

# The **GSE** REPORT™

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## ***Major Events***

### ***Subprime contagion...***

Freddie Mac reports \$2 billion loss for the third quarter

Analysts question if Freddie Mac has more “bad news” coming in the 4<sup>th</sup> quarter

Fannie Mae’s fuzzy math only goes so far...

Fannie Mae and Freddie Mac mayhem

Fannie Mae and Freddie Mac shares sink to 10-year lows,  
losing a combined \$57 billion in market value

Fannie and Freddie’s Achilles’ heel

Representative Kanjoriski says it is “essential” for OFHEO to keep  
Fannie’s and Freddie’s 30% capital surcharge in place

*Hello... GSE reform anyone?*

### **Freddie Mac reports \$2 billion loss for the third quarter**

- On November 20, Freddie Mac stunned Wall Street with an unexpected loss of \$2.03 billion for the third quarter (\$3.29 per share), far exceeding Wall Street analysts’ expectations of a \$0.22 a share loss. The company’s fair value of net assets attributable to common stockholders (before capital transactions) fell 25% to approximately \$8.1 billion during the third quarter versus an increase of \$300 million during the third quarter of last year. Freddie Mac’s management attributed the company’s largest-ever loss to a “significant deterioration” in the housing market, which resulted in a higher provision for credit losses (\$1.2 billion) and losses on mark-to-market items (\$3.6 billion). The company’s third quarter loss has eroded its core capital to \$34.6 billion, its lowest capital level in two years and only \$600 million above its regulatory requirements. Freddie, which bought back \$1 billion of its common stock during the first nine months of the year, is planning to issue as much as \$5 billion in preferred stock to shore up its capital base, according to a person close to the matter. Freddie Mac has hired Goldman Sachs Group Inc. and Lehman Brothers Holdings Inc. to advise management on “very near-term capital raising alternatives.” Freddie also “is seriously considering” reducing its fourth quarter dividend by 50% in order to shore up capital, which could preserve about \$646 million a year in capital, according to Keefe, Bruyette & Woods’ analyst Frederick Cannon. If these measures aren’t sufficient, Freddie Mac “may consider

additional measures in the future such as limiting growth or reducing the size of [its retained mortgage portfolio].” Freddie Mac said its retained mortgage portfolio shrank by 16.9% [approximately \$20 billion] to \$703.1 billion in October and expects its retained portfolio might decline during the remainder of the year in an effort to improve its capital ratio. Freddie’s stock tumbled 35% on the day of its earnings release, extending their slump to a fifth day on analysts’ concerns that the company’s losses will continue into next year.

- In a statement, Freddie Mac chairman and CEO Richard Syron said, “We recognized the challenges facing the mortgage markets, however, and have taken further steps to address them. At the same time, as our charter mandates, we have continued to meet our mission by playing a stabilizing role in the markets and supporting our customers. It will take time for this market to turn around. But as it improves, we are optimistic about Freddie Mac’s longer-term prospects.”
- In a conference call with investors, Syron warned, “Given the continuation of the same market trends that produced these results through October and November, it is likely that the fourth quarter will prove difficult as well. We do not believe it would be wise to be sanguine about the near-term outlook for the housing market. The right thing for us to do now is to take steps to strengthen our capital position. Anthony Pizel, Freddie Mac’s CFO added, “There is nothing we see right now to be more optimistic. ... We are predicting fourth quarter performance about in-line with the third quarter.” Company executives said that Freddie’s losses on bad loans would probably exceed \$10 billion, more than double the amount the GSE has written-off to date (\$4.6 billion in pretax credit-related items). “We have begun raising prices, tightening our credit standards, and enhanced our risk management practices,” said Pizel. He also said that the company is looking to raise capital “to get beyond the first quarter [of 2008] and to really get through 2008 and the end of the credit cycle.” Pizel added, “We are looking to do something, assuming our board supports it, in the very, very, very near term.” Separately, Pizel said that Freddie Mac would file its fiscal year 2007 financial report on a “timely basis early next year.” He added, “We will meet our 60-day year-end commitment.” Syron also told investors, “We have had discussions with [OFHEO] on the [company’s excess capital requirement].” “That obviously is a key issue. We expect to have discussions in the future.” When asked if OFHEO had rejected his request for relief from the capital rule, Syron responded, “You can interpret the answer.”
- In a November 20th statement, OFHEO director James B. Lockhart, III said, “Freddie Mac’s announcement of the steps it intends to take reflects prudential actions for the company that are appropriate in light of current market conditions. These actions should enhance its ability to continue to fulfill its housing finance mission. We will continue to monitor the mortgage markets and the enterprises closely.” In an earlier interview with *Dow Jones Newswire* in October, Lockhart defended the capital surplus requirement as an important element to ensuring the safety and soundness of the GSEs. “That 30% [surplus capital requirement] was very fortuitous for both companies,” said Lockhart. Brian Gardner, Keefe, Bruyette & Woods’ vice president

of research, said that Freddie Mac's capital position created an "I told you so" moment for OFHEO." He added, "I think there will be some kind of increased pressure—some quarters will be calling for OFHEO to change its policy. But I really think this strengthens Lockhart's hand."

- Although Fitch Ratings affirmed Freddie Mac's long-term default rating at AAA, derivative investors are treating Freddie Mac [and Fannie Mae] as if it were eight notches [Baa2] below its AAA-rating, the second to the lowest rung on the investment-grade ladder, according to Moody's Investors Services' implied rating unit. Rajiv Setia, agency strategist at Barclays Capital, said, "There is a lot of uncertainty around the GSEs and their mortgage exposure. If they can survive the next few quarters, in the long-term, their outlook is good. As long as they manage their capital well, they will be seen as safe."
- Fitch has placed Freddie Mac's preferred stock, currently rated AA-, on notice for possible downgrade and indicated that stock may be cut one notch to A+, depending on if the GSE is successful in meeting its future capital requirements. Fitch said, "The growing component of preferred stock to total capital, currently at 23.4% of regulatory core capital, results in a higher expectation of loss absorption by preferred stock." The rating agency anticipates that it will resolve its ratings watch in the short term, after Freddie has finalized its plans to raise capital. Fitch has assigned a stable outlook on Freddie Mac's issuer rating. S&P Ratings lowered its outlook on Freddie Mac's preferred stock and subordinated debt due to the company's weak earnings outlook and capital reserves and changed the outlook to negative from stable on its AA- rating of the risk that the company poses to government coffers. Moody's also cut their outlook on Freddie Mac's A- Bank Financial Strength, Aa2 subordinated debt and Aa3 preferred stock ratings, and said the outlook remains stable on Freddie Mac's Aaa senior debt rating.
- Wall Street analysts cut their target prices for Freddie Mac, following the company's third quarter earnings release. Goldman Sachs' analyst James Fotheringham cut his price target on Freddie's stock by 66% to \$24, based upon expectations of further declines in the company's fair value of net assets over the coming quarters and a near-term capital offering of preferred stock. Fotheringham estimates that Freddie Mac will lose \$3.45 a share during the fourth quarter. Credit Suisse analyst Moshe Orenbuch cut his price target to \$27 from \$45, reflecting Freddie Mac's limited capital flexibility and the expectation of the GSE's loss of about \$2.4 billion, or \$3.75 a share, for the fourth quarter. Fotheringham and Orenbuch have a "neutral" rating on the stock. Friedman Billings' analyst Paul Miller downgraded Freddie to "underperform" from "market perform" and slashed his price target to \$20 from \$55. Miller expects the GSE to raise up to \$5 billion in capital over the near term. Freddie Mac's valuation will continue to come under pressure until credit cost and capital levels stabilize, said Miller. "We believe that [Freddie's] capital issues are somewhat artificial, which is mainly due to the capital surcharge requirement," wrote Miller in a note to clients. Miller also doesn't think that Freddie's projections on its expected charge-offs are realistic. Freddie projected that charge-offs will climb from 0.03%

(or \$500 million) to 0.08% (\$1.5 billion) in fiscal year 2008 and 0.11% (\$2.1 billion) in fiscal year 2009. Miller believes that Freddie Mac's provisions for credit losses should be closer to 0.20%. "They're going to have to continue to provision at about \$1 billion to \$1.5 billion for the next few quarters. So the drag on earnings is going to be meaningful," said Miller. (*Wall Street Journal*, James R. Hagerty, 11/20/07; *Dow Jones Newswires*, Damian Paletta, 11/20/07; *Bloomberg News*, Kabir Chibber, 11/23/07; *Reuters*, 11/20/07; *Seeking Alpha*, Steven Towns, 1/20/07; *Dow Jones Newswires*, John Flowers, 11/20/07; *Associated Press*, 11/20/07; *Reuters*, Patrick Rucker, 11/20/07; *CNNMoney.com*, Chris Isidore, 11/20/07; *Dow Jones Newswires*, Damian Paletta, 11/20/07; *Dow Jones Newswires*, Romy Varghese, 11/20/07; *Reuters*, 11/21/07; *Bloomberg*, James Tyson, 11/20/07; *BusinessWeek*, Dawn Kopecki, 11/20/07; *Dow Jones Newswires*, Anusha Shrivastava, 11/20/07; *Dow Jones Newswires*, Anusha Shrivastava, 11/20/07; *American Banker*, Harry Terris, 11/20/07; *Washington Post*, Thomas Heath, 11/21/07; *Wall Street Journal*, James R. Hagerty and Damian Paletta, 11/21/07; *Bloomberg*, Kabir Chibber, 11/23/07)

- In *Econbrowser* [blog], David Pearson wrote, "The majority of [Freddie Mac's] book of biz is sound - 86% fixed rate, 91% owner-occupied and overall the garbage ratio is relatively small: 8% Alt-A, 9% IO and 1% option arm (note: due to the overlap of categories percentages are not additive). The problem [Freddie] has is that the 38% of its book concentrated in '06 and '07 vintages has very different characteristics from the overall book: 39% Alt-A, 44% IO and 14% option arm. (WHAT were they thinking, these past 21 months, enquiring minds want to know?) It's a very good question: Freddie Mac was not founded with the idea that it would buy a pool of mortgages 44% of which were interest-only. Or look at it another way—[Freddie] has only \$36 [billion] of core capital and Fannie another \$42 billion of core capital—the 'in the neighborhood of \$50 billion' loss on just the [GSEs'] \$170 billion of subprime MBS would wipe out about 2/3 of the total \$78 billion in GSE core capital. THAT's not where we are or where we're going to be, let us all hope. ...[S]hould both [Freddie] and [Fannie] COMPLETELY eliminate their dividends? Of course. Should they be allowed to expand above-and-beyond the OFHEO-directed limit? In a potentially long-lived crisis when we're probably no further along than the 2nd inning of a 9 inning game, I think the answer has to be, NO. Survival should happen, but needs to be assured." (*Econbrowser*, David Pearson, 11/22/07)
- In a November 21<sup>st</sup> editorial, the *Financial Times* wrote, "Freddie Mac's loss, an unpleasant mixture of credit impairment and falls in the value of interest rate derivatives, matters less than its resulting shortage of capital. So far, prime mortgages have been little affected by turmoil in the securitization markets but if Freddie Mac were unable to buy or guarantee as many loans, it could further affect the availability of credit to prospective house buyers in the U.S." (*Financial Times*, 11/21/07)
- Freddie Mac's earnings announcement rippled through the mortgage industry, fueling concerns that a growing credit squeeze could push more lenders into bankruptcy. For example, jitters in the market forced Countrywide Financial, the nation's largest

mortgage lender, to issue a statement denying rumors that it was near bankruptcy, as some of the company's debt fell to prices suggesting that "people are anticipating a default," according to Jim Cusser, portfolio manager at Waddell & Reed. Countrywide Financial's "survival strategy" of dealing with Fannie Mae and Freddie Mac is less viable when those entities themselves are capital-constrained, said Cochran Caronia Waller, an analyst with Fox-Pitt Kelton.

- "There is no danger of [Fannie or Freddie] going bankrupt," said Fox-Pitt, Kelton analyst Howard Shaprio. "The real question is: 'How bad is this for the mortgage market and the housing downturn?' To the extent that [Freddie Mac is] growth-constrained and Fannie Mae is growth-constrained, there is less capital in the mortgage markets. That means the cost of buying a home will go up. Fewer people will buy homes. The decline in home values will be exacerbated. It's not good news." (*Washington Post*, Thomas Heath, 11/21/07; *Wall Street Journal*, James R. Hagerty and Damian Paletta, 11/21/07; *Wall Street Journal*, Rob Curran, 11/21/07)

#### Analysts question if Freddie Mac has more "bad news" coming in the 4th quarter

- Wall Street analysts fear that there will be more bad news to come from Freddie Mac, specifically related to the company's \$105.4 billion of private label mortgage-backed securities, which are collateralized by subprime mortgage and account for about 15% of the GSE's mortgage and related securities holdings. Credit Suisse Group's analysts Moshe Orenbuch and Kerry Hueston have warned investors that Freddie may need to write down the value of the subprime bonds by as much as \$5 billion next year. According to ABX indexes, the value of Freddie Mac's subprime MBS have a "suggested" value between 75 and 90 cents on the dollar, they added.
- In an interview with the *Wall Street Journal*, Freddie's chief financial officer Buddy Pizsel argued that nearly all of the subprime-mortgage bonds held by Freddie are rated AAA. Since the holders of the lower-rated bonds absorb the first losses from defaults, more than half of the mortgage borrowers whose loans are included in the bonds would have to default before Freddie would incur losses, said Pizsel. According to value-estimates services, most of the subprime bonds held by Freddie have a market value above 90 cents on the dollar, he said. The ultimate value of the bonds, which depends on how many homeowners default and how much can be recovered by selling their homes, won't be determined for years, Pizsel added.
- Analysts also worry that Freddie Mac's default and loss assumptions might be too optimistic and that the losses might not be temporary. In all, Freddie recorded \$4.4 billion in unrealized losses on its securities and \$4.3 billion in unrealized losses on derivatives during the third quarter, which the company generally considers temporary and do not flow through earnings. "The loss severity they talked about was 26% to 30% [on all loans]," said Joshua Rosner, managing director of Graham Fisher & Co. "While it sounds like a very high number, relative to history, that's not the peak," he said. "[Loan loss rates of] 25% to 30%, given the historically unprecedented bursting of a real estate bubble, is not either conservative nor would it

be unrealistic to expect. Given the deterioration in conditions, the severity could be significantly higher than that.” In a November 21<sup>st</sup> report, Moody’s Investor Services’ analysts Brian Harris and Crai Emrick wrote that Freddie Mac may report wider losses than it forecast as the slump in credit markets worsens. Freddie Mac may have underestimated when it projected that 0.11 percent of the debt it guarantees will go bad in the next two years, wrote Harris and Emrick. “Continued deterioration in the mortgage market, resulting in further decline in these books, may lead to credit losses in excess of their 11 basis point loss forecast,” they concluded.

- On September 30, Fannie Mae held about \$42.4 billion of subprime MBS, which accounted for about 6% of its mortgage holdings. Fannie also may need additional write-downs on the securities, said Credit Suisse’s Hueston, who has not estimated the potential damage. Fannie Mae, who argues that the ABX index is not a good measure of value, said it doesn’t expect losses on these mostly AAA subprime bonds.
- Freddie’s independent auditors and OFHEO eventually are likely to insist on a write-down if the bonds continue to trade far below their face value, said Huetson. In a statement, OFHEO director James Lockhart said that “at this point it does not surprise me” that Freddie hasn’t written down its subprime bonds. He noted that Freddie is following generally accepted accounting principles. “We will be monitoring this on an ongoing basis,” Lockhart added.
- Assuming *no* additional write-downs of the subprime securities are made, Credit Suisse forecasts that Freddie will report a \$2.4 billion loss for the fourth quarter and \$1.1 billion for fiscal year 2008. The GSE’s projected losses for the next five quarters (\$3.5 billion) would deplete approximately 70% of Freddie Mac’s proposed capital raising effort (of approximately \$5 billion) during the fourth quarter of 2007. The company’s losses could be larger, if Freddie Mac includes larger loss provisions for its subprime securities. (*Wall Street Journal*, James R. Hagerty, 11/23/07; *BusinessWeek*, Dawn Kopecki, 11/20/07; *Bloomberg News*, Kabir Chibber, 11/23/07)
- In *Seeking Alpha*, Daniel Jones posed the question: “Are [Fannie] and [Freddie] potentially insolvent?” Jones continued, “That question has probably never really been entertained up until today; the GSEs are supported by an implicit U.S. government guarantee, although we’ve never actually tested the resolve of this backstop. Given present market conditions, I believe that we cannot, as an economy, exit this mortgage crisis until we fully test this GSE guarantee’s strength. Will our government be willing to come to the aid of [Fannie] and [Freddie]? The total tab for that would likely be in the hundreds of billions of dollars – just assuming a small haircut of value impairment across \$3+ trillion in portfolio holdings implies that sort of valuation at risk here. Are these two companies technically insolvent? My answer is: It’s very likely. These two stocks’ respective meltdowns signal that something seriously fundamental is wrong here...” (*Seeking Alpha*, Daniel Jones, 11/21/07)
- R. Christopher Whalen, managing director of Institutional Risk Analytics, said, “Neither Fannie nor Freddie have enough capital to really withstand serious losses,”

said Whalen. “They could end up insolvent. I think ultimately the government is going to have to take over one or both of these organizations.” [Unfortunately, Congress has failed to pass GSE regulatory reform legislation, which would give the GSE regulator the power to handle the failure of a GSE] (*Associated Press*, 11/21/07)

Fannie Mae’s fuzzy math only goes so far...

- On November 15<sup>th</sup>, Fannie Mae hastily arranged an investor conference call for Friday, November 16<sup>th</sup> in an attempt to quell analysts’ concerns that the company was “camouflaging steep credit losses.” In a November 14<sup>th</sup> article in *Fortune Magazine*, Peter Eavis wrote, “Investors might want to take a closer look at Fannie Mae’s latest earnings report. Lost in the unsurprising news of the mortgage lender’s heavy losses was a critical change in the way the company discloses its bad loans—a move that could mask that credit losses that are rising above levels that the company predicted just three months ago. Without the change in disclosure, an important yardstick for credit losses that Fannie Mae ...provides to investors would have looked much worse than it did in financials filed last week.”
- “Fannie Mae’s potentially misleading disclosure comes at a crucial time for the company. Fannie Mae was severely penalized last year for overstating earnings and for a lack of oversight. As part of its punishment, the amount of home loans that Fannie Mae can make was limited. But now influential members of Congress, including Senator Charles Schumer, want ...the Office of Federal Housing Enterprise Oversight ...to temporarily lift the portfolio limits on the company and its rival Freddie Mac. Legislators want both lenders to buy more subprime mortgages to help stave off foreclosures.”
- “Fannie Mae already holds a substantial amount of risky mortgages in its \$2.4 trillion mortgage book—and the recent shift in how it discloses a much-watched credit yardstick disguises just how quickly bad loans may be rising. If that’s the case, Fannie Mae will face a new barrage of questions about its bookkeeping. Fannie Mae controller David Hisey responds that the change in how its loss numbers were presented makes them ‘more transparent, not misleading.’ But Fannie Mae’s numbers effectively make its credit look better than it is. It all comes down to what’s known as the credit loss ratio—a measure that Fannie Mae has consistently provided to investors to help them assess the credit quality of its mortgages. The credit loss ratio expresses bad loan losses as a percentage of Fannie Mae’s loans. In August, Fannie Mae predicted its credit loss ratio would be 0.04-0.06 of a percentage point for all of 2007. ... A range of four to six basis points may not sound like a big deal for an institution involved in mortgages, but for Fannie Mae it is the norm. What matters is if Fannie Mae goes above that range. And Fannie Mae appears to have already done that this year. But its disclosure change makes that worrying development very hard to see. ...”
- “...Last week, as part of its earnings report, Fannie Mae revealed that the company had changed the way it calculates the credit loss ratio. Under the new method, Fannie

Mae's annualized credit loss ratio was just 4 basis points in the first nine months of the year. At first glance, four basis points looks to be at the low-end of Fannie Mae's full-year forecast. Problem is, because the company is using a new methodology, the previous estimate no longer makes sense to use."

- "So what would have happened if the company had compared apples to apples—and stuck with the old method of calculating its loss ratio? Under the previous method, Fannie Mae would have been well outside of its range. The company would have reported an annualized loss ratio of 7.5 basis points in the first nine months of this year."
- "What exactly caused the change—and how did it lead to a reduction in the credit loss ratio? In its third quarter financial statements, Fannie Mae started to break out credit losses taken to fulfill an accounting treatment called SOP 03-3, which the company said it adopted at the start of 2005. These SOP 03-3 losses were previously included in its credit loss ratio calculation, but Fannie Mae last week removed them from that calculation, causing its loss ratio to look much lower. The company said it made the change to add transparency to its loss numbers and to show a more cash-based reflection of credit losses. In a statement, Fannie Mae spokesman Brian Faith said that the forecast of four to six basis points was 'predicated on our estimation of what our realized losses would be for the year.' What does realized losses mean? When asked that, Faith referred to Fannie Mae's most recent quarterly filing. There, realized losses appear to be defined as losses calculated under the new method. In other words, Faith appears to be suggesting that the 2007 forecast was always based on the new method of calculation."
- "Why is that hard to believe? When the company issued that range in August, it expressed all its published credit loss ratios under the old method. And on an August conference call, when discussing the full-year range of four to six basis points, Fannie Mae executives did not mention any change in calculation of the ratio."
- "Management acknowledges that credit losses are mounting. During an analyst call last week, Fannie Mae CEO Daniel Mudd warned that the company's loss ratio could rise to eight to 10 basis points in 2008, due to a worsening housing market. It's not clear whether that forecast is based on the old or new methodology."
- "The company may already be exceeding that 2008 guidance. Based on the old methodology for calculating the loss ratio for the third-quarter alone, the company's annualized loss ratio is already at 14 basis points. If so, Fannie Mae's mounting losses are disturbing."
- "So what could a soaring loss ratio mean for Fannie Mae? Consider these numbers: At Sept. 30, Fannie Mae had exposure to \$74 billion of loans with a FICO credit score below 620. Loans scored below 620 are generally classified as subprime. In addition, Fannie Mae has exposure to \$196 billion of Alt-A mortgages, home loans for which the borrower doesn't have to submit complete documentation for basic

criteria like income. At the same time, Fannie Mae has only \$40 billion of capital. Worst-case, credit losses from high-risk loans like subprime and Alt-A could eat away at that capital and leave the mortgage giant on an extremely weak financial footing.” (*Fortune Magazine*, Peter Eavis, 11/14/07)

- In response to Eavis’s column which triggered a sell-off of the GSE’s stock, Fannie Mae held a conference call on November 16<sup>th</sup> with analysts to address detailed questions about the company’s \$670 million mark-to-market losses on delinquent loans. Fannie Mae CFO Stephen Swad argued that the provision “has the effect of pulling losses forward well before they are realized and ...including loans before they’re cured.” As a result, Fannie changed the way it reports credit losses to exclude the mark-to-market write-downs on loans bought out of pools until after the loss has been realized. Swad also argued that most mark-to-market losses would actually come back to the company and be booked as income when Fannie cures defaulted loans and also reduces its expenses for foreclosed properties. During the call, analysts were largely skeptical of Swad’s arguments, because Fannie did not provide any information on its historical cure rate for defaulted loans. According to *Bloomberg News*, Fannie Mae “extended its largest two-day slide since 1987” after the company failed to reassure investors of further credit losses during its November 16<sup>th</sup> conference call. (*American Banker*, Kate Berry, 11/16/07; *Minyanville.com*, 11/16/07)
- In a November 16<sup>th</sup> article in *Fortune Magazine*, Peter Eavis wrote, “...In response to investor concerns about the change [in the way the GSE discloses its bad loans], first reported this week on *Fortune.com*, Fannie Mae executives held a conference call with analysts Friday morning that did little to placate investors. Fannie Mae shares fell \$2.32, or 5.39%, Friday [November 16<sup>th</sup>]. The company’s stock price has plunged 17% since *Fortune* revealed the change in disclosure [on November 14<sup>th</sup>]...”
- “The company and some analysts insist that Fannie Mae disclosed the change properly. However, none of Fannie Mae’s financials for the third quarter ended Sept. 20 showed that 7.5 basis point number. Instead, enterprising investors had to parse the new disclosures and do some extra math to calculate the 7.5 basis point figure. When companies typically provide new ways of calculating key metrics, they disclose the metric under both the old and new methods for a period, so investors can make an easy comparison.”
- “On Friday, Fannie Mae executives spent most of the call defending why the company changed the way it disclosed the ratio. But chief financial officer Stephen Swad and other executives failed to answer some important questions about the company’s loan losses—and left many still in doubt about the company’s financial footing.”
- “Essentially, the company was able to lower the ratio by excluding a certain type of loss known as an SOP 03-3 loss. Here’s how SOP 03-3 losses work: Fannie Mae guarantees mortgages, which have been packaged and sold to investors as bonds. If a

homeowner falls significantly behind on his payments, Fannie Mae has to buy back the loan from the bondholder. If the mortgage has an outstanding amount of, say, \$100,000 and unpaid interest of \$5,000, Fannie Mae would have to pay \$105,000—its full value—to make the bondholders whole. However, the \$105,000 loan may actually be worth less on the market. It is Fannie Mae’s job to estimate the market value, or fair market value, of the loan and to record that price on its books. So if the fair market value is \$80,000, Fannie Mae takes a loss of \$25,000 (the difference between \$105,000 and \$80,000). That loss is considered an SOP 03-3 loss—so named after the applicable accounting rule. Until recently, Fannie Mae included SOP 03-3 losses as part of its credit-loss ratio. But here’s the trick: Fannie insists that, based on past trends, it can recover a large part of that \$25,000 loss by, for example, helping the borrower renew payments. So it simply decided to stop including SOP 03-3 losses in calculating its credit-loss ratio.”

- “Investors have plenty of reasons to be spooked by that move [because:]”
  - “The timing is suspect. Fannie Mae’s decision to exclude SOP 03-3 losses coincide with their shocking rise: In the third-quarter ended Sept. 30, 2007, the company’s SOP 03-3 losses came to \$670 million, up from \$37 million in the same period a year ago.”
  - “It’s not clear why SOP 03-3 losses are skyrocketing, but it suggests that Fannie Mae is having credit problems and is having to buy a lot more bad loans back from bondholders. Not so, counters Fannie Mae. The company argues that the increase in SOP 03-3 losses is driven chiefly by a decline in the fair value of mortgage loans in the market—and not because the company has been forced to buy back a large amount of bad loans. However, when asked on the call, Fannie Mae executives did not provide numbers to back up that claim.”
  - “Some analysts doubt that Fannie Mae can, despite its claim, recoup most of its SOP 03-3 losses. Executives failed to provide numbers showing what proportion of those losses get recovered, but promised to disclose them in the future. One possible reason why Fannie Mae doesn’t want to provide data on recoveries is because it might be using assumptions that are too optimistic, potentially underestimating SOP 03-3 losses.”
  - “Also, why would Fannie Mae exclude SOP-3 losses at a time when balance sheet valuations are under the spotlight at some of the world’s largest banks, from Merrill Lynch to Citigroup to UBS? Investors, regulators and auditors are pressing lenders to apply rigorous market values to assets like mortgages, even if the lenders don’t like those values. Yet, Fannie is now excluding market values from its credit loss ratio.”
  - “Using fair value accounting, Fannie Mae’s capital—the company’s net worth—has declined sharply this year. According to a fair value version of its balance sheet contained in a recent filing, Fannie Mae’s capital was \$34 billion on Sept.

30, a 20% drop from the end of last year. Capital is the key number to watch at Fannie Mae. The company can choose to keep those SOP 03-3 losses out of its credit loss ratio. But accounting rules prevent the company from leaving them out of capital calculations.”

- “The fuzzy math goes only so far.” (*Fortune Magazine*, Peter Eavis, 11/14/07)
- On *Calculated Risk* [blog], David Peterson wrote, “They [Fannie Mae] set the expectations for 2008 losses on the [November 9<sup>th</sup>] call, and the analysts plug[ed] those into their models. Could the analysts be more diligent? Yes. Are their salaries bloated for someone so spoon fed? Obviously. But it is what it is. So the models the analysts ran on Friday had the wrong plug for ‘08 losses. Eavis, or rather the short hedge fund that no doubt fed him the tip, corrected this. Now the analysts have to take down their numbers, and the market didn’t like that.”
- “Tempest in a teapot? I don’t think so. When Fannie is as thinly capitalized as it is, loss expectations, and the volatility thereof, matter a lot. We’re talking about ‘pull-forward’ of losses, that’s true, but the ‘pull forward’ offsets the ‘rear view mirror view’ that management is trying to promote. The fact is that their historical experience of losses is hardly a guide to this housing cycle, and management should be smart enough to know that by this time.” (*Calculated Risk*, David Pearson, 11/17/07)

#### Fannie Mae and Freddie Mac mayhem

- In a November 20<sup>th</sup> editorial, the *Wall Street Journal* wrote, “Chuck Schumer is lucky Congress ignored him. We’re referring to the New York Senator’s idea, which he has loudly promoted for months, that Fannie Mae and Freddie Mac should ride to the rescue of the housing market by buying up unwanted mortgages and guaranteeing them. Now those two mortgage giants are themselves under scrutiny amid concerns that they’ll report big losses.”
- “Last week, *Fortune Magazine* reported that Fannie had adjusted how it reports troubled mortgages in order to better meet its own projections. Fannie claims the accounting change was legitimate, but its explanations so far have done little to stem investor anxiety. ...And whether you believe the new lower numbers or the old higher ones, delinquencies in Fannie’s portfolio are rising fast.”
- “This matters because Fannie and Freddie, owing to their special status as ‘government sponsored’ mortgage securitizers, operate with a relatively small capital base. Fannie reported earnings for the first three quarters of this year on November 9, bringing its financial information up to date for the first time since it was hit with an accounting scandal in 2004.”
- “According to those figures, Fannie has a capital base of \$40 billion supporting a \$2.8 trillion book of business, including more than \$2 trillion in mortgage-backed

securities it has guaranteed and sold to the public and over \$700 billion more in mortgages it is holding on its balance sheet. That high degree of leverage means it would take only a small movement in the value of its assets to cause serious problems.”

- “At the same time, New York Attorney General Andrew Cuomo has launched a probe into the appraisal practices of banks selling loans to Fannie Mae. Whether there’s any substance to the charge that the appraisals were inflated remains to be seen, and Fannie has said it is cooperating with the investigation. But any suggestion that Fannie’s mortgages might be less safe than advertised is bound to cause jitters in the current environment. Freddie Mac reports results today [of a \$2 billion loss for the third quarter]...”
- “Given these question marks, it’s hardly surprising that the companies’ stocks have been under pressure, with Fannie’s down some 45% from its August highs. That was the period when investors began to believe their political troubles were over, and that Mr. Schumer and House Financial Services Chairman Barney Frank would even expand their ability to make government subsidized profits. Let’s hope that delusion has now passed.”
- “The questions around their earnings and accounting suggest that Fannie and Freddie need to attend to their own problems, rather than pose as white knights for housing in order to grab mortgage market share. If these two mortgage giants get into trouble, the people stuck with rescuing them will be the taxpayers. Which is what some of us have been warning about all along.” (*Wall Street Journal*, 11/20/07)

#### Fannie Mae and Freddie Mac shares sink to 10-year lows, losing a combined \$57 billion in market value

- On November 23, *Bloomberg* reported that Fannie Mae’s and Freddie Mac’s common stock sank to 10-year lows with the GSEs having “lost [a combined] \$57 billion in market value because of write-downs caused by record U.S. mortgage foreclosures.” Since December 29, 2006, Fannie Mae’s and Freddie Mac’s common stock are down 45.8% and 61.0%, respectively. (*Bloomberg In Focus*, 11/23/07; 13:07:18; *Bloomberg*, Kabir Chibber, 11/23/07; *Morningstar.com*)
- On November 21, Peter Eavis wrote, “Freddie Mac and Fannie Mae can only make it through a prolonged credit crisis if they raise billions of dollars of new capital. That, in a nutshell, is what the plunging stock prices of both mortgage buyers are saying... Both [Fannie and Freddie] have lost more than half their value since the end of September. The market is worried that that neither company has a strong enough financial footing to deal with further credit losses...”
- “Fannie and Freddie are seen to be an important source of demand for mortgages, so any problems at these companies could end up reducing the amount of mortgage lending that gets done by the banks that sell mortgages to Fannie and Freddie.

Because of their integral role, it would be no surprise if OFHEO, as well as other financial regulators like the Federal Reserve, were keen to see a ramp up in capital at both companies. Such capital increases will have to be very large. Neither Fannie nor Freddie is close to having sufficient capital to weather a full-blown recession. Freddie Mac had \$25.8 billion in capital at the end of the third quarter, which is equivalent to just 3.2% of assets. Fannie Mae's \$40 billion of capital as of Sept. 30 is equivalent to 4.8% of assets. Compare that with 8.8% for Bank of America, which has more than \$270 billion of residential mortgages on its books. ...**Yup, that capital increase is going to have to be very large indeed.**" [Emphasis supplied]. (*Fortune Magazine*, Peter Eavis, 11/21/07)

### Fannie and Freddie's Achilles' heel

- In the November 25<sup>th</sup> issue of *Fortune Magazine*, Carol Loomis writes, "Mortgage giants Freddie Mac and Fannie Mae need capital—in today's credit crisis, there's no doubt about that. ...And Freddie and Fannie are going to need some especially creative alternatives. Why? When either Freddie or Fannie attempt to build capital, they are handicapped by a peculiarity that very few investors know about: They cannot sell the most popular kind of preferred stock, the 'cumulative' variety, because their regulator will not let these securities count toward capital.
- "What 'cumulative' signifies in this context is that if dividends are missed, they pile up to be paid on some brighter day, if that arrives. To the extent that Freddie and Fannie issue preferred shares, therefore, they are forced into selling the 'non-cumulative' variety. That means if a dividend is missed, say, in the first quarter of 2008, the owners of the preferred will never get that dividend. It's just gone, zip! Naturally, prudent investors are not wild about owning non-cumulative preferred shares, which is why there are not many of these securities around. What smart investor unnecessarily wants to put himself in the position - no matter how remote - of missing a dividend and never thereafter being able to capture it?"
- "But the fact is that many investors don't read their prospectuses, don't get full disclosure from their brokers, and are not clued-in to this market wrinkle. For example, Fannie Mae sold \$500 million of preferred shares on November 16th. Go to Fannie's website, where the security is described: 'non-cumulative, perpetual, fixed-rate preferred stock at a dividend rate of 7.625% per annum.' How many investors, particularly those being solicited by retail firms to buy these \$25 securities, really understood the implications of the term 'non-cumulative'? Of course, the dividend on that preferred will keep on being paid as long as any common dividend is paid. A company can't deny a payout to its preferred shareholders while continuing to reward its common shareholders, and thus far there are no signs that Fannie will stop paying its common stock dividend. Still, the \$500 million that Fannie just raised will not solve its total capital needs; it'll be coming to the market again."
- "But it's Freddie that right now has the emergency. Because of big losses Freddie has taken, its capital has fallen perilously close to the minimums required by its regulator.

So that's why it's seeking 'capital-raising alternatives.' All this, of course, means dilution for Freddie's existing common shareholders. During a Freddie conference call this past week, analyst Fred Cannon of Keefe Bruyette & Woods probed what the damage could be by asking whether Freddie might not have to raise \$2 billion to \$4 billion in capital. The company's chief financial officer ducked, saying simply, 'This will be a large transaction.' It won't be, he added, a sale of common stock. That leaves the world expecting Freddie to offer a boatload of convertible preferred - non-cumulative, of course. The security will have to be priced well, with a good dividend and a conversion price not way above the market."

- "And speaking of that market, Freddie closed at \$26.47 a share last week. That's 35% below its price a week earlier. If Freddie wants to calm investors, it had better figure out its 'alternatives' quickly." (*Fortune Magazine*, Carol Loomis, 11/25/07)

Representative Kanjorski says it is "essential" for OFHEO to keep Fannie's and Freddie's 30% capital surcharge in place

- Representative Paul Kanjorski (D-PA), who chairs the subcommittee overseeing the GSEs, said OFHEO's increased capital requirements for Fannie Mae and Freddie in the wake of their accounting scandals are necessary. In a statement to *Dow Jones Newswires*, Kanjorski said this capital requirement was essential. "While increasing capital may cause short-term pain, it will hopefully prevent long-term systemic problems," said Kanjorski. "We should therefore continue to defer to the judgment of the regulator about the need to maintain the 30% capital surcharge during this interim period. ...By relying on the regulator's judgment, I hope to avert repeating the mistakes of the savings-and-loan crisis."
- Kanjorski has been one of the few Democrats to say that regulatory constraints should remain in place during the subprime mortgage crisis. Following Freddie Mac's third quarter earnings announcement, Senator Chuck Schumer (D-NY) released a statement which said: "Given the increasing severity of conditions in the housing market, it should come as no surprise that Fannie and Freddie's businesses have been negatively impacted. Today's news does nothing to lessen the critical role that the GSEs must play in providing much-needed liquidity to a struggling market. The whole reason Fannie and Freddie exist is to help in times like these." A spokesman for Schumer confirmed that the Senator was referring to his own plan to temporarily lift the GSEs' portfolio caps by 10%. In the House, Representative Carolyn Maloney (D-NY) echoed Schumer's arguments, saying that lifting the caps was needed "to help borrowers who are stuck in risky adjustable rate mortgages refinance to safer mortgages." Privately, a senior Democratic aide acknowledged that allowing the GSEs to grow will be a "tough [row] to hoe."
- In a press release, Senator Richard Shelby (R-AL), ranking member of the Senate Banking Committee, said, "Because the GSEs are already large enough to pose a risk to the entire housing finance system, we must focus our efforts on making sure they are well-capitalized and well-regulated, rather than discussing ways to expand them."

Robert Steel, the Treasury's under secretary for domestic finance, told the *Hill* newspaper that Congress should focus on passing comprehensive GSE reform legislation rather than raising the enterprises' portfolio caps. (*Dow Jones International News*, Damian Paletta, 11/20/07; *Investor Business Daily*, Sean Higgins, 11/20/07)

Hello... GSE reform anyone?

- In a November 18<sup>th</sup> editorial, former Congressman J.C. Watts wrote, "...[E]veryone in Congress has the facts lying before them regarding the financial shenanigans of Fannie Mae and Freddie Mac. These two taxpayer-supported financial organizations have restated their earnings and skewed their financial statements to an extent that would make any Enron or WorldCom executive blush. Executives from both companies have resigned under a cloud with billions of dollars unaccounted for. Every member of Congress is well aware of this, yet it has been extremely difficult to get the U.S. Senate to act on reforms."
- "Every significant voice, including the last two Federal Reserve chairs, the last two HUD secretaries, the last two Treasury secretaries as well as the department within HUD that regulates Fannie and Freddie have said these two companies pose a serious risk to taxpayers and the economic system of the United States. Indeed, just last week, New York Attorney General Andrew Cuomo, a HUD secretary in the Clinton administration, opened an investigation of Fannie and Freddie over a scandal concerning inflated appraisals. With all of this for the world to see, one House leader has said he likes Fannie and Freddie the way they are."
- "We can speculate and hold high-profile public hearings on what we suspect may be happening in the world of televangelism, but we know beyond the shadow of doubt that Fannie and Freddie should have been reformed years ago. We need a strong regulator who will enforce congressional mandates concerning low- and moderate-income housing goals and to keep Fannie and Freddie within their congressionally mandated boundaries. They have ignored both. They are publicly traded companies that enjoy the benefits of not paying any state and local taxes and the protection of government guarantees if they fail."
- Given that, why shouldn't they have to file timely public disclosure statements or abide by the Sarbanes-Oxley Act like every other public company? You deserve to know. These are on-the-record facts, and your United States Congress is not acting. Instead, Congress would rather speculate on nonprofits." (*Las Vegas Review-Journal*, J.C. Watts, 11/18/07)

Congress turns to legislative “solutions” for subprime mortgage crisis:

The House of Representatives passes broad mortgage reform bill (H.R. 3915)  
by vote of 291-127

Senate Banking Committee Chairman Dodd says mortgage bill may not be needed

H.R. 3915 is fraught with peril for the housing and credit markets—and consumers

The government can not –and should not—  
try protect us from all of the consequences of our choices

Bills reforming the FHA and lifting the GSE portfolio caps  
are in limbo in the Senate

House bill to provide bankruptcy relief for subprime borrowers is on hold until ‘08

Other notes of interest

The House of Representatives passes broad mortgage reform bill (H.R. 3915) by vote of 291-127

- On November 14, the House of Representatives passed a broad mortgage reform bill (H.R. 3915), aimed to tighten the mortgage regulations in response to the turmoil in the subprime lending market. H.R. 3915 requires lenders to consider the borrower’s ability to repay their loan and mandates that refinanced mortgages must have a net tangible benefit to the borrower. The legislation would establish minimum underwriting standards for home loans, establish new standards for the appraisal industry, establish certain limits on high-cost mortgages, and bring mortgage brokers, currently regulated by the states, under a nationwide licensing registry. The bill also requires the establishment of escrow accounts to pay taxes and insurance for subprime mortgages. The bill intends to prohibit brokers from steering customers to mortgages they are unlikely to be able to repay. Under the bill, prepayment penalties are prohibited for subprime mortgages and limited in prime mortgages. A critical amendment to the bill, which attracted Republican support, would clearly establish the federal government’s role in enforcing standards for loans to be sold in the secondary market. Specifically, the amendment would narrow “the scope of the preemption provision to make it clear that states cannot use or adopt state laws against securitizers/assignees for violations of the national standards or to impose remedies outside of the unique Federal remedy established in the bill, and to make it clear that actions for fraud, misrepresentation, deception, false advertising or civil rights laws are not preempted.” House Financial Services chairman Barney Frank

(D-MA), said that one of the main goals of H.R. 3915 was to extend regulatory policies governing federally-regulated lenders to their state counter-licensed counterparts.

- During floor debate, lawmakers voted down last minute amendments to the bill, which would have toughened the bill's liability standards and beefed up consumer protections. Such efforts threatened to throw-off balance a delicate compromise reached with Representative Spencer Bachus (R-AL), ranking member of the House Financial Services Committee, who agreed to co-sponsor H.R. 3915, after subjective terms and specific underwriting standards were struck from the bill. Bachus later told reporters that increasing the liability in the bill would have forced him to vote against the legislation. "All along, we've said this isn't about creating unnecessary litigation, this is about protecting borrowers," said Bachus. "I would have to remove my support because, right now, lenders are hesitant to make loans, and if you increase their liability and their exposure beyond a certain point, it's counterproductive." H.R. 3915 passed by a vote of 291 to 127, which included the support of 67 Republican lawmakers.
- Many Republican lawmakers and the White House expressed reservations about H.R. 3915, which they argued would increase federal oversight and dry up already tight credit. "What we are doing here is practicing medieval medicine," said Representative John Campbell (R-CA). "We are bleeding the patient. We are going to make the patient worse ... by drying up credit." Representative Richard R. Baker (R-LA) said, "It is appropriate [for Congress] to address certain practices in the sub-prime mortgage market that have harmed consumers. But burdening the broader market, which has not experienced these problems, with additional regulation and heightened exposure to liability jeopardizes the stability of our housing finance system. Given the current state of the markets, Congress should focus on targeted policies that become the standard for both originators and the secondary market. True reform would create a national standard and not permit a patchwork of state policies, and any effort that neglects this will do more harm than good. H.R. 3915 creates a false sense of security that could cause unforeseen harm to homeowners and limit the choices consumers have in finding loans."
- The White House voiced similar reservations about the bill in its Statement of Administration Policy. "While the Administration appreciates several key goals of H.R. 3915, the Administration has concerns with the bill as drafted because it includes provisions that unduly restrict access to credit for potential homebuyers and reduce re-financing opportunities for current homeowners," said the White House. The administration endorsed only the features of the bill which simplify disclosure, focus on curbing unfair or deceptive practices, enhance supervision of loan originators, and improve education opportunities for borrowers. The White House dismissed many of the bill's objectives, arguing that many key activities are already under way at HUD, which plans to announce soon proposed revisions to revise regulations that implement the Real Estate Settlement Procedures Act, and at the

Federal Reserve Board, which is crafting new lending rules under the Home Ownership and Equity Protection Act to address unfair or deceptive credit practices.

- Upon the bill's passage, the Mortgage Bankers Association immediately issued a press release, stating that H.R. 3915 would "hurt more consumers than it would help." MBA chairman Kieran P. Quinn said, "Have no doubt, this bill will limit credit availability and options for thousands of Americans who want to grab their share of the American dream of homeownership." The lending industry argues that the bill will force the industry to deal with a state-by-state set of regulations, because the bill would not pre-empt tougher state mortgage laws. Trade groups also argue that the bill is too vague and exposes lenders to significant legal risk. (*American Banker*, Stacy Kaper, 11/16/07; *Washington Post*, Alan Zibel, 11/16/07; *Bureau of National Affairs*, 11/19/07; *CQ Today*, Benton Ives, 11/14/07; *Dow Jones International*, Damian Paletta, 11/15/07; *Press Release from Congressman Richard H. Baker*, 11/15/07; *Bureau of National Affairs*, Richard Cowden, 11/15/07)

Senate Banking Committee Chairman Dodd says mortgage bill may not be "necessary"

- In a November 15<sup>th</sup> statement, Senate Banking Committee chairman Christopher Dodd (D-CT) applauded the House's passage of H.R. 3915. Dodd said, "As I have said before, to be effective, legislation must meet two requirements: first, it must establish strong standards against abusive practices such as prepayment penalties, steering, and other problems. Second, it must provide for strong enforcement to ensure that those standards are met. My bill, which I will introduce soon, will meet both requirements and help protect homeowners from predatory lending."
- In a November 16<sup>th</sup> conference call with reporters, Dodd's position appeared to shift, saying that the Fed's proposed mortgage regulations may be enough to address his concerns about subprime mortgages. Dodd said, "I have a bill pretty much ready and thought about introducing [my bill] yesterday or today. But I think I want to work on it a little bit more over the next couple of weeks, and then my plan would be to put it down here for comment, obviously, and thoughts on it." Dodd said he is watching the Federal Reserve, which plans to propose new lending regulations for subprime loans in December. "My hope is that these proposed regulations [by the Fed] will lead to a level of satisfaction that minor legislation will be necessary, but may be nothing," Dodd said. "We'll see what they propose. If I find it comes up short, then obviously a more complete response legislatively will be necessary." He added, "I've decided to go forward and announce a bill here on the first of December so people have some idea where we're headed." No matter what the Fed proposes, however, some analysts say that political pressure will continue to grow for Dodd to move a mortgage bill through the Senate Banking Committee. (*Bureau of National Affairs*, Richard Cowden, 11/15/07; *Dow Jones International News*, Damian Paletta, 11/16/07; *American Banker*, Rob Blackwell, 11/16/07)

- Kurt Pfothner, senior vice president at the Mortgage Bankers Association, said he doesn't expect the Senate to vote on mortgage reform legislation before next year. The complexity of the bill and opposition from lenders and others will likely make it difficult for the Senate to reach a compromise, and he added that slow progress on these issues isn't necessarily a bad thing. "If Congress acts quickly, it usually does the wrong thing," said Pfothner. (*Wall Street Journal*, Damian Paletta and James R. Hagerty, 11/16/07)
- Meanwhile, the Reverend Al Sharpton has joined the chorus, criticizing Dodd for the time he takes away from the Senate Banking Committee and housing-related issues such as mortgage reform legislation in order to campaign for the Democratic presidential nomination for the 2008. At a November 15th news conference, Sharpton called on Dodd to oppose HUD's proposal for risk-based pricing and its ban on downpayment assistance for FHA-insured loans. He praised Representatives Barney Frank (D-MA), Maxine Waters, (D-CA) and Gary Miller (R-CA) for their work on these matters and faulted Dodd's failure to take a stand on the issues. "I would be stunned [that Dodd] would want to see votes from a community that turned the other way when they needed his vote in the U.S. Senate," said Sharpton. "Those that want votes from us ought to be willing to give their vote for us, and that is our appeal to Senator Dodd. A lot of us around the country will take seriously or not Sen. Dodd's presidential campaign if he stays silent on a policy issue like this that is already in his domain. You don't have to wait to see until he goes to the White House. He is already chairman and we need to know why he has not spoken out." (*American Banker*, Joe Adler, Bonnie McGeer, Cheyenne Hopkins, and Stacy Kaper, 11/19/07)
- In a speech before the Women in Housing Finance, Senator Robert Bennett (R-UT) said that the Senate Banking Committee's pace would likely pick up in early February, suggesting that committee chairman Christopher Dodd (D-CT) would likely drop out of the race to be the Democratic presidential candidate after a wave of primaries. "I don't want to be disrespectful of the chairman of the Senate Banking Committee, but it is my suspicion that on the sixth of February, he will be more available to preside over the committee," said Bennett, who is the second ranking Republican on the panel. "If he's not, well, I will give him my best wishes ...but it doesn't look too good for his presidential hopes right now. We are operating under the assumption that he will be back full time as chairman of the banking committee after super duper Tuesday [February 5]." (*Dow Jones Newswires*, Damian Paletta, 11/14/07)

H.R. 3915 is fraught with peril for the housing and credit markets—and consumers

- In the November 10<sup>th</sup> issue of the *Wall Street Journal*, Stuart Saft, a partner in the law firm Dewey & LeBoeuf LLP, wrote, "The Mortgage Reform and Anti-Predatory Lending Act [H.R. 3915] ...is intended to overhaul mortgage lending and legislate our way out of the subprime mortgage crisis. Unfortunately, like most actions taken in the immediate aftermath of a high-profile event, the bill should not become law. It

is fraught with peril to the housing and credit markets, and it will not help low-income housing purchasers.”

- “Take, for example, the ‘federal duty of care’ that the bill imposes on mortgage lenders. Explaining what this duty amounts to will, without a doubt, require hundreds of pages of complex regulations that few lenders and their employees will understand—but nevertheless be in jeopardy for failing to obey. Lenders must for example determine what loan products are ‘appropriate’ to the consumer’s existing circumstances. Does that mean that the lender has to investigate whether the borrower is telling the truth? What if the borrower fails to understand the questions the lender is asking? The lender must also ‘diligently’ present the borrower with options. How will that be decided? At trial? What jury will find for the lender against the borrower?”
- “The bill also creates a federal cause of action for the lenders’ failure to comply with the law. This is just what the federal courts need—mortgage foreclosure lawsuits added to their dockets. Lenders must make ‘a reasonable and good faith determination based on verified and documented information’ that the consumer had a reasonable ability to repay the loan. Who will be able to say what is reasonable or taken in good faith? Would you like to make a loan if years later you can be called before a federal agency or a jury and cross-examined as to whether your actions were reasonable? Could some aggressive prosecutor one day attempt to make his or her career by going after a lender criminally?”
- “The law wipes out a portion of the Uniform Commercial Code by negating the concept of a holder in due course. This feat is accomplished by permitting a borrower to sue the assignees of his loan—including securitizers—for rescission, that is, cancellation of the debt, and for repayment of the consumers’ costs, if the loan violates, for example, the statute’s minimum standards for reasonable ability to repay.”
- “Thousands of loans are packaged and sold as part of Mortgage Backed Security pools. How long will housing mortgages continue to be part of these pools after Congress creates a due diligence standard that no securitizer will want to or be able to meet?”
- “The *pièce de résistance* [emphasis supplied] is that all of the bill’s new standards and mandates will serve borrowers as a possible defense to foreclosure. And so we enter the brave new world, where no mortgage can be foreclosed without a trial. But not for very long, as how many lenders will offer new mortgages with this threat in the background?”
- “If this bill becomes law, lenders who do foreclose will have to take over the property subject to leases entered into prior to the foreclosure—even if the lease was entered into without the lender’s consent, at a significantly below-market rent, and for an indefinite term. In other words, this would permit financially troubled borrowers to

stave off foreclosure by entering into uneconomic or long-term leases, which would preclude lenders from foreclosing because they could not sell the property at auction.”

- “The bill will also make it more difficult for lenders to comply with the Community Reinvestment Act, which requires all lending institutions to make credit available in low-income neighborhoods. The Mortgage Reform and Anti-Predatory Lending Act is at war with this obligation—as it will make it more difficult, and legally perilous, for lending institutions to make loans to people who might not be able to afford them. These are of course the very people supposed to be served by the CRA.”
- Although [H.R. 3915] may have been written with intentions that are good, its consequences are not. As the members of Congress consider this bill they might think about where the money comes from that is lent to home buyers. Tens of millions of Americans’ savings and pensions are tied up in the millions of mortgage loans. If Congress makes it more difficult or even impossible for lenders to foreclose on defaulting loans, it is those people whose savings and pensions have provided the financing that will be hurt.”
- “Capital, like water, seeks its own level. If the people who buy the securitized loans, and the institutions who invest in pools of mortgage loans, are no longer secure in being able to get their money back or the interest paid, they will find other investments, and countries, where they can. This is hardly what the troubled housing and credit markets need.” (*Wall Street Journal*, Stuart A. Saft, 11/10/07)

The government cannot –and should not—try protect us from all of the consequences of our choices

- Can the housing correction get much worse? Diana Furchtgott-Roth, senior fellow and director of the Hudson Institute’s Institute for Employment Policy, believes it can after the “let’s fix-it-crowd”—including Congress, federal regulators, think tanks, and professors—marches on the stage with their “solutions.” Furchtgott-Roth writes, “Just as the Enron, WorldCom, and Tyco auditing problems spawned the burdensome Sarbanes-Oxley legislation, which led to some publicly-owned companies setting up shop in London, Paris, or Hong Kong, the subprime problems could lead to over-regulation.”
- “Take Mr. Frank’s bill. Section 103 prohibits ‘mortgage originators from steering, counseling, or directing a consumer into any residential mortgage loan that is not in the consumer’s interest.’ And Section 104 requires originators ‘to act solely in the best interest of the consumer, including finding the residential mortgage loan that best meets the needs of the borrower...’ This is surprisingly vague language to come from an experienced legislator like Mr. Frank.
- “It’s difficult for consumers to work out what kind of loan is in their ‘best interest,’ even when lenders proffer all the facts. Calculations of fixed or adjustable interest

rates depend on estimates of future income and guesses about future interest rates and inflation. Even mortgage originators with financial expertise can be wrong about the future. Make lenders liable for wrong guesses and some will drop out of the lending business, shrinking consumers' borrowing opportunities."

- "Moreover, there is something philosophically amiss with a law that declares that lenders must calculate what is in borrowers' best interests. This is akin to making auto dealers determine what car shoppers should buy. Full disclosure is essential, but consumers ultimately must choose desired levels of risk and take responsibility. In the end, government cannot — and should not try to — protect us from all consequences of our choices." (*Hudson Institute*, Diana Furchtgott-Roth, 10/26/07)
- Dr. Ronald D. Utt, Ph.D., a Herbert and Joyce Morgan Senior Fellow at The Heritage Foundation, also argues that H.R. 3915 has many problems—among them “vague and subjective standards and requirements” in several sections, notably Sections 122, 201, and 202. Utt writes, “Section 122, for example, would amend the Truth and Lending Act by adding a new section 129A, which (among other changes) would require that mortgage loan originators with respect to each consumer seeking or inquiring about a residential mortgage loan, diligently work to present the consumer with a range of residential mortgage loan products for which the consumer likely qualifies and which are appropriate to the consumer’s existing circumstances, based on information known by, or obtained in good faith by, the originator.”
- “The phrase ‘appropriate to the consumer’s existing circumstances’ is problematic. Existing circumstances that may impact a borrower’s repayment prospects include health, marital stability, and employment prospects, so fulfilling this requirement could require a massive invasion of a borrower’s privacy. Since the bill relies upon the threat of subsequent litigation to settle the extent to which lenders fulfilled this requirement, lenders that fail to require applicants to submit to a complete physical, a session with a marriage counselor, and an employer interview could face uncertain risks in the courts. Inasmuch as these three issues are often factors contributing to loan defaults, they would certainly be valid ‘existing circumstances’ that the law would expect lenders to uncover.”
- “Section 201 amends the Truth in Lending Act by adding a new Section 129B that imposes a ‘reasonable ability to repay’ duty on lenders by requiring the following:”
  - “(1) IN GENERAL- In accordance with regulations prescribed jointly by the Federal banking agencies, in consultation with the Commission, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance, and assessments. [And]”

- “(3) BASIS FOR DETERMINATION- A determination under this subsection of a consumer’s ability to repay a residential mortgage loan shall be based on consideration of the consumer’s credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio, employment status, and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan.”
- “This section would likely have a direct impact on homeownership levels. Section 201(3), for example, specifies lenders must consider ‘other financial resources’ before making a loan, but does that mean lenders should consider such assets a mandatory requirement for loan qualification? Inasmuch as many borrowers struggle to meet the downpayment requirement, this additional burden would serve to limit mortgage credit and homeownership to a wealthier class of borrower than has heretofore been the practice in the United States. It would also, presumably, undermine all of the federal programs designed to encourage homeownership among moderate income households since few, if any, of the program participants have a net worth of any consequence—as required for program eligibility.”
- “Section 202 of the bill would amend the Truth in Lending Act by adding to the new Section 129B (discussed above) additional language to ensure that there is a ‘Net Tangible Benefit for Refinancing of Residential Mortgage Loans.’ Specifically, the new provision states: (1) IN GENERAL- In accordance with regulations prescribed under paragraph (3), no creditor may extend credit in connection with any residential mortgage loan that involves a refinancing of a prior existing residential mortgage loan unless the creditor reasonably and in good faith determines, at the time the loan is consummated and on the basis of information known by or obtained in good faith by the creditor, that the refinanced loan will provide a net tangible benefit to the consumer.”
- “This provision effectively deputizes the mortgage industry as a quality of life police force by requiring them to pass judgment upon what exactly it is that a borrower intends to do with any additional monies acquired by way of a loan refinancing. If the borrower intends to buy a new car, would the lender need to know how many cars the household already owns, predicted major uses of the new car, the availability of bus and trolley service in the neighborhood, and whether the hoped-for vehicle is an extravagant sport utility vehicle or a sturdy little pre-owned sedan? What if the loan is to pay prospective medical bills? Would the lender then have to judge whether the procedure is justified at this time or whether it could be safely delayed until the cost could be met through accumulated savings rather than debt? Again, since the penalty to the lender of making the wrong decision is to become chum for trial lawyers, there is every expectation that refinancing would become unavailable for many prospective borrowers.”
- “As currently written, H.R. 3915 would force an unprecedented measure of caution on mortgage lenders by forcing them to acquire much more information than has been

typical in the past and thereby intrude upon borrowers' privacy. It also would establish an explicit series of credit standards for lenders, which could have the effect of excluding many moderate income borrowers from the ownership market. In sum, the enactment of H.R.3915 would delay the housing market recovery that is now struggling to get underway." (*The Heritage Foundation's WebMemo No. 1703*, Ronald D. Utt, Ph.D., 11/14/07)

#### Bills reforming the FHA and lifting the GSEs' portfolio caps are in limbo in the Senate

- On November 15, the Senate failed to move the FHA reform bill (S. 2338) to the floor, when Senators Tom Coburn (R-OK) and Jim DeMint (R-SC) blocked Senate Majority Leader Harry Reid's effort to seek unanimous consent on the bill. [Under Senate rules, a single senator can object to a unanimous consent rule and force lawmakers to delay considering the bill.] In a statement, Coburn said, "It is naive, irresponsible and reckless for the Senate to claim it can fix this national challenge by blowing a bill through the chamber without debate and without the opportunity to improve the bill through amendments. This bill was reported out of committee only two days ago and has been read by only a handful of staff and very few elected Senators." A spokesman for DeMint said that bill contains "important policy changes that merit scrutiny... The last thing we want to do is rush this bill through without careful consideration." Due to Republican opposition, Reid also abandoned quick action by the chamber on a bill introduced by Senator Chuck Schumer (D-NY) which would lift restrictions on Fannie Mae's and Freddie Mac's mortgage portfolios by 10% over a six month period. "Why aren't we moving [this bill]?" asked Schumer. "It's because this administration has ideological handcuffs. That's what blocks us." (*Bureau of National Affairs*, Richard Cowden, 11/19/07; *American Banker*, Cheyenne Hopkins, 11/15/07; *Congressional Quarterly*, Benton Ives and Libby George, 11/15/07)

#### House bill to provide bankruptcy relief for subprime borrowers on hold until '08

- Representative Brad Miller (D-NC) said that lawmakers won't be acting quickly on legislation that would give bankruptcy judges more flexibility to alter the terms and conditions of mortgages for homeowners in bankruptcy. "It's Thursday, and we're going home, so it's obviously not going to be handled this week," said Miller, a sponsor of the bill. Miller, who has tried to push for a vote on the measure in the House Judiciary Committee for weeks, said he has been told the bill will not be "on the floor until after the first of the year." Miller said he is still trying to broker a deal, which would attract support from some Republicans. One compromise provision, he says he would reluctantly support to obtain passage of the bill, would be a requirement that only loans in foreclosure could be amended in the bankruptcy process. The banking industry has lobbied intensely against Miller's bill, arguing that the proposed changes to the bankruptcy law could create more risk for lenders and raise the price of mortgages for borrowers. (*Dow Jones International News*, Damian Paletta, 11/15/07)

### Other notes of interest

- Senators Chuck Schumer (D-NY), Sherrod Brown (D-OH) and Bob Casey (D-PA) announced that the House of Representatives passed the Transportation, Housing and Urban Development Appropriations conference report, which included \$200 million for nonprofit foreclosure prevention programs to provide subprime borrowers foreclosure counseling. The conference report will now go to the Senate for final approval. (*US Fed News*, 11/15/07)
- Senator Jack Reed (D-RI) has introduced the Government-Sponsored Enterprise Mission Improvement Act of 2007, which would direct Fannie Mae and Freddie Mac to help finance approximately \$500 million to \$900 million a year for economic development programs tied to affordable housing programs. Under the bill, the GSEs would be required to “set aside an amount equal to 4.2 basis points for each dollar of unpaid principal balance of its new business purchases.” The measure would allocate 65% of the GSEs’ “contributions” toward an Affordable Housing Block Grant Program, run by HUD, and the remaining 35% of the funding would go toward a Capital Magnet Fund to finance “competitive grants for financial activities that leverage affordable housing development, construction and preservation for low-, very low-, and extremely low-income families. The bill would in addition create a new requirement for the companies to serve “underserved markets,” noted Reed. “I believe that deepening Fannie and Freddie’s responsibilities towards affordable housing must be a part of any type of GSE reform that we undertake in the Senate.” (*Dow Jones Newswires*, Damian Paletta, 11/16/07)
- In a November 21<sup>st</sup> interview with the *Wall Street Journal*, Treasury Secretary Henry Paulson said that he is “aggressively encouraging” the mortgage-service industry to develop criteria that would enable large groups of borrowers who might default on their payments to qualify for loans with better terms—a shift from his earlier view that the problems didn’t warrant a group approach. Paulson said his perspective has evolved as he has learned more about the problem and recognizes that the potential number of home-loan defaults “will be significantly bigger” in 2008 than in 2007. “We’re never going to be able to process the number of workouts and modifications that are going to be necessary doing it just sort of one-off,” said Paulson. “I’ve talked to enough people now to know there’s no way that’s going to work.” The momentum for a new approach to work with troubled subprime borrowers received a boost when four major mortgage loan servicers, including Countrywide Financial, agreed to endorse a plan promoted by Governor Arnold Schwarzenegger, which would temporarily freeze rates to help borrowers in good standing from facing foreclosure when their loans reset to higher interest rates. Paulson said he supports finding a way to develop “standard criteria that’s going to allow for modifications and workouts.”

- The Secretary faulted Congress for failing to pass several bills –including FHA reform—which could provide troubled borrowers relief. Noting that he understands Senator Coburn’s concerns about the FHA reform bill, Paulson said, “This is not business as usual. This is an extraordinary situation.” He also said it is “very frustrating” that the Senate has not passed GSE regulatory reform legislation, saying the GSEs need to play a bigger role in the housing market. “If we ever need them, it’s during times like today, and they’re most valuable when there is distress in the mortgage market. I’d like to see them play an even bigger role.” The Secretary declined to endorse efforts to lift the GSEs’ surplus capital requirements, saying that decision was best left to OFHEO. “It would be particularly inappropriate for me to get between the regulator and Fannie and Freddie given what’s going on,” Paulson added. The Secretary would like Congress to temporarily allow the GSEs to purchase mortgages above their conforming loan limit (\$417,000), which might improve the availability of jumbo loans. However, the Bush administration doesn’t want to expand the GSEs role in the jumbo market, unless such a move is accompanied by passage of GSE regulatory reform legislation by Congress. (*Wall Street Journal*, Deborah Solomon, 11/21/07)
- Howard Glaser, who served as an aide to HUD Secretary Andrew Cuomo in the Clinton Administration, said his former boss—and New York’s attorney general—is likely aiming for a broad deal with the mortgage industry on appraisal practices as the end result of the AG’s investigation into appraisal practices. Glaser speculated that if Cuomo stops short of proving systemic fraud in court, then the AG’s investigation would probably not trigger widespread forced loan buybacks. During a conference call hosted by Keefe, Bruyette & Woods, Glaser said it is doubtful that Cuomo is seeking any “record-breaking fines” or subject lenders to repurchase loans—“unless ... the industry does not respond to his desire to implement prospective change.” The former Cuomo aide speculated that the AG is “using his investigative powers ...and his public relations acumen ...to force lenders and other market players to the table to negotiate.” Cuomo has “revealed the problem in a very public way [and made] others aware of it who didn’t see that it was there, parties who have an interest in ensuring that the appraisals were accurate ... may be ... prompted to take action,” said Glaser. “[But,] they’re difficult cases to bring. ... You have to develop that evidence a pretty long way, and if in fact I’m right and that the goal here is a public policy objective, you never get that far. That doesn’t mean somebody else couldn’t launch their own investigation.”
- “Getting it done at the end of the day in court is a very different thing than using the threat and pressure of that to come to the table and agree to a public policy change that improves the valuation standards and the independence of the appraisers,” said Glaser. “If you short-circuit this by going right to that objective, you never get to the evidentiary phase. [For a plaintiff] to go back in time and reconstruct each and every [loan appraisal to establish fraud would be] a herculean task.” Cuomo is suing eAppraiseIT LLC and its parent, First American Corp., for allegedly caving to pressure to inflate appraisal values by Washington Mutual. Glaser speculated that Cuomo probably targeted Washington Mutual because of the availability of “lurid”

evidence against the thrift. “It just happened to be [Wamu’s] bad luck that First American was very forthcoming in their internal e-mail traffic about the pressure they were under from Wamu,” he said. “The evidence happened to be uniquely graphic.” (*American Banker*, Harry Terris and Kate Berry, 11/15/07)

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

### Steady hands at the helm of OFHEO in turbulent times

- In OFHEO’s 2007 Performance and Accountability Report, director James B. Lockhart provided his perspective of his agency’s role in the supervision of Fannie Mae and Freddie Mac in the context of the recent turmoil in the mortgage market. Lockhart wrote, “Uncertainty and instability in the mortgage markets have captured the attention of OFHEO and the nation in the past year. Problems in the subprime and nontraditional mortgage markets have been especially troublesome for many homeowners. After a rapid three-year growth, beginning in the late fall of 2006, originations of subprime mortgages have declined, many of the top subprime lenders have left the business and delinquencies and foreclosures have risen dramatically. OFHEO has been monitoring developments closely and has taken several steps to enhance the Enterprises’ ability to assist borrowers while still ensuring that Enterprise operations remain safe and sound. OFHEO worked closely with the federal banking regulators, the White House, the Treasury Department and the Department of Housing and Urban Development. OFHEO directed Fannie Mae and Freddie Mac to comply with interagency guidelines on nontraditional and subprime mortgages. The guidelines, developed by the federal banking agencies, are designed to reduce risks to borrowers and reduce future mortgage market volatility. By applying the guidelines to mortgages purchased directly by Fannie Mae and Freddie Mac and indirectly through their purchases of private-label mortgage-backed securities, the guidelines are being uniformly applied throughout most of the primary and secondary mortgage market.”
- “The final months of fiscal year 2007 brought much discussion about the retained mortgage portfolio caps that OFHEO put in place in 2006 because of operational, risk management and financial reporting problems at the companies. OFHEO decided not to allow any major increases in the portfolios because of the ongoing operational risk, market risk and growing credit risk, which are primary safety and soundness concerns. However, OFHEO did provide additional flexibility to enhance the Enterprises’ ability to purchase or securitize subprime mortgages, refinanced mortgages for borrowers with lower credit scores and affordable multifamily housing mortgages. This flexibility, along with their ongoing ability to securitize, sell assets and replace maturing assets, enables Fannie Mae and Freddie Mac to buy and securitize tens of billions per month in subprime rescue mortgages without further increasing the portfolio caps.”

- “OFHEO is focused on overseeing Fannie Mae and Freddie Mac’s remediation of the problems that led to the portfolio caps in the first place. When OFHEO completed its special examinations at the Enterprises, each company was directed to address accounting, internal controls, risk management, governance and financial reporting problems. In 2007, both Enterprises continued to make progress, but neither company has completed all of the items identified in their consent orders. Both Enterprises expect to begin filing timely, audited financial statements in February 2008. OFHEO will lift the portfolio caps once they have fully resolved their pertinent safety and soundness issues.”
- “Subsequent to the lifting of the caps, OFHEO will also review the 30 percent additional capital requirement. These actions will create further need for enhanced regulator oversight from a stronger regulator as proposed in comprehensive GSE reform legislation currently pending before Congress.”
- “...The challenges facing OFHEO, Fannie Mae and Freddie Mac and all stakeholders in the nation’s housing market continue to grow. I remain impressed with the abilities and commitment of OFHEO’s employees to accomplish the agency’s important mission. The challenges will persist in fiscal year 2008 as credit conditions in the housing market continue to be a concern and as Fannie Mae and Freddie Mac continue their remediation efforts. Enhanced supervision of the Enterprises and the legislation needed to strengthen GSE oversight will be crucial to prevent a recurrence of past problems and the appearance of potentially more serious ones in the future.” (*OFHEO 2007 Performance and Accountability Report*, November 2007)

#### Freddie Mac joins Fannie Mae in raising mortgage fees

- Freddie Mac is joining Fannie Mae in raising fees on mortgages that it buys from lenders because of the increased risks in slumping housing and mortgage markets. Effective March 1, Freddie Mac will charge between 0.75% to 2% (determined by credit scores) to borrowers with credit scores below 680, whose loans exceed 70% of their property’s value. On November 6, Fannie Mae also announced higher fees on mortgages that it buys. “Classic economics will tell you reduce the price of an asset when you reduce the amount of potential buyers,” said Rod Dubitsky, head of asset-backed research in New York for Credit Suisse Group. “And when it’s Fannie Mae or Freddie Mac, it’s different than Joe the community banker doing it.” (*Bloomberg News*, Jody Shenn, 11/15/07)

#### Hot off the press

- In *National Mortgage News*, Paul Muolo reports, “THIS JUST IN: One mortgage executive close to Morgan Stanley’s Saxon Mortgage group said the Wall Street firm

is talking to Fannie Mae and Freddie Mac about selling loans to the two GSEs. The loans, in theory, would be ‘subprime’ in nature but would be underwritten to standards the GSEs would be comfortable with. A Morgan spokesman said, ‘We are not exiting subprime but we are being smart about it.’ On Thursday [August 15], Saxon suspended originations of two subprime products ‘ScorePlus’ and ‘ScorePlus2.’ It’s all there on its website...” (*National Mortgage News*, Paul Muolo, 11/20/07)

#### Intentional backlog at the Senate Banking Committee?

- In the November 17<sup>th</sup> edition of *RealClearPolitics.com*, Robert Novak wrote, “Senator Christopher Dodd’s absence from Washington while campaigning for the Democratic presidential nomination has not only created a backlog of House-passed legislation at the Senate Banking Committee that he chairs. It also has resulted in unconfirmed presidential appointees, including three governors of the Federal Reserve Board. The three proposed Fed governors—financier Larry Allan Klane, banker Elizabeth A. Duke and economist Randall S. Kroszner (now serving on the board)—all were nominated in May. Hearings were held by August, but the Banking Committee has taken no action on them. No hearings have been held on other nominations referred to the Banking Committee: two members of the Council of Economic Advisers, director of the Federal Housing Finance Board, president of the Government National Mortgage Association and under secretary of commerce for international trade.” ([www.RealClearPolitics.com](http://www.RealClearPolitics.com), Robert Novak, 11/17/07)
- On November 16, Senate Banking Committee Chairman Christopher Dodd (D-CT) suggested that he might not bring a vote on the renomination of Federal Reserve Governor Randall Kroszner, who is a leading the bank’s effort to overhaul its mortgage regulations under HOEPA. On January 31, Kroszner’s term at the Fed expires. The White House has nominated Kroszner to a 14-year term that would run through 2022. During a conference call to reporters, Dodd said, “There’s one nomination here that would be for somebody [for] 14 years. We’re frankly getting down to less than a year away from the (November 2008) election. On nominations of that length, I’m fairly reluctant.” Kroszner serves as one of five members on the Fed’s board, which currently has two empty seats. Dodd also declined to discuss the Klane or Duke nominations. (*Dow Jones International News*, Damian Paletta, 11/16/07)

#### Bush administration news

- On November 15, President Bush announced his intention to nominate Neel T. Kashkari to serve as Assistant Secretary of the Treasury. Kashkari has served as senior advisor to Treasury Secretary Henry Paulson since July 2006. Previously, he served as vice president of Goldman, Sachs & Co. in San Francisco. (*Bureau of National Affairs*, 11/16/07)

- Senate Majority Leader Harry M. Reid (D-NM) has forwarded the names of Luis A. Aguilar and Elisse B. Walter to the White House for vetting to fill their party's two vacancies on the SEC, according to people briefed on the nominations. Aguilar is a partner at McKenna Long & Aldridge, an Atlanta, GA law firm, who has drawn criticism among union representatives and former SEC officials for casting doubt in published interviews about the effectiveness of the 2002 Sarbanes Oxley Act. Aguilar also served as a top lawyer at Invesco, an investment company. He received strong backing for this appointment from Senator Robert Mendendez (D-NJ), who serves on the Senate Banking Committee. Walter has a long history in Washington. Most recently, she has focused on educating and warning investors about scams and improving regulation of mutual funds. She is a former general counsel of the Commodity Futures Trading Commission, a onetime chief operating officer at NASD, and served for more than a decade in various posts at the SEC. The SEC appointments touched off an intense lobbying battle within the Democratic Party. Unhappy with Aguilar's nomination, labor groups lobbied for Damon A. Silvers, an AFL-CIO lawyer, to be named as one of the nominees. (*Washington Post*, Carrie Johnson, 11/14/07)
- Carlton Advisory Services has hired John Jackson from OFHEO to head the real estate investment bank's loan sale advisory group, where he will oversee business development with a focus on residential loan sales. At OFHEO, Jackson supervised the analysis of Fannie Mae's \$723.2 billion retained portfolio. Previously, he worked for Fannie Mae and E-Trade Financial Group. (*American Banker*, William Launder, 11/13/07)

Derivatives debut in commercial real estate
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- "In a [commercial] market that's going up 10% a year, nobody's thinking about hedging their portfolio, but we really are at a tipping point where the hedging of assets starts to make sense," says Neal Elkin, president of Real Estate Analytics LLC. New commercial property indices from Standard & Poor's and Moody's Investors Service now provide investors the option of hedging their investments through derivatives trading. In September, S&P and GRA/Charles Schwab Investment Management unveiled the S&P/GRA Commercial Real Estate Indices, which contains sales data collected by Charles Schwab Investment Management, along with 13 years of historic data from McGraw-Hill Construction. In October, Moody's and Real Estate Analytics partnered in the publication of Moody's/Real Commercial Property Price Indices, a set of 29 indices based on data from Capital Analytics. The Moody's and S&P indices use sales data to track property values, while the NCREIF Property Index, published by the National Council of Real Estate Investment Fiduciaries, uses appraisals to determine valuation trends.
- "There are a lot of transaction costs to buying real estate. You've got to locate the property, negotiate it, and it's not easy to do standardized deals," said David Blitzer,

managing director and chairman of S&P's index committee. "Once the derivative market is up and running, you'll be able to participate by going to the futures market. It's easier to get in, it's easier to get out." In October, the Chicago Mercantile Exchange began hosting futures trading based on the S&P/GRA indices; trading based upon the Moody's/Real indexes should begin in early 2008. (*National Real Estate Investor*, Matt Hudgins, 11/01/07)

## ***Fannie Mae***

### Fannie Mae prices \$500 million of preferred stock

- On November 16, Fannie Mae priced 20 million shares of non-cumulative, perpetual, fixed-rate preferred stock, designated Series R, with a stated value of \$25 per share and a dividend rate of 6.725%. Fannie Mae will have the option to redeem all or part of the Series R preferred stock on or after November 21, 2012. Lehman Brothers and Morgan Stanley were the lead underwriters for this \$500 million issue. (*Fannie Mae Press Release*, 10/16/07)

### Fannie Mae is renegotiating about 750 subprime loans a week, says CEO Mudd

- At the National Association of Realtors' annual convention, Fannie Mae CEO Daniel Mudd outlined the steps that his company is taking to help homeowners who face foreclosure. Mudd said Fannie is renegotiating problem loans—most of which are subprime mortgages—at a rate of about 750 a week. "We are working our way through this problem," he said. "They are clearly not enough in the face of this downturn, the most serious disruption in the housing and mortgage markets in decades. ... We're all seeing – from families to neighborhoods to cities to the country at large – a pretty slow-moving tragedy playing itself out. ... An unnecessarily prolonged housing correction, highlighted by the level of foreclosures we are all seeing, hurts everyone. ... It may be a couple of years before a more customary 4 or 5 percent growth rate returns to the market." Mudd added that Fannie Mae is urging federal regulators and lawmakers to allow his company provide more funding for more mortgages and higher priced mortgages to help alleviate the credit crunch. (*Dallas News*, Steve Brown, 11/14/07)

### OFHEO approves Fannie Mae's ADC program

- In an interview with *MortgageWire*, OFHEO director James B. Lockhart, III said he had "signed off" on the restart of Fannie Mae's construction lending program, but had set some "growth" parameters on Fannie's purchases of acquisition, development and construction loans from lenders in his approval. Fannie Mae is still waiting for HUD to complete a review of the program. A HUD spokesman confirmed that the agency has started a review of the ADC program, but could not provide any guidance on

when the review might be completed. (*MortgageWire*, 11/16/07)

Fannie Mae survey finds that 92% of Americans believe  
more needs to be done to address homelessness

- According to a new Gallup poll released by Fannie Mae, 92% of Americans believe more effort is needed to address the issue of homelessness in the U.S, while 28% of Americans indicate that they have been concerned that they may not have a place to live. The survey finds that 48% of Americans indicate that a lack of affordable housing is a major cause contributing to homelessness, while 45% believe home foreclosures are a major factor. Nearly two-thirds (65%) of Americans believe job loss/unemployment is a major factor contributing to homelessness, while more than half (51%) think that the inability to pay medical expenses is a major contributor.
- “It is clear from this poll that Americans are very concerned about homelessness and do not feel enough is being done to address this critical issue,” said Stacey D. Stewart, Senior Vice President of the Office of Community and Charitable Giving at Fannie Mae. “There needs to be greater attention directed towards preventing and ending homelessness. Fannie Mae is committed to providing real solutions through permanent supportive housing and has invested more than \$4 million in grant funding this year.” (*Fannie Mae Press Release*, 11/14/07)

## ***Freddie Mac***

### Class action lawsuit filed against Freddie Mac over risk controls

- Freddie Mac shareholders have filed a class action lawsuit against the company, alleging that the GSE didn't have adequate risk-control measures in place between August 2006 and November 2007. The suit also alleges that Freddie Mac's operating procedures led to inflated appraisals, which increased the risk of mortgage defaults. The suit, filed by the law firm Coughlin Stoia Geller Rudman & Robbins LLP in the U.S. District Court in Manhattan, seeks to represent purchasers of Freddie Mac shares between Aug. 1, 2006 and Nov. 19, 2007. (*Marketwatch*, Robert Schroeder, 11/21/07; *Reuters*, Paritosh Bansal, 11/21/07)

### "There is no silver bullet" for the subprime mortgage crisis

- On November 13<sup>th</sup>, Freddie Mac CEO Richard F. Syron discussed the causes of the tough times in the mortgage industry and volatile times in the broader financial markets. Syron identified three base factors which caused the serious liquidity crunch in the financial markets. "One root cause has been widely noted: tight credit spreads due to a global glut of savings. But a major contributing factor has been much less remarked upon—the role of China. For the first time in modern history, the world's largest emerging economy was a net exporter of both capital and, in effect, of labor."
- "A second cause was advances in technology and financial engineering that de-institutionalized the mortgage market. On the whole, these new tools and techniques have been a good thing. But here they also separated the origination decision from the investment decision. So in this instance, combined with other factors, they were part of some very bad outcomes – and also have complicated resolving the situation."
- "A third cause involved the age-old balance between fear and greed. After periods of relative stability, greed often prevails. It got to the point where some mortgage product could be originated for almost any applicant. Many of these mortgages had risky features, including large payment shocks upon reset. Essentially, if you made a mortgage, somebody would buy it."
- Syron asked, "What are some useful solutions?" He continued, "It's important to acknowledge there is no silver bullet. Even if the entire system works perfectly going forward – including the political and regulatory components – the fact is we have a substantial housing inventory overhang, and it will need considerable time to be absorbed. Still, there are useful things we [the GSEs] can do. ...Not because we are a panacea or a white knight... We've had our own problems but we must be part of the solution..."

- “Here’s some of what Freddie Mac has done to be part of the solution. First, we raised standards – early. In February, we were the first investor to announce tightened lending standards to limit payment shock for subprime borrowers, and help ensure these borrowers can afford and keep their homes. The only subprime securities we buy today that are backed by short-term adjustable-rate mortgages have been underwritten to a fully-indexed, fully-amortizing level. This is consistent with a number of our other efforts to combat predatory lending and help families not only to buy homes, but to keep them.”
- “Next, in April, we committed to purchase an incremental \$20 billion in more consumer-friendly mortgages that will provide better choices for subprime borrowers. We began delivering on that commitment this summer...”
- “We are also working hard to ensure there is no disruption in the supply of mortgage funds. For example, in August we offered needed support to the Alt-A market by providing a 90-day forward purchase commitment to certain lenders, which allows borrowers to ‘lock in’ their rate.”
- “Finally, we have consistently been at the forefront of efforts to help borrowers avoid foreclosure. This year, through September, we helped more than 33,000 families find alternatives to foreclosure that keep them in their homes. That brings our total of such workouts since the beginning of 2004 to almost 200,000.”
- “In the course of our efforts on the subprime problem, we’ve developed a greater understanding of this former backwater of the mortgage market. It can be roughly divided into three parts. The top group of subprime loans might have been eligible for prime credit but ended up in subprime. It may well be possible to ‘upstream’ or refinance these into many of the prime or FHA loans available today. We’re also finding a bigger role for the GSEs buying whole loans of this kind. A second group of loans probably are legitimately in subprime, but could benefit from better subprime products – for example, loans with reasonable reset terms and better underwriting standards. Finally, there’s the bottom group of subprime loans that may not have been repayable in any reasonable scenario unless house prices continued to escalate. Price inflation can bail out a lot of bad underwriting. For people in this bottom group, it may be better to be renters rather than homeowners at this point in the cycle. That used to be the norm. Meanwhile, issues of moral hazard aside, it’s in all of our interests to see this transition occur with as little harm to neighborhoods as possible.”
- “Part of the problem is that subprime loans were doing a lot of work for which they were never intended. We must remember, subprime traditionally has been a niche market. In the mid-1990s, according to a Bear Stearns study, only 2 percent of subprime loans were for home purchase; and even by 2001, subprime comprised only about 5 percent of the overall market. Subprime historically was kind of an emergency bridge loan, equity product, primarily for refinance purposes. Only recently did it become a product for ordinary homebuyers and even investors to buy homes, such that from 2004 through 2006, almost half of subprime loans were for

home purchase – and they accounted for about a fifth of mortgage originations overall. That kind of mission creep and outsized growth should tell us something.”

- “The harsh reality is that as a society, we must stop looking almost exclusively to housing finance to solve the problem of housing affordability. When you consider the panoply of issues affecting the cost of housing—from supply side factors such as zoning and permitting to transportation to income inequality—it’s very hard to conclude that the cost of money in the world’s most developed mortgage market is the root cause why we lack enough affordable housing. To the contrary, as Daniel Patrick Moynihan said, the basic problem with poor people is, they don’t have enough money.”
- “...Now, all of Freddie Mac’s special efforts I mentioned a minute ago are a good thing and they are helping to cushion the negative effects on borrowers and communities. But I would argue that over time, it is the GSEs’ everyday activities to carry out our mission that are making the greatest difference. And I would further argue that this is no accident – because this is the very kind of situation for which we were designed.”
- “One reason Freddie Mac and Fannie Mae were created was to mitigate the impacts on the housing finance system of a liquidity crunch like this one. Clearly, the market is experiencing a flight to quality. At times like these, the GSEs provide stability to the housing sector by providing funds counter-cyclically to lenders.”
- “...[A]t the point in the business cycle when economic activity is contracting, Freddie Mac and Fannie Mae should increase their relative provision of funds to the mortgage market, and vice versa. In contrast, other mortgage investors make credit available pro-cyclically, such that fewer funds are available when they are most needed—as during a housing downturn. By acting counter to the business cycle, Freddie Mac and Fannie Mae should help reduce the depth of a housing recession and support credit flows during an expansion on an ‘as needed’ basis.”
- “...Critics of our retained portfolio ignore the fact that it allows us to manage overall mortgage risk, not just mortgage credit risk. This lets us bring our skills at prepayment and interest rate risk management to bear, as well as our low funding costs. The retained portfolio lowers our cost of capital and allows us to keep mortgage rates relatively low, as suggested in some of Stuart Gabriel’s research. It also significantly broadens our investor base and enables us to insource U.S housing finance from abroad—because GSE debt is more broadly appealing to foreign investors than mortgage backed securities or whole loans, both of which entail prepayment risk. Equally important, the retained portfolio lets us diversify our risk exposure, especially in periods of great stress – like now.”
- “A key benefit of the retained portfolio is that it helps us complete markets, as Professor Roll detailed in the *Journal of Financial Services Research*. And it is

fundamentally a market instrument, allowing us to respond nimbly to market developments.”

- “There seems to be a misperception that the GSEs’ operations and our retained portfolios are infinitely elastic to political and policy demands. But the fact is, we are also shareholder-owned corporations, and there are points beyond which our business model simply cannot work on a sustainable basis. The retained portfolio is a market instrument that must continue to answer to market dictates, not solely political dictates, if we are to continue performing our mission.”
- “And how is that mission going, in terms of the subprime crisis? In fulfillment of the \$20 billion commitment I mentioned earlier, by the end of this year we will have purchased over \$30 billion of loans from credit-challenged borrowers, many of whom likely were in the subprime market in the past. This \$30 billion figure includes not only purchases into our SafeStep subprime product, but also refinancing into our standard offerings, such as our targeted affordable offering, Home Possible.”
- “This doesn’t solve the whole subprime problem—not by a long stretch—and our efforts will continue. But it does represent meaningful progress. And the 33,000 workouts instead of foreclosures this year that I mentioned are helping the overall housing situation as well.”
- “I want to mention one other helpful aspect of Freddie Mac’s routine functioning these days—namely, our securitization activities. By providing a corporate guarantee, Freddie Mac’s mortgage backed security provides an active, useful guarantee very different than a private label, asset-backed security. The private label instrument in today’s market seems like a structured security having almost the characteristics of a story bond. Today, people aren’t buying the story – or if there’s a story involved they don’t even want to hear it.”
- “So in this time of uncertainty, by providing a solid corporate guarantee, our securitization activities are in themselves a very useful thing. We’ve had to bear some added credit risk to be as active as we’ve been during this period. But it has helped the conforming market remain orderly, and it’s been the right thing to do for our mission.”
- “At a time of elevated risk like this, a liquidity premium is to be expected. And of course, we don’t want to suppress the market price for risk. One healthy aspect of this liquidity crunch is that it’s been part of a widespread reassessment of the pricing of risk. Where to draw the line is a judgment call. But again, no one wants the GSEs to play any role in artificially reversing or suppressing the price of risk.”
- “I want to mention loan limits, because this is a topic especially germane for this forum. There’s been a great deal of discussion back in Washington of letting the GSEs buy loans larger than the current limit of \$417,000. Again, there’s obviously no move that will solve everything. But the basic principle is unassailable. At

ordinary times, the spread between conventional and jumbo loans is about a quarter point. As Professor Roll has written, that's one sign of the efficiency of the GSE part of the market. At the worst of the recent crisis, the spread quadrupled to a record of about 100 basis points; now it's closer to double, at 50 to 60 basis points."

- "It makes no sense to assume that housing costs are the same throughout the contiguous United States. For example, in a high-cost state like California, the median home price in August was more than \$150,000 above the conforming loan limit. What this means is simple. The housing crunch here will be worse than it needs to be, because low-cost GSE financing will be less available here."
- "I'll end with a brief word on the mortgage market's direction. The market is coming back today to the long-term, fixed rate, prepayable mortgage—what I call 'the American Mortgage.' And I must say, I think that's a good thing, and not only because it's what the GSEs finance best. This kind of lending has a host of advantages for families and our nation. For example, recent research for the UK Treasury and the IMF shows that such fixed-rate lending makes a nation's economy less prone to boom and bust."
- "The GSEs are a key reason why the U.S. is the only major economy where this type of mortgage is prevalent. And it remains the revealed preference of a high proportion of American families. Together with access to second mortgages, it provides much of what consumers need to make their life cycle optimization decisions. So I find the fact that borrowers and lenders have moved back in this direction to be a heartening development."
- "In closing, I'll repeat once more that Freddie Mac is not the whole solution. We've been far from perfect and we have a lot left to do. But given the serious liquidity and credit concerns still disturbing the markets today, we need to put the past behind us and all focus on what each of us, including the GSEs, can do to stabilize the markets and give Americans the future they deserve." (*Prepared remarks of Richard F. Syron, 11/13/07*)

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

### Merger of Dallas and Chicago FHLBs closer to becoming a reality

- The merger discussions between the FHLB-Dallas and FHLB-Chicago are gaining momentum and could result in a combination of the two banks early next year, according to sources familiar with the negotiations. The Banks' discussions picked up traction after the Federal Housing Finance Board issued a cease-and-desist order for the FHLB-Chicago, which imposed capital requirements and dividend restrictions on the Bank. The source said that discussions have moved from theoretical issues to practical discussions. Key issues remain to be resolved, including deal price, dividend rates, and the future of the Chicago Bank's Mortgage Partnership Finance program. Observers say that the FHLB-Chicago is trying to maintain at least an even hand in negotiations. The Finance Board is encouraging the Banks' discussions, but is not pressuring them to merge. Basic issues remain, including when dividends would resume and how the merged entity would pay dividends to members. The parties are close to reaching an agreement which would segregate the stock, which would allow the Dallas members to continue receiving dividend payments, while the Chicago members would continue to remain under the restrictions of their C&D order with the Finance Board. (*American Banker*, Steven Sloan, 11/20/07)

### FHLB-Des Moines receives regulatory approval to accept 1-4 family construction loans as collateral for advances

- The Federal Housing Finance Board has approved the FHLB-Des Moines's request to accept one-to-four family construction loans as collateral for advances at a time when many members have stepped up their borrowings from the Bank. "[For many community banks,] construction loans are an important part of their lending portfolio" and expanding the list of eligible collateral will help members "maximize their borrowing capabilities," said Richard Swanson, president and CEO of the Bank. (*MortgageWire*, 11/15/07)

### FHLBs announce dividends guidance

- The FHLB-Boston's board of directors declared a fourth quarter dividend with an equivalent yield of 6.5%, payable on December 4. (*PR Newswire*, 11/15/07)
- The FHLB-Atlanta announced that it expects to pay an annualized dividend in the range of 5.5% to 6.0% for the fourth quarter of 2007. (*FHLB-Atlanta Press Release*, 10/15/07)

- The FHLB-Des Moines' board of directors has declared a third quarter dividend payable at the annualized rate of 4.50%, an increase of 0.25% from the prior quarterly dividend of 4.25%. The dividend will be paid to shareholders on November 19. (*FHLB-Des Moines Press Release, 10/13/07*)
- On October 30, the FHLB-Seattle board of directors declared a \$0.20 share dividend on average Class B stock outstanding during the third quarter and a \$1.28 per share dividend on average Class A stock outstanding during the period. (*FHLB-Seattle Press Release, 10/13/07*)

FHLBs' director election results and Finance Board appointments
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- The FHLB-Chicago announced the board election results for three year terms beginning on January 1, 2008. William W. Sennholz, president and CEO of Marshfield Savings Bank in Marshfield, WI, has been elected to the Bank's board by its Wisconsin member institutions. P. David Kuhl, chairman of the board of Freestar Bank in Pontiac, IL, has been re-elected to the Bank's board by its Illinois member institutions. Kuhl is chairman of the FHLB-Chicago's board of directors, of which he has been a member since 2000. Kathleen E. Marinangel, CEO, president and chairman of the board of McHenry Savings Bank, McHenry, IL, has been re-elected to the Bank's board of Directors by its Illinois member institutions. Marinangel has been a member of the Board since 2002. (*PR Newswire, 11/14/07*)
- The FHLB-Boston announced that A. James Lavoie, trustee, Middlesex Savings Bank, Natick, MA, was elected to serve on the Bank's board of directors. In addition, Stephen F. Christy, president and CEO of Mascoma Savings Bank, FSB, Lebanon, NH, and Peter Crosby, president and CEO of Passumpsic Savings Bank, St. Johnsbury, VT, were reelected to the Bank's board of directors. All will serve three-year terms commencing January 1, 2008. (*PRNewswire, 11/15/07*)
- The Federal Housing Finance Board has re-appointed Daniel Fauske of Anchorage, AK, and Jack Riggs of Coeur d'Alene, Idaho, to serve on the FHLB-Seattle's board of directors for a three-year term commencing on January 1, 2008. Fauske is CEO and executive director of the Alaska Housing Finance Corporation (AHFC), a publicly owned corporation administering state housing programs. He also serves on the National Housing Development Corporation board of directors and the UAA School of Nursing Advisory board. Dr. Riggs is a partner in North Idaho Medical Care Centers, an urgent-care medical practice serving northern Idaho. Since 2005, he has also served as the CEO of Pita Pit USA. (*Datamonitor NewsWire, 11/13/07*)
- The Federal Housing Finance Board has appointed Joan Carty, of Bridgeport, CT, and John T. Eller, of Newbury, NH to serve on the FHLB-Boston's board of directors for a three year term beginning on January 1, 2008. Since 1994, Carty has served as president and CEO of Housing Development Fund in Stamford, CT. She has also served as executive director of Bridgeport Neighborhood Fund of Bridgeport, CT;

Neighborhood Preservation Program of Stamford, CT; and Neighborhood Housing Services of Brooklyn, NY. Eller serves as a director of the New Hampshire Housing Finance Authority. Previously, he served as senior vice president/director, housing and community investment at the Bank, where he managed the Affordable Housing Program. (*PR Newswire*, 11/15/07)

## ***Ginnie Mae***

The time to move on FHA reform was *last year*

- At the National Association of Realtors' annual convention, FHA Commissioner Brian Montgomery said that if Congress had passed FHA reform legislation, some of the current mortgage problems would have been avoided. "The time to move on this was last year," said Montgomery, who reiterated his plea for Congress to approve changes to his agency. "We have the products and the services necessary to assist hundreds of thousands of moderate-income homebuyers," said Montgomery. "All we need now is the legislation to put these improvements into practice." FHA has already expanded its refinance business to provide mortgages for borrowers in trouble with subprime loans, he added. "We project that we will serve approximately 80,000 delinquent borrowers this year," said Montgomery. (*Dallas News*, Steve Brown, 11/14/07)

HUD is expected to move ahead with a risk-based premium structure

- *MortgageWire* reports that, "Despite congressional opposition, [HUD] is expected to move ahead with a risk-based premium structure but give [FHA] lenders more time to adjust to the changes. House and Senate lawmakers are urging HUD to postpone implementation at least until Congress passes an FHA reform bill. The Senate bill contains a 12-month moratorium on FHA adopting a RBP structure. Currently, FHA charges a 150 basis point upfront premium and a 50 bp annual premium for most borrowers. With RBP, FHA officials say they could increase the upfront premium to 2.25% for the riskiest borrowers with low credit scores and low downpayments and help an estimated 20,000 subprime borrowers refinance into new FHA-insured mortgages in fiscal year 2008. In moving ahead with a RBP structure, sources expect HUD will postpone the Jan. 2 implementation date—possibly for three months." (*MortgageWire*, 11/21/07)

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

### Senate fails to break Farm Bill impasse

- On November 16, the Senate fell five votes short of the 60 needed to pass a cloture motion, limiting debate on the 2007 Farm Bill. Majority leader Harry Reid (D-NV) filed the cloture motion, after he failed to reach an agreement on amendments to the bill with Minority Leader Mitch McConnell (R-KY). (*ABA Ag Banker*, 11/21/07)
- In a November 16<sup>th</sup> editorial, the *Yankton Daily Press & Dakotan* [Yankton, SD] wrote, “THUMBS DOWN to the possibility that the long-delayed Farm Bill may have to wait until after the 2008 elections to get completed. That was the sentiment of Iowa Senator Tom Harkin (D) ...as he assessed the progress on the Senate version of the bill. The current bill was enacted in 2002 and has been running on temporary extensions since the end of September. Thus, farmers and ranchers wondering just what the new Farm Bill will mean to them may have to wait another year to find out. And that leaves a lot hanging in the balance of doubt.” (*Yankton Daily Press & Dakotan*, 11/16/07)
- On November 16, a coalition of 27 farm groups urged senators to vote against an amendment to the Farm Bill sponsored by Senator Saxby Chambliss (R-GA) which would expand the Farm Credit System’s lending authority, unless the provision specifically directs FCS to do more for small, mid-sized, beginning and socially disadvantaged ranchers. In a letter, the groups wrote, “When looking at the FCS lending portfolio, you can see that they are focused on lending to large, strong borrowers.” The trade groups pointed out that loans of more than \$500,000 comprised 58% of the FCS portfolio at the end of 2006, while loans over \$5 million accounted for 24%. “[The FCS] has not demonstrated a serious commitment to addressing the challenges that small and mid-size, beginning and socially disadvantaged farmers and ranchers encounter,” said the trade groups. (*ABA Ag Banker*, 11/21/07)
- On November 15<sup>th</sup>, Representative Jerry Moran (R-KS) introduced legislation that would extend the 2002 Farm Bill, which expired in September, until September 2008. Moran said that the current Senate impasse on the Farm Bill leaves farmers without the certainty that they need to make decisions concerning their 2008 crops. The extension measure has 22 original co-sponsors, including House Agriculture Committee ranking member Bob Goodlatte (R-VA). (*ABA Ag Banker*, 11/21/07)

### Don’t let the bureaucrats take our FCS away from us

- In a November 14<sup>th</sup> Letter to the Editor of the *News Leader* [Springfield, MO], Charles Chastain wrote, “A major move is underway in Congress to fundamentally

alter the Farm Credit System (FCS). Proposed changes will change its character and move its focus away from rural America and its responsibility to maintain a vibrant agricultural industry as a bedrock of our nation's security. ...Make no mistake about what is occurring in Congress. The issue is not about improving access to farm credit resources, it is about compensation levels for government employees. Managers and employees of the system justify what they earn through the complexity of their jobs and the income they produce. The larger the division managed or the portfolio serviced, the better their ability to justify ever increasing salaries. Greater administrative costs do not improve service; to the contrary, service often becomes secondary to turf building with client needs only an afterthought..."

- "A well-capitalized, well-managed Farm Credit System has an essential role to play in today's agribusiness industry. System members, beneficiaries and taxpayers must become involved in finding methods to induce more private sector involvement and seek ways to improve access to its benefits. FCS has a critical role to play in providing venture capital for agricultural operations that otherwise would not be possible. This is its proper role and its vital mission; don't let bureaucrats take it from us. Call your member of Congress and let them know you expect them to fight for our way of life." (*News Leader*, Charles Chastain, 11/14/07)

FCA adopts final rule extending distribution deadline
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- On November 8, the FCA board of directors adopted a final rule allowing the Farm Credit System institutions 90 days after the end of the fiscal year to prepare and distribute copies of their annual reports to shareholders. Under the rule, institutions will be required to file electronic copies of the reports with FCA and post the reports on their Web sites within 75 days of the end of the fiscal year. This rule will become effective 30 days after the publication in the Federal Register. (*FCA Press Release*, 11/08/07)

## ***Postal Service***

USPS Board of Governors agrees to file its next rate increase  
under a new pricing system tied to inflation

- On November 15, the USPS Board of Governors said it will file its next rate increase under the new pricing system that indexes rate adjustments to inflation. Post Master General Jack Potter said, “This delivers one of the main goals of the new law for business mailers – a predictable price schedule.” The postal reform legislation also enables the USPS to respond and anticipate the market when establishing prices on competitive products. Potter stressed, “We intend to use this new flexibility to grow our competitive business, offering volume discounts and contract pricing.” Under the Postal Enhancement and Accountability Act, the Board of Governors had the option of filing one last rate case under the pre-postal reform rules. The USPS will likely propose an index-based price adjustment in early 2008. (*USPS Press Release*, 11/15/07)
- According to the November 16<sup>th</sup> issue of *eNAPUS Legislative & Political Bulletin*, “The new pricing and product flexibility will be especially important to the USPS and its employee as we grapple with a sluggish U.S. economy and erratic mail volume. By reading the business section of your local newspaper, you can conclude that all is not well in the retail trade. In part, this observation is drilled home by the USPS FY 2007 Year End Review. Overall mail volume fell by 0.4%; first class mail continued to trend down by 1.6%; and standard mail grew by an anemic 1%. Evolving service standards and ‘intelligent mail’ need to be selling points in marketing postal products to the business community and grow revenue. While the EXFC yardstick demonstrates exceptional performance within the class of mail that is evaluated, it does not measure the types of mail that our major costumers send. Moreover, despite 2007’s continued growth in ‘total factor productivity,’ this measurement is less relevant under the new postal business model, which emphasizes retained earnings. Consequently, Postmasters will be looking to Postal Headquarters for ways in which to generate more revenue. Simply continuing to shrink the number of employees – a reduction of 36 million work hours in FY 2007 – does not grow revenue or generate mail volume. Moreover, sustained postal contraction will adversely impact customer service.” (*eNAPUS Legislative & Political Bulletin*, 11/16/07)

USPS posts \$5.1 billion loss for fiscal year 2007

- For the fiscal year ended September 30, the USPS posted a \$5.1 billion loss, attributable to mandatory funding requirements of the Postal Act of 2006. Without the funding requirements, the agency would have ended the year with a \$1.6 billion surplus. The agency’s loss is about \$300 million less than projected earlier in the

year. Total revenue in FY2007 was \$74.0 billion, while expenses totaled \$80 billion. Mail volume was 212 billion pieces. (*USPS Press Release*, 11/15/07)

APWU “wins significant victory” with introduction of bill  
that would curtail subcontracting by USPS

- The American Postal Workers Union told its members that they won “a significant victory on November 15, when Representative Stephen Lynch (D-MA) introduced legislation that would require the Postal Service to bargain with postal unions before making a commitment to significant subcontracting. H.R. 4236 would require the USPS to submit to arbitration if management and the affected unions were unable to reach agreement. The APWU has been strenuously advocating such legislation for several months.” (*APWU Web News Article #107-07*, 11/16/07)

Can rising productivity at USPS sustain falling mail volume?

- In its *Postal TrendWatch* for the third quarter of 2007, the Lexington Institute wrote, “The Postal Service experienced both revenue and volume growth in the first three quarters of FY 2007. However, overall volume growth appears to be slowing. In particular, First Class Mail continued its historic decline. The big question that remains is whether the strong growth in productivity and Standard Mail can fill the gap left by shrinking First Class Mail. Also, after six years of uninterrupted productivity growth, has the Postal Service finally reached a limit to wringing out more productivity gains?”
- “...Taking all mail categories into account, USPS revenue through Q3 FY 2007 was up 2.2% over the corresponding period last year, and overall volume inched up 0.2%. In Q3 alone, revenues were up 2.4% while volume declined 1.3% over the same period of FY 2006. These numbers bear out the broader trend of a slow decline in First Class Mail volume. What’s less certain is if that decline will ultimately drag revenues down, as well. If it does, will USPS be able to fill the breach through more efficient Standard mail and sustained productivity gains?” (*Postal TrendWatch*, The Lexington Institute, Quarter 3, FY2007)

# TVA

TVA's nuclear push appears to be "not so much by design as by default"

- In a November 12<sup>th</sup> editorial, the *Tennessean.com* wrote, "The Tennessee Valley Authority appears to be going headstrong into a new nuclear power era. But the entire nuclear push in this nation seems not so much by design as by default."
- "TVA recently announced it would join a consortium of 12 other utilities in submitting an application with the Nuclear Regulatory Commission to build two new nuclear power plants at TVA's Bellefonte site in northern Alabama. TVA in September began work on finishing a second reactor at its Watts Bar nuclear plant near Spring City, Tenn. TVA's nuclear jumpstart falls in line with other efforts throughout the country. Nuclear is in. Old-fashioned energy sources are out. That's what we're being led to believe."
- "But hold on. As nuclear power gains new traction in the current political climate, it's important to listen to the reasons being given for the rush into nuclear power. Then notice what's not being said. Advocates for reviving the nation's nuclear power projects are pointing to all sorts of world events. They emphasize the need for 'clean' energy. They point to the filthy smokestacks of coal-fired power plants, the effects of greenhouse gases and — now they tell us — the reality of global warming. They point to the rising price of oil and the nation's dependence on foreign sources of oil, with all the baggage of international turmoil, including war. To hear all those arguments as reason to turn to nuclear energy, one would assume there had been a remarkable new breakthrough in the safety of nuclear energy to coincide with those world events. But no one is making that claim. In fact, at a time we're all being reminded of terrorist targets, the one sort of new energy plant that might make an excellent target for terrorism is a nuclear site."
- "The fact is, no matter how ugly the advocates for nuclear power try to paint so many of the current major sources of energy, it doesn't do one thing to make the case for nuclear power. All we hear is the awful characteristics of the way things are, not the dangerous, expensive aspects of nuclear plants. We hear about the need for energy that's 'clean' and 'efficient.' We don't hear that nuclear energy is potentially dangerous."
- "The most recent nuclear plant design advocated by the TVA and the consortium called NuStart is a Westinghouse AP1000. People concerned about nuclear power point out that the new plant design would not withstand an attack from a jet airliner. It shouldn't be too much to ask the NRC to require that new plants take terrorist attacks into account."

- “A lot of the excuses for going nuclear don’t hold up anyway. Take price. Yes, oil prices are climbing, but guess what? So has the price of uranium. In fact, rising costs are becoming factors in biofuels and other energy sources. So the assumption that rising oil prices would make alternative fuels the clear choice financially isn’t happening as rapidly as some had hoped, although alternative fuels should certainly remain the environmental goal. But don’t paint nuclear power as cheap, and don’t leave the impression that it’s foolproof. The world knows better.”
- “The United States went down the flawed path of nuclear power a few decades ago. All it wound up with was debt. TVA generated a lot of debt. If the emphasis is to be on clean, efficient alternatives to oil, look harder at solar power, wind power and the great potential of agricultural sources. They’re the sensible alternatives. Nuclear isn’t.” (*The Tennessean.com*, 11/12/07)

TVA helps bring \$5.6 billion in economic development to its trade area
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- For the fiscal year ending September 30, TVA estimates that its economic development staff worked on business investments totaling \$5.6 million, more than a 33% increase than the previous year which sets the stage for growth in the region. “There have been some significant announcements in the past few years that have caused a lot of people to really take notice of the Tennessee Valley,” said John Bradley, senior vice president of economic development for TVA. The utility’s decision to certify industrial properties as “megasites” which can handle major manufacturers has helped boost the agency’s economic development activities, said Bradley. The designation was critical in attracting Toyota’s new plant in Tupelo, MS and the \$400 million PACCAR diesel engine plant in Columbus, MS. TVA budgets \$17 million a year for its economic development activities through its staff of 56 employees. (*Associated Press*, 11/18/07)

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