

The **GSE** REPORT™

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Contents of GSE Report™

Major Events

- [Subprime shockwaves: \(p. 3\)](#)
 - [Failure of Bear Stearns' hedge funds triggers backlash on Wall Street \(p. 3\)](#)
 - [The absence of fear--and its fallout \(p. 4\)](#)
 - [Federal Reserve Chairman Bernanke tells Congress that the Fed will ban some mortgage practices \(p. 8\)](#)
 - [Federal Reserve Bank Governor Poole advocates correcting fundamental problems in the subprime market rather than its symptoms \(p. 9\)](#)
 - [Fannie and Freddie are playing a “more risky role” in the subprime market, says OFHEO Director Lockhart \(p. 13\)](#)
 - [Fannie and Freddie “drop the bomb” \(p. 14\)](#)
 - [State regulators adopt subprime mortgage guidance \(p. 16\)](#)
 - [House Republicans introduce bill to create a national licensing and registry system for mortgage brokers \(p. 16\)](#)
 - [Other notes of interest \(p. 16\)](#)

Fannie Mae and Freddie Mac

- [Chairman Dodd says his panel’s pace reflects bipartisan strategy \(p. 18\)](#)
- [Federal Reserve Chairman Bernanke and OFHEO Director Lockhart urge the Senate to address the size and public purpose of the GSEs’ mortgage portfolios \(p. 19\)](#)
- [House Republican lawmakers question the fairness of the Housing Trust Fund \(p. 20\)](#)
- [Tools of the lobbying trade: “patience and a bit of scandal” \(p. 21\)](#)
- [Public comments submitted to OFHEO on agency’s guidance on the calculation of conforming loan limits \(p. 24\)](#)
- [HUD announces creation of the Fair Housing Lending Division \(p. 26\)](#)
- [HUD studies conclude Fannie and Freddie have made “recent improvements” in the purchase of home mortgages made to lower-income families \(p. 26\)](#)
- [Bush administration notes \(p. 27\)](#)
- [Rising foreclosures turn up the heat on Mers \(p. 27\)](#)

Fannie Mae

- [Fannie Mae increases its third quarter dividend 25% \(p. 29\)](#)
- [Fannie Mae alumni news \(p. 29\)](#)

Freddie Mac

- [Freddie Mac CEO Syron waived \\$200,000 of his guaranteed pay at the request of company's compensation committee \(p. 30\)](#)
- [Freddie Mac prices \\$500 million of preferred stock \(p. 30\)](#)
- [Freddie Mac forms new business relationship with Greystone Residential Funding \(p. 30\)](#)

Federal Home Loan Banks

- [FHLBs “shut out” credit unions from their affordable housing grants \(p. 31\)](#)
- [Thomas Goldstein leaves the FHLB-Chicago’s board of directors \(p. 31\)](#)
- [FHLB-Indianapolis announces its second quarter dividend \(p. 31\)](#)

Ginnie Mae

- [HUD extends the comment period on its proposed rule to prohibit seller-funded down payment “gifts” \(p. 32\)](#)
- [NAHB urges Congress to pass FHA reform legislation \(p. 32\)](#)
- [Reverse mortgage “revolution” \(p. 33\)](#)

Farm Credit System / Farmer Mac

- [Chairman Frank asserts the Financial Services Committee’s joint jurisdiction on the 2007 farm bill \(p. 34\)](#)
- [FCA approves merger of two North Dakota institutions to “better serve” segments of agribusiness “such as ethanol operations” \(p. 34\)](#)
- [FCS board adopts proposed rule providing the FCS a 90-day window to distribute annual reports to shareholders \(p. 36\)](#)
- [Non-traditional farmers are a driving force in FCS \(p. 37\)](#)

Postal Service

- [USPS and NALC reach tentative agreement on a five-year contract which includes new limits on contracting out city letter carrier work \(p. 38\)](#)
- [Taxpayer and consumer advocates are seeking end to USPS monopoly on mailboxes \(p. 38\)](#)
- [Congress should avoid micromanaging the USPS \(p. 39\)](#)
- [Higher postal rates will likely result in declining mail volumes ...and the downward spiral continues \(p. 39\)](#)
- [Day of reckoning coming soon for the USPS \(p. 39\)](#)
- [The EU Parliament wants to end national mail delivery monopolies by 2011 \(p. 40\)](#)

TVA

- [President Bush nominates a Georgia banker and two Tennessee incumbents to serve on TVA’s board of directors \(p. 40\)](#)
- [Southern utilities continue to resist renewable energy alternatives \(p. 41\)](#)
- [Fitch assigns ‘AAA’ rating to TVA bonds \(p. 41\)](#)
- [Memphis Power Light and Water blames TVA’s higher utility rates as the primary cause for the utility’s 113% increase in net write-offs \(p. 42\)](#)

Major Events

Subprime shockwaves:

Failure of Bear Stearns' hedge funds triggers backlash on Wall Street

The absence of fear—and its fallout

Federal Reserve Chairman Bernanke tells Congress that
the Fed will ban some mortgage practices

Federal Reserve Governor Poole advocates correcting the fundamental problems
in the subprime market rather than its symptoms

Fannie and Freddie are playing a “more risky role” in the subprime market,
says OFHEO Director Lockhart

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for mortgage brokers

Other notes of interest

Failure of Bear Stearns' hedge funds triggers backlash on Wall Street

- On July 17th, Bear Stearns told investors in its two failed hedge funds [High-Grade Structured Credit Strategies Fund and High-Grade Structured Strategies Enhanced Leveraged Fund], that they'll get little if any money back after “unprecedented declines” in the value of securities used to bet on subprime mortgages. On July 19th, Federal Reserve Chairman Ben S. Bernanke said that there will be “significant financial losses” of “between \$50 billion and \$100 billion” associated with subprime mortgages. “The worst is not over in the subprime mortgage market,” wrote Chris Flanagan, the head of structured finance strategy at JPMorgan Chase & Co., in a July 19th report. Chriss Street, the treasurer of Orange County, California, fears that the market for collateralized debt obligations will collapse if funds try to dump holdings whose value has fallen. “At the end of this quarter that just passed, people are going to start printing their numbers out,” said Street. “Folks are going to get their mutual fund statements, they're going to get their investment statements, and then those nice folks in Armani suits, the CEOs that run these organizations, are going to price this product, and then I think you're going to see basically a collapse. I think you've only

seen the first part of this challenge. The next one's going to be a doozy.'" (*CNN Money*, 07/19/07; *Bloomberg News*, Andreas Hippin, 07/21/07)

- Falling house values, along with loan resets triggering sharply escalating house payments, have triggered the collapse of the subprime market with little hope of relief over the next 18 months. Freddie Mac CEO warned that the subprime mortgage crisis may likely deepen before housing prices improve in 2008. "Unfortunately, I don't think we've hit bottom," said Syron in an interview with *Bloomberg News*. "I think things are going to get worse. ...It's a very, very serious issue." Syron warnings echo those of Moody's Investor Service, Standard & Poor's, and Fitch rating agencies, which have told investors that the housing slump is broadening. As a result, Moody's cut ratings on \$5 billion of subprime mortgage bonds, while S&P cut its ratings on \$6.4 billion of these bonds. On July 12th, Fitch analyst Robert Curran said he anticipates that a decline in housing will be "as intense, if not more severe" than it was earlier this year. In a July 10th report, S&P wrote, "We do not foresee the poor performance abating." (*Bloomberg News*, Brian Sullivan and Jody Shenn, 07/18/07)
- The fallout from the U.S. subprime sector has much farther to run and could ultimately have consequences for the broader economy, warned Karen Weaver, Deutsche Bank's global head of securitization research at its industry conference on derivatives in Barcelona, Spain. "This can be a very slow-moving train and it still has a long way to run," said Weaver. "The important thing is what it does to the overall housing market. When many borrowers become forced sellers, it reprices the entire housing stock. The concerns in U.S. home prices now under way could derail consumer spending and precipitate a U.S. recession," although she argued that this remained a small risk. Anshu Jain, co-head of Deutsche Bank's investment bank, acknowledges that there is now a rising danger of so-called "event risk" not only in the subprime sector but also in leveraged finance. "The question is whether that has happened in subprime could now be repeated in leveraged lending, given that leverage ratios continue to ratchet up," said Jain. "[It is] likely not—at least for as long as the world economy keeps growing in line with our analysts' projections. [But] if growth slows down, there could be consequences." (*Financial Times*, Joanna Chung, 07/13/07; *Financial Times*, Gillian Tett and Joanna Chung, 07/12/07)

The absence of fear –and its fallout

- In a June 28th speech to CFA Society in Chicago, IL, Robert L. Rodriguez, CEO of First Pacific Advisers' FPA Capital, said, "We are concerned that, after many years of an excessively easy monetary Fed policy, a bubble of massive proportions has been created in the housing market. Many experts believe that the housing cycle is at or nearing a trough or at least is at a stable level. We are not of this opinion. We do not believe you inflate prices and demand over at least a decade and then this over stimulation is corrected in barely 18 months. We are of the opinion that this bubble has infected many areas of the financial economy..."

- “There have been several studies as to how inflated housing prices had become prior to the present correction. According to the work done by Gary Shilling’s firm, home prices would have to correct between 22% and 28% to return to the equivalent of the median asking rent or to the trend line of the CPI. Prior to 1996, both of these measures approximated the rate of increase in home prices. According to Robert Shiller of Yale University, his real quality-adjusted existing house price index would have to correct nearly 45% to bring it back into alignment. My initial reaction to this estimate was one of disbelief and that it appears excessive; however, home prices would appear to have a considerable way to fall, given the high level of total homes available for sale. With nearly 4.5 million homes for sale in 2007, this compares to an average of approximately 2.5 million homes since 1990 or an excess of approximately 2 million homes. Since 1965, the median dollar volume of single-family homes sales as a percentage of nominal GDP has averaged 8.4% versus 16.3% at the 2005 peak, according to Northern Trust Global Economic Research.”
- “This housing price bubble has infected the fixed income market. As loan underwriting standards deteriorated, more potential home buyers were then able to qualify for a loan. We are seeing the initial effects of this erosion in underwriting standards by the collapse in the prices of sub-prime mortgage securities and the firms that originated them. The sub-prime mess has been detailed quite extensively but not another area—Alt-A. Alternative-A refers to a class of borrowers that cannot qualify for a conventional mortgage. Typically, they are owners of businesses that do not take out income in the form of W-2. They also have limited documentation; however, they have credit scores that are at or near prime credit scores.”
- “Two years ago, we noticed a problem developing in our bond portfolios involving Alt-A securities. Despite having average FICO scores of 718 on the underlying loans, these securities experienced rapidly escalating delinquencies and defaults after just nine months. We sold them since we did not want to wait around to find out the reason why this was happening. Our worst fears were recently confirmed in a study by First American Financial entitled, ‘First American Real Estate Solutions Report, Alt-A Credit—The Other Shoe Drops?’ This report shows the following changes in underwriting standards between 1998 and 2006, with the major changes occurring in the last two or three years:
 - ARM % of originations rose from 0.7% to 69.5%
 - Negative Amortization rose from 0% to 42.2%
 - Interest Only rose from 0.1% to 35.6%
 - Silent Seconds rose from 0.1% to 38.7%
 - Low Documentation rose from 57% to 79.8%
 - FICO scores were essentially unchanged at an average of 706.”
- “What is interesting is that the origination volumes for the last two years, when the most egregious deterioration in underwriting standards occurred, total more than the previous seven years of originations combined. Of further interest, Dale Westoff, senior managing director of Bear Stearns, Inc., estimates that 25.8% of sub-prime and

41.2% of Alt-A originations were in California; the combination of these total 33.7% of the total sub-prime/Alt-A universe. For 2006, sub-prime/Alt-A represented approximately 40% of total mortgage originations. I reference this Alt-A underwriting data because I believe it reflects the wider trend of underwriting deterioration throughout the entire mortgage universe. Because of a laxness in credit underwriting standards, along with an accommodative Fed, the housing price bubble was magnified and, thus, it has spread into the asset-backed securitizations market.”

- “We have witnessed an explosion in the size and types of securitizations, with mortgage securitizations leading the way. We were on the March 22 call with Fitch regarding the sub-prime securitization market’s difficulties. In their talk, they were highly confident regarding their models and their ratings. My associate asked several questions. ‘What are the key drivers of your rating model?’ They responded, FICO scores and home price appreciation (HPA) of low single digit (LSD) or mid single digit (MSD), as HPA has been for the past 50 years. My associate then asked, ‘What if HPA was flat for an extended period of time?’ They responded that their model would start to break down. He then asked, ‘What if HPA were to decline 1% to 2% for an extended period of time?’ They responded that their models would break down completely. He then asked, ‘With 2% depreciation, how far up the rating’s scale would it harm?’ They responded that it might go as high as the AA or AAA tranches. Adding to this appraisal, in a recent study by Joshua Rosner, managing director of investment research firm Graham Fisher & Co., and Joseph R. Mason, associate finance professor at Drexel University, ‘Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions,’ they say, ‘the senior levels of these structures are probably not as safe and secure as the rating companies have said, as an investor would assume, or as regulators are counting on.’ In an interview, Mr. Rosner commented that whether the top-rated classes of these securities are downgraded, ‘depends on home price appreciation. It is a strong possibility that there could be downgrades.’”
- “The asset quality problems in sub-prime and Alt-A have the potential to affect other areas, such as the collateralized debt obligation (CDO) market, in ways that many of the holders of those securities have little idea of how exposed they might be to unexpected changes in the security’s credit rating. It is estimated that U.S. banks have invested as much as 10% of their assets in CDOs, and the Office of the Comptroller of the Currency (OCC) requires that all of those CDOs be investment grade, says Kathryn Dick, deputy comptroller for credit and market risk. She says, ‘We rely on the rating agencies to provide a rating.’ As Kevin Fry, chairman of the Invested Asset Working Group of the U.S. National Association of Insurance Commissioners says, ‘As regulators, we just have to trust that rating agencies are going to monitor CDOs and find the subprime.’ This statement really enhances my comfort level.”
- “Investors have been gobbling up CDOs, sub-prime, Alt-A securitizations because they can earn considerably higher yields than if they deployed the capital into similarly rated corporate debt. The key element of this strategy is the rating assigned

to the particular security. Various financial institutions have bought into this thinking. *In other words, a corporate bond rating is equal to a securitization rating or a CDO rating.* Encouraging this strategy are the international bank capital rules, established by the Bank of International Settlements, that do not differentiate between types of debt rated securities (corporate versus securitized) other than to require a 0.6% capital allocation for a AAA security and higher capital requirements as the credit rating declines, so that a BBB requires a 4.8% weighting. According to Darrell Duffie, professor of finance at the Stanford Graduate School of Business, ‘you can’t compare these CDO ratings with corporate bond ratings. These ratings mean something else—entirely.’ While so many investors and regulators are relying on these ratings, the rating agencies take the position, as exemplified by S&P, ‘Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision.’ As Joseph Mason, finance professor at Drexel University says, ‘The ratings giveth and the disclaimer takes it away.’”

- “A recent example of the flawed nature of this market came to my attention when my associate, Julian Mann, showed me a very garden variety LIBOR sub-prime floating rate security. A major pricing service valued this bond at par, while on March 19, 2007, one of the major rating agencies rated this bond A3. To affirm the accuracy of this bond’s pricing, we went to two brokerage firms that traffic in this type of security and requested what their bid might be, if we owned this security. One responded with a \$7 bid. In other words, a 7% of par bid, a difference of 93% to the pricing service. The other firm declined to bid, but they did indicate that, if they were to, their bid would have probably been around this level. Julian has found several other similar examples, so this one does not represent the proverbial ‘needle in the haystack.’”
- “We believe that many of these models are flawed and give a spurious representation of accuracy. Given the deterioration in underwriting standards, models predicated on prior experience have little value when compared to the data of the last two or three years. In essence, one is assuming a normal distribution curve of data for modeling purposes, while in reality you have data that comes from a highly skewed distribution. We are beginning to see the negative effects of flawed modeling by the growing number of downgrades in the sub-prime sector. This trend is also starting to develop in the Alt-A sector as well. We believe these trends will continue to unfold over the next two or three years and should lead to a retrenchment in the securitization/origination industry. If our assessment is reasonably correct, mortgage credit availability will likely contract and, therefore, exacerbate the housing contraction and its effects upon the general economy. We disagree with the opinion expressed by our esteemed Federal Reserve Chairman Bernanke, when he said in his speech of May 17, 2007 at Chicago’s 43rd annual conference on Bank Structures and Competition, ‘We believe the effect of the troubles in the sub-prime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the sub-prime market to the rest of the economy or to the financial system.’ We will see if this optimistic assessment proves to be the correct one.”

- “We are of the opinion that the distancing of the borrower from the lender has contributed to the development of lax underwriting standards. Each participant, in the securitization/origination process, takes their ounce of payment, but no one truly worries about the underlying credit quality since the loan will be sold. Furthermore, most participants are compensated on volume and not quality of loan originated. In our opinion, ‘a rolling loan gathers no loss.’ Possibly, with so many sub-prime originators failing because of loan put-backs to them, some degree of underwriting discipline will return to the market; however, with so many types of loan originators operating outside of the regulatory system with minimal capital, it is far better to originate a loan, capture the fee, and then get out of Dodge, should the business go bad. One can always return another day.”
- “Finally, the securitization market and the multiplicity of products that have been created have never been truly tested in a major credit contraction like that of 1990-94. This is because most of today’s securitization products did not exist back then. Another risk is how have they been used in various types of leveraged investment strategies? Have the creators of these products structured their operations to be able to handle a contracting market? It remains to be seen how this all works together. One may gain some insight to the potential risk by reviewing the collapse of the manufactured-housing securitization market. After seven years, it is still a fraction of its former size with all the former major originators gone.” (*CFA Society of Chicago Speech*, Robert L. Rodriguez, 06/28/07)

Federal Reserve Chairman Bernanke tells Congress that the Fed will ban some mortgage practices

- In testimony before Congress, Federal Reserve Chairman Ben Bernanke said that the Fed plans to review the practices of lenders who are significant players in the subprime mortgage space and ban some mortgage practices to bolster its consumer protection efforts. “Based on the information we are gathering, I expect that the (Fed) will propose additional rules under” the Home Ownership and Equity Protection Act (HOEPA) later this year “to address specific practices that are unfair or deceptive”, Bernanke told the House Financial Services Committee. “I believe that we are moving as fast as we responsibly can,” he added. “We have to do it right.” The Fed is taking a “top-to-bottom review” of possible regulatory tools it could use to prevent future subprime problems. The mortgage practices being reviewed by the Fed include certain prepayment penalties, low documentation loans, and loans which do not require escrow accounts for tax and insurance payments. The Fed will also look at the possibility of requiring all lenders to underwrite loans to the fully-indexed rate for adjustable rate mortgages. He said the Fed also would propose new disclosure rules “to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them.” When the timeframe for the new rules would take effect was questioned, Bernanke said that his agency was moving as fast as procedure would

allow, adding, “if you feel the regulatory process is too slow, my only advice is for the Congress to act directly.” Bernanke told lawmakers that the central bank is opposed to a public “bailout” as a means of stabilizing the subprime mortgage market. “One thing we should be careful about is that we don’t want to reward lenders for making bad loans,” he said. We don’t want to get into sort of a bailout situation, where essentially lenders who made bad loans find themselves getting paid off.”

- The Fed will take the added step of launching a cooperative pilot program with state agencies to crack down on abusive practices and focus on lenders that might otherwise not face federal oversight. The reviews, which will begin in the fourth quarter of 2007, “will include independent state-licensed lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies and mortgage brokers doing business with or serving as agents of these entities.” Other participants in the program include the Office of Thrift Supervision, the Federal Trade Commission and the American Association of Residential Mortgage Regulators. The groups said that they plan to share information, discuss lessons learned and “take action where appropriate”. John Ryan, EVP of the Conference of State Bank Supervisors, said “We are trying to connect the dots so we can look at this as one industry with the shared goal of consistent application of law.”
- Bernanke told the Senate Banking Committee that he prefers state regulation and increased state federal cooperation in regulating mortgage lenders as opposed to federal regulation of mortgage lenders. After the hearing, Chairman Chris Dodd said that Bernanke’s position “doesn’t stop us from legislating.” He added, “We will have legislation [on the regulation of mortgage lenders].” (*Prepared remarks before the House Financial Services Committee*, Federal Reserve Chairman Ben S. Bernanke, 07/18/07; *Bureau of National Affairs*, Len Bracken, 07/20/07; *Dow Jones Capital Markets Report*, Damian Paletta, 07/18/07; *Dow Jones Newswires*, Damian Paletta, 07/18/07; *Wall Street Journal*, Damian Paletta and Brian Blackstone, 07/20/07; *Washington Post*, Dian ElBoghdady, 07/18/07; *Dow Jones Newswires*, Damian Paletta, 07/18/07)

Federal Reserve Governor Poole advocates correcting the fundamental problems in the subprime market rather than its symptoms

- In a July 20th speech to the St. Louis Association of Real Estate Professionals, Federal Reserve Board Governor William Poole discussed the challenge of reforming and preserving the subprime mortgage market. Poole said, “...Some of the problems we’re seeing in the non-prime market [which includes subprime and Alt-A mortgages] may have been inevitable given the breakneck innovation and growth of recent years, followed by a significant cooling of housing-market activity. Yet it is important that we learn the correct lessons from these problems. In a future housing-market slowdown, we want to avoid repetition of recent problems. We also want to preserve appropriate access to credit by those with impaired credit standing. The

subprime market in particular is an immature market—a baby market in age, though not in size—and we want to remember the adage about not discarding the baby with the bathwater.”

- “My premise today is that a lasting improvement in the functioning of the non-prime market is most likely if we correct the fundamental problems that seem to be causing the greatest difficulties, rather than attacking mere symptoms of the problem. ...I believe the fundamental problems in the non-prime mortgage market amenable to improvement stem from inadequate incentives among some of the parties operating in the market to create and maintain strong reputations for quality and fair-dealing. A solid reputation is a valuable asset for the individual firm, for the economy and society as a whole...”
- While discussing the evolution of the nonprime mortgage market, Poole noted, “One aspect of recent developments was odd and has turned out to be the source of much difficulty in the non-prime market. The steep yield curve during much of the 2002-04 period reflected investor expectations that short-term interest rates would be rising, which they in fact did. Yet, many mortgage-market participants apparently did not anticipate this increase. Of course, I would not expect average homeowners to be able to read the yield curve, but I find it odd that apparently sophisticated investors in non-prime mortgage-backed securities now claim surprise that many non-prime ARM borrowers are facing payment shock because of the increase in short-term interest rates over the past few years. Apparently driven by the prospects of high fee income and substantial spreads on non-prime ARMs, mortgage originators persuaded many relatively unsophisticated borrowers to take out these mortgages; then, investors willingly purchased them when they were securitized. Many of these mortgages are now in default, some of the lenders are bankrupt, and the mortgage-backed securities are trading at deep discounts to face value.”
- “It is important to emphasize that what is odd is not that there was a risk of rising short-term interest rates, as there always is, but that the market clearly expected an increase, as indicated by the shape of the yield curve. This expectation, in turn, was encouraged by the Fed’s Open Market Committee. ...Given these widely held expectations of rising interest rates, it is difficult to avoid the judgment that these ARM loans were poorly underwritten at the outset. It was imprudent for mortgage brokers and lenders to approve borrowers who likely could not service the loans when rates rose, and it is surprising to me that sophisticated capital-market investors willingly purchased securities backed by such poorly underwritten mortgages.”
- “...[W]e do know that the total amount of home mortgages outstanding at the end of March 2007 was about \$10.4 trillion. It appears that as much as \$1.3 trillion of subprime mortgages was outstanding at that time, along with about the same amount of Alt-A mortgages (although different data sources provide somewhat different estimates of this sector). Thus, the subprime and Alt-A segments each represent 13 or 14 percent of the overall mortgage market. These sectors together accounted for only about 10 percent of mortgage originations in 1995. The jumbo sector—comprising

mortgages larger than the maximum loan size eligible for purchase by Fannie Mae and Freddie Mac—consisted of perhaps \$2.5 trillion in March 2007, while prime, conventional, conforming mortgages comprised the remaining \$5 trillion. In terms of the number of subprime borrowers, there are about 7.5 million first-lien subprime mortgages outstanding, out of a total of more than 50 million first mortgages. Despite the heterogeneity in the non-prime market, the bottom line is that more people have access to mortgage credit now than ever before. The non-prime market has become very large; it is evolving constantly, and yet remains relatively opaque. Despite its limitations and flaws, the non-prime market has served a large number of borrowers very well.”

- “...Like other observers, we [at the Fed] have noted with great concern the increasing delinquency and foreclosure rates on certain non-prime loan categories during 2006 and 2007. Because Congress has assigned to the Federal Reserve and to the Federal Trade Commission the primary responsibility of interpreting and implementing several important consumer-protection statutes, we have been undertaking a number of consumer-protection initiatives and actions. We have been working on revising required credit-card disclosures for several years and, beginning in 2006, we have turned our attention increasingly to non-prime-mortgage issues. I will list briefly some of the more important recent Federal Reserve consumer-protection initiatives related to non-prime mortgages:
 - In coordination with the other federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures.
 - Federal Reserve banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations.
 - We are working with organizations that provide counseling about mortgage products to current and potential homeowners.
 - We are meeting with market participants—including lenders, investors, servicers and community groups—to discuss their concerns and to gain information about market developments.
 - We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of recent problems, including more-effective disclosures to help consumers defend against improper lending.
 - We held five public hearings across the country during 2006 and 2007, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable-rate products...

- By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them.
- We have improved a disclosure that creditors must provide to every applicant for an adjustable-rate mortgage product to explain better the features and risks of these products, such as ‘payment shock’ and rising loan balances.
- We plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive, including but not limited to pre-payment penalties, the use of escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the evaluation of a borrower’s ability to repay.
- In coordination with the other federal supervisory agencies, in 2006, the Fed issued principles-based guidance on nontraditional mortgages, and, in June of 2007, the Fed issued supervisory guidance on subprime lending.
- We reviewed our policies related to the examination of non-bank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.
- As a result of that review and following discussions with the Office of Thrift Supervision, the Federal Trade Commission and state regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected non-depository lenders with significant subprime mortgage operations.”
- “Based on these activities, I think you will agree that the Federal Reserve takes its consumer-protection responsibilities in the area of non-prime mortgage lending very seriously.”
- “...Based on my observation of financial markets, institutions and regulation over many years, I am convinced that we need to search for ways to strengthen borrower protections without so increasing regulatory costs and risks to lenders that they withdraw from the non-prime market. When we consider regulations designed to address abusive lending practices, we need to understand their possible impact on responsible lenders. We will not be helping potential borrowers if we eliminate abuses by imposing regulations that have the unintended effect of eliminating the entire subprime market. My comment is not a counsel of despair, but a counsel of caution. Regulators need to be creative and not necessarily inactive.”

- “We need to emphasize individual responsibility and accountability in every corner of the market. Lenders and brokers who put naïve borrowers into unsuitable mortgages, which later go into default, deserve the losses they suffer. But these lenders and brokers also lose a long-term business opportunity. A successful borrower, who is able to stay current on a subprime mortgage, can expect to become a prime borrower in time. Every mortgage lender or broker should want that borrower to become a repeat customer. Regulators should do what they can to help educate borrowers and encourage improvements of incentives and business practices.” (*Prepared remarks before the St. Louis Association of Real Estate Professionals, Federal Reserve Board Governor William Poole, 07/20/07*)

Fannie and Freddie are playing a “more risky role” in the subprime market, says OFHEO Director Lockhart

- In a July 18th speech at the Exchequer Club, OFHEO Director James B. Lockhart, III said, “...Fannie Mae and Freddie Mac are starting to play a bigger, more risky role in the subprime market by buying and holding subprime mortgages directly. Over time, these purchases should help reduce some of the pain in the subprime market. OFHEO will be monitoring them closely to ensure that they make and manage these purchases in a safe and sound manner. Although their \$40 billion-plus planned commitment to subprime over the next several years is small compared to the \$1.5 trillion subprime market and well less than 1 percent of their combined book of business, it does represent over half their combined GAAP capital.” Lockhart also noted that Fannie and Freddie own \$170 billion of AAA Private Label Securities, which comprised approximately 3.8% of their aggregate retained portfolio of \$1.4 trillion. (*Prepared remarks at the Exchequer Club of Washington, D.C., James B. Lockhart, III, 07/18/07; Dow Jones International News, Damian Paletta, 07/18/07*)
- In *Business Week*, Dawn Kopecki wrote, “Fannie Mae... and Freddie Mac... have been cast as saviors in the [subprime] housing drama that’s roiling the financial markets[,...][but that doesn’t mean they’re immune to the pain. Like the big private-sector players, these government-sponsored companies, which own or guarantee 45% of all residential mortgages, have taken on more risk in recent years. Now they hold a sizable piece of subprime and other potentially toxic debt-securities and largely illiquid loans that could take a hit after the recent fire sale prompted by two Bear Stearns hedge funds. And given the state of the broader housing market, more trouble may lie ahead. That would be bad news for shareholders and investors who own their mortgage-backed securities. ‘We don’t know how much trash is on their balance sheet,’ says Josh Rosner of researcher Graham Fisher & Co. ‘It seems they’ve shot themselves in the foot.’ Fannie declined to comment. Says a Freddie spokeswoman: ‘We are well positioned to withstand even a severe and enduring period of heightened credit risk.’
- “Driven by market competition and regulatory mandates, the two have become big buyers of adjustable-rate mortgages, or ARMs, and MBSs that include them. Those

items accounted for 18% of Freddie's volume in 2006 and 22% for Fannie in 2005, the latest data available. That's up from virtually nothing in 2001. A large chunk comes in the most exotic flavors, such as payment-option ARMs and interest-only loans. With home prices falling, ARMs, both prime and subprime, are especially scary. Some \$300 billion in ARMs guaranteed by the agencies will automatically reset through 2011, according to Banc of America Securities. The unknown is just how many homeowners will default. By Fannie's own estimates, 18% of the subprime ARMs industrywide that reset in the first three months of 2007 have gone south. The two have also moved more prominently into low-documentation loans, which require little or no proof of the borrower's income. That segment has proven to be rife with abuse in recent years. A study by the Mortgage Asset Research Institute found that 90% of borrowers with so-called stated income loans upped their annual incomes falsely to qualify for more money. In almost 60% of low-documentation loans, the borrower's income was inflated by more than 50%."

- "Much of Fannie and Freddie's shift into riskier parts of the mortgage market has been driven by the government's affordable housing mandates... [OFHEO] estimates that Fannie holds \$292 billion of such mortgages, or 40.6% of its portfolio, on its books because the loans are less liquid and can't easily be repackaged and sold to investors. Freddie owns \$68 billion of those loans, some 9.5% of its portfolio. Problems from Fannie's and Freddie's risky loans are mounting. Foreclosures are on the rise, and it's harder to sell the houses they own as a result. Some are worth pennies on the dollar. Fannie has a 'charming colonial' on the market for \$7,000 in Detroit, despite the \$59,000 outstanding on the loan. The property, repossessed in May, has been looted, with the kitchen sink and drainpipes stolen. Meanwhile, agent Debbie Leslie of Le Valley Real Estate has cut the price on a home Freddie owns in Flint, Mich., five times this year, from \$10,900 to \$5,250. The mortgage is \$26,250. 'We're waiting to see where the floor is,' says Leslie. Such exposure is taking its toll. Freddie upped its loan-loss reserves by \$125 million in the first quarter in response to higher foreclosure rates; the company reported a \$211 million loss during that period. Fannie, still reeling from an accounting scandal earlier this decade, hasn't reported its financials for 2006 or 2007, but will likely face a similar fate when it does. Looking at the numbers, says James B. Lockhart III, director of OFHEO, 'you can see the impact not only on their portfolios, but also their MBSs.'" (*Business Week*, Dawn Kopecki, 07/20/07)

Fannie and Freddie "drop the bomb"

- At OFHEO's request, Fannie Mae and Freddie Mac has mailed letters to its mortgage originators notifying them that the GSEs will not buy mortgages originated on or after September 13th that do not comply with the Interagency Guidance on Non-Traditional Mortgages [issued in September 2006], which includes (1) an evaluation of the borrower's ability to pay the mortgage loan at the fully indexed rate, assuming a fully amortizing repayment schedule; (2) limitations on reduced documentation requirements for such mortgages; (3) limitations on risk-layering without

compensating factors; (4) a focus on consumer improved consumer disclosure requirements; and (5) strengthened portfolio and risk management practices.

- OFHEO Director James B. Lockhart, III said, “These initiatives by the Enterprises support the guidances issued by federal and state financial regulators and will address most originators of mortgages, both regulated and unregulated. This is a significant step. OFHEO will continue to work with federal and state regulators and the Enterprises to assure conformance with both the Interagency Guidance and the Subprime Statement. These actions reinforce the necessity for safe and sound underwriting practices, which serve the interests of lenders and borrowers in promoting sustained homeownership.” (*OFHEO Press Release, 07/13/07; Bureau of National Affairs, Richard Cowden, Prepared remarks at the Exchequer Club of Washington, D.C., James B. Lockhart, III, 07/18/07*)
- In *WealthDaily.net*, Steve Christ wrote, “[W]atching the government do practically anything is akin to watching molasses run down the hill in January. But as slow as that bureaucratic morass is, when it finally does manage to make a decision with some real weight, it comes crashing down like a massive hammer. That at least was the sound heard last Friday when [OFHEO] finally forced Fannie Mae and Freddie Mac to comply with the Interagency Guidance on Nontraditional Mortgage Product Risks introduced last fall. ...The new guidelines demanded that any mortgage containing an interest-only feature be underwritten at the highest possible interest rate or subsequent amortizing payment, and that any mortgage containing a negative-amortizing feature (an option ARM) be underwritten at the highest possible balance and interest-rate adjustment. In short, what they tried to do was bring a little sanity to a segment of the industry that sorely needed it. In a stroke of brilliance, the regulators decided that it would be a good idea for underwriters to actually consider a borrowers’ ability to repay the loan beyond the first year.”
- “What a concept. But despite that common sense approach to mortgage finance, those guidelines have gone largely ignored by the biggest buyers of mortgage paper-- Freddie and Fannie-- even though both of them were ordered to comply with the new rules only last February. That stare down, however, came to end last Friday, which fittingly enough also turned out to be the 13th. That’s when the two mortgage giants finally blinked and informed their customers of the ensuing changes in their underwriting standards. Additionally, they both also indicated that they would begin to implement a program in the future to address their subprime standards, in move to become compliant the regulators Statement on Sub Prime Mortgage Lending. That means that compliance with those ‘guidelines’ will now become mandatory for any mortgage bought by either enterprise with an application date on or after of September 13, 2007. And while all of that may seem like nothing more than some fancy mortgage lingo, in practice it fell on already weakening housing market like 500lb. bomb.” (*WealthDaily.net, Steve Christ, 07/19/07*)

State regulators adopt subprime mortgage guidance

- On July 17th, the Conference of State Bank Supervisors (CSBS), the American Association of Residential Regulators, and the National Association of Consumer Credit Administrators adopted subprime lending guidelines mirroring the federal policies unveiled in June. The three groups took a similar step in November, by urging its members to adopt the nontraditional mortgage guidance issued by the federal agencies last year. “This is part of the evolution both of a more coordinated system of regulation,” said John Ryan, executive vice president of CSBS. “What we really wanted to accomplish here was a consistent expectation throughout the industry on the application of this guidance.” (*American Banker*, Cheyenne Hopkins, 07/17/07; *Bureau of National Affairs*, Richard Cowden, 07/18/07)

House Republicans introduce bill to create a national licensing and registry system for mortgage brokers

- On July 12th, senior Republicans on the House Financial Services Committee introduced a bill [H.R. 3012] that would create a national licensing system and registry to be managed by the states or HUD; require all lenders to escrow for taxes and insurance on subprime loans; and ban prepayment penalties on hybrid adjustable-rate mortgages for four months before the loan resets and any time afterward. The bill, sponsored by Representatives Spencer Bachus (R-AL), Paul Gillmor (R-OH), and Deborah Pryce (R-OH), would require background checks, fingerprint analysis, and credit checks for all mortgage brokers and require [broker] applicants to complete 20 hours of training on loan rules and laws, as well as ethics. The bill also would also require bank regulators to develop a one-page disclosure form to be given to customers, which would list the amount of the fully-indexed monthly payment and whether there is a prepayment penalty and would require lenders to provide subprime mortgage borrowers a list of approved credit counselors. The bill also includes a \$100 million appropriation to fund for credit counseling for 2008 through 2011. (*American Banker*, Stacy Kaper, 07/13/07; *Dow Jones Newswires*, Damian Paletta, 07/12/07)

Other notes of interest

- On July 12th, the Senate Appropriations Committee unanimously approved a spending provision which would direct \$100 million toward community groups approved by HUD to offer foreclosure prevention counseling. The provision, offered by Senators Charles Schumer (D-NY), Sherrod Brown (D-OH) and Robert Casey (D-PA), had originally sought \$300 million for such programs. The bill also contained an amendment introduced by Senator Richard Shelby (R-AL) that would permanently block the Treasury Department from releasing funds to finalize a 2000 proposal allowing banks to offer real estate brokerage services. (*American Banker*, Stacy Kaper, 07/13/07)

- The State of Massachusetts plans to create a \$250 million fund to bailout people who cannot pay their mortgages. The new fund, which will aid approximately 1,000 homeowners with subprime mortgages who are up to 60 days behind on their mortgages, will help homeowners refinance their loans over a 40-year period at a fixed rate of 7.8%. The Massachusetts Housing Finance Agency will contribute \$60 million to the fund, while Fannie Mae will add \$190 million to the fund. The State's taxpayers will not be asked to bail out these homeowners. Instead, the money for the fund will be raised when MassHousing sells taxable bonds at variable and fixed rates to private investors, said an agency spokesman. (*Reuters*, Svea Herbst-Bayliss, 07/11/07)
- HSBC-North America has provided a \$1 million grant to Money Management International, Inc., a non-profit counseling agency affiliated with Consumer Counseling Services, to help homeowners who have fallen behind on their mortgage payments and are in danger of foreclosure. The grant money will be used to help pay outstanding debts and allow the homeowner to resume monthly mortgage payments. (*Chicago Sun Times*, Terry Savage, 07/18/07)
- The National Association for the Advancement of Colored People (NAACP) has filed a class action lawsuit against 14 subprime mortgage lenders, alleging that they engaged in institutionalized, systemic racism by steering blacks into higher-interest, subprime loans while giving more favorable loan terms to white borrowers. The lawsuit, filed in the U.S. District Court of Los Angeles, named Ameriquest, Wells Fargo & Co, Fremont General Corp, Countrywide Financial Corp, Citigroup Inc and HSBC Holdings Plc, Washington Mutual Inc. and others as defendants. The filing cited data from the National Community Reinvestment Coalition and the Center for Responsible Living to support their claims. (*Reuters*, 07/11/07; *Dow Jones Newswires*, 07/12/07)
- At a California Mortgage Bankers Conference in San Francisco, Angelo Mozilo, chairman and CEO of Countrywide Financial Corp., predicted that the mortgage industry would endure additional losses during the remainder of the year and in 2008, before rebounding in 2009. "I think we're going to go through an enormous correction period, and we have a long way to go," said Mozilo. "This is just the beginning of the process." The silver lining? "If this thing is really bad, it could bring down rates," he added. According to Mozilo, OFHEO played a role in the market downturn by "unnecessarily punishing" Fannie Mae and Freddie Mac for their accounting "irregularities." With the GSEs sidetracked, "a void was created," he argued. Wall Street filled it and "the disciplines of underwriting started to disappear." Mozilo repeated his concern that regulators will overreach with their mortgage guidelines and further limit market liquidity, when borrowers whose adjustable-rate mortgages are about to reset need to refinance into products that are no longer available. "While I think there is some justification for the interagency guidelines, they did negatively impact liquidity," he said. "A lack of liquidity will

kill you instantly, and that's the issue we're facing today." (*American Banker*, Kate Berry, 07/20/07)

Fannie Mae and Freddie Mac

Chairman Dodd says his panel's pace reflects bipartisan strategy

- Senate Banking Committee Chairman Christopher Dodd (D-CT) said that his panel's slower legislative pace reflects his bipartisan strategy. "I'm trying to work on as much of it as I can, rather than just sort of parachuting into a markup without having a clear indication of where my Democratic colleagues are, and Republican colleagues," said Dodd in an interview with *Dow Jones Newswires*. A complicating factor is the committee's even split of members (10 Democrats and 10 Republicans), caused by the absence of Senator Tim Johnson (D-SD), while he continues to recover from a brain aneurism suffered earlier this year. The Senate panel has held 22 hearings and reported out seven bills out of committee so far this year, compared to 48 held by the House Financial Services Committee and its approval of 17 bills. "We're moving along on the stuff, and I don't want to give you the premature reports about success, but I think there will be some areas where we will be more successful," said Dodd. "[In other areas,] we may just have to do a 'jump ball' and just do the best we can." Among the unresolved and potentially divisive issues the panel faces is GSE regulatory reform, whose fate remains uncertain. While Dodd had said in January that he hoped to pass a GSE reform bill in March, he has yet to introduce a bill or hold a hearing on the issue. After a July 19th committee hearing, Dodd told reporters that the panel would likely take up GSE legislation this fall. (*Dow Jones Newswires*, Damian Paletta, 07/12/07; *Wall Street Journal*, Damian Paletta, 07/09/07; *CQ Today*, Michael R. Crittenden, 07/19/07)
- Dodd's first priority this year has been his underdog candidacy for the presidential nomination for 2008. Some close to the chairman describe him as a presidential candidate first and committee chairman second. Dodd continues to travel extensively with his campaign, forcing him to spend a lot of time outside Washington. To date, he has raised \$12 million for his campaign and has enjoyed broad financial support from the financial services industry. [According to FEC records, Dodd has raised \$13,400 from 21 employees of Fannie Mae, which included contributions from the company's CEO Daniel Mudd (\$1,000) and its general counsel Beth Wilkerson (\$2,300).] Although most polls place Dodd in the single digits behind the party's front runners, advisors believe that the Senator will have adequate cash on hand to complete next year's primaries. Dodd campaigns with his wife, Jackie Marie Clegg Dodd, and their two daughters, ages 5 years and 22 months. Clegg-Dodd, who served as an aide for 10 years to former Senator Jake Garn (R-UT) and as Vice Chair, First

Vice President and COO of the Export-Import Bank during the Clinton Administration, formed Clegg International Consultants, a lobbying and strategic planning firm, in September 2001. Clegg-Dodd also serves on the boards of directors of several corporations, including Blockbuster, the Chicago Board of Trade, Cardiome Pharma and Innovative Drug Delivery Systems. (*Dow Jones Newswires*, Damian Paletta, 07/17/07; <http://www.javelinpharmaceuticals.com/board.html>; http://www.sourcewatch.org/index.php?title=Jackie_Marie_Clegg; <http://investor.cmegroup.com/directors.cfm?bioID=16089>)

- A number of financial services lawmakers have already declared their support for individual candidates in the 2008 presidential campaigns. Hillary Clinton has the support of two Senate Banking members – Senators Charles Schumer (D-NY) and Robert Mendez (D-NJ), along with the support of Representative Ruben Hinojosa (D-TX), who serves on the House Financial Services Committee. Senator Barack Obama has the support of Representatives Melissa Bean (D-IL), William Lacy Clay (D-MO), Luis Guterrez (D-IL) and Gwen Moore, (D-WI), who are members of the House Financial Services Committee. While none of the Senate Banking Committee Democrats have endorsed the panel’s chairman, Senator Chris Dodd (D-CT), he has won the endorsement of nine House members, including House Financial Services Committee member Christopher Murphy (D-CT)
- On the Republican side of the aisle, former New York City mayor Rudolph Giuliani has earned the support two House Financial Services committee members— Representatives Peter King (R-NY) and Ed Royce (R-CA). Mitt Romney enjoys the support of Senate Banking Committee members Wayne Allard (R-CO) and Robert Bennett (R-UT), along with four House Financial Services committee members Ginny Brown-Waite (R-FL), John Campbell (R-CA), Tom Feeney (R-FL), and Tom Price (R-GA). Senator John McCain (R-AZ) has been endorsed by Representative Spencer Bachus (R-AL) the minority leader of the House Financial Services Committee, along with three other panel members—Steven LaTourette (R-OH), Rick Renzi (R-AZ), and Chris Shays (R-CT). Three House panel members – Representatives J. Gresham Barrett (R-SC), Marsha Blackburn (R-TN) and Donald Manzullo (R-IL)— have endorsed former Senator Fred Thompson (R-TN), who has yet to formally announce his candidacy. (*American Banker*, Rob Blackwell, Joe Adler, and Steven Sloan, 07/16/07)

Federal Reserve Chairman Ben Bernanke and OFHEO Director Lockhart urge the Senate to address the size and public purpose of the GSEs’ mortgage portfolios

- In testimony before Congress, Federal Reserve Chairman Ben Bernanke urged lawmakers to design a regulatory structure that ties the GSEs’ mortgage-related portfolios to a public purpose such as affordable housing. “Right now [the portfolios] can expand almost at will and it’s not tied directly to public purpose,” said Bernanke at a Senate Banking Committee hearing. “I [advocate] tying the portfolios to affordable housing or housing goals in some explicit way,” he added. For the first

time, Bernanke commented publicly on a provision passed in the House's GSE reform bill, which would direct the new regulator to consider only safety and soundness issues related to the GSE itself in evaluating the size of the its portfolio. "The amendment in the House does concern me greatly," said Bernanke. "One might imagine a situation where greatly increasing the size of the GSE's portfolio is in the interest of the company but raises the risk to the overall system. And as I said a moment ago, in my role, my principal concern is about the stability of the overall system. And I fear that without some consideration of the overall financial stability implications, that this new regulation would be incomplete." (*Dow Jones Newswires*, Damian Paletta, 07/20/07)

- In a July 18th speech to the Exchequer Club, OFHEO director James B. Lockhart, III pointed out the "irony" of the wording of the House provision, addressing the size of the GSEs' portfolios. Lockhart said, "There is a certain irony that the insertion of three words on the House Floor in H.R. 1427 might cause a regulator to greatly reduce [the GSEs'] subprime commitment [of \$40 billion]. As originally written, the section giving the regulator the ability to regulate the size and growth of the Enterprises' portfolios charged the regulator to consider risks of the portfolios; but the change was to consider only the risks 'to the Enterprises.' A regulator could interpret that to require focus on subprime mortgages' risks to shareholders rather than the housing finance markets just when the Enterprises should be fulfilling their mission of stabilizing the housing markets. I hope the Senate will recognize this potential unintended consequence and that the risks to the housing finance markets should be considered in their deliberations." Lockhart urged Congress to pass GSE regulatory reform legislation that provides "enhanced powers to allow the new, stronger regulator to focus on housing GSEs and prevent the past problems from recurring." He added, "At stake is the future health of a key component of our economy, housing and ultimately, increased home ownership." (*Prepared remarks at the Exchequer Club of Washington, D.C.*, James B. Lockhart, III, 07/18/07)

House Republican lawmakers question the fairness of the Housing Trust Fund

- On July 19th, the House Financial Services Committee members debated the concept of a dedicated affordable housing trust fund, as proposed in the National Affordable Trust Fund Act of 2007 (H.R. 1427) and funded by GSE regulatory reform legislation (H.R. 1427) and FHA reform legislation (H.R. 1852). House Financial Services Committee chairman Barney Frank (D-MA) argued the proposed trust fund would provide a flexible source of funding for affordable housing which would not be subject to the vagaries of the congressional appropriations process.
- While several committee Republicans said they favor the goals of the trust fund, they voiced serious reservations about its structure. "Rather than creating yet another housing bureaucracy, I believe that our focus should be on increasing efficiencies in existing programs," said ranking member Spencer Bachus (R-MS). Judy Biggert (R-IL), ranking member of the Subcommittee on Housing and Community Opportunity,

expressed concerns that the proposed trust fund would not be an efficient means of providing affordable housing assistance to eligible families. She also questioned the funding strategy, which would in essence impose a tax on mortgages purchased by the GSEs and on borrowers whose loans are insured by the FHA. “To me it’s robbing Peter to save Paul,” said Biggert. According to a recent CBO estimate, H.R. 1852 would generate about \$370 million in surplus revenues during the first year and \$2.1 billion from FY2008 through FY2012, thanks largely to premiums charged by FHA on reverse mortgages (or HECMs). “Now normally, we would say a surplus is a good thing, but not in this case,” said Biggert. “In this case the surplus would come from overcharging seniors on their reverse mortgages.” Noting the similarity of the proposed trust fund to HUD’s existing HOME Investment Partnerships Program, Biggert argued, “Rather than create a new federal bureaucracy to address low-income housing availability, we should instead focus our efforts on improving the HOME program.”

- FHA Commissioner Brian Montgomery told the lawmakers that the Bush administration expressed its opposition to the housing trust fund in a Statement of Administration Policy on H.R. 1427 to “any provisions that would divert funds from this bill to a new, separate housing trust fund.” Montgomery also argued that while the GSE funds would be separate from the congressional appropriations process, the funds generated from the proposed FHA reform bill would be considered a credit to HUD and therefore could be reallocated by congressional appropriators. Frank vehemently disagreed with Montgomery’s position. “I’ve been working with HUD budgets for 27 years,” said Frank. “It has never been the position of appropriators that the amount appropriated to HUD would rise or fall according to FHA receipts. There’s a bookkeeping matter whereby FHA receipts are entered into the general fund ...but no one has ever suggested that the budget of HUD goes up or down—is any way dependent upon net receipts or deposits from the FHA.”
- Henry Cisneros, the Clinton administration’s former HUD secretary, testified that the proposed trust fund is needed to meet the needs of very-low income families with annual incomes below 30 percent of the area median. He pointed out that the 600 local and state trust funds have been proven to be a successful and flexible method of addressing affordable housing problems. Cisneros also noted that the bill would identify new funding sources “in such a way as not to cannibalize other programs and in such a way as not to exacerbate the federal fiscal challenge.” The proposal has garnered bipartisan support, he argued, pointing to the joint statement supporting the National Affordable Housing Trust Fund that Cisneros has endorsed along with former HUD Secretary Jack Kemp. (*Bureau of National Affairs*, Richard Cowden, 07/20/07)

Tools of the lobbying trade: “patience and a bit of scandal”

- In the weekly column Pit Boss appearing at www.politico.com, Jeanne Cummings wrote, “Lobbyists use all sorts of tools to get their way on Capitol Hill. But sometimes the best lobbying strategy turns out to be patience -- and a bit of scandal.

Those are the key ingredients that bring FM Policy Focus and its key allies on Capitol Hill, including Louisiana’s Republican Representative Richard Baker, to the brink of success today. For nearly eight years, the organization of bankers, consumer advocates and financial houses has been pushing for greater scrutiny on mortgage lending giants Fannie Mae and Freddie Mac. To that end, it spent millions lobbying Congress, producing reports and rounding up allies in both the Clinton and Bush Treasury departments, including former Federal Reserve Board Chairman Alan Greenspan.”

- “None of that seemed enough to best the well-oiled, well-financed and well-connected lobbying armada built by the two quasi-governmental lending offices in the 1990s. But FM Policy Focus and its key allies didn’t go away. When Fannie and Freddie stumbled two years ago, the groups struck hard and fast—even when faced with threatened legal action by the lending firms’ then-newest high-powered lobbyist: Kenneth Starr. Earlier this year, the House passed legislation creating a new regulatory office to watch over Fannie, Freddie and a dozen other government home loan banks, equipping it with enhanced enforcement and oversight powers. The proposal now awaits action in the Senate, and Banking Committee Chairman Chris Dodd (D-CT) says it is a top priority.”
- “The story of FM Policy Focus’ success, thus far, is as much about the organization’s persistence as it is a cautionary tale about how hubris contributed to the unraveling of two of Washington’s biggest corporate lobbying giants. Originally called FM Watch, the group was founded in 1999 amid growing concerns that Fannie and Freddie were overextended and had moved well beyond their mandates to make mortgages available to minority and low-income borrowers. Their expanded lending portfolio—which included expensive second homes—was crowding private lenders’ turf. But when they first ventured onto Capitol Hill to make their case, ‘nobody really wanted to talk about it,’ said William Michael House, the group’s executive director and a partner at Hogan & Hartson.”
- “The reason was clear. The two quasi-governmental institutions had spent years nurturing relationships with lawmakers. They had spent a combined \$15 million lobbying Congress since 1998, and Freddie had donated nearly \$9 million to candidates and committees during the same period. In 2000 alone, Fannie Mae gave \$2.4 million in campaign donations, including \$1.1 million in now-banned ‘soft money’ checks delivered in \$100,000 and \$50,000 chunks to party committees. They also developed a rep for playing hardball with their opponents, threatening to withhold foundation money from local housing programs and labeling their critics as the enemies of poor homeowners.”
- “FM Policy Focus concentrated its early efforts on re-educating its audience, said House. Baker was among a handful of lawmakers who were willing listeners. He’d been around during the savings and loan collapse of the 1980s and wanted Congress to be proactive if a similar financial crisis loomed. The bookkeeping secrecy around Fannie and Freddie—which finance two out of every five U.S. home loans—seemed

to him to be just the sort of dangerous mix that needed to be corrected. He introduced legislation in 2000 aimed at shedding light on their finances. Next thing Baker knew, Fannie was holding forums in his Baton Rouge district to promote its homeownership programs—and build a grass-roots base of allies to use later to apply pressure on him. Fannie used similar tactics on other lawmakers. Baker’s bill went nowhere.”

- “The collapse of Enron a year later prompted more lawmakers to question the lending giants’ ability to operate without more aggressive oversight. In 2002, [Representatives] Christopher Shays (R-CT) and ...Ed Markey (D-MA) introduced a bill requiring Freddie and Fannie to comply with the same Securities and Exchange Commission disclosure requirements as private firms. But Freddie and Fannie did an end run around the legislation by announcing they would voluntarily comply with most SEC requirements. When those first reports came due, however, the bottom fell out of Freddie, forcing officials to acknowledge a history of accounting irregularities that led to a \$4.5 billion correction in its earnings, a wholesale firing of its management team and a \$125 million fine.”
- “Fannie Mae denied that it rigged its books in a similar way. Its defiant position allowed it to escape greater scrutiny until the fall of 2004, when the SEC confirmed a government report accusing Fannie of accounting irregularities. That’s when Baker used his most potent weapon. For nearly a year, the congressman had been in possession of Fannie Mae’s executive salary data. In October, he called a meeting of his Capital Markets Subcommittee, and word spread he was going to release the compensation figures. On the eve of the hearing, Starr met briefly with the House Financial Services Committee’s Republican staff and warned that publication of the list could lead to civil lawsuits, people in the meeting later recalled. The committee hearing was jammed as Baker unveiled his poster-sized list of compensation packages for Fannie Mae’s top 22 executives, 20 of whom received more than \$1 million in 2002. Of that group, a dozen collected more than \$2 million; nine received more than \$3 million. The sums outraged lawmakers. Fannie Mae’s chairman, Franklin D. Raines, retired, clinging to a severance package that included a \$1.4 million annual paycheck and \$30 million in stock options.”
- “In 2005, news of Fannie Mae’s accounting practices worsened, but Congress still didn’t pass legislation mandating that the two agencies comply with SEC regulations. Representative Barney Frank (D-MA) had witnessed Baker’s battles as ranking member of the House Financial Services Committee. When he became chairman this year, he moved swiftly and pushed the bill through the chamber in May with a 313-104 vote. The Frank legislation is significantly tougher than the one Fannie and Freddie fought so bitterly in 2000, an irony that pleases Baker. ‘With every iteration, it got stronger. It’s to the point where I didn’t know what else there was to put in it,’ the congressman chuckled.”
- “The measure still faces some challenges. Members of the House of Representatives attached a controversial affordable housing fund—which the White House doesn’t like—that could reopen negotiations in the Senate. And the lending giants, while

chastened, are not inactive. Sharon McHale, a Freddie Mac spokeswoman, said the organization is hoping to adjust language in the bill as it moves through the Senate. That said, she says Freddie ‘very much wants to see reform legislation enacted.’ Asked why, after such a long fight, she replied: ‘It’s a perception issue.’” (www.politico.com, Jeanne Cummings, 07/09/07)

Public comments submitted to OFHEO
on the agency’s guidance on the calculation of conforming loan limits

- “Freddie Mac believes decreasing our loan limits would be disruptive to the single-family mortgage market and would increase costs for the full range of single-family mortgage market participants, including homebuyers, homeowners, originators, home builders, real estate brokers, secondary market investors, mortgage insurers and the Enterprises,” wrote Robert E. Bostrom, the company’s EVP and General Counsel in a July 19th letter to OFHEO. “A reduction in our loan limits has repercussions beyond the conventional market, as it also would reduce loan limits for FHA-insured loans and reduce the maximum guarantee amount for VA-guaranteed loans, a loan program that provides important benefits for our nation’s veterans.”
- The company continued, “A decrease in Freddie Mac’s loan limits would harm families by adversely affecting homeownership opportunities, increasing the down payment required to refinance into a conforming mortgage, increasing mortgage interest costs, and delaying refinance out of more expensive mortgage products. Accordingly, we do not believe there is any public policy, housing or residential mortgage market reason for reducing Freddie Mac’s loan limits. Any public policy objective of keeping the conforming market at roughly a constant percentage of the mortgage market would be better served by offsetting any decrease against future increases in adjusting the loan limits...” (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard*, Robert E. Bostrom, 07/19/07)
- In a July 19th letter to OFHEO, the American Financial Services Association, the Consumer Mortgage Coalition, and the Housing Policy Council, The Financial Services Roundtable wrote, “...[W]e do not believe that a reduction in house prices should result in a reduction the GSE loan limits. *We have taken this position even though our organizations are continuing to oppose the proposed increase in the conforming loan limit that was included in the House-passed GSE reform legislation, H.R. 1427.* [Emphasis supplied.] Instead, we recommend that for purposes of arriving at the limits, any decrease in house prices be recorded and netted against any future increases.”
- “We arrived at this conclusion for two reasons. First, a downward adjustment in the loan limit ceiling would result in significant costs to the industry, as well as costs to borrowers. Second, decreases in the GSE loan ceiling would send the wrong message at the wrong time. The industry is currently undergoing significant turmoil. Layering on this additional requirement(s) is simply not worth the cost, particularly since there

is a workable alternative that is fair...” (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard, American Financial Services Association, the Consumer Mortgage Coalition, and the Housing Policy Council, The Financial Services Roundtable, 07/19/07*)

- In a July 19th letter to OFHEO, the Mortgage Bankers Association wrote, “...[I]t is MBA’s position ...that the [conforming loan limit (CLL)] should not be decreased below its current level of \$417,000. We base our position on our views that, (1) Statutory authority for OFHEO to decrease the CLL is unclear at best; a plain reading of the statute is that it contemplates increases, but not decreases; (2) Due to the volatility of the FHFB Survey data and the usage of prices for only one month (October) of any year, the charter mandated survey data does not serve as a reliable annual indicator of home prices for purposes of decreasing the CLL; We believe the current system should not be used for decreases; (3) There is not a safety and soundness justification for decreasing the CLL; (4) There are strong public policy reasons not to decrease the CLL; harm to consumers, the businesses of Fannie Mae and Freddie Mac, and the lending industry could result from a decrease in the CLL; and (5) The government loan programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA), which are tied to the CLL, also would be limited, resulting in curtailment of government loans to borrowers who need assistance most, and resulting in a loss of funds generated by those programs and by Ginnie Mae. (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard, Mortgage Bankers Association, 07/19/07*)
- In a July 19th letter to OFHEO, the Independent Community Bankers of America wrote, “ICBA generally agrees with the proposed guidance, but urges that, given the current difficult conditions, market stability should be the primary goal and OFHEO should consider delaying decreases in conforming loan limits beyond one year and allow them to aggregate beyond 1 percent, so as not to cause further deterioration, making it even more difficult for consumers to buy homes or refinance their mortgages.” (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard, Community Bankers of America, 07/19/07*)
- In a July 19th letter to OFHEO, the American Bankers Association noted that they support the guidance, but sought one clarification. “The proposal indicates that loans which are originated as conforming loans would be grandfathered, i.e., treated as conforming, even if the loan limits were to decrease. We would strongly suggest that OFHEO clarify this guidance so that loans that were conforming either when originated or sold to one of the Enterprises are grandfathered and thus remain conforming even in the event of a price decline. To elaborate: if a lender makes a non-conforming jumbo loan and holds that loan on their books for a number of years, during which time the loan limits increase, and then sells that loan to one of the Enterprises as a conforming loan, it should remain conforming, even if the limits decrease.” (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard, American Bankers Association, 07/19/07*)

- In a July 18th letter to OFHEO, America’s Community Bankers noted that they strongly support the guidance because it would “essentially adopt the 2006 procedures on a going-forward basis and would provide a consistent, uniform methodology for addressing such declines in the future. We believe the framework will also minimize operational challenges to the mortgage and financial markets by: appropriately deferring declines for the later of one year or until they reach at least a cumulative one percent level; and ‘grandfathering’ all loans that were within the conforming loan limit at the time of origination.” (*Correspondence to OFHEO’s General Counsel Alfred M. Pollard, America’s Community Bankers, 07/18/07*)

HUD announces creation of the Fair Housing Lending Division

- HUD has announced the creation of the Office of Fair Lending Division that will review mortgage lending policies and practices throughout the nation. The office will also monitor Fannie Mae and Freddie Mac to ensure that the loans that the GSEs purchase in the secondary market comply with fair lending laws. The agency has hired a senior-level economist to run this office and will hire five fair lending specialists to investigate allegations of mortgage lending discriminations. “Specifically, the new Fair Lending Division will investigate discrimination complaints against lenders who have allegedly violated the Fair Housing Act by refusing to make mortgage loans, refusing to provide the same information regarding loans, or imposing different terms or conditions for granting a loan, such as factors based on the race or national origin of the borrower,” said HUD. (*HUD Press Release, 07/11/07; Associated Press, 07/12/07*)

HUD studies conclude Fannie and Freddie have made “recent improvements” in the purchase of home mortgages made to lower-income families

- HUD has released studies showing that Fannie Mae and Freddie Mac have made “some recent improvements in meeting the agency’s affordable housing goals. Working paper HF-017, “Goal Performance and Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac, 2001-2005,” examines the loan and borrower characteristics of the mortgages purchased by the GSEs. Working Paper number HF-018, “The GSEs’ Funding of Affordable Loans: A 2004-05 Update,” compares the borrower and neighborhood characteristics of single-family mortgages purchased by Fannie Mae and Freddie Mac between 1999 and 2005 with those of loans in the primary market. These studies are available at HUD’s website at <http://www.huduser.org/publications/hsgfin/workpapr.html>. (*HUD Press Release, 07/18/07*)

Bush administration notes

- The Treasury Department has hired two staff members from Capitol Hill: Bob Foster, who worked for former Representative Michael Oxley (R-OH) for 19 years, and Jeremiah Norton, who worked as a legislative assistant for Representative Ed Royce (R-CA). Foster has been appointed as Treasury's deputy assistant secretary for banking and legislative affairs. Norton will serve Treasury as its deputy assistant secretary for financial institutions policy. (*American Banker*, Rob Blackwell, Joe Adler, and Steven Sloan, 07/16/07)
- The Federal Reserve Board has promoted Brian F. Madigan, an agency veteran, to serve as the Director of the Division of Monetary Affairs, which advises the board on matters related to domestic monetary policy. Madigan will assume his new position on July 23. (*American Banker*, Rob Blackwell, Joe Adler, and Steven Sloan, 07/16/07; *Bureau of National Affairs*, 07/09/07)
- Emil Henry Jr., the Treasury Department's former assistant secretary for financial institutions, has joined Lehman Brothers as a managing director in its private equity division. Henry will be based in Lehman's New York office, where he will focus on global investments in infrastructure and report to Michael J. Odrich, managing director and global head of private equity in the company's investment management division. (*American Banker*, Rob Blackwell, Joe Adler, and Steven Sloan, 07/16/07)

Rising foreclosures turn up the heat on Mers

- With foreclosures on the rise, Merscorp, Inc. (Mers), which operated an electronic loan registry, is facing a growing number of lawsuits, challenging the company's basic business model. In 2007, four lawsuits have been filed against the company, along with two suits filed in 2006 and three others filed from 2000 to 2003, all contesting Mers authority to foreclose on behalf lenders. Mers electronic registry, created in 1996, now covers 60% of all mortgage loan originations. The company's subsidiary, Mortgage Electron Registration Systems Inc., is listed as in the public record as the holder of the mortgage rather than the lender. [While the registry tracks the sales of loans and the right to service them for its 3,500 member companies, the unit remains the owner of record throughout the life of the loan.] Consumer advocates and litigants argue that it is unfair to obscure the mortgage's true owner. In a proposed class action suit filed last year in the U.S. District Court for the Middle District of Florida in Jacksonville, the litigants accuse Mers of unfair trade practices. The suit argues that while Mers identifies itself as a creditor, it has failed to register as a consumer collection agency in Florida and does not have a license as a mortgage lender that would allow it to act on behalf of its members. "They're collecting a debt that they don't have a right to collect and in a manner to which they're not legally entitled to collect," said April Charney, a senior attorney at Jacksonville Area Legal Aid Inc., representing nine borrowers in the proposed class action. "The point of

having a recording system is so everyone, including the consumer, can know who owns the mortgage,” said Charney. “Mers is an attempt to evade that. Why should they be listed instead of the party that actually owns the note? That lack of transparency makes it very difficult for consumers to even know whom to serve process on.”

- Bill Hultman, a senior vice president with Mers, said that while property statutes were created to provide notice to third parties that there is a lien on a house but “not necessarily who the owner of the lien is” or what entity owns the loan. “There’s no requirement anywhere that any of these documents be recorded in the land record, so it’s not true that the statutes are there for full disclosure. They’re to protect third parties from fraudulent transfers,” Hultman said. “There are people in the mortgage industry that took advantage of borrowers, and somehow we got caught up in this, because our name is on the foreclosure papers, and that we’re somehow trying to hide things from the world, and that’s just not the case.” Hultman argues that the proposed class action hinges on a technicality and that he believes the suit will be dismissed. “There’s this misnomer that people have that we’re not the mortgagee of record, even though the borrower makes us the mortgagee when they sign their mortgage, and that’s a matter of contract rights between the borrower and the lender,” he said.
- Fannie Mae owns 60% of Mers. Freddie Mac, more than a dozen lenders, five insurance companies, three trade groups and Mers’ eight executives own the balance of the company’s shares. Mers members include the top 100 originators and servicers, whose dues range from \$264 to \$7,500 depending on the member’s size. (*American Banker*, Kate Berry, 07/10/07)

Fannie Mae

Fannie Mae increases its third quarter dividend 25%

- Fannie Mae's board of directors increased the company's quarterly dividend for its common stock by 25%, or \$0.10, to \$0.50 a share. The dividend payment will be made to registered shareholders of record on July 31st to be payable on August 27th. The board also declared dividend payments for the company's preferred issues in accordance with their respective terms. (*PR Newswire*, 07/17/07)

Fannie Mae alumni news

- Daniel J. Barry, has joined the Financial Planning Association to serve as the Director of Government Relations. Most recently, Barry served as the Director of Regulatory Policy for Fannie Mae. (www.investmentwires.com, 07/20/07)

Freddie Mac

Freddie Mac CEO Syron waived \$200,000 of his guaranteed pay at the request of company's compensation committee

- According to the *Washington Post*, "Freddie Mac's chairman and chief executive Richard F. Syron, who ranked eighth [among the Washington area's most highly paid executives] with reported compensation of \$14.7 million, was recruited in 2003 to clean up after an accounting scandal at the ...company. That work remains unfinished: Freddie Mac has been unable to issue quarterly financial statements on a timely basis. The remediation efforts 'suffered during 2006 from ineffective planning and inconsistent execution,' [OFHEO] reported. Based on the company's performance, and at the request of the board's compensation committee, Syron waived \$200,000 of his guaranteed pay. Syron's accomplishments have included progress in upgrading the company's internal controls, gains in market share and returning money to shareholders through a 92 percent increase in the dividend, Sharon J. McHale, a Freddie Mac spokeswoman, said by e-mail." (*Washington Post*, David S. Hilzenrath, 07/16/07)

Freddie Mac prices \$500 million of preferred stock

- On July 17th, Freddie Mac priced \$500 million of fixed-rate non-cumulative perpetual preferred stock that is expected to be issued on July 24th. The 20 million shares of preferred stock were offered to investors at \$25 per share with a dividend rate of 6.02%. Freddie Mac will have the option to redeem all or part of the shares on or after June 30, 2012 at \$25 per share plus accrued dividends. The offering was managed by Merrill Lynch & Co. through a syndicate of dealers which included Great Pacific Securities, Loop Capital Markets, L.L.C., MFR Securities, Inc., Toussaint Capital Partners, L.L.C., Utendahl Capital Partners, L.P. and Williams Capital Group, L.P. (*Freddie Mac Press Release*, 07/17/07)

Freddie Mac forms new business relationship with Greystone Residential Funding

- Freddie Mac has entered into a new business relationship with Greystone Residential Funding, an emerging leader in wholesale funding which will provide the GSE's community lenders with greater flexibility, enhanced tools and lending options. Through this relationship, Freddie Mac's customers will gain access to an expansive mortgage product menu, innovative technology and a comprehensive set of tools to streamline and enhance their mortgage operations. Dan Rotert, Greystone's president and CEO, said, "We have developed our business model to focus exclusively on community lenders ...by providing them with the best mortgage products and technology available, enabling their mortgage lending success." (*PR Newswire*, 07/17/07)

Federal Home Loan Banks

FHLBs “shut out” credit unions from their affordable housing grants

- During the last 30 days, the FHLBs of Boston, Pittsburgh, Cincinnati and Dallas have awarded more than \$30 million in affordable housing grants to members – but not a cent of it to their credit union members. The Banks’ representatives said that the awards reflect the applications that they have received for funds and not the result of any bias by directors, none of whom represent credit unions. The FHLB-San Francisco is the only bank which has awarded one grant this year for just over \$1 million of its \$34.7 million AHP funds to credit union members. Geoff Bacino, a former NCUA board member and who now sits on the Federal Housing Finance Board, said that the FHLBs generally fund about 60% of the AH applications they receive, but few applications are submitted by credit unions. More than 1,000 credit unions are now members of the FHLBs. (*Credit Union Journal*, Ed Roberts, 07/16/07)

Thomas Goldstein leaves the FHLB-Chicago’s board of directors

- Thomas Goldstein resigned from the FHLB-Chicago’s board of directors upon his resignation as senior vice president of LaSalle Bank NA, effective July 11th. (*Chicago Tribune*, Becky Yerak, 07/12/07)

FHLB-Indianapolis announces its second quarter dividend

- The board of directors of the FHLB-Indianapolis declared cash dividends on its B-1 stock at an annualized rate of 4.5% and on its B-2 stock at an annualized rate of 3.6% for the second quarter, payable on July 23rd. (*FHLB-Indianapolis Press Release*, 07/16/07)

Ginnie Mae

HUD extends the comment period on its proposed rule to prohibit seller-funded down payment “gifts”

- HUD has set a 30 day extension to August 10th for the comment period for the agency’s proposed rule prohibiting seller-funded down payment assistance programs (DPA) on loans insured by FHA. Representatives Maxine Waters (D-CA), chairwoman of the Housing and Community Opportunity subcommittee, and Gary Miller (R-CA), the subcommittee’s ranking minority member, formally requested the extension to allow the panel time to study the program. Members of both parties have expressed opposition to the proposal and urged HUD to withdraw the proposed rule.
- The U.S. Conference of Mayors (USCM) passed a resolution endorsing the DPA programs at its annual conference. “[The nonprofit groups] who provide private downpayment assistance are not only helping people nationwide buy homes, but also stabilize neighborhoods and cities, and create stronger families,” said USCM president and Trenton, N.J., Mayor Douglas Palmer.
- However, GAO auditors and the HUD’s inspector general argue that the proposed rule is necessary because DPA programs lead to inflated sale prices, higher loan amounts, and higher foreclosure rates (16%) which are more than twice that of other FHA-insured home loans. (*American Banker*, Kate Berry, 07/12/07; *National Mortgage News*, 07/09/07)

NAHB urges Congress to pass FHA reform legislation

- The National Association of Home Builders (NAHB) called on Congress to implement reforms to the Federal Housing Administration’s single-family mortgage insurance programs to enable more working families to become home owners. “Improving the FHA program would be highly effective and possibly the most appropriate means for Congress to address problems in the subprime mortgage market,” said David Crowe, NAHB senior staff vice president for regulatory and housing policy, in testimony before the Senate Banking Committee. If granted proper authority by Congress, FHA’s single-family mortgage insurance programs could insure fixed-rate, adjustable-rate and hybrid adjustable-rate mortgage loans to borrowers with limited cash reserves or slightly tarnished credit on far better terms than the subprime loans, said Crowe.
- To give the FHA the tools it needs to meet its mission objectives more effectively, NAHB urges Congress to (1) grant the FHA authority to establish greater flexibility in setting downpayment requirements for its single-family programs; (2) revise FHA requirements for condominium loans, which are often burdensome and differ

significantly from mortgage loans for detached single-family homes; (3) allow the FHA to establish a risk-based mortgage insurance premium pricing structure that rewards higher-risk borrowers who establish a track record of timely payments; (4) permit the FHA to extend the maximum loan maturity to 40 years to enable borrowers to reduce their monthly mortgage payments; increase the current limit for FHA-insured mortgages to enable deserving potential home buyers to buy homes in high-cost areas; and (5) give the HUD secretary increased flexibility to increase the FHA multifamily mortgage loan limits in high cost areas. (*National Association of Home Builders Press Release, 07/18/07*)

Reverse mortgage “revolution”

- While IndyMac Mortgage’s Financial Freedom and Wells Fargo continue to dominate the reverse mortgage industry, there is a growing group of moderate-sized originators now that are successful in this market, said Jeff Lewis, chairman of Generation Mortgage of Atlanta, which recently purchased Amston Mortgage as an entry into this market. “The hold that a small group of companies had on the reverse industry is breaking,” said Lewis.
- The subprime market meltdown presents an opportunity for reverse lenders, said Lewis. “There are seniors that have loans that are a real burden to them, and they can be refinancing into a reverse mortgage,” he added. “People are recognizing that the value of their house isn’t going to go up forever ... so they may look to take advantage of current home values as a basis for taking out a reverse.”
- According to HUD, reverse mortgage volume has been growing at a rate of more than 50% a year for the past three years thanks largely to the 78 million baby boomers who are planning for their retirement. In 2006, borrowers took out 76,276 federally-insured reverse mortgages, which comprised 90% of the market according to FHA. In February, Generation Mortgage introduced a jumbo reverse mortgage products for homes appraised at values up to \$6 million in California and up to \$4 million outside of California. (*American Banker, Kate Berry, 07/12/07*)

Farm Credit System / Farmer Mac

Chairman Frank asserts the Financial Services Committee's joint jurisdiction on the 2007 farm bill

- In a July 11th letter to House Speaker Nancy Pelosi (D-CA), Representative Barney Frank (D-MA), chairman of the House Financial Services Committee, and ranking member Spencer Bachus (R-AL) said the farm bill being reported by the House Agriculture Committee (H.R. 2419) should next be reviewed by his committee. Frank said that the bill's provisions "represent a fundamental change in the mission [of FCS]" by greatly expanding the scope of the Farm Credit System's purview into areas traditionally dominated by the banking industry. The lawmakers wrote that the proposals "crossed the jurisdictional line from traditional farm credit into the broader jurisdiction of the Committee on Financial Services." As an example, they cited language from H.R. 2419 that would allow "persons primarily engaged in processing, preparing for market, handling, purchasing, testing, grading, distributing, or marketing farm products, or providing services and supplies to farmers" to borrow from the FCS for activities "related to renewable energy." By leaving the definition of the terms "primarily engaged in" and "related to renewable energy" to the FCA rather than defining them in the legislation, the bill could potentially result in a significant expansion in the scope of FCS lending, said the lawmakers.
- The American Bankers Association praised the committee's leadership for alerting Pelosi of the jurisdictional overlap of the farm bill. ABA executive director Floyd Stoner said, "By accepting the language of the proposed credit title of the House farm bill, the House would be taking the 'farm' out of the Farm Credit System." (*American Banker*, Stacy Kaper, 07/13/07; *Bureau of National Affairs*, Marcia Kass, 07/13/07)

FCA approves merger of two North Dakota institutions to "better serve" segments of agribusiness "such as ethanol operations"

- On July 12th, the FCA board of directors granted preliminary approval of the proposed merger of Farm Credit Services of Grand Forks, ACA and AgCountry Farm Credit Services, ACA. According to FCA's press release, "The associations requested the consolidation to better serve segments of agribusinesses in their service areas that are also consolidating, such as ethanol operations." The consolidated association, to be headquartered in Fargo, ND will have total assets of approximately \$2.3 billion and will serve 41 counties in northwestern Minnesota and eastern North Dakota. Eugene Smestad will serve as CEO of the new association. (*US Fed News*, 07/12/07)
- Farm Credit Services of Grand Forks, ACA (FCSGF) has entered into a non-binding term sheet with Liberty Renewable Fuels, LLC (Liberty Renewable Fuels or LRF) to

facilitate the company's construction of the largest ethanol plant in Michigan and its purchase of Auburn Bean & Grain for an aggregate cost of \$233 million. The term sheet which "contemplates" that FCSGF will issue \$54.85 million of traditional senior debt and the tax exempt bonds, with letters of credit supporting the bonds, of approximately \$63.75 million for a combined total of approximately \$118.6 million of financing for the construction of LRF's ethanol plant. Liberty Renewable Fuels was organized in June 2006 with an initial equity investment of \$16.4 million. On June 7, 2007, the company launched a new offering of its membership units for \$50 million to \$100 million. Investors must be willing to invest a minimum of \$20,000 in ownership units of \$5,000 each. GreenStone Farm Credit Services has offered extend credit to its members who are interested in investing in Liberty. (*Midland Daily News*, Cheryl Wade, 07/13/07; *Lansing State Journal*, Jeremy W. Steele, 07/08/07; *Liberty Renewable Fuels LLC Offering Circular*, 07/07/07)

- As FCA institutions expand their loan exposure in the ethanol industry, one has to wonder what the future may hold for this sector. According to the July 16th issue of *Energy Speculator*, "...Congress' new energy bill is stupefying. Anyone paying attention to the science of ethanol can see it's a misguided policy, to say the least. If corn-based ethanol is the answer, then the question must be 'Which fuel can worsen America's energy crisis?' That's because there are now credible studies which prove that it is not an efficient fuel. Most studies find that it takes between 0.74 – 0.80 units of fossil energy to produce a comparable unit of ethanol energy. However, professors David Pimentel and Tad Patzek have published research that concludes it takes a total of 1.29 units of fossil energy to create a unit of ethanol energy. Whether corn-based ethanol production consumes more energy than it produces is still a topic of some debate, but what is obvious is that ethanol's utility as a fuel is marginal at best."
- "...The rise in 'popularity' of corn-based ethanol gained force when vote-hungry politicians, looking to buy favor with farmers, met the irresistible force of cash from agro-businesses lobbying for an artificial support to crop prices. Special-interest groups, briefcases stuffed with campaign contributions (read: bribes), have skewed the debate on ethanol..."
- "...It has only been two years since America's politicians created this ruinous scheme, yet major repercussions are already being felt. Corn prices rose above \$4 a bushel in January and have doubled over the past two years. Because corn is the most common animal feed, this affects the price of milk, cheese, eggs, meat, as well as corn-based sweeteners and cereals. This has resulted in dramatic worldwide increases in food prices. Milk prices have nearly doubled in the U.S. Butter prices in Europe have spiked by 40%. And pork prices in China are up 20%. In Mexico this year, there have even been riots, protesting a 400% rise in the price of corn flour, accompanied by a 60% rise in the price of tortillas. Thanks to Congress, it appears that hand in hand with peak oil has come the end of cheap food..."
- "...As for reducing greenhouse gases (GHGs), lowering gas prices or reducing U.S. dependency on foreign energy supplies, ethanol does none of the above. Corn-based

ethanol might cut down your car's emissions, but its impact on the overall reduction of greenhouse gases is negligible. That's because corn is one of the most fertilizer-intensive crops to grow. It takes a lot of fossil fuels to make nitrogen fertilizer in the first place, and when that fertilizer interacts with soil bacteria, N₂O – a much worse GHG than CO₂ – is the result. The U.S. Department of Agriculture (USDA) admits that in its best-case scenario, the rising use of ethanol will cut America's overall GHG emissions by all of 0.13%. To add insult to injury, government subsidies cost taxpayers US\$520 per one metric ton of CO₂ reduction. If instead these subsidies were used directly to reduce CO₂, they would be enough to buy 8 metric tons in carbon offsets on the European Climate Exchange, or 45 metric tons on the Chicago Climate Exchange.”

- “Okay, then, what about the idea that ethanol will make America more energy self-sufficient? Nope, biofuels won't do that either. The main growth in ethanol supply is **coming from imports**, which rose from 135 million gallons in 2005 to 653.3 million gallons in 2006. [Emphasis added.] According to the pro-ethanol USDA, ethanol production in 2006 equated to a reduction of foreign oil independence by 1.5%, and by 2017, we will max out at 3.7%. So much for making America becoming less dependent on the rest of the world for its energy needs. And as for gas prices, we all know how much ‘lower’ they've gone recently.”
- “The latest ‘innovation’ in the biofuel industry is cellulosic ethanol. It has been hailed as much cleaner and more net-energy positive than corn-based ethanol, but it is no savior waiting in the wings. Cellulosic ethanol remains significantly more expensive to produce. While corn-based ethanol costs around \$1.50/gallon to produce, production of cellulosic ethanol costs at least \$2.25/gallon (depending on commodity prices). And the capital costs associated with cellulosic ethanol are seven times higher than those associated with corn. Even with a glut of government subsidies, developers of cellulosic ethanol are just scraping by, meaning that cellulosic ethanol will likely never be a viable option either.”
- “Conventional oil supplies are dwindling, and alternative fuels are needed, but corn and cellulosic ethanol are not the solution. In 2006, ethanol production required between US\$13-\$17/MMbtu in subsidies. That's more than twice as expensive as a comparable unit of energy from natural gas, which is a much better alternative fuel source for vehicles. Years from now, America will surely look back at this fad for biofuels as one of its more embarrassing and costly missteps in the ongoing quest for sustainable energy.” (*Energy Speculator*, 07/16/07)

FCS board adopts proposed rule providing the FCS a 90-day window to distribute annual reports to shareholders

- The FCA board also adopted a proposed rule allowing FCS institutions 90 days after the end of a fiscal year to prepare and distribute paper copies of their annual reports to shareholders. Institutions would still be required to file electronic copies of the

reports with FCA and post them on their websites within 75 days. The proposed rule will be published in the Federal Register for a 30-day comment period. (*US Fed News*, 07/12/07)

Non-traditional farmers are a driving force in FCS

- According to Land Bank of North Mississippi’s president Gary Gaines, “15 to 20 years ago, we were big with traditional farmers. The non-traditional borrower is now driving our new offices [and business.]” In the old days, a typical FCS customer was a small, rural farmer who needed loans to buy land for expansion, equipment or pay for marketing and crop production. Today, the Land Bank customer is just as likely to be a retiring pilot or lawyer wanting to buy property for a retirement home, an agricultural corporation buying land for a duck camp or an investor buying 1,000 acres or more of timber land as an investment, said Gaines. Land Bank, formerly known as Federal Land Bank Association of North Mississippi, is a member of the Farm Credit System and serves 32 counties in the region. The impending arrival of Toyota’s Highlander assembly plant between Tupelo, MS and New Albany, MS will present tremendous growth opportunities for everyone, including Land Bank, said Craig Shideler, the institution’s EVP and chief credit officer. (*Memphis Business Journal*, Christopher Sheffield, 07/16/07)

Postal Service

USPS and NALC reach tentative agreement on a five-year contract which includes new limits on contracting out city letter carrier work

- On July 12, the USPS and the National Association of Letter Carriers reached a tentative agreement for a five year contract, retroactive to November 21, 2006, which provides general wage increases of 8.85% over five years along with regular cost-of-living adjustments and a single lump-sum COLA payment of \$686 for the period between July 2006 and May 2007. The proposed contract also includes new limits on contracting out city letter carrier work in more than 3,000 city delivery installations and establishes a six-month moratorium on contracting out city carrier services elsewhere across the county. During the moratorium, a union-management task force will attempt to develop an “evolutionary approach to the issue of subcontracting, taking into account the legitimate interests of the parties and relevant public policy considerations.” Consistent with trends in the private sector, the proposal also provides the USPS relief on health care costs by increasing the share of health care premiums paid by city letter carriers by five percentage points over the five-year duration of the contract.
- NALC president William H. Young said, “This agreement is fair to hard-working letter carriers by taking necessary steps toward protecting their jobs now and well into the future, along with financial compensation that takes into account increases in the cost of living and the difficult task carriers often face in delivering mail to our nation’s growing population. At the same time, it helps the U.S. Postal Service to build on its record as the most efficient and affordable postal service in the world.”
- The proposed agreement, which would expire on November 20, 2011, was approved unanimously by the NALC Executive Council, will be submitted to the union’s membership for rank-and-file ratification. (*PR Newswire*, 07/12/07)

Taxpayer and consumer advocates are seeking end to USPS monopoly on mailboxes

- According to the *Federal Times*, “A group of taxpayer and consumer advocates are calling for an end to the U.S. Postal Service’s monopoly on mailboxes. In response to a Federal Trade Commission request for comment in the May 1 Federal Register, the group questions a rule that bars putting letters or packages in mailboxes without paying a fee to the Postal Service. The rule ‘injects unnecessary nuisance, cost and inefficiency into simple acts of community communication,’ the group writes in a June 29 letter to the FTC. The letter is signed by officials from the Consumer Postal Council, the National Taxpayers Union, Americans for Tax Reform and other groups.” (*Federal Times*, Daniel Freidman, 07/09/07)

Congress should avoid micromanaging the USPS

- Noting that Congress has scheduled five oversight hearings on postal issues over the span of three weeks in late July and early August, PostCom vice president Kate Muth writes, "...While oversight [of the USPS] is necessary –especially when the entity being reviewed is a government entity with monopoly rights—meddling provides little value and micromanagement is downright dangerous. Unfortunately, it appears that Congress is heading from oversight to meddling, with a threat of micromanagement. ...I think the larger problem lies in how we view the Postal Service. If we continue to think of it as a federal program, like Amtrak or highways, then members of Congress will always feel it is their duty to look out for their constituencies rather than to do what is best for the postal system and the nation. In short, they will meddle. The solution seems to be to move the Postal Service as far into the commercial realm as possible and as far out of the political realm as possible. Let's hope the new law takes us in that commercial direction, because too much congressional meddling would be another anchor on a weighed-down postal system. (*Postcom.org*, Kate Huth, 07/11/07)

Higher postal rates will likely result in declining mail volumes ...and the downward spiral continues

- The *Fredericksburg Free Lance-Star* reports, "The businesses taking the biggest hit [from the recent round of postal rate increases] are those who aren't able to pass the postage increases on to their customers. These include doctors and insurance agents working on commission who typically mail everything from appointment cards to billings to newsletters or possibly even birthday cards to retain clients and drum up new ones. Consultants have advised them to look at electronic means of communication....The University of Mary Washington's admissions office, for example, doesn't want to stop mailing potential applicants copies of its 'view book,' a 24-page publication about the university that has an application form tucked in the back. But her office now mails view books only to people who request copies rather than sending them to everyone who visits the university or its Web site, umw.edu. 'In the past, I've sent up to 10,000 to 15,000 out,' Burkett said. 'That's not going to happen this year...'" (*Fredericksburg Free Lance-Star*, Kathy Jett, 07/12/07)

Day of reckoning coming soon for the USPS

- Tony Conway, executive director of the Alliance of Nonprofit Mailers, said he expects the Postal Service to "evolve, probably into more of a focus on the strength of the organization, which is its delivery network. That's the heart and soul of the organization, no current private carrier can compete with it. [But,] it may or may not be a government organization." Conway added, "The \$64,000 question is how to keep the delivery network affordable." While the only significant growth area is

standard mail [primarily advertising], as the cost of postage rises, “at what point do you start losing that volume growth,” he said. “The days of reckoning are coming sooner than people probably now appreciate.” The USPS is adding 2 million new delivery points every year, which raises costs on a declining revenue base. “That’s not a pretty financial model.” (*Associated Press*, Randolph Schmid, 07/06/07)

The EU Parliament wants to end national mail delivery monopolies by 2011

- On July 11th, the European Parliament voted to dismantle national monopolies on mail delivery by 2011, but provided additional delays of up to two more years (2013) to EU’s 12 newest member states and countries with scattered population or islands.” To date, Sweden, Britain and Finland have scrapped all legal monopolies for postal service with Germany and the Netherlands planning to do so soon. While not opposed to the idea, France, Luxemburg, Belgium and others are lagging behind on the privatization process. A key unresolved issue to be addressed by the European Parliament is how to finance universal public service that would ensure all Europeans gets at least one delivery and collection a day, five days a week, after rival companies move into markets. The EU assembly is considering proposals which would (1) allow governments to subsidize loss-making operators guaranteeing universal mail delivery service or (2) create a of a fund into which all active postal operators contribute to cover such losses. EU member governments will debate the issue after the summer recess and new rules are expected to be put into place by the end of this year, said Austrian lawmaker Markus Ferber. (*International Herald Tribune*, 07/11/07)

TVA

President Bush nominates a Georgia banker
and two Tennessee incumbents to serve on TVA’s board of directors

- President George W. Bush has nominated Thomas Gilliland, the executive vice president for United Community Banks in Blairsville, GA, to serve on TVA’s board of directors. Gilliland, who was recommended by Senators Saxby Chambliss (R-GA) and Johnny Isakson (R-GA), will be the first TVA board member from Georgia. He replaces Bill Baxter, who resigned in January with four years left on his term. President Bush also announced the renominations of Bishop William Graves of Memphis, TN and Susan Richardson Williams of Knoxville, TN to five year terms on TVA’s board of directors. (*Chattanooga Times Free Press*, Herman Wang, 07/13/07)

- Senator Isakson said, “President Bush has selected an outstanding candidate who is extremely knowledgeable about the environmental, recreational and power resources provided by the TVA. The TVA has jurisdiction over power issues that are critical to Georgia, and I’m extremely pleased my constituents will finally have a voice on that governing board.” Senator Chambliss added, “I am extremely pleased that the people of Georgia will have a voice on the TVA board. Tom Gilliland’s background and experience will serve him well in this capacity and greatly benefit the TVA and the communities it serves.” (*US Fed News*, 07/11/07)
- Senator Lamar Alexander (R-TN), chairman of the TVA Congressional Caucus, said, “The re-nomination of Bishop William Graves and Susan Williams of Tennessee and the nomination of Thomas Gilliland of Georgia is very good news. I hope the Senate grants a speedy confirmation to these individuals, so that all TVA customers can be fully represented by individuals committed to pushing for reliable, clean power at the lowest possible cost.” (*US Fed News*, 07/12/07)

Southern utilities continue to resist renewable energy alternatives

- Although six of the nation’s 10 largest sources of carbon dioxide emissions are coal-fired power plants in the South, the region’s lawmakers continue to balk at mandating utility companies to generate cleaner, renewable energy. In June, Republican senators from the south provided about half of the votes that defeated federal legislation that would have required power companies to generate 15% of their electricity from renewable sources by 2020. While almost half of the states have adopted their own renewable energy mandates, only one state—Texas—is in the south. In response to heavy lobbying from local utilities, southern lawmakers argue that their region isn’t conducive to solar or wind power and that a “one size fits all” standard would drive up utility bills in their region. While the Energy Department said the failed Senate proposal would have increased utility bills by less than 1% through 2030, officials acknowledge that the south would see slightly higher increases, in part because the region’s electricity rates are among the nation’s lowest. (*Associated Press*, 07/14/07)

Fitch assigns ‘AAA’ rating to TVA bonds

- Fitch has assigned an ‘AAA’ rating to \$1 billion of TVA global power bonds series A with a stable outlook. The bonds were priced on July 12th by co-senior managers Morgan Stanley and Lehman Brothers. The net proceeds from the offering will be used to refinance TVA’s existing debt. (*Nashville Business Journal*, 07/12/07)

Memphis Power Light and Water blames TVA's higher utility rates
as the primary cause for the utility's 113% increase in net write-offs

- The Memphis Light, Gas and Water Division (MLGW) has the highest level of uncollectibles—in both actual dollars and as a percentage of operating revenues—of the “big five” utilities which purchase power from TVA. In 2006, MLGW’s uncollectibles represented 0.84% of operating revenues, compared to Knoxville (0.43%), Nashville (0.23%), Chattanooga (0.13%) and Huntsville (0.08%). Moreover, the MLGW’s adjusted uncollectibles (to account for Memphis’s poverty levels) as a percentage of total revenues are nearly 25% higher than the next highest city, Knoxville. Since 2002, the Memphis utility’s write-offs have increased 113% from \$6.0 million to \$12.8 million in 2006.
- MLGW officials largely blame the increase on TVA’s rate hikes and rising costs for natural gas over recent years. MLGW’s controller, Dana Jeanes said, “TVA’s had a couple of rate increases along the way, and of course the natural gas prices continue to escalate, the wholesale prices that we have to pay. That basically makes the total bill that the customer has to pay a bigger amount -- that puts additional pressure on them to be able to make that larger payment.” Some local officials believe that the City Council’s insistence in 2003 that MLGW institute an annual moratorium on the cut-offs from mid-December to mid-January has contributed to rise in uncollectible accounts. “It just doesn’t seem to be constructive in the big scheme of things, because it does really give an incentive for customers not to pay a bill, and they’re still going to use the gas or electricity,” said Jeanes. “The day of reckoning still comes. It just gets pushed off.”
- “I believe that both MLGW and the City Council, with good intentions, have allowed for a loosening of cut-off procedures and implemented a winter moratorium,” said MLGW board member Nick Clark. “Yet what was not realized at the time was that we have caused MLGW to exhibit the predatory lending characteristic of allowing customers to incur debt beyond their means. In the long run, this hurts those customers, their credit record and the other choices that they have to make in life.” In place of the moratorium, Clark said he supports the establishment of a “prepay” meter system that allows customers to better manage their utility costs, “while at the same time not damaging their credit record.” (*Commercial Appeal*, Michael Erskine, 07/15/07)

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