

# The **GSE** REPORT™

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## ***Major Events***

House of Representatives approves massive housing bill

President Bush promises to veto the bill in its current form

Senate Banking Committee schedules to mark-up of mortgage bills this week

Will the proposed bailout of housing be effective in stemming foreclosures?

What will be the unintended consequences of a housing bailout?

### House of Representatives approves massive housing bill

- The House of Representatives passed sweeping legislation aimed at shifting subprime mortgages into affordable loans and stemming the tide of mortgage foreclosures. Members approved the legislation as three separate amendments. By a vote of 266 to 154, the chamber adopted the centerpiece of the housing package, which would make \$300 billion of FHA guarantees available to lenders, who agree to reduce the outstanding principle balance on mortgages. In exchange for the FHA-insured loan, homeowners must share with the government any profits on their homes through the subsequent sale of their properties.
- The housing package also incorporated (1) provisions for GSE regulatory reform and modernization of FHA; (2) provisions which protect loan servicers from investor lawsuits when servicers make long-term loan modifications; and (3) provisions that protect disabled veterans in bankruptcy from discrimination and provide aid to specified low-income housing developments. By a vote of 266 to 154, the chamber also approved a last-minute provision to the housing package, permanently increasing the loan limits for GSEs and FHA insurance programs to a maximum of \$729,500 in certain high cost markets. The House also passed bills providing a one-time \$7,500 tax credit for new homeowners which will be paid back over a 15-year period and \$15 billion for states and municipalities to buy and rehabilitate foreclosed properties. And, the House adopted an amendment by Representatives Brad Miller (D-NC) and Steven C. LaTourette (R-OH) which would prevent any provision in the bill or two major banking federal statutes from pre-empting any state law addressing residential foreclosures. Characterizing the housing legislation as a [“voluntary”] “cooperative approach to solving the housing mess,” House Financial Services chairman Barney Frank said strong-arming lenders and servicers would become “politically irresistible” if servicers fail to encourage borrowers to refinance their loans with the FHA.

- According to CBO estimates, the housing bill would help roughly 500,000 homeowners at a cost of \$2.7 billion over the next five years. The relatively low participation rate in the program –only 17.9% of the estimated 2.8 million subprime or exotic mortgages likely to face foreclosure over the next four years—is caused largely by the existence of second liens which exist on 40% of these mortgages. CBO concludes that the holder of the second lien has little if any reason to participate in a plan that forgives a portion (or all) of that debt.
- Earlier in the week, House Republican leader John Boehner (R-OH) called on the GOP caucus to vote down the bill, saying: “The bill ... is really asking taxpayers to bail out scam artists and those who were speculating in the market. And they’re asking the American taxpayers to pick up the tab.” Thirty-nine Republicans, many in districts hit hard by the subprime crisis, voted with Democrats to pass the measure—falling short of a two-thirds majority needed to over-ride a presidential veto. “We have a housing crisis in Ohio,” says Representative Steven LaTourette (R-OH). “As a loyal Republican, I’d like to be supporting Republican legislation, but it wasn’t bold action. Chairman Frank is taking bold action. ...When I go home and talk to crowds, they want something accomplished. When losing homes and paying \$3.77 a gallon for gasoline, they want to know that the government is going to do something – not just hear that ‘I’ve saved you from the nasty Democrats.’”
- In a speech before Mortgage Bankers Association, House Financial Services chairman Barney Frank said, “I think the chances are very good that somehow in June we’re going to see this [housing] package passed. ...We are very optimistic that these reforms will be accepted by the Senate. I am hoping in early June the President will [sign it].” Frank warned loan servicers and lenders that if they do not voluntarily write-down mortgages to help borrowers avoid foreclosure to facilitate refinancing these loans through the FHA, then tougher rules would be adopted by Congress next year. “If inducements to lenders to voluntarily recognize loss fails, we will see much tougher rules and in some cases they may be too tough,” said Frank. “The business methods we’ve seen are going to be under assault.” Frank also said he was “disappointed” that problems continue in the jumbo loan market, despite Congressional action to temporarily raise conforming loan limits in high cost markets. “We fought very hard to raise the loan limits for Fannie and Freddie, and there have been a lot of problems in implementation,” he said. Frank added that he will hold a hearing in late May to ask the Securities Industry and Financial Markets Association “why we don’t have more bang for the buck” in this market. He added, “There is a chain of people blaming each other, and we’re going to call everybody into the hearing.” (*Wall Street Journal*, John D. McKinnon, Damian Paletta, and Henry J. Pulizzi, 05/08/08; *Housing Wire*, Paul Jackson, 05/08/08; *CQ Today Online News*, Benton Ives, 05/08/08; *Bureau of National Affairs*, Thecla Fabian, 05/09/08; *Associated Press*, 05/05/08; *Washington Post*, Lori Montgomery, 05/03/08; *CQ Today Midday Update*, 05/08/08; *The Christian Science Monitor*, Gail Russell Chaddock, 05/09/08; *Washington Post*, Lori Montgomery, 05/03/08; *American Banker*, Kate Berry, 05/06/08; *Housing Wire*, Paul Jackson, 05/08/08; *Associated Press*, 05/08/08)

## President Bush promises to veto the bill in its current form

- In a May 5<sup>th</sup> statement, President Bush said he would veto the housing bill, saying its “would constitute a costly bailout for lenders and speculators and would delay the economic recovery it purports to advance.” The administration wrote, “It would force FHA and taxpayers to take on excessive risk, and jeopardize FHA’s financial solvency.” The principle beneficiaries of the bill would be private lenders, who now own vacant land and foreclosed properties, rather than struggling homeowners, argued the administration. At the heart of the White House’s objections are the cost of the program and lack of flexibility in the bill for FHA to charge risk-based premiums to borrowers. CBO estimates that the FHA guarantee program would cost \$2.7 billion over five years—which is a “fairly significant line we’re not willing to cross,” said Keith Hennessey, director of the National Economic Council. Administration officials also remain concerned that a large federal bailout could artificially drag out the correction in the housing market that is currently underway, by putting a government-subsidized floor under home prices.
- In a May 8<sup>th</sup> interview with *Fox Business News*, Treasury Secretary Paulson said that the problems with the housing bill passed by the House are “not insurmountable” and that he would work toward negotiating a bill that President Bush would sign. “I can’t talk about a compromise now, other than the problems here are not insurmountable, and it’s my job and others working for the president to get to a housing bill that is acceptable and one that he can sign,” said Paulson. As currently structured, the House bill would shift too much risk from financial institutions to taxpayers, said the Treasury Secretary. He added that it was unacceptable to make permanent an increase in loan limits for government-sponsored housing enterprises Fannie Mae and Freddie Mac. “This is not good long term policy and flies in the face of the GSEs’ affordable housing mission,” said Paulson.
- House Financial Services chairman Barney Frank (D-MA) said Treasury Secretary Henry Paulson expressed his support for the House bill in discussions with him and other panel members. Frank said, “I’m ready to accept risk-based pricing [for FHA insurance], but I want to shelter low-income families who are responsible enough to make their payments on time.” Several banking industry and consumer group representatives said they believed that the administration’s veto threat may be more of a negotiating maneuver than true commitment to veto the bills.
- In a run-up to the House vote on May 8<sup>th</sup>, Federal Reserve chairman Ben Bernanke voiced support for a greater role for the federal government for curbing foreclosures. In a May 5<sup>th</sup> speech at the Columbia Business School, Bernanke said, “As a consequence of rising delinquencies, foreclosure proceedings were initiated on some 1.5 million US homes during 2007, up 53 percent from 2006, and the rate of foreclosure starts looking likely to be yet higher in 2008” ...[D]oing what we can to avoid preventable foreclosures is not just in the interest of lenders and borrowers. It’s

in everybody's interest." Bernanke called on Congress to "reconcile and enact legislation permitting ...[FHA] to increase its scale and improve its management of risks" and "move forward on GSE reform legislation, which includes strengthening the regulatory oversight of these companies." (*Dow Jones Newswires*, Michael R. Crittenden and Henry J. Pulizzi, 05/08/08; ; *The Christian Science Monitor*, Gail Russell Chaddock, 05/09/08; *Wall Street Journal*, John D. McKinnon, Damian Paletta, and Henry J. Pulizzi, 05/08/08; *Prepared Remarks by Federal Reserve Chairman Ben S. Bernanke at the Columbia Business School's 32<sup>nd</sup> Annual Dinner*, 05/05/08; *Reuters*, 05/08/08)

- Public opinion appears to be divided on the proposed bailout of subprime borrowers. According to a May 9<sup>th</sup> CNN/Opinion Research Poll, 49% of Americans believe that homeowners about to default on their mortgages should receive special treatment, while 48% feel that homeowners should not receive assistance and 3% were undecided. The survey polled 1,008 adults by telephone on Monday, April 28<sup>th</sup> through Wednesday, April 30 and had a margin of error is plus or minus 3%. (*CNNMoney.com*, Beth Braverman, 05/08/08)

#### Senate Banking Committee schedules to mark-up of mortgage bills this week

- Despite the threat of a presidential veto, Senate Banking Committee chairman Christopher Dodd said he will move ahead with markup of his bill to allow the FHA to help refinance troubled subprime loans. "I don't know who he [the President] is listening to," Dodd said. "He's obviously not listening to key advisers [including Federal Reserve chairman Ben Bernanke and FDIC chairman Sheila Bair]. He's not listening to the American people." Dodd indicated he will move ahead with markup of his FHA refinancing measure and GSE regulatory reform legislation. He said he is working to secure an agreement with Senator Richard Shelby (R-AL) on both bills. According to a lobbyist briefed on the GSE negotiations, the sides remain "too far apart" with GSE capital standards remaining a sticking point, particularly in light of OFHEO's recent relaxing of the GSEs' excess capital requirements. Dodd said he also plans to include a provision which would make permanent an increase in the GSEs' loan limits in high cost markets. (*CongressDaily*, Bill Swindell, 05/08/08)
- During a taped appearance on C-SPAN's Newsmakers, Dodd defended his plan to expand the FHA program to insure up to \$400 billion in refinanced mortgages and blasted President Bush's threat to veto similar legislation passed by the House of Representatives. Dodd said, "I get a kick out of this White House. This is a White House that was willing to put \$29 billion of American taxpayer [money] on the table to make the deal sweet enough for J.P. Morgan Chase with Bear Stearns. That never came for a vote up here at all, and they are relying on Bear Stearns evaluation of their assets that they help to sell over the next few years. So with all due respect to the administration, they've already put taxpayer at great risk...Candidly, to find the administration saying we shouldn't put taxpayer money at risk here – taxpayer money is at risk every single day with continuing foreclosures. With all due respect this morning to the president, what was the point of that statement? Here, we are

beginning a process to deal with housing. And the president says I'm going to veto this bill, even before we've had a chance to work on it. Why not say, 'listen, I want to see what you are going to do. We'd like to cooperate.'... At least sound as though you are trying to work on this. This idea 'I'm going to veto this bill no matter what you do,' that's just infuriating to people who are struggling every day to keep their families together. 280,000 people have lost their jobs. Consumer confidence is at a 25-year low. The fiscal condition of the country is a mess. The dollar sinks every day. Oil is \$120 a barrel, and the president is going to veto a bill where you are trying to keep someone in their homes. Now what kind of leadership is that?"

- Dodd argued that the costs of the housing bailout are "limited." He told viewers, "The actual exposure here, potential exposure, is very, very limited... Remember this, for every 7,000 to 8,000 foreclosures that are filed every day, there are 15,000 homes that live next door to that foreclosed property. And what we're getting here is a spiraling down effect... This is not only designed to deal with the homeowner who could lose their home, its also the properties adjacent in the neighborhood of that home as well to make sure that they don't end up losing value as many are today." He justified the bailout, by arguing: "I'm not interested in bailing anyone out. I'm not interested in sanctioning irresponsibility. But the fact is, if you end up with foreclosed properties, there is a domino effect. That neighbor next door who says, you know what, I got the kind of loan I could afford. Why didn't my neighbor do the same? I just remind that person next door - I understand your feelings, but if your neighbor next door has the property foreclosed and the property of their home begins to decline, then have you really gained, haven't you lost something as well?" (*Wall Street Journal Blog*, Damian Paletta, 05/07/08)
- *Housing Wire's* Paul Jackson tips his hat to the one man, who appears to be the roadblock for Dodd's FHA proposal: Senator Richard Shelby (R-AL), "who is either the last bastion of sensibility or a troublesome holdout, depending political affiliation." Jackson wrote, "Shelby has been an obstacle, but I think the pressure to get something done here will eventually rule the day, even within the GOP," said one source, a lobbyist in Washington, D.C.' Republicans and Democrats in Congress need to be able to tell their respective voting blocs that they've done something.'"

#### Will the proposed bailout of housing be effective in stemming foreclosures?

- Even if Congress eventually passes a housing bill, how much impact would such a bill have? Even supporters of the legislation, including Chairman Frank, acknowledge that hurdles still exist in helping distressed homeowners. Chief among these obstacles is that the \$300 billion FHA program is voluntary. Further, it will also take significant time to get the FHA program up and running—if it gets enacted at all, said observers.
- Even if the bill is enacted by the summer, it would likely take regulators three to six months to promulgate and implement regulations for the FHA loan program. "Best-case, it would be operational by the end of this year, maybe early next. It would be

nice to have it up and running now. But this is still going to be a problem going into '09," said Mark Zandi, chief economist for Moody's Economy.com. "No matter what you do, it is going to take a while to really have much of an impact, and all of that is still in theory; it's not clear if in practice is going to result in as much of a benefit as hoped for."

- Others argue that, even if the legislation were enacted soon, there remains the obstacle of modifying loans on a loan-by-loan basis, which may be too slow and should be replaced by a bulk refinancing option. Sources close to the modification process argue that it would be too complicated to create a way to auction loans in bulk for widespread refinancings that could meet all the criteria for loan and borrower eligibility. "People have given up," said a representative from a large banking company. "There is no way to do this with securitized loans unless you do it loan by loan. There is just no other way. Quickly is just not feasible anymore. You have to look at the borrower. You can't just broadly categorize these things."
- And, there is the question of how many borrowers this bill will help. Chairman Frank initially estimated the plan would help 1.5 million borrowers refinance – but CBO lowered that estimate to perhaps a third of Frank's projection—500,000. "Given the constraints over existing contracts and what our jurisdiction is... this [legislation] is the best thing we can think of," conceded Frank the week of April 28<sup>th</sup>. Scott DiFife, a lobbyist for the Securities Industry and Financial Market Association, said, "None of the big-picture hurdles have changed."
- Consumer groups agree with this assessment. Josh Nassar, a lobbyist for the Center for Responsible Lending, said, "Chairman Frank's proposal could potentially help more homeowners than existing efforts. Nevertheless, the proposal is voluntary and will take some time to get up and running. Meanwhile, over 20,000 subprime homeowners lose their homes every week." Bruce Marks, the CEO of the Neighborhood Assistance Corporation of America, said "It's really more about the perception that Congress is doing something than that Congress is really doing something. It will have no significant impact on the mortgage crisis." (*American Banker*, Stacy Kaper, 05/08/08)
- Last month, Chairman Frank told *The Hill* it was "irrelevant" how many borrowers the bailout plan actually helped. "I would hope a million [could benefit]," said Frank. "It's irrelevant. There's not downside. Why not try?" (*Heritage Foundation's Foundry Blog*, 05/06/08)
- In an April 6<sup>th</sup> commentary, Heritage Foundation's *Foundry Blog* wrote, "...Don't let anybody fool you, federal government market intervention is at the core of the nation's mortgage meltdown and the bottom lines of the government entities doing the intervening reflect it. If current mortgage default rates continue, the FHA will face a \$1.4 billion deficit in 2009 and Freddie Mac and Fannie Mae already racked up \$9 billion in mortgage-related losses last year and have another \$19.9 billion in unrealized losses still on their books. So what is Congress doing in the face of these

federal government failures. Like a degenerate gambler they are on the brink of taking tax payer money and doubling down [by passing the FHA mortgage bailout and “supersizing Fannie and Freddie]. ... Gamblers always seem to take bigger risks when they are playing with house money. Do the American taxpayers really want Congress playing this fast and loose with the U.S. treasury?” (*Foundry Blog*, 05/06/08)

Fannie Mae surprises Wall Street with wider than forecast loss of \$2.2 billion
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- Fannie Mae reported a far worse-than-expected first quarter loss of \$2.2 billion (\$2.57 a share) versus earnings of \$961 million (\$0.85 share) a year ago. Fannie’s first quarter loss was more than three times analysts’ forecast of \$0.81 a share loss, according to Thomson First Call. Fannie Mae CEO Daniel Mudd said “severe weakness” in the housing market was worse than expected during the first quarter and the weakness is expected to continue through the remainder of the year. “Right now, we are in the belly of this cycle,” said Mudd. Fannie now forecasts that home prices will sink 7% to 9% in 2007, 2% worse than its previous estimate, which could ultimately result in a 19% decline in home prices from peak levels. The company’s loss marked the third straight quarterly loss reported by the GSE, albeit an improvement from its \$3.6 billion loss during the fourth quarter of 2007.
- The company’s first quarter earnings were adversely impacted by a fivefold increase in credit and derivative losses totaling \$8.9 billion. During the quarter, Fannie Mae raised its loan loss reserves \$1.8 billion to \$5.2 billion. On March 31<sup>st</sup>, 1.15% of Fannie Mae’s single-family home loans were seriously delinquent, up 17% from 0.98% on December 31<sup>st</sup>. During its conference call with investors, Fannie’s management said that 43% [\$946 million] of its \$2.2 billion loss in the first quarter was attributable to Alt-A loans. Mudd said, “[The] Alt-A book [\$344.6 billion] will continue to drive an outside portion of our overall credit losses.” Every company has a part of their book that worries them most, said Mudd. “In our case, it’s the Alt-A book and we are focused on that.”
- According to Fannie’s Capital Raise Road Show presentation, 74% of the company’s Alt-A portfolio was originated in 2005-2007. The portfolio (1) has an average FICO score of 718; (2) has 40% credit enhancement; (3) is largely collateralized by primary residences (77.8%) with condo and coop properties accounting for 10.9% of the portfolio; (4) and has accounted for 31.4% of Fannies credit losses in 2007 and 42.7% of its credit losses during the first quarter of 2008. Fannie also holds \$30.6 billion in private-label Alt-A securities and \$30.4 billion in private-label subprime RMBS. Although all its Alt-A holdings are rated AAA, the company said 15% of its holdings were on negative credit watch on March 31<sup>st</sup> and \$6.4 billion of its private label subprime RMBS (21% of the portfolio) were on a negative credit watch. CFO Steve Swad said that Fannie’s Alt-A book had about half the cumulative default rate of private-label Alt-A securities. Swad said the location of collateral properties also has played a significant role in Fannie’s credit situation. Collateral properties in Florida

and California represented 32% of the company's Alt-A total assets. For example in Detroit, MI, area properties accounted for only 3% of Fannie's first quarter single-family home book, but accounted for 23% of credit losses during the first quarter. Michigan and California alone accounted for 38.2% of Fannie's credit losses during the first quarter. Fannie also listed \$56.1 billion in Level 3 assets, a category of illiquid assets that can only be priced using the company's own valuation models. .

- Fannie's fair market value of net assets plunged to \$12.2 billion on March 31<sup>st</sup>, from \$35.8 billion on January 1<sup>st</sup>, due to market volatility and declining house prices. Approximately \$16.9 billion of Fannie's \$23.6 billion decline in market value net worth came from increasing the value of a liability, representing future payouts on mortgage guarantees. At March 31<sup>st</sup>, Fannie's net worth attributable to common shareholders would have been a *negative* \$2 billion and \$14 billion attributable to preferred stock holders. Fannie's marked-to-market losses increased \$1.1 billion to \$4.4 billion during the first quarter. In April, the company adopted new hedge accounting rules which management believes should reduce the volatility of its future earnings. Fannie increased its estimates for credit losses from 11 to 15 basis points in 2008 to 13 to 17 basis points—and stated that losses in 2009 will exceed the updated estimate. Fannie Mae declined to predict when the company's credit losses would peak or at what level. "We're not able to give more visibility at this time [due to uncertainty over house prices]," said CFO Stephen Swad. According to Morgan Stanley analyst Kenneth Posner, every basis point of credit loss is equivalent to 15 cents of earnings per share. Posner said he expects Fannie Mae's credit losses to balloon to 20 basis points as the housing crisis unfold. As a result of Fannie's first quarter loss, Moody's Investors Service downgraded the company's financial strength by one notch and other ratings agencies warned that they may follow suit. Fitch Ratings said it may cut Fannie Mae's preferred stock rating from A+ to AA-. "While Fitch views the prospect of incremental capital and dividend reduction positively, the proportion of preferred stock to total capital may grow higher from already elevated levels," said the rating agency in a statement. "As a result, Fitch believes that preferred shareholders could absorb higher losses as their proportion of total capital increases."
- Fannie Mae announced plans to sell \$6 billion in additional capital through new issues of common and preferred stock and to slash its dividend 28% to \$0.25 a share starting in the third quarter. In a conference call with analysts, Mudd said that the trade-off the company is making now [by raising capital and diluting existing shareholders] will pay off for shareholders over the long term. "We will feast off this ...business that we're putting on for many years to come," Mudd told the analysts. "...[W]e are being asked to play a broader role in the future of U.S. housing." Mudd said the company also is benefiting from the current housing and credit woes, by being able to grow its book of business and increase its mortgage-backed securities' market share to 50.1% from 48.5% during the fourth quarter of 2007. "This is likely to be the story for the months ahead—a painful cure from the housing correction—and incredibly healthy opportunities from our resurgent role at the center of the recovery," said Mudd. "Both are happening at the same time."

- As part of the company's turnaround plans, Fannie Mae announced a new refinancing option for homeowners whose loans are owned by the GSE. These homeowners, who are current on their payments, but now owe more than their home is worth, will be able to refinance their mortgages at up to 120% of the current value of their home. Fannie also committed to work with state agencies to provide \$10 billion in financing to first time homebuyers and help families in hard-hit communities live in foreclosed properties on a rent-to-own basis. For the remainder of 2008, Fannie Mae will buy jumbo conforming mortgages for its portfolio for about the same prices as regular conforming loans. "We've been asked to play a role in the [jumbo] marketplace," said Mudd. "We're basically going to absorb the liquidity premium [to] get some movement going on in those markets."
- OFHEO lifted its consent order on Fannie Mae and lowered the amount of capital it must hold, on the heels of the company's announcement of its \$2.19 billion loss for the first quarter. The regulator cut Fannie's surplus capital requirement from 20% to 15% and committed to reduce the surplus to 10% in September, so long as there is "no material adverse change" in the GSE's regulatory compliance. "The lowering of the prudential cushion was appropriate in line with the company's progress and with the need to maintain safe and sound operations," said OFHEO director James B. Lockhart, III. By reducing the company's capital level, Fannie Mae will be able to buy and guarantee more loans, which could also put the company at great risk. Publicly, Lockhart has expressed strong confidence in Fannie Mae and Freddie Mac. However, a high ranking member of Lockhart's staff said some officials have begun considering the worst. "It's not irrational to begin thinking about a bailout," said the staffer, who requested anonymity.
- On May 8<sup>th</sup>, Fannie Mae priced \$2.25 billion [82 million shares] of a new offering of its common stock at \$27.50 per share and \$2.25 billion [45 million shares] of 8.75% Non-Cumulative Mandatory Convertible Preferred Stock, Series 2008-1. The Preferred Stock has a stated value and liquidation preference of \$50 per share, and will pay quarterly non-cumulative cash dividends, when and if declared by the Board of Directors, at a rate of 8.75% per annum on the stated value. Each share of the Preferred Stock will automatically convert on May 13, 2011, into between 1.5408 shares and 1.8182 shares of Fannie Mae common stock. Also, at any time at the election of the holder, each share of the Preferred Stock may be converted into 1.5408 shares of Fannie Mae common stock. Fannie Mae has granted the underwriters for the offerings a 30-day option to purchase up to 12.3 million additional shares of common stock and a 30-day option to purchase up to an additional 6.75 million shares of the Series 2008-1 Preferred Stock. Both offerings are expected to close on May 14, 2008, subject to satisfaction of customary closing conditions. As previously announced, these offerings will be followed in the very near future by an offering of non-cumulative, non-convertible preferred stock.
- Lehman Brothers Inc., J.P. Morgan Securities Inc. and Citigroup Global Markets Inc. are joint book-running managers for the common stock offering, with Goldman,

Sachs & Co. and Morgan Stanley acting as co-managers. J.P. Morgan Securities Inc., Lehman Brothers Inc. and Banc of America Securities LLC are joint book-running managers on the Preferred Stock offering, with Goldman, Sachs & Co. and Merrill Lynch acting as co-managers. Lehman Brothers Inc. and J.P. Morgan Securities Inc. acted as global coordinators in both offerings.

- “These guys [at Fannie] have been confident on their conference calls for the last couple of quarters, but then they come up with bigger and bigger losses,” said Paul Miller of the Friedman, Billings, Ramsey Group. “Wall Street wants to be bullish about something, and they think Freddie and Fannie are going to lead the way. But at some point, investors are going to wake up and realize these guys are losing real money.” Miller estimates that Fannie will lose an additional \$2 million to \$2.5 million during the next three quarters of 2008. In a note to clients, Miller wrote, “We believe that the [GSEs] will continue to have trouble with both credit losses and capital levels and recommend that investors remain cautious.” He added, “The housing bubble is bursting, and the GSEs will not be left untouched.”
- Fannie Mae’s \$6 billion capital raising may still not be enough if the housing slump continues into 2009, said Ajay Rajadhyaksha, head of fixed-income strategy for Barclays Capital. “They are now starting to realize the fact that their credit losses will be considerably higher than they were in 2007,” said Rajadhyaksha. “Things in the housing and credit markets are deteriorating very fast and this will not be the last capital raising this year.” Peter Schiff, president at broker-dealer EuroPacific Capital in Darien, CT, said he believes falling real estate prices will bankrupt Fannie and Freddie Mac because of their thin capital cushions, representing just 5% of assets. “There’s no way to avoid it,” said Schiff.
- Senator Richard Shelby (R-AL) said, “Regulators need all the tools they can get to make sure these companies don’t fail, especially since we’re talking about entities that have over \$5 trillion in financial commitments and debt. Six billion dollars looks like a pretty paltry sum, and if we get into a further housing downturn, that capital can go pretty fast.” Senator Mel Martinez (R-FL) said, “We’ve taken tremendous risks by loosening these companies’ purse strings. They would cause an economywide meltdown if they got into real trouble and leave the public on the hook for billions.” (*New York Times*, Charles Duhigg, 05/06/08; *Housing Wire*, Paul Jackson, 05/06/08; *Fannie Mae Press Release*, 05/08/08; *Fannie Mae Capital Raise Road Show*, Fannie Mae, May 2008; *Bloomberg News*, Dawn Kopecki, Bryan Keogh, Charles Stein, and Abigail Moses, 05/06/08; *Forbes.com*, Maurna Desmond, 05/06/08; *Wall Street Journal*, David Reilly and Peter Evans, 05/07/08; *Fortune*, Colin Barr, 05/06/08; *New York Times*, Charles Duhigg, 05/07/08; *CNNMoney.com*, Chris Isidore, 05/06/08; *Washington Post*, David S. Hilzenrath, 05/07/08; *Wall Street Journal*, James R. Hagerty, 05/07/08; *Wall Street Journal Online*, Donna Kardos, 05/06/08; *Bloomberg News*, Jody Shenn and Dawn Kopecki, 05/06/08; *CNNMoney.com*, Chris Isidore, 05/06/08; *Fannie Mae Press Release*, 05/08/08; *Reuters*, Tenzin Pema, 05/07/08; *Bloomberg*, Bryan Keogh, 05/06/08)

- In a *Wall Street Journal* commentary, Mark Gongloff wrote, "...As long as home prices keep falling, the delinquency trend seems unlikely to reverse, meaning more losses and a need for more capital [for Fannie Mae and Freddie Mac]. An April report from their regulator called Fannie's interest-rate-risk program in the 'low range of satisfactory' and Freddie's internal controls 'not fully effective.' It's probably true the government will always be there with its safety net. But why GSE shareholders seem to think they will be rescued, too, is a mystery. Bear Stearns's weren't." (*Wall Street Journal*, Mark Gongloff, 05/06/08)

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

FDIC chairman Bair proposes \$50 billion plan to help distressed homeowners

- FDIC chairman Sheila Bair has proposed a plan to help distressed homeowners in which the Treasury Department would lend \$50 billion directly to borrowers to prevent more than 1 million homes from going into foreclosure. Bair's plan, which was introduced in a May 1<sup>st</sup> media campaign, caught many off-guard. Apparently, the plan had not been widely circulated on Capitol Hill or vetted by the Bush administration. With the administration negotiating with Congress on a plan to use the FHA to help distressed homeowners, some saw the FDIC chairman's "gambit" as muddying the waters and coming too late in the process to be helpful. "The debate is so far down the track right now with Frank and Dodd that I'm pretty skeptical" the FDIC plan can move, Brian Gardner, analyst for Keefe, Bruyette & Woods, Inc.
- Under the plan, mortgage investors would apply to the Treasury for Home Ownership Preservation Loans for up to 20% of the principle of an "unaffordable" mortgage, creating a second lien on the property owned by the government. Eligible mortgages are defined in the plan as loans originated between January 2003 and June 2007 with debt-to-income ratios of 40% or higher and loan balances below \$362,000. In turn, loan servicers must restructure the remaining loan balance into a 30-year, fixed rate product and pay a subscription fee equal to the first five years interest payments on the loan that Treasury made to the investors. After five years, the borrower would begin paying the interest on the second loan at Treasury rates. In the event of foreclosure, Treasury's loan would supersede the original mortgage in repayment priority. The plan would need to be approved by Congress.
- In an interview with *American Banker*, Bair said, "[The plan] recognizes that everybody needs to contribute a little to make the program work. We think it has good bipartisan appeal. It's not meant to substitute for any of the other existing plans. It's to complement them." She added that the plan is a systematic approach that would reach borrowers the FHA refinancing plan would not. She also cautioned against relying too heavily on the FHA "There are some generally acknowledged limitations with FHA," said Bair. "One is just scale. ... They're a wonderful agency, but they're a relatively small agency. The second is [that] refinancing is by definition a loan-by-loan process. You have to find a new lender. You have to re-underwrite. You have to get a new appraisal. ... I think there's going to be a time element of how quickly you can do these."
- House Financial Services Committee chairman Barney Frank (D-MA) said that Bair's proposal posed clear problems. "The one thing that we've avoided [in the FHA refinancing bill is] we don't write checks to ... the people that hold the loans," said Frank. "That is a pretty big problem in trying to get [Ms. Bair's plan] done ... ; it would require writing some checks to them." Scott Talbot, the Financial Services

Roundtable's chief lobbyist, said, "It sets the federal government up as a lender, which creates a whole host of problems. Procedurally, Congress and the administration are far along in addressing the subprime situation through expanding FHA. The session is running out of days, and the proposal would take us back to square one. The housing market and the economy need a response now."

- The White House and Treasury Department had no immediate reaction to Bair's proposal, but indicated that their priority would be to pass bills that are currently in the works—specifically FHA and GSE reform bills. (*American Banker*, Joe Adler and Stacy Kaper, 05/01/08; *Los Angeles Times*, Maura Reynolds, 05/01/08; *Bureau of National Affairs*, Richard Cowden, 05/01/08; *Financial Times*, James Politi and Krishna Guha, 05/01/08)

The road to Hades is paved with good intentions
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- In the May 1<sup>st</sup> *Criterion Economics Commentary*, Joseph R. Mason wrote, "Sheila Bair [has] proposed ... a new five-year stopgap measure to fight foreclosures. Notwithstanding the fact that five years is an ad hoc time period and that foreclosures are perhaps an unavoidable consequence of poor credit decisions—or at least that avoiding foreclosures produces significant moral hazard—the proposal smacks of using interest-only loans to fight the effects of interest-only loans. What do we already know about interest-only loans? Defaults spike at the beginning of the amortizing period when borrowers move to higher payments. The only way to put off the effect is by moving the borrower into another interest-only loan. It is tempting to believe that as long as home price appreciation is above the rate of interest (zero, in this case) the collateral appreciates at a higher rate than the loan so this is a good investment. There are two points to realize about this claim. First, the lender (even if it is the government) can only be indifferent between full interest earning loans and those with interest-only teaser periods if the total net present value of interest in the interest-only arrangement amounts to the same level of earnings as that of the fully interest-earning arrangement. Hence, interest on the interest-only teaser arrangement – once it applies – has to be higher than that on the full interest loan. (There is no free lunch.)"
- "Second, even the scheme proposed by Bair included 'fees,' which are a loan cost just like interest. Higher fees would have to be recovered from—you guessed it—home price appreciation to make this a reasonable investment. It doesn't matter whether that amortizing period occurs within the existing loan or after refinancing, the problem is the amortization. Eventually, therefore, if the goal is homeownership the borrower will have to make much higher payments that actually pay down the loan balance. Cashing out home equity through another interest-only loan will help borrowers who can't afford the payments on their existing loan continue to make payments on a higher balance interest-only teaser loan, but will not help them achieve the magic goal of amortization that is homeownership..."

- “Congress similarly relies on popular fallacies about financial engineering as a basis for their FHA guarantee scheme. Many claim the guarantee is costless to the government and therefore has no budgetary effect. Such a claim reveals a fundamental misunderstanding of finance. In finance, you can initially price a contract so that it has zero value to either side. The simplest example is futures markets, in which the price of, say, a corn future contract is today’s value of the corn plus the cost of storing the corn until the future delivery date. But, as students of finance know well, only the value of the contract at inception is zero. Once corn prices move, one side of the contract gains value and the other loses. Hence, futures markets require the losing side to deposit money each trading day to keep an account of their losses.”
- “When people who can’t afford their loans begin defaulting, or even just continue consuming regardless of their risk (because of the moral hazard of being bailed out), the government’s side of the contract will post losses in the value of the guarantee because the probability of paying on the guarantee is higher. Will the government have to post a cash collateral account to accommodate those losses? I don’t see that in the bill. Nor do I see expected values of the future payouts. I do hope the GAO picks up this reasoning and removes the fallacy of long-term budget neutrality.”
- “One of the biggest problems in today’s markets is valuing credit default guarantees, both among those who have sold the guarantees and those who have bought them to hedge some loss (or speculate). Many issuers of those guarantees, including the major bond insurers, are known to be insolvent but valuations difficulties are allowing regulators to exert forbearance instead of shutting the firms down in the public interest. Needless to say, it may not make sense to build government policy on such shaky foundations.”
- “The sobering truth is that many subprime borrowers can’t afford their homes. An analysis by T2 Partners LLC in March 2008 showed that to maintain (0% decline) borrowing power among the affected borrowers, interest rates on fully amortizing mortgages would have to drop from about 6.75% to 1.41% or rates on interest only mortgages would have to drop to 4.09%. Note that this analysis assumes a 35% debt-to-income ratio, so rates would have to drop further for less creditworthy borrowers. (The FHA plan is willing to target up to 55% debt-to-income ratio borrowers – deep subprime territory) Additionally, it is extremely important to note that borrowing power can only be maintained if the borrower’s leverage goes to roughly 8.6x annual income, which is again hardly prudent.”
- “The point is that using the most innovative and creative financing instruments, with respect to both mortgage and government finance, is hardly the prescription for fighting a credit crisis arising from the most innovative and creative financing instruments. Instead, it is just a recipe for pushing the effect of the credit crisis further down the road.”

- “True solutions for borrowers are far less politically attractive. Financial education and discipline – both fiscal discipline of borrowers and bank discipline imposed by regulators – are the key. But those will not sell in an election year.” *Criterion Economics Commentary*, Joseph R. Mason, 05/01/08)

Treasury Secretary urges lenders to expand their efforts to modify mortgages

- In a series of private meetings, Treasury Department officials, regulators and servicers from several large banking companies discussed ways to expand efforts to help more distressed homeowners. In an all-day discussion on May 6<sup>th</sup>, the attendees discussed how to help a wider swath of homeowners, means to deal with second lien holders, and ways to improve disclosure of loan modification efforts. According to sources, much of the discussion focused on how to expand the criteria for homeowners eligible for streamlined loan modifications, by perhaps including prime loans and borrowers whose income cannot be immediately verified. The attendees also discussed how to provide the servicers more flexibility without having investors balk at accepting a modification. The group discussed the development of a temporary approval process, in which a short-term modification was granted but servicers and lenders would reserve the right to refine later. Attendees included Treasury officials, staff from the OCC, Federal Reserve Board, and FHA, along with servicing and loss-mitigation executives from Washington Mutual, Citigroup, Bank of America, JPMorgan Chase, Wells Fargo, Ocwen, IndyMac, and Residential Capital. Representatives from Fannie Mae and Freddie Mac attended the morning segment of the meeting. (*American Banker*, Cheyenne Hopkins, 05/08/08; *Washington Post*, Renae Merle, 05/07/08)

Fannie and Freddie bailout unlikely if Congress passes GSE reform legislation

- In an interview with *CNNMoney.com*, OFHEO director James B. Lockhart, III said that declining home prices are the larger problem faced by Fannie Mae and Freddie Mac than other issues, such as credit market volatility or unrecognized losses on the GSEs’ books. “If house prices fall another 10%, the capital that they are raising now should see them through those kinds of problems,” said Lockhart. “If housing prices fell [another] 20%, obviously there’d be a whole different scenario out there.” Lockhart conceded the market prices could fall further, especially without a pickup in confidence by potential home buyers. “It is a risk,” Lockhart said. “There was a bubble. House prices went up too high and after a bubble there’s a correction. What we’re concerned about....is trying to prevent an over-correction that could cause more dramatic fall in prices.” A continued slide in home prices and rising losses at Fannie and Freddie have prompted some economists and lawmakers to wonder if there will need to be a federal bailout of Fannie and Freddie, a rescue that could cost taxpayers more than \$1 trillion, according to some estimates.

- Lockhart said he's confident that a bailout of Fannie and Freddie will not be necessary if Congress passes a long-debated GSE regulatory reform legislation. "I don't think it's a real possibility. If we're doing our job, it shouldn't happen," he said. Lockhart cautioned, however, that OFHEO and the GSEs have little control over market volatility that can cause wide swings in the value of the firms' derivatives and trading portfolios, which can cause billions in losses by declining home prices and rising delinquencies. "That swing can be pretty dramatic either way, although for the past three quarters it's been dramatic the wrong way," said Lockhart. He also repeated his concerns about a move by Congress earlier this year to dramatically raise the size of the loans that the firms could purchase or guarantee up to about \$730,000 in high cost markets, which are largely concentrated in California, a state that has seen among the most severe home-price declines. (*CNNMoney.com*, Chris Isidore, 05/07/08)

Getting regulation of the GSEs "right" is critical
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- In an April 28<sup>th</sup> commentary appearing in *USA Today*, Freddie Mac CEO Richard F. Syron wrote, "Freddie Mac supports improved regulation of our company and of mortgage lending generally. But especially today, getting it right is critical. Freddie Mac was created by Congress to provide liquidity, stability and affordability to the residential mortgage market. We are a shareholder-owned company using private capital — not taxpayer funds — to achieve our mission. And the model has worked. Freddie operates at the center of what is still, even with today's market downturn, the finest housing finance system in the world.
- "...Freddie is a unique institution, and it should be regulated as such. Some would have us regulated like a bank, especially with regard to capital, but we are a very different entity. We invest only in residential mortgages, and our capital levels need to be consistent with that. It would be impossible for us to provide the same support to the housing market if capital levels are not tied appropriately to risk. We must simultaneously operate safely and soundly, fulfill our mission, and provide a reasonable and competitive return to the shareholders whose money makes our mission possible. Regulation needs to strike the difficult balance among these objectives. This is a complex task that needs to be done carefully. Done wrong, it could do more harm than good." (*USA Today*, Richard F. Syron, 04/28/08)

Risk-averse DNA needed at Fannie and Freddie, along with a strong regulator
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- At Berkshire Hathaway's annual meeting of shareholders, chairman and CEO Warren Buffet said that Fannie Mae and Freddie Mac were extraordinary examples of two of the biggest accounting misrepresentations in the world. "What is needed is someone at the top whose DNA is risk adverse," said Buffet. He also discussed his disappointment in OFHEO, whose sole responsibility was to monitor the GSEs and they didn't. (*Financial Post*, Jonathan Ratner, 05/06/08)

#### OFHEO updates the temporary conforming loan limits in three markets

- On May 5<sup>th</sup>, OFHEO updated the maximum conforming loan limits temporarily in effect as a result of the Economic Stimulus Act of 2008 for Gunnison County, CO; Blaine County, ID, and San Juan-Caguas-Guaynabo, Puerto Rico Metropolitan Statistical Area. The new maximums for temporary conforming loans in these areas are \$433,750, \$729,750, and \$606,250, respectively. (*OFHEO Press Release*, 05/05/08)

#### Bush administration to release details on expanded FHA insurance plan on May 15<sup>th</sup>

- On May 15<sup>th</sup>, the Bush administration will release new details on its expanded FHA insurance program, which will include a sliding scale of insurance premiums based upon the risk profile of the borrower. The policy, which could help an additional 100,000 borrowers refinance into affordable mortgages, goes into effect July 14<sup>th</sup>. HUD is expected to announce that the FHA will begin charging an upfront premium between 1.25% and 2.25% of the loan amount, rather than the flat 1.50% premium currently paid by borrowers. FHA will set the premium based upon the borrower's loan-to-value ratio and credit score. (*Wall Street Journal*, Damian Paletta, 05/09/08)

#### Is fair value accounting the right test?

- In a May 1<sup>st</sup> commentary appearing in *Financial Times*, Peter J. Wallison, fellow with American Enterprise Institute, wrote, "Fair value accounting is clearly the reigning orthodoxy among accountants, but is that the right test? Accounting is simply a measurement system. What we want to know determines what and how we measure. Which is more important, the balance sheet or the income statement? Do we want to measure financial strength or earnings per share or cash flows? Is the purpose to inform equity investors or creditors and counterparties? Does one measurement system meet all of these objectives?"
- "Given its impact on institutions and whole economies, common sense suggests that we consider whether one means of measurement is the only one we should be looking at. The world view of accountants at a particular time should not determine the answers to these questions. It is important to recall the famous remark of Clemenceau that war is too important to be left to the generals." (*Financial Times*, Peter J. Wallison, 05/01/08)

- New York Attorney General Andrew Cuomo may face legal challenges to his effort to overhaul the way homes are appraised in the U.S, which could help clarify how far state officials can go in setting public policy for the nation as a whole. Earlier this year, Cuomo made an end run around federal regulators and Congress by threatening to sue Fannie Mae and Freddie Mac for allegedly failing to ensure that appraisers were shielded from pressure to inflate home values in their appraisal reports. To avoid a legal battle, Fannie, Freddie, and OFHEO agreed with Cuomo to adopt an Home Appraisal Code of Conduct, which will take effect on January 1<sup>st</sup>. The plan has drawn criticism from a wide array of participants in the mortgage industry and regulators, who argue that the Code could raise costs for consumers, cause unnecessary disruption in the appraisal business, and result in significant unintended consequences.
- In an April 30<sup>th</sup> letter to OFHEO, a broad coalition of financial groups called on the agency to disavow the recent accord it entered into with Cuomo on appraisal standards, arguing that the agreement violates federal law and likely wouldn't withstand a court challenge. The groups argued that the accord and new valuation code would create new obligations for member institutions in a way that violates federal law. "We believe that OFHEO should withdraw its assent to the Agreement, should not permit the GSEs to implement the Agreement, and should take steps to assure that this type of rulemaking by settlement does not occur in the future," wrote the American Bankers Association, the American Financial Services Association, the Consumer Bankers Association, the Consumer Mortgage Coalition, the Housing Policy Council, the Financial Services Roundtable, the Independent Community Bankers of America, the Mortgage Bankers Association, and the Real Estate Services Providers Council, Inc. In the 14-page letter, the groups strongly hinted that they are ready to mount a court challenge, by outlining citations to court decisions, federal statutes, and regulations to support their contentions. In effect, the groups argued that the agreement that Cuomo entered into with Fannie Mae and Freddie Mac has the effect of creating binding conditions for federal institutions that either never had a say in the agreement, or that are governed by a different set of legal standards. They also argued that the agreement conflicts with provisions of the 1989 Financial Institutions Reform, Recovery, and Enforcement Act, governing appraisal standards, and creates obligations and legal duties that are only appropriate after implementing federal notice and comment procedures. Moreover, the agreement wrongly delegates federal authority to state decision makers and requires national banks to abide by standards that are already preempted by federal law, the groups argued.
- "[Unless Cuomo works with the industry to revise the Code,] somebody out there is likely to file litigation," said Steve O'Connor, SVP of the Mortgage Bankers Association. Roy DeLoach, EVP of the National Association of Mortgage Brokers, says legal action against the Code is "one option" his group will consider. Industry officials argue that the Code is tantamount to federal regulation, which is subject to

the U.S. Administration Procedures Act that requires that proposed regulations first be published and comments solicited before going into effect.

- In a separate comment letter, the Appraisal Institute and three other home valuation groups argued that the Code “could eliminate some of the strongest protectors of the [mortgage underwriting] process: namely competent, unbiased real estate appraisers.” The Mortgage Bankers Association wrote that the plan could “present safety and soundness risks to the GSEs and financial institutions generally” and contended that the Code would increase costs to consumers.
- The Office of Thrift Supervision also criticized the agreement, saying, “...OTS believes that institutions that it regulates will not be able to fully identify, manage, and monitor their credit risk under the ambiguous terms of the Code and could force our institutions into an ‘unsafe or unsound operation.’” The agency was also critical of the process by which the accord was reached, calling it fairly rushed and shallow. “The consultations [by federal bank and thrift regulators] were initiated at a point when it did not appear to encourage any meaningful collaboration or changes based on industry practice and our long supervisory experience. ... The documents were prepared without the benefit of appropriate industry or regulator input and do not take into account the actual and potential effects and consequences upon OTS-regulated lenders,” wrote OTS Deputy Director Timothy T. Ward.
- In response to the industry’s criticism of the agreement, Cuomo said, “The overwhelming response to the agreement has been a positive one, with almost everyone agreeing that significant reform is needed. It is not surprising that current industry participants, many of whom have significant economic interests of their own at stake, have differing perspectives.” Cuomo promised he would “thoughtfully consider” the suggestions made by industry representatives and others about the plan. (*Wall Street Journal*, James R. Hagerty, 05/01/08; *Reuters*, Patrick Rucker, 04/30/08; *Bureau of National Affairs*, R. Christian Bruce, 05/03/08; *Wall Street Journal*, James R. Hagerty, 05/08/08; *American Banker*, Cheyenne Hopkins, 05/02/08; *Dow Jones Newswires*, Michael R. Crittenden, 05/02/08; *Bloomberg News*, Sharon L. Lynch, 05/01/08)

The not ready for prime time “Mortgage ‘Cop’ Dann”
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- Ohio Attorney General Marc Dann, dubbed the “New Mortgage ‘Cop’ Dann” by the *Wall Street Journal*, has been spending his time recently fending off calls for his resignation, after acknowledging that he had an affair with a subordinate, while one of his lieutenants (a personal friend of Dann’s for more than 20 years, who was also one of his roommates) was accused of sexually harassing two other attorney-general staffers and another top aide tampered with the handling of the harassment complaints and deleted files from department computers. Thus far, three top administrators in the AG’s office have resigned—but their boss remains adamant that he will not resign, sparking calls for his impeachment by state lawmakers.

- Dann, a onetime Gary Hart campaign staffer and divorce lawyer, defeated his well known, Republican candidate, Betty D. Montgomery, by running on a platform of targeting the mortgage industry and holding everyone who helped create the subprime crisis “accountable.” “My job is to be the bad cop, and I’m comfortable with that role because I believe a terrible crime has been committed,” Dann told voters. He promised not only to “punish” the out-and-out criminal fraudsters, but also to pursue the deep-pocked parties that benefited from the subprime boom, such as credit rating agencies. Dann’s message resonated with voters, who elected him to office with 53% of the vote. After taking office, he assigned a well-known corporate lawyer to find creative ways to “go after” foreclosure problems. On January 24<sup>th</sup>, Dann made a rare personal appearance in a Cincinnati courtroom to “test-drive” a legal strategy to slow foreclosure actions. In an unusually pointed ruling, Magistrate Michael Bachman wrote that Attorney General Dann was “using this court to advance a political agenda rather than seek a remedy in a legal court of law.” Now, Dann’s “gutter level behavior” appears to be catching up with him with 44 Ohio lawmakers calling on him to resign, although most have stopped short of pledging support of an impeachment resolution.
- In the May 4<sup>th</sup> lead editorial, the *Columbus Dispatch* wrote, “Ohio’s attorney general must be able to provide leadership, command respect and exercise strong judgment. Marc Dann has failed miserably in all three and is not fit to serve. Dann disgraced himself and his department, operating an office where the atmosphere was, in his words, ‘embarrassingly undignified.’ ...In explaining why things went awry, Dann said he was surprised by his election victory over ...Republican Betty D. Montgomery, and that he wasn’t prepared to run a large state office. He wouldn’t be the first person who was better prepared to run a campaign than a large state agency. And while that might explain administrative shortcomings, it offers no excuse for the gutter-level behavior that Dann not only tolerated but engaged in.”
- “Though the damage done to the attorney general’s office was serious enough to send three top administrators packing, their boss is adamant that he won’t resign. Dann says he wants to continue the ‘great legal work’ being done in crime prevention, consumer protection and other areas. But such work requires an attorney general who demonstrates leadership and who commands respect inside and outside the agency. Most important, the top law officer in the state must possess moral authority. Dann can provide none of these things. This situation is a debacle for Dann and a tragedy for the state. He took over the office with high hopes, energy and a desire to run an effective office. That promise has been destroyed, and Dann has no one but himself to blame. Dann betrayed the trust the voters placed in him, and that will dog the attorney general’s office for as long as he remains.” (*Wall Street Journal*, Aaron Lucchetti, 10/08/07; *Columbus Dispatch*, 05/02/08; *Columbus Dispatch*, Joe Hallett, Alan Jackson, and Mark Niquette, 05/07/08; *Columbus Dispatch*, 05/04/08; *Columbus Dispatch*, James Nash, 05/11/08; *WKYC*, Kim Wendel, 05/07/08)

- It appears that the credit crisis has eased. In an interview with *Associated Press*, Treasury Secretary Henry Paulson said that the credit turmoil which has gripped Wall Street since August and took a turn for the worse in March, appears to have eased somewhat. “There’s progress,” said Paulson. “I think we’re closer to the end of this [than the beginning]. ...Again, I think we’re on the right path.” JPMorgan Chase CEO Jamie Dimon concurred with Paulson’s comments. Dimon said that the financial crisis that gripped the market is mostly over. “I look at it as... 75%-85% done,” said Dimon. (*MarketWatch*, Robert Schroeder, 05/08/08; *Associated Press*, Jeanne Aversa and Martin Crutsinger, 05/08/08; *Reuters*, 05/08/08)
- It is very likely that April 2008 will mark the bottom of the housing market, according to Cyril Mouille-Berteaux, managing partner of the hedge fund Traxis Partners, LP. The current housing bust is nearly three years old with home sales peaking in July 2005. New home sales are down 63% from peak levels of 1.4 million and housing starts have fallen more than 50%. New home inventories peaked at 598,000 homes in July 2006 and stood at 482,000 homes at the end of March, an equivalent of an 11 month supply. Home inventories are expected to drop to 400,000—a seven month supply—by the end of the year. (*Wall Street Journal*, Cyril Mouille-Berteaux, 05/06/08)
- Of the 80 million homes in the U.S., about 55 million (68.8%) have mortgages and 4 million of those mortgages (7.3%) are behind in their payments. In 2006, foreclosure proceedings were begun on approximately 1.5 million homes, an increase of more than 50% from 2006. According to estimates by Moody’s Economy.com, roughly 4 million mortgages (8.3%) currently owe more than their homes are worth and by 2009 nearly 12 million (25%) homeowners will be “underwater.” In 2008 and 2009, Moody’s projected that nearly 2.5 million homeowners will lose their home to foreclosure. (*Wall Street Journal*, Ruth Simon and Nick Timiraos, 05/09/08; *Wall Street Journal*, David Wessel, 05/08/08)
- Barclays Capital warned that roughly half of all subprime and Alt-A mortgages will soon exceed the value of the borrower’s collateral property, putting \$800 billion of mortgage debt at greater risk of default. According to Barclays Capital analysts Ajay Rajadhyaksha and Derek Chen, “Mortgage loans are moving underwater at a very sharp pace, far more than suggested by aggregate home price data.” (*Bloomberg News*, Jody Shenn, 04/29/08)
- A key factor driving a historic surge in borrower delinquencies and defaults is the preponderance of simultaneous second liens [SSLs or “piggyback loans] among recent Alt-A vintages, said Fitch Ratings. These loans are defaulting at very high rates relative to other loans and to history, said the rating agency. “There is a substantial performance divide, between loans with a SSLs and those without, with SSL loans exhibiting delinquency levels 71% to over 300% higher than those without depending on the product,” said Fitch senior director Suzanne Mistretta. “Borrowers

that have perceived equity in the home, including those underwritten to a low doc program, are exhibiting significantly lower delinquency rates than their SSL counterparts.” (*HousingWire*, Paul Jackson, 05/08/08)

- The FBI has launched 24 task forces nationwide to investigate possible criminal conduct regarding mortgage lending practices. The FBI’s task force partners include HUD, the IRS’s criminal division, the Veterans Administration, and numerous state and local law enforcement units, including state attorneys general. (*Bureau of National Affairs*, Stephen Joyce, 05/07/08)
- Borrowers with private mortgage insurance, fell more than 60 days behind on their payments at an increased pace in March, as the number of primary insurance defaults increased 37% in April over year-ago numbers. According to Mortgage Insurance Companies of America [the PMI companies’ trade group], 58,131 defaults were recorded in March, up from 42,362 in March 2007. Cure rates have risen steadily since January (51.4%) to 87% in March, yet well below the 92.3% recorded in March 2006. (*Housing Wire*, Paul Jackson, 05/02/08)
- MGIC is pulling in the reins for the second time this year on its underwriting guidelines for mortgage insurance. Effective June 1<sup>st</sup>, MGIC will essentially no longer provide mortgage insurance for any Alt-A loans and will no longer allow cash-out refinances in any market, investment properties, multiple units, and option ARMs, to qualify for MI. It will also no longer write insurance for any loans collateralized by condos and attached houses in Florida. The company will require a minimum of 3% down on any eligible purchase transaction. For conforming jumbo loans, MGIC will require a minimum 90% CLTV and minimum FICO score of 700 to qualify for insurance. In restricted markets, the maximum CLTV will be 85%. The maximum jumbo conforming loan which MGIC will insure is \$650,000 in any geographic market. According to MGIC’s June 1<sup>st</sup> underwriting update, the insurer’s restricted markets has been expanded to include the entire states of Kentucky, New Jersey, and Michigan. (*HousingWire*, Paul Jackson, 05/09/08)
- “The whole subprime crisis has raised the question about how much homeownership is a benefit for everyone and how much of it is something that people need to be ready for ... before they get into it,” said Peter A. Tatian, a senior research associate with the Urban Institute. “[As to the question of a 65% or 70% homeownership rate being sustainable,] I’m not sure. ... [Perhaps we] needed to do a better job as a society of trying to help them get into that position before having them take on the responsibility. Ideally we would like to have more people be homeowners, but it doesn’t help people to get them into homeownership if then they’re going to fall out of it again a few years later.” (*American Banker*, Harry Terris, 05/02/08)
- “The link between lender and borrower in the current residential mortgage industry is a multilayered, tightly — if not hopelessly — entangled ‘assembly line,’ the purpose of which seems to be the avoidance of responsibility,” wrote Judge Joel B. Rosenthal of the U.S Bankruptcy Court of Massachusetts in his ruling, in which he fined Wells

Fargo & Co. \$250,000 for failing, in its role as a securitization trustee, to correct misrepresentations made by Ameriquest Mortgage Co. (*American Banker*, Allison Bisbey Colter, 05/01/08)

President Bush to nominate Paredes to SEC
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- President George W. Bush has nominated Troy Paredes, a law professor from Washington University, St. Louis, MO, to fill a Republican commissioner position at the SEC. If confirmed, Paredes would fill the seat vacated by Paul Atkins, who announced his intention to leave the commission on May 5<sup>th</sup>. (*Wall Street Journal*, Kara Scannell and Joann S. Lublin, 05/07/08)

## ***Fannie Mae***

### The U.S. housing market: *terra incognita*

- During a speech at a business journalism conference in Baltimore, MD, Fannie Mae CEO Daniel Mudd said he doesn't expect to see "some recovery and growth" in the housing market until 2010. "We think at Fannie Mae that '08 is going to be a tough year, kind of a continuation of the end of 2007; '09 will be similar," said Mudd. Although there have been some recent improvements in the capital markets which play an important role mortgage rates, the Standard & Poor's/Case-Shiller home price index posted declines in almost all the 20 metro areas measured, said Mudd. Seventeen markets reported the biggest decreases in value, since their inclusion in the index which was began in 1987 and has been subsequently expanded. "I think the reality of it is that nobody knows where we are right now," said Mudd. "This is *terra incognita*." (*Baltimore Sun*, Jane Smith Hopkins, 04/30/08)

### Fannie Mae's goal is to work out at least 50% of its troubled mortgages

- During its conference call with investors, Fannie's chief business officer Robert J. Levin said, "We're making sure every delinquent borrower is contacted and offered a workout. Our goal is to work out at least 50% of our troubled loans. In March, we worked out 56% of our troubled loans." Michael A. Quinn, Fannie Mae's SVP and single-family risk officer, said the company is "starting to ramp up" its effort to pursue deficiency judgments against borrowers with second homes and speculators who default on their mortgages. (*American Banker*, Allison Bisbey Colter, 05/08/08)

## ***Freddie Mac***

Freddie Mac is expected to raise additional capital after its first quarter earnings release on May 14<sup>th</sup>

- Fresh on the heels of well-received capital offerings by Fannie Mae, Freddie Mac may announce a similar sale after the release of their first quarter results on May 14<sup>th</sup>, said Wall Street analysts. “It would be reasonable to expect that Freddie Mac will look to raise capital next week,” said Moshe Orenbuch, equity research managing director for Credit Suisse. Orenbuch speculated that Freddie would look to raise between \$4 billion and \$5 billion if the company does not have to take the write-downs on their asset-backed securities portfolio. “It could be higher than that if they did,” adding between \$3 billion and \$5 billion, said Orenbuch. Analysts expect that demand for Freddie Mac’s offering wouldn’t be dampened by Fannie Mae’s offerings. “You are not just getting a little yield from Fannie Mae and Freddie Mac—but a lot,” said Andrew Harding, chief investment officer for Allegiant Asset Management. “We feel that these securities are some of the most attractive in the debt markets because you are getting very high yields with nice upside potential,” Harding added. Bret Barker, portfolio manager with Metropolitan West Asset Management, said Fannie and Freddie are “striking while the iron is hot. There is so much cash on the sidelines, so there is money to put to work in these new deals.” (*Reuters*, Julie Haviv and Jennifer Ablan, 05/09/08)

S&P may cut Freddie’s credit rating due to concern about growing losses and need to raise additional capital

- Standard & Poor’s Ratings Services said it may downgrade Freddie Mac ratings on concerns that the company’s losses will continue to mount as the housing crisis worsens, which would result in Freddie having to raise additional capital. On May 6<sup>th</sup>, S&P reiterated its AAA rating for Freddie’s senior debt, but placed the AA- rating on its subordinated debt on a watch list for possible downgrade. While the agency’s move typically means that it may cut the rating within the next six to 24 months, S&P said it will resolve the watch “shortly after” Freddie Mac reports first-quarter results on May 14. “The outcome will either be an affirmation of ‘AA-’ ratings or a one-notch downgrade to ‘A+,’” said S&P said. “The action was a result of expected lower earnings for 2008 and 2009 and quarterly earnings volatility that is reaching beyond the tolerance for the ‘AA-’ rating.” (*Associated Press*, 05/06/08)

### Freddie Mac's loan quality "improves" during the first quarter?

- During a panel discussion hosted by the Mortgage Bankers Association, Connie Ferran, vice president for single-family credit management at Freddie Mac, said, "It looks like we're getting back to where we need to be [regarding] loan quality." On May 2<sup>nd</sup>, Freddie Mac told lenders that they would not have to reduce loan-to-value ratios below 95% in declining markets. Moreover, Patricia Cook, the company's chief business officer, told attendees that Freddie Mac's "declining markets policy" is a guideline and not a hard-and-fast-rule. "[We] are just asking for extra caution," added Cook. (*Reuters*, Al Yoon, 05/05/08)

### The Freddie Mac spin

- When explaining its executive pay for last year, Freddie Mac put a markedly different spin on the company's performance for 2007, relative to that provided by OFHEO in its recent report to Congress. According to Freddie's annual report, the board's compensation committee listed a number of "notable accomplishments" by management that "have better positioned the company," which included its "market-leading response to early signs of the subprime crisis." The board committee also cited the company's "successful offering of \$6 billion in preferred stock in December 2007, which substantially strengthened our capital position." In 2007, Freddie Mac's chairman and CEO, Richard F. Syron, received \$13.8 million in compensation, including a \$1.2 million salary, \$3.5 million in bonuses, \$8.3 million in stock awards, and \$771,585 in perks and benefits. Syron's performance bonus (\$2.2 million) was only 66% of his targeted amount because "Freddie Mac's financial performance in 2007 was not good," said company spokeswoman Sharon McHale. He also received the first installment of a "special extension bonus"
- In contrast, OFHEO reported to Congress that Freddie Mac remains "a significant supervisory concern," given the company's recent operating losses caused by its purchase of loans "with weak underwriting" and its "strategic decision" to acquire riskier loans in 2006 and 2007. The regulator said that Freddie's need for additional capital was partly the result of poor planning by the company and that its increasing the dividend and buying back its own stock earlier in 2007 was "mistimed." The agency wrote, "Freddie Mac's expensive emergency corrective action in the fourth quarter emphasizes the need for more permanently heightened attention to income forecasting, and more prudent capital management generally." OFHEO also noted that Freddie Mac's board has been slow to replace the company's former operating officer and has failed to separate the positions of chairman and chief executive officer, after agreeing to do so in 2003. A year ago, Freddie Mac's chief operating officer, who was Syron's heir apparent to fill the position of CEO, announced he was leaving the company. (*Washington Post*, David S. Hilzenrath, 04/30/08)

Freddie Mac lays off 116 workers and  
announces plans to close a Chicago IT office by mid-June

- Freddie Mac laid off 116 workers in its information technology department and announced plans to close its Schaumburg, IL office by mid-June. Affected workers will be receiving severance packages, said Freddie Mac spokeswoman Shawn Flaherty. “This was not an easy decision, but it’s based on a reflection of the market,” she said. “We’ve been going through a restatement of our earnings and lost a lot during this mortgage crisis. This is a reflection of the market.” (*Daily Herald* [Chicago, IL], Anna Marie Kukec, 05/08/08)

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

FHLB System reports 12.2% increase in first quarter profits

- On March 31<sup>st</sup>, the FHLBanks reported combined total assets of \$1.323 trillion, an increase of 4.0% from year-end 2007. The Banks’ advances increased 4.3% to \$913 billion and represented 69.0% of the System’s total assets. Investments rose 4.8% to \$311 billion and member mortgage assets, totaling \$91 billion, were down 0.9% from year-end 2007. The System’s consolidated obligations outstanding totaled \$1.217 trillion at March 31, 2008, an increase of 3.3% from year-end 2007, which consisted of discount notes (\$394 billion) and bonds (\$823 billion).
- The System’s combined net income for first quarter 2008 was \$697 million, a 12.2% increase from the first quarter of last year. The Banks’ combined net income was reduced by the FHLBank-Chicago’s net loss of \$78 million, which included an other-than-temporary impairment loss of \$33 million on certain private-issue MBS primarily collateralized by first lien mortgages to subprime borrowers. The 11 FHLBs do not expect to record any material other-than-temporary impairment charges as of March 31, 2008. (*FHLBanks Office of Finance Press Release*, 04/28/08)

FHLB-Chicago reports \$78 million loss for first quarter

- The FHLB-Chicago reported a \$78 million loss for the first quarter, largely because of its troubled Mortgage Partnership Finance Program and volatility of the larger mortgage market. Previously, the Bank had announced that it would discontinue purchasing loans under its MPF program on July 31<sup>st</sup>, largely because of volatility from the program’s interest rate risk. According to observers, the Bank may need years to recover from losses associated from its mortgage portfolio. “The short answer is it could take two to three years before they can work their way through the

magnitude of the situation,” said Jim Vogel, the head of fixed-income research at FTN Financial Capital Markets Corp.

- Separately, the FHLB-Chicago has named Matthew Feldman as its president and CEO. In April, Feldman had been named interim president, following the resignation of Mike Thomas on April 11<sup>th</sup>. Previously, Feldman was the Bank’s executive vice president of operations and administration. He has worked for the FHLB-Chicago since 2003. The Bank has also named John Stocchetti as acting group head of operations and administration, a position previously held by Feldman. (*American Banker*, Steven Sloan, 05/07/08; *American Banker*, Steven Sloan, 04/29/08; *American Banker*, Steven Sloan, 05/01/08; *American Banker*, Matthias Rieker, Stacy Kaper and Steven Sloan, 04/28/08))

Failure of FHLBs’ mortgage program was inevitable
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- The FHLB-Chicago unveiled its Mortgage Partnership Finance Program in 1997, touting the vehicle as a way for the FHLBs to compete with Fannie Mae and Freddie Mac in the mortgage market. Observers argue that the FHLB-Chicago did too much too fast, while others blamed the Federal Housing Finance Board for not allowing the Bank to securitize its mortgage holdings. “This was a good idea surrounded by a lot of bad action, and the [FHLB-Chicago] got caught,” said Diane Casey-Landry, the SVP and COO of the American Bankers Association. “You can’t run this kind of system indefinitely and have illiquid assets on your book,” said Bruce Morrison, who served as chairman of the Federal Housing Finance Board at the time of the MPF was introduced. “That outlet was never developed.” Morrison said he tried to open the door to securitization during his chairmanship, but noted “you’ve got to walk before you can run—it had to go through the pilot stage.” He added, “We trusted our successors to be as willing as we were to use the regulatory authority to provide the results, and our successors were not willing to take that step.” Morrison’s successors were increasingly lukewarm to the MPF program and had differing views on the Bank’s capital adequacy. “You want them to do the program, then you don’t want them to do it,” said Casey-Landry. “Regulatory inconsistency really created the problem.”
- Others blamed the failure of the MPF program on the Bank’s reliance on member stock, which could be redeemed within six months. “[Alex Pollock, the Bank’s former president,] believed using six-month stock was OK,” said Morrison. “I think it was a fatal error and it doomed the program.” Others argue that the MPF program grew too quickly, leaving the FHLB-Chicago vulnerable. “It was just inevitable in terms of the size,” said Brian Harris, an analyst for Moody’s Investors Service Inc. “There’s a tremendous amount of volatility ... and it has been more recently that the bank has been discovering the income implications.” On December 31<sup>st</sup>, the MPF portfolio totaled \$34.6 billion. Al DelliBovi, president of the FHLB-New York, agreed that the FHLBs’ mortgage portfolios could only grow so big. “We just did not see this as a business that could have grown to be anywhere near as large as our

advance business safely,” said DelliBovi. (*American Banker*, Steven Sloan, 05/01/08)

FHLB-New York partners with Magyar Bank to provide \$6 million  
in a housing assistance and recovery program

- The FHLB-New York, Magyar Bank (New Brunswick, NJ) and a Somerset church are partnering to provide \$6 million for the Housing Assistance and Recovery Program. The program buys homes from distressed owners in Middlesex and Somerset counties [NJ] and leases them to the owners, until they have re-established their credit and can buy back their homes. Magyar is providing 70% of the funds with the FHLB’s support and the First Baptist Community Development Corp. is providing the balance of the funds. (*American Banker*, 05/08/08)

## ***Ginnie Mae***

Ginnie Mae issues its first FHA-insured jumbo mortgage MBS

- On April 15<sup>th</sup>, Ginnie Mae issued its first FHA jumbo mortgage-backed securities pools, while jumbo activity at Fannie Mae and Freddie Mac has yet to register on anyone’s radar screen. (*HousingWire*, Paul Jackson, 04/28/08)

FHA Commissioner Brian Montgomery named the 2008 recipient  
of the Robert J. Corletta Award for Achievement in Affordable Housing

- HUD’s Assistant Secretary for Housing and Federal Housing Commissioner Brian Montgomery was named the 2008 recipient of the Robert J. Corletta Award` for Achievement in Affordable Housing last week. The Corletta Award, presented annually by the National Association of Home Builders and the Neighborhood Development Collaborative, recognizes individuals who have shown extraordinary creativity and dedication to affordable housing. In bestowing the award to Montgomery, the groups cited in particular his efforts to keep FHA programs viable for the production and rehabilitation of rental apartments that low and moderate income households can afford. “Given the current difficulties in the mortgage markets, FHA programs are more important than ever, and Brian has played a critical role in ensuring that these programs support the creation of affordable housing for America’s working families,” said Bob Nielsen, NAHB vice president/secretary. (*Affordable Housing*, 05/05/08)

## *Farm Credit System / Farmer Mac*

Farm Credit System reports 17.7% increase in net income for first quarter

- The Farm Credit System reported combined net income of \$770 million for the three months ended March 31<sup>st</sup>, a 17.8% increase over the System's income for the same period of the prior year. "The System continued to generate strong earnings during the first quarter of 2008, despite the current unstable conditions in the U.S. financial industry," said Jamie B. Stewart, Jr., president and CEO of the Federal Farm Credit Banks Funding Corporation. "The overall agricultural economic conditions remained favorable during the first quarter due to strong global demand for agricultural commodities and a weak U.S. dollar resulting in significantly higher crop prices. However, the volatility in crop prices and increased cost of farm inputs resulted in higher risk profiles for livestock producers, marketers of grains and oilseeds, and borrowers that use corn or other grains in their products. In this environment, managements of System institutions continue to be vigilant in applying prudent loan underwriting standards and monitoring the credit quality of their loan portfolios."
- The System's gross loans increased 7% to \$10.026 billion at March 31, 2008, with more than half of the loan growth attributable to growth in loans to agricultural cooperatives to fund higher commodity prices. The System's non-accrual loans increased \$155 million to \$667 million on March 31<sup>st</sup>, while the System's non-performing loans increased \$192 million to \$813 million (representing 0.53% of accruing loans). During the quarter, the System made a \$23 million provision for loan losses, as compared to a \$1 million loan loss reversal for the first quarter of 2007. Loan loss provisions during the period were primarily due to credit deterioration in a limited number of loans. Net loan charge-offs totaled \$10 million during the first quarter, as compared to net loan recoveries of \$2 million for the first quarter of 2007. On March 31<sup>st</sup>, the System's allowance for loan losses totaled \$794 million, representing 0.52% of loans outstanding. (*BusinessWire*, 04/30/08)

Farm Bill negotiations near end without HORIZONS provisions, *but* new FCA rule appears to give its members a license to lend anywhere to anyone...

- In the April issue of *Farm Credit Watch*, Bert Ely wrote, "The congressional conferees negotiating the 2008 Farm Bill reportedly are making progress in resolving differences between the House and Senate versions of the bill, which largely resolve around money. Currently, the conferees are working against a May 2 deadline, when the 2002 Farm Bill is scheduled to expire. That deadline may be extended again to allow more time to complete the 2008 Farm Bill negotiations. Importantly, there are strong indications that the conferees have not included any of the FCS's HORIZONS provisions in the bill. However, in the legislative process, nothing is over until it is

over, which is why bankers must continue to express opposition to the inclusion of any HORIZONS provision in the Farm Bill.”

- [House and Senate negotiators agreed on a \$285 billion farm bill on May 7<sup>th</sup>, which increases the funding of public feeding programs by \$10.4 billion over 10 years and denies one crop subsidy program to the wealthiest Americans. According to White House spokeswoman Dana Perino, “it seems unlikely” that the final bill will satisfy the administration’s drive for farm-program reform. Senate Agriculture Committee chairman Tom Harkin (D-IA) said, “I’m still hopeful that the president will sign this bill. We’ve got the votes to override a veto and we will.”]
- “Showing uncanny timing as the FCS’s HORIZONS agenda fades in Congress, the Farm Credit Administration (FCA) has finalized a Processing and Marketing (P&M) regulation giving the FCS greatly expanded authority to lend to non-farmer-owned or controlled businesses. The FCA ignored over 3,000 letters from bankers and others opposing the rule, which weakens existing farmer ownership rules governing FCS lending to ‘legal entities’ processing and marketing farm products. This expanded lending authority far exceeds long-standing congressional intent, which limits FCS P&M lending to (1) farmers and ranchers (‘eligible borrowers’) and (2) to P&M legal entities at least 50% owned by eligible borrowers who also provide some of the commodities, or ‘throughput,’ processed or marketed by the entity.”
- “The new regulation is FCA’s attempt to give the FCS what Congress is about to reject. The FCA tried, unconvincingly, to dress up its rationale for the P&M rule with platitudes, such as permitting the FCS ‘to more effectively meet the credit needs of farmers, ranchers, and producers or harvesters of aquatic products;’ that is, those who are eligible FCS borrowers. According to the FCA, FCS lenders must be ‘able to meet their statutory mandate of serving the processing and marketing credit needs of agricultural producers’ and to allow the FCS ‘to follow its customers as they integrate upward into processing and marketing activities, with eligibility criteria tailored more closely to the way producers actually want and need to structure their value-added businesses.’ While all this sounds good, the FCA does not provide concrete evidence for these expanded authorities, other than it will boost FCS lending.”
- “The new regulation, which is 75 pages long and reads like a legal brief anticipating a future court challenge, adds three criteria for determining which legal entities—owned 50% or less by eligible borrowers—can now borrow from the FCS ‘as a processing or marketing credit need of an eligible borrower directly related to the eligible borrower’s production operation.’ The majority-ownership-by-farmers requirement is dead.”
- “The three additional criteria: One, eligible borrowers need only provide ‘some throughput and exercise majority voting control over the legal entity or constitute a majority of the board of directors. . . and exercise control’ over the entity’s operations. Two, eligible borrowers ‘evidence a strong level of commitment by owning a significant equity stake (at least 25%), providing a substantial amount of

throughput (20% or more), and maintaining representation on the [entity's] board of directors.' Three, the P&M entity is a 'direct extension or outgrowth of the eligible borrower's production operation' and certain criteria are met 'concerning the entity's creation, business needs, functional integration, and throughput requirements.' The third criteria might as well be called the 'open barn door' criteria."

- "The new criteria permit multiple interpretations by the FCS and the FCA as to what constitutes control of a P&M entity. Given the FCA's strong tilt towards looking the other way when the FCS abuses its lending authority, the FCS will stretch this expanded definition of what constitutes control to the horizon. A provision in the new rule requiring the board of directors of each FCS institution making P&M loans 'to adopt a policy that, at a minimum, directs institution management to establish procedures for ensuring compliance with the eligibility provisions' of the new rule will have no effect given the FCS's longstanding desire to lend to anyone anywhere."
- "The competitive unfairness of the new rule is illustrated by an example the FCA staff presented at the April 10 FCA board meeting when the rule was adopted. The example: A dairy farmer wishes to integrate downstream by selling some of his production to an ice cream plant that a family member constructs. The ice-cream plant would be eligible for an FCS P&M loan even though the farmer would only have a minority interest in the plant. That operation, of course, would be using its low-cost FCS financing to compete against other ice-cream makers that are not eligible to borrow from the FCS. This competitive unfairness is an issue Congress should investigate, but perhaps the FCS will try to head off such an investigation by lending to any ice-cream maker who integrates backwards by buying a dairy farm from which it then obtains 'throughput' for its ice-cream plant. The P&M rule tries to block this possibility by requiring that the legal entity taking out an FCS P&M loan 'was created for the primary purpose of processing or marketing the eligible borrower's throughput and would not exist but for the eligible borrower's involvement.' This protection from FCS misdeeds hardly seems enforceable—which came first, the chicken or the egg?" (*Farm Credit Watch*, Bert Ely, April 2008; Reuters, 05/07/08)

#### FCA's mission creep continues

- On May 8<sup>th</sup>, the Farm Credit Administration board of directors approved a proposed rule to authorize Farm Credit System institutions to purchase and hold investments in rural communities. FCA Chairman Nancy Pellett said, "Authorizing FCS institutions to make community investments in their rural communities to improve health care services, infrastructure improvements, quality-of-life projects, and other economic opportunities is meaningful to rural residents and contributes to a strong agriculture."
- Since 2005, FCA has approved 37 requests by System institutions on a case-by-case basis to initiate pilot programs enabling them to make investments in rural communities. Based upon the success of these programs, FCA is proposing a rule to

allow all System banks, associations, and service corporations to make certain investments in rural communities for essential community facilities; basic transportation infrastructure; rural communities recovering from disaster; debt securities for rural development projects sponsored or guaranteed by the United States, U.S. agencies, any of the 50 states, Puerto Rico, or local and municipal governments; debt securities that support the rural development activities of non-System financial institutions; rural business investment companies; and venture capital funds that invest in rural businesses that create jobs and economic growth under specific conditions. The proposed rule would enable the FCS to work with government and non-System financial institutions to invest in facilities, infrastructure, services, and projects that create jobs that benefit rural communities and their residents. Investments in rural communities under the proposed rule, however, would be restricted to rural communities outside of urbanized areas as determined by the latest decennial census of the U.S. Census Bureau. The U.S. Census Bureau defines rural communities as having fewer than 50,000 residents.

- The proposed rule establishes controls to ensure that investments in rural communities do not adversely affect the safety and soundness of System institutions. These controls also serve to maintain System compliance with statutory authorities and to ensure that the FCS continues its primary mission of lending to agricultural producers, eligible cooperatives and agribusinesses, and rural utilities. The proposed rule will be published in the Federal Register for a 60-day comment period. (*FCA Press Release*, 05/08/08)

America's "return" on its \$8 billion annual investment in ethanol
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- What is America's return on its \$8 billion annual investment in ethanol? According to *National Review's* David Freddoso, "The answer is that we get two days of gasoline—that's all." Today, approximately 25% of America's 13-billion bushel corn crop is used for ethanol production. A recent study by the National Academy of Science concluded that ethanol contains about 25% more energy than is consumed by the process of making it. In other words, the farming, distilling, and shipping required to bring five gallons of ethanol to market consumer the energy equivalent of four gallons of ethanol. The minor gain of two days of gasoline supply—the energy equivalent of 868 million gallons of gasoline—seems hardly worth the \$6.3 billion to \$8.7 billion in annual direct and indirect federal and state ethanol subsidies, estimated by Dough Koplou, biofuel expert with Earth Track. Freddoso concluded, "Congress should not be satisfied with merely reducing the ethanol mandate, but repeal it and end this inherently wasteful policy. There has never been a better opportunity to end federal support of ethanol — to drive the stake through this monster's heart, once and for all." (*National Review's* David Freddoso, 05/06/08)
- Presumptive GOP presidential nominee John McCain (R-AZ) and 23 Republican Senators have asked EPA Administrator Stephen L. Johnson to consider waiving a requirement in the 2007 Energy Bill, which mandated a fivefold increase in the production of biofuel in the U.S. In their May 2<sup>nd</sup> letter, the Senators wrote,

“American families are feeling the financial strain of these food-to-fuel mandates in the grocery aisle and are growing concerned about the emerging environmental concerns of growing corn-based ethanol. It is essential for the EPA to respond quickly to the consequences of these mandates. Congress made the mandates in the [2007 Energy Bill] different from existing mandates to provide flexibility and to encourage innovation in advanced and cellulosic fuels. We believe today’s circumstances merit the use of this flexibility.” (*CQ Today Midday Update*, 05/05/08)

- In a May 11<sup>th</sup> lead editorial, the *New York Times* wrote, “The time has come for Congress to rethink ethanol, an alternative fuel that has lately fallen from favor. Specifically, it is time to end an outdated tax break for corn ethanol and to call a timeout in the fivefold increase in ethanol production mandated in the 2007 energy bill. This does not mean that Congress should give up on biofuels as an important part of the effort to reduce the country’s dependency on imported oil and reduce greenhouse gas emissions. What it does mean is that some biofuels are (or are likely to be) better than others, and that Congress should realign its tax and subsidy programs to encourage the good ones. Unlike corn ethanol, those biofuels will not compete for the world’s food supply and will deliver significant reductions in greenhouse gases...” (*New York Times*, 05/11/08)
- Brazil’s ethanol industry called on the World Trade Organization to protest U.S. farm aid, if the U.S. Congress passes a bill to extend a tariff on biofuel imports and a tax credit to fuel blenders. Unica, a trade organization representing over 80% of Brazil’s sugar and ethanol producers, said the bill would further limit access to the U.S. market, harming free trade. “It would broaden the trade discrimination against Brazilian ethanol in the U.S.,” said the group. As written, the proposed 2008 Farm Bill would extend a tariff of 54 cent a gallon on imports of ethanol; it would also continue a tax credit to ethanol blenders, which would be reduced to 45 cents a gallon from 51 cents. (*Calgary Herald News Service*, 05/10/08)
- On September 30, 2007, FCA institutions had outstanding loans and loan commitments totaling \$4.2 billion to the ethanol industry. According to Ken Auer, president and CEO of the Farm Credit Council, the ethanol industry will need an additional \$105 billion in capital over the next 15 years to meet the ethanol production requirements in the 2007 Energy Bill. (*Ethanol Producer Magazine*, Jerry W. Kram, April 2008)

## *Postal Service*

### USPS reports second quarter loss of \$707 million

- The Postal Service ended its second quarter with a \$707 million net loss, driven by a continued decline in mail volume resulting from the current national economic slowdown. Revenue was \$18.9 billion in the second quarter, an increase of 3.2%, while expenses totaled \$19.6 billion, an increase of \$52 million or 0.3%. Mail volume for the three months ended March 31<sup>st</sup> totaled 51.3 billion pieces, down 3.3% from the previous second quarter. First class mail volume declined 3.1%, while Standard Mail volume was down 3%. Year-to-date mail volume is down 3.1% compared to the same period last year. “Weakness in the housing and credit markets, both of which are heavy users of mail, are leading the declines in mail volume,” Postmaster General John Potter told the Postal Service’s Board of Governors. “While mail volume may rebound with the economy, it is clear we need to accelerate our efforts to seek new structural and process changes to remain economically viable and to further improve customer service.” The Postal Service continues to focus on reducing its operating costs and increasing its efficiency and is implementing new pricing flexibility to better serve its customers and increase its mail volume. (*UPSP Press Release, 05/07/08*)

### USPS gives licking to average patron by increasing postal rates 31% over past decade

- In the *Asbury Park Press*, Robert Schrum of the Lexington Institute wrote, “On [May 12<sup>th</sup>], the price of a first-class stamp will rise by a penny. With gas now costing nearly four bucks a gallon, a 42-cent stamp may not sound like much. But while stamp prices climb, the Postal Service keeps offering sweetheart deals to bulk mailers and the postal labor unions. Ordinary consumers ought to ask why the Postal Service is delivering for everyone but them. In the last decade, stamp prices have gone up 31 percent. ...An extra penny for a stamp surely won’t break the bank. But the Postal Service shouldn’t lean on ordinary consumers to fund its money-losing deals with big mailers or its cozy relationship with its labor unions.” (*Asbury Park Press, Robert Schrum, 05/09/08*)

### Long-term trends for mail volume don’t look promising for USPS business model

- According to an analysis by Bradley Tisdahl, strategy analyst at Pitney Bowes, the U.S. household generated mail, or mail which is primarily consumer originating, has been in a steady decline over the past six years. Changes in consumer behavior based, in part, around electronic substitution, have led to a reduction in the amount of mail individuals send. Despite these changes, it still accounts for around 10% of the total mail mix in the U.S. Electronic substitution appears to have a greater impact on

transaction based mail, largely consisting of bill payments. Correspondence mail volume, such greeting cards, is stable overall, but on a per capita basis, is also in decline. In the future, three key levers will impact household generated mail: regulatory changes, continued technological innovation and expansion, and consumer behavioral shifts. Tisdahl concluded, “We predict that there will be continued declines in overall household generated mail, however, changes are not likely to take place suddenly.” (*U.S. Household Generated Mail: U.S. Market Overview*, Bradley Tisdahl, May 8, 2008)

Count every vote?

- Following an April 15<sup>th</sup> hearing by the Congressional Committee on House Administration on the distribution, collection and delivery of military ballots and overseas elections ballots, the panel was poised to take up The Military Voting Protection Act (H.R. 5673), which would direct the Secretary of Defense to collect absentee ballots of absent overseas uniformed services voters for elections for Federal office and deliver the ballots to State election officials prior to the closing of the polls on the date of the election.
- According to the *eNAPUS Legislative Political Bulletin*, “A week ago, NAPUS learned that the Committee was poised to take up H.R. 5673 on Wednesday, April 30; however, as the result of aggressive grassroots activity, the Committee elected to defer action on the bill. The entire postal community raised concern about H.R. 5673, including Postmaster General Jack Potter. NAPUS alerted Postmasters in the states whose Representative serve on the Committee and communicated Postmaster objection of the legislation. H.R. 5673 would require the Department of Defense to establish procedures for ‘private courier’ collection and delivery of absentee military ballots. The proposal is contrary to the ‘private express statutes.’ Moreover, the USPS already enjoys a longstanding and close partnership with the Military Postal Service Agency (MPSA) in handling military election mail, through Army/Air Force and Fleet Post Offices. Consequently, the USPS and the MSPA communicate with local election authorities to handle election material as expeditiously as possible.” (*eNAPUS Legislative Political Bulletin*, 05/02/08)

“Letter Logger” will serve as a letter’s GPS

- The USPS commissioned TrackingTheWorld to create the “Letter Logger,” the world’s first letter tracking GPS device. The Letter Logger is a two-ounce, 3.9-by-1.5 inch micro-SD flash memory card, which stores GPS coordinates throughout its journey over a two-week period. While the Postal Service uses a variety of tracking devices for its letters and packages and uses GPS to track vehicles, the agency does not have a GPS system to track individual packages, said USPS spokesman James Wigdel. In addition to avoiding lost mail, the Letter Logger will also help the Postal

Service and delivery companies minimize the amount of time it takes to send a letter.  
(*The Examiner*, Mike Rosenberg, 05/05/08)

## TVA

TVA is a victim of “partisan, playpen politics”

- Senator Lamar Alexander (R-TN) took to the Senate floor to decry a decision by Majority Leader Harry Reid (D-NV) to block the two pending nominations for TVA’s board of directors, calling the move “disheartening playpen politics” he accused Reid blocking these appointments because of “their party affiliation [which] overturns 75 years of Federal law and custom.” Alexander pointed out that one nominee, Bishop William Graves, an African American, is “not even a Republican,” but is the most experienced member of the TVA board, coming from the agency’s largest customer [Memphis Power and Light], and is the “presiding bishop of over one of America’s largest religious denominations.” The Senator called Reid’s “hold” on Graves’ nomination “an insult” to Memphis. Senator Bob Corker (R-TN) said, “I came here to work in a bipartisan way to solve our country’s problems, and for the majority leader of the U.S. Senate to say he’s not going to proceed with the confirmations of Bishop Graves and Susan Williams to the TVA board because they aren’t Democrats diminishes him, diminishes the Senate, and diminishes all of us who serve in it.”
- In a May 4<sup>th</sup> article in the [Memphis] *Commercial Appeal*, Otis L. Sanford, the editor of the paper’s opinion page, wrote, “...Ah, politics. You’ve got to love it. After the TVA board was expanded from three members to nine, President Bush nominated Graves in 2006 to fill a term that was about to expire the following year. Bush then renominated Graves in July 2007 for a new five-year term. But Reid, who became Senate majority leader after the 2006 election, has been sitting on the nomination. His reason is that Bush should appoint a Democrat. The fact is—and Reid knows this—that presidents get to appoint whoever they darn well please. In this case, Graves identifies himself as a registered Democrat who votes as an Independent. But he has been a close Bush ally for years and served as a co-chairman of the local Bush-Cheney re-election campaign in 2004. Yet, his appointment to the TVA board was more than just blind patronage. Graves had served for 10 years on the board of Memphis Light, Gas and Water Division, the TVA’s largest customer. And he is well versed in crucial utility issues. He is respected and capable. In other words, Bush got this one right. Which is why Alexander showed no hesitancy in going after Reid for foot-dragging on Graves’ renomination. The CME bishop, Alexander says, “has served with distinction,” even though his seat is barely warm. And now a liberal Democrat is trying to keep him out of the chair altogether.
- “[O]ne thing we do know is that most black Memphians don’t take kindly to political mistreatment, perceived or real. So Alexander was all too eager to paint

Reid into a corner as the villain, and to make sure the local folks knew about it. The next move is Reid's, and he needs to quit this partisan charade. Chances are, if he keeps stalling on the Graves nomination, he'll have some tall explaining to do." (*State News Service*, 05/01/08; *Knoxville News Sentinel*, Michael Collins, 05/01/08; *Commercial Appeal*, Bartholomew Sullivan, 05/02/08; *Commercial Appeal*, Otis L. Sanford, 05/02/08)

Department of Energy provides \$4 million grant to TVA  
to develop plans for a small-scale nuclear waste processing facility

- TVA has received a \$4 million grant from the Department of Energy to develop a conceptual design for a nuclear waste reprocessing plant, as part of a collaborative effort to deal with issues of nuclear waste. TVA president and CEO Tom Kilgore said that the waste facility is a "long-term effort" which is "going to take a decade, maybe two, to perfect" and will "get into the billions of dollars" of investment if plans come to fruition. Possible sites for the facility include the former Clinch Breeder Reactor site or "somewhere on the Oak Ridge Reservation," said Kilgore. (*Knoxville News Sentinel*, Larisa Brass, 05/06/08; *Associated Press*, 05/07/08)
- According to a report by the Inspector General, TVA spent more than \$100,000 entertaining lawmakers, business prospects and its employees in 2005 and 2006. Expenditures included \$2,100 for cigars given to Tennessee legislators during a session on government ethics reform, \$106,000 for food and tickets to sporting and theatrical events, and \$19,000 for receptions for auto executives from Michigan and Georgia. TVA also gave \$10,971 in gift cards to TVA employees during a meeting in late 2005. The expenditures came a year after the agency's board adopted a new hospitality policy aimed at ending lavish spending on gifts and meals. Ben Cunningham, spokesman for Tennessee Tax Revolt, called TVA's expenditures on entertaining "a real insult to ratepayers," who faced a 12% increase on [wholesale] electric rates on April 1<sup>st</sup>. "It indicates that TVA has some misplaced priorities and they are not looking out for the ratepayer," said Cunningham. TVA officials argue that entertainment spending is needed to attract new industry to the TVA Valley and recognize employees' achievements. TVA spokesman Gil Francis notes, however, that cigars are no longer given out as part of the agency's revised hospitality policy. (*Associated Press*, 04/29/08)

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