R-NE), introduced the “National Infrastructure Bank Act of 2007” to finance the revitalization, repair, and replacement of aging and crumbling roads, bridges, transit systems, and water treatment facilities. Under the bill, the National Infrastructure Bank would be an independent entity of the federal government, modeled after the FDIC and governed by a five-member board of directors appointed by the President and approved by the Senate. The Bank would be responsible for evaluating and financing capacity-building infrastructure projects of substantial regional and national significance.
- Under the bill, infrastructure projects with a minimum federal investment of \$75 million would be submitted to the bank by a project sponsor, such as a state, locality, tribe, infrastructure agency, or a consortium of these entities. The bank would use a sliding scale method that incorporates an analysis of the infrastructure system or systems, project location, project cost, current and projected usage, non-federal revenue, regional or national significance, promotion of economic growth and community development, reduction in traffic congestion, environmental benefits, land use policies that promote smart growth, and mobility improvements to determine a level of federal investment. After the federal investment in the project is established, the bank would develop a financing package with “full faith and credit from the government,” which could include direct subsidies, direct loan guarantees, long-term tax-credit general purpose bonds, and long-term tax-credit infrastructure project specific bonds. The bill sets an initial ceiling of \$60 billion to issue bonds.
- The bill recognizes the findings of the Center for Strategic and International Studies in 2005 and 2006, which highlighted the urgent need for a national plan and investments to improve infrastructure needs across the nation. “The current infrastructure in our country is wholly inadequate to handle the demands of a 21st Century economy,” said Hagel. “We see our ports backed-up by expanding international trade, our rails overloaded by our increasing energy demands and our highways hopelessly clogged by traffic. We run the risk of being left behind by our international competitors if we do not begin to modernize our national infrastructure.” (*Bureau of National Affairs, Derrick Cain, 08/02/07*)

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

Farm Credit System reports 12.5% increase in net income for the second quarter

- The Farm Credit System reported a combined net income of \$1.001 billion for the second quarter, representing a 25% increase from the corresponding period in 2006. The System's earnings benefited from its higher level of earning assets caused by continued growth in the System's loan and investment portfolios. Gross loan volume increased \$6.1 billion to \$129.5 billion on June 30<sup>th</sup> versus the System's year-end loan volume. Non-accrual loans decreased \$64 billion from December 31<sup>st</sup> to \$469 million on June 30<sup>th</sup>. The System's nonperforming loans, consisting of non-accrual loans, accruing restructured loans, and accruing loans 90 days or more past due, were \$613 million on June 30<sup>th</sup>, representing 0.47% of the System's outstanding loans at June 30, 2007. At the end of the second quarter, the System reported total capital of \$25.949 billion, representing 15.1% of the System's assets of \$172.1 billion. (*BusinessWire*, 07/31/07; *Omaha World-Herald*, Steve Jordan, 08/01/07)

## ***Postal Service***

GAO concludes that the Postal Service's processing alignment efforts need better integration and explanation

- According to GAO, the USPS has four major initiatives in progress, including (1) the consolidation of mail processing to increase efficiency and use of existing automation by consolidating mail processing operations into facilities with excess capacity; (2) the development of essential infrastructure for a more efficient processing network; (3) the automation of sorting flat mail, such as large envelopes and catalogs to increase efficiency; and (4) the establishment of a flexible and efficient transportation network. "To strengthen planning and accountability for USPS' realignment efforts, the Postmaster General should ensure that the Facilities Plan, required by the Postal Accountability and Enhancement [initiative], explains the integration of realignment initiatives and establishes measurable targets to track USPS' progress in meeting realignment goals," recommended the GAO. "To help improve communication about realignment with stakeholders, the Postmaster General should modify USPS' communication strategy to improve the quality of public notices and engagement, and increase transparency in decision making."
- While the USPS has made varying progress in the development and implementation of its network realignment initiatives, the GAO argues that it is not apparent if these initiatives will meet its network realignment goals. "Our objectives for this report

were to describe the initiatives the US Postal Service has undertaken since 2002 aimed at realigning its processing network and the status of these initiatives, evaluate how the planning, impacts, and results to date of these initiatives align with the goals of USPS' processing network realignment and evaluate USPS' communications practices with stakeholders in making network realignment decisions, and the challenges and leading practices associated with public engagement," wrote the GAO. (*DMNews.com*, Giselle Abramovich, 07/30/07)

#### Postal rate increases are starting to pinch small publishers

- *National Catholic Reporter* wrote, "Every year we plan for increases in operating expenses. Using past trends and reasonable guesses, we are usually able to produce a budget that makes sense. Recently, we've had to make major adjustments to our planning. Like many small publications, we've been notified of a 23 percent postal increase for the upcoming year. This is approximately \$95,000 more than last year's postage costs, which reduces the amount of money available for covering our expenses by \$2.37 per subscriber. It will now cost 6 cents more each week per copy mailed to your home. From the \$43.95 we receive for each subscription, \$12.94 will go directly to the U.S. Postal Service. This does not include printing or any other costs for producing the NCR newsweekly. Reasonable increases are to be expected, but something else is happening here." (*National Catholic Reporter*, Sr. Rita Larivee, SSA, 08/03/07)
- The weekly political magazine, *The Nation* (circulation 186,000) has recently begun soliciting its community of readers to help pay for its looming \$500,000 postal bill. That bill represents an 18% increase in postal rates that took effect in July. *The Nation's* more dramatic rate increase is indicative of what smaller, independent magazines are experiencing, said Teresa Stack, the publication's president. (*Circulation Management*, 07/25/07)

#### Two wrongs don't make a right

- In an analysis of the government-imposed advantages and burdens of the Postal Service's competitive products, the Institute for Research on the Economics of Taxation wrote, "...[O]ne of the most important thoughts to keep in mind is that the Postal Service's special advantages and disadvantages in competitive markets both cause problems. If one looks only at the Postal Service's bottom line, the advantages, which lower the government enterprise's costs, and the disadvantages, which raise its costs, have partially offsetting effects. It might almost seem as though the two sides partially counterbalance each other, as though two wrongs make a right."
- "From the perspective of the broader economy, however, the advantages and disadvantages rarely cancel out. In general, the advantages create distortions and the disadvantages cause additional distortions. In other words, the advantages do not

correct the inefficiencies and higher costs caused by the burdens. Instead, the advantages generally take the form of transfers from others in the economy and act as indirect government subsidies that cover up some of the financial problems due to the Service's burdens."

- "For instance, many statutory requirements increase the Service's labor costs. They range from the highly specialized, such as being forced to comply with the Davis-Bacon Act on construction projects, to the very broad, such as the requirement that the Service provide employees with several expensive fringe benefits. These statutory obligations apply to all Postal Service production; they do not distinguish between market-dominant and competitive product operations."
- "The higher labor costs hurt the government enterprise's bottom line and reduce its ability to offer attractive combinations of price and service to customers. On the other hand, the Service saves money because of an assortment of exemptions and privileges that run the gamut from the small, such as not being bound by local zoning requirements on its construction projects, to the large, such as paying zero property tax on its huge property portfolio. These advantages apply to all the Service's activities, including its competitive product operations. In terms of the Service's finances, these burdens and benefits partially net out, but they are not offsets in other respects. The Service pays more than needed for labor, which is wasteful; it infringes on the authority of local governments to set zoning rules, which may result in inferior land use decisions; it weakens local tax bases, which hurts local government finances; and because of the combination of indirect government subsidies and higher labor costs, it may sometimes capture business that could be done more economically in the private sector."
- The proposition articulated here does not apply only to the U.S. Postal Service. In a wide variety of circumstances, the distortions generated by special government burdens are compounded, not corrected, by special government favors. For example, at Amtrak, the government's inter-city passenger rail line, most long routes make terrible economic sense but are there for political reasons. The billions of dollars of federal subsidies that Amtrak has received and continues to obtain have kept the government enterprise in operation (barely) but are a burden on taxpayers and do not transform Amtrak's many wasteful and inefficient routes into efficient ones. As another example, consider European farmers, who must comply with many government requirements that increase their production costs but also receive generous agricultural subsidies. If the requirements do not pass a cost-benefit test they should not be there, regardless of the subsidies. And for efficiency in production in domestic and international markets, the subsidies should not be there, period. In the postal arena, the European Commission implicitly recognizes this principle when it objects to the blanket VAT exemption that the UK and German governments grant to their former monopoly posts. Although Royal Mail and Deutsche Post do have various government imposed burdens, European Union Tax and Customs Commissioner Laszlo Kovacs correctly requests that the VAT be "applied in a way that [minimizes] distortions of competition between former monopolies and market

entrants to ensure that all operators enjoy the freedom to provide postal services across Europe.” (*IRET Policy Bulletin No. 91*, Institute for Research on the Economics of Taxation, 07/30/07)

Back to the drawing board with postal reform?
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- In *DMNews.com*, Cary H. Baer, past chairman of the Association for Postal Commerce, wrote, “...Without significant productivity increases, staff reductions, mail volume growth or reduced service levels, the Postal Service will be unable to operate within the parameters established by the [2006 postal] reform legislation. This all was obvious at the time reform legislation was being pushed through Congress. It was obvious to supporters of the legislation both in industry and Congress. They just chose to ignore the obvious.”
- “Well, here we are in 2007. While there may be service glitches here and there, ...the USPS functions pretty well. It’s just that its business model will not continue to work without significant change, or significant price increases. Something has got to give or change. If not, the Postal Service will wind up the same basic basketcase as the so-called Detroit big three automakers.”
- “And while the recently concluded contract with the city carriers provides some labor peace, it resolved no real issues. The agreement provides wage increases of more than the CPI, abolishes the use of low-wage temps or casuals and replaces them with bargaining-unit ‘transitional employees,’ establishes a six-month moratorium on contracting out delivery, and establishes a union and management task force to develop an “evolutionary approach” to contracting out. The only financial benefit to the Postal Service is an increase in the share of healthcare premiums paid by city carriers by 5 percent over the five-year life of the contract.”
- “Frankly, I don’t understand why the Postal Service agreed to these terms. It’s hard to believe they would have done worse through arbitration. And it’s pretty obvious that the rural carriers will wind up with at least as a good a deal with the arbitrator or through a negotiated settlement. In any case, unless there is a set of mirrors I’m missing, this settlement guarantees that the Postal Service will be unable to operate under the CPI. My guess is that in about three or four years Congress will need to get back into the act.” (*DMNews.com*, Cary H. Baer, 08/03/07)

## TVA

### House passes energy bill which excludes TVA from the renewable energy requirement

- On August 4<sup>th</sup>, House of Representatives passed an energy bill, requiring most utilities to generate at least 15% of their electricity from renewable energy sources by the year 2020. To gain the 220-190 vote majority, the bill's sponsors had to agree to exclude from the requirement public power agencies, including the TVA and its distributors. The Tennessee Valley Public Power Association, the trade group representing the municipalities and co-ops that distribute TVA-generated electricity, lobbied against the House version of the renewable portfolio standard. TVPPA Communications Director Phillip Burgess said its members fear they could still be included in final legislation from a conference committee between the House and Senate. "We are not opposed to renewable energy, but there isn't as much capacity for wind or solar in the Southeast and our distributors have to rely upon TVA which doesn't generate much renewable energy," he said. (*Chattanooga Times Free Press*, Dave Flessner, 08/04/07)

### TVA's board of directors votes unanimously to complete construction of a second reactor at Watts Bar Nuclear Plant

- TVA's board of directors voted unanimously to begin a five-year plan to finish a second nuclear reactor at the Watts Bar Nuclear Plant, about 50 miles south of Knoxville, TN on the Tennessee River. In 1985, the plant's second reactor was mothballed in mid-construction when TVA shut down its entire nuclear program over safety concerns. After reviewing a \$20 million internal study on the feasibility of finishing the reactor, on August 1<sup>st</sup> the TVA board approved a plan to complete construction of the reactor for an estimated cost of \$2.5 billion. Upon its completion by 2013, the nuclear unit would provide 1,180 megawatts of electricity—or enough power to serve about 650,000 of the utility's customers. TVA board chairman Bill Sansom said future forecasts for power requirements in the utility's coverage area could require more nuclear projects, as well as increased conservation. "This isn't 'either/or' as it comes to conservation," said Sansom. "We need this and all the conservation you can bring on." TVA has a construction permit for the Watts Bar Unit 2 from the Nuclear Regulatory Commission that will have to be renewed in 2010. After work is completed on the unit, TVA will have to secure an operating license for the reactor.
- Anti-nuclear advocates and environmentalists, who oppose the plan, have asked for a year's delay in the construction of the second reactor to allow time for further study. "There are a lot of people that will be in this fight," said Ann Harris, a former TVA whistleblower at Watts Bar and Sierra Club activist. "The anti-nuclears. The safety advocates. The people who work on conservation." During TVA's evaluation of

completion of Watts Bar Unit 1, activists' opposition to the project was fierce with protestors blocking plant entrances and demonstrators being physically removed from TVA board meetings. Whistleblower complaints forced TVA to replace large amounts of cabling and piping, which delayed completion of the reactor and drove the cost to \$7 billion. "This time people will have a lot more knowledge," said Harris. "There are lots of opportunities to ask for public hearings, [to seek] injunctions and media that didn't exist before." (*Associated Press*, Duncan Mansfield, 08/01/07; *PR Newswire*, 08/01/07)

#### TVA names a new chief financial officer

- TVA has named Southern Co. executive Kimberly Scheibe Greene to serve the utility's CFO and executive vice president of financial services, responsible for all TVA financial functions, including treasury, accounting, risk management, financial planning and investor relations. Greene, 40, is SVP of finance and treasurer at Atlanta-based Southern Co., one of the country's largest investor-owned utilities. In 1991, she joined Southern as a mechanical engineer. On September 4, she will assume the position from interim CFO John Hoskins, who will continue as senior vice president of finance. Greene, who will receive \$500,000 annually, will report to TVA President and CEO Tom Kilgore. She holds a bachelor's degree in engineering science and mechanics from the University of Tennessee, a master's in biomedical engineering from the University of Alabama-Birmingham and an MBA from Samford University in Birmingham, AL. "With Kim's appointment, we are able to bring to TVA a rare combination of business skills and experience," said Kilgore. "Her financial expertise is grounded in power system operations and that gives her an outstanding perspective on the business challenges TVA is facing." (*Associated Press*, 08/03/07)

#### TVA distributors organize a non-profit to invest in power facilities

- The majority of TVA's municipal utilities and power cooperatives have formed Seven States Power Corp, a nonprofit corporation which plans to issue bonds backed by long-term power purchase contracts from TVA distributors to finance the purchase or building of power plants. The new venture is designed to help TVA expand its power generation without requiring the utility or its distributors to borrow more money. Jack Simmons, the president of the Tennessee Valley Public Power Association, will serve as the CEO of Seven States and Harold DePriest, CEO of Chattanooga distributor EPB, will serve as the group's vice president. According to management, ownership of Seven States will be determined by the amount of power they agree to buy from the venture. Collectively, the 133 TVA distributors have put \$1,000,000 (approximately \$7,500 each) while EPB has contributed \$22,000 toward the venture.

- “TVA for the past 74 years has been the sole source of power in the Valley and all of the generation as a result has been owned by the federal government,” said Simmons. “What we’re trying to do now is to put this equity shift in place to get the ownership of those assets out of the hands of the U.S. Treasury and puts it in the hands of the stakeholders in the Valley.” DePriest added that the venture will allow municipalities and co-ops to gain equity in the generating assets they help pay for through their purchase contracts. “This approach will allow the people of the Valley to own some of the assets they are going to pay for anyway with their power bills,” said DePriest. Under a pilot program, Seven Seas proposes pay for most of the expense of buying or upgrading one or more of the gas-fired combustion turbines that TVA is adding this year. TVA would retain a minority interest in the plant and operate the facility as part of its power generation mix. Simmons said that Seven States may issue \$300 million to \$600 million in bonds in late 2007 or early 2008 to finance its share of another power plant. The distributors also would commit to purchase power from the new plant for 20 to 30 years to repay the bonds. Through this structure, the distributors will be able to buy rather than rent the power generation facilities. “You may pay about the same for years, but when you buy a home and the mortgage is paid off you have increased your overall worth,” he said. By creating a company jointly owned by TVA distributors, the municipalities and co-ops that participate can minimize their own risk and expense, said DePriest. “When we learn how to make this work through the pilot program, I think there will be an appetite among distributors to do even bigger projects,” he added. (*Chattanooga Times Free Press*, Dave Flessner, 07/28/07)

The Nuclear Energy Institute recognizes TVA’s “vision and leadership”  
in their nuclear fuel inspection program

- The Nuclear Energy Institute has presented TVA with a special recognition award for the “vision and leadership demonstrated” in its nuclear fuel assembly inspection program. “The inspection program has contributed to improvements in fuel reliability in our reactors,” said TVA Chief Nuclear Officer Bill Campbell. “This is a good example of our employees using their creativity and teamwork to improve the performance of TVA’s nuclear power plants with better processes and programs. This application was also recognized as one of TVA’s strengths by the Institute of Nuclear Power Operations in its most recent review of nuclear reliability at TVA.” (*US Fed News*, 07/25/07)

Siren tests fail at TVA nuclear facility near Chattanooga, TN

- According to TVA officials, the majority of emergency sirens failed to operate during a routine test at a nuclear station near Chattanooga on August 1<sup>st</sup>. During the drill, 77 of 108 sirens never sounded in the ten-mile radius surrounding Sequoyah Nuclear Station in Soddy-Daisy. Since each of the 77 non-functioning sirens were found to be operating as designed, technicians concluded that the failure was caused by the

electronic communications systems that communicate with the sirens. (*Associated Press*, 08/02/07)

TVA will likely raise its rates because of the summer drought

- The lack of rainfall this summer has reduced TVA's ability to generate hydroelectric power, its cheapest form of power generation. "We're only able to generate a small amount of power, about half of what we ordinarily get," said TVA spokesman Gil Francis. As a result, TVA has had to generate power from more expensive sources. "Coal, natural gas, purchasing power, and the price of fuel goes up, there's a fuel adjustment to cover increased cost of fuel," said Francis. "Consumers will see that reflected in their future bills." On September 30<sup>th</sup>, TVA will determine if it will be necessary to add a fuel adjustment charge to distributors' bills. (*WVLT-Channel 8 Knoxville*, Allison Hunt, 07/27/07)

Former TVA manager pleads guilty  
for failing to disclose payments from agency contractors

- John L. Symonds, a former TVA manager of the Browns Ferry Nuclear Plant, has pleaded guilty in federal court to failing to disclose money he received from contractors at an Alabama facility. Symonds, who was the plant's manager from late 2000 through 2002, faces up to five years in prison and a \$250,000 fine for failing to disclose \$54,000 he received on his annual financial disclosure forms. He and his former wife also owned a company that did business with Holtec International, a company hired by TVA to design and build a dry cask storage system for spent nuclear fuel rods at the facility. U.S. Attorney Russ Dedrick said that the couple received two checks for personal expenses from a subcontractor, but the money actually came from Holtec. Symonds "knowingly and willfully failed to disclose" that income, as is required of executives at Knoxville-based TVA, the nation's largest public utility, said Dedrick. Symonds will be sentenced on November 29th. (*Associated Press*, 08/03/07)

Happy to be back with TVA

- More than 10 years ago, Bristol Virginia Utilities (BVU) left TVA, when an Ohio firm offered them significantly lower rates. However, when the contract ran out, local customers were hit with a 40% rate hike from their current provider, Appalachian Power. "We left TVA because we were offered a number that couldn't be refused," said BVU chairman Farnham Jarrad. "But I think we have a much better comfort level with TVA. I'm happy to be back." Starting January 1<sup>st</sup>, BVU will again purchase its power from TVA. (*Tricities.com*, David McGee, 07/24/07)

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