

# The **GSE** REPORT™

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## *Major Events*

Reverberations from the perfect storm of “unprecedented proportions”:

Treasury Secretary Paulson announces plan giving the Federal Reserve broad new authority to oversee the stability of the financial markets

Chairman Frank calls for significant changes in the regulation of the financial services industry

We’re living in desperate times, which require “decisive action and creative leadership”

### Reverberations from the perfect storm of “unprecedented proportions”

- In a March 17<sup>th</sup> article, John Mauldin notes that many are upset about the bailout of Bear Stearns, decrying the “moral hazard.” Mauldin wrote, “...I can understand the sentiment, as it appears that tax-payer money may have been used to bail out a big Wall Street bank that acted recklessly in the subprime mortgage markets. But that is not what has happened. This is not a bailout. The shareholders at Bear have been essentially wiped out. Note that a third of the shares of Bear were owned by Bear employees. Many of them have seen a lifetime of work and savings wiped out, and their jobs may be at risk, even if they had no connection with the actual events which caused the crisis at Bear. Don’t tell them there was no moral hazard. For all intents and purposes, Bear would have been bankrupt this morning [March 17<sup>th</sup>]. The \$2 a share offer is simply to keep Bear from having to declare bankruptcy which would mean a long, drawn out process and would have precipitated a crisis of unimaginable proportions. Cue the lawyers.”
- “As I understand this morning, JPMorgan will take a \$6 billion write down, which is essentially what they are paying for Bear. The Fed is taking \$30 billion dollars in a variety of assets. They may ultimately take a loss of a few billion dollars over time, although they may actually make a profit. When you look at the assets, much of it is in paper that will likely get close to par over time, and the good paper will pay premiums mitigating the potential loss. The problem is, as the essays below point out, no one is prepared to take that risk today. If it was 2005, Bear would have been allowed to collapse, as the system back then could deal with it, as it did with REFCO. But it is not 2005. We are in a credit crisis, a perfect storm, which is of unprecedented proportions. If Bear had not been put into sound hands and provided solvency and liquidity, the credit markets would simply have frozen this morning. As in ground to a halt. Hit the wall. The end of the world, impossible to fathom how to get out of it type of event. The stock market would have crashed by 20% or more, maybe a lot more. It would have made Black Monday in 1987 look like a picnic. We

would have seen tens of trillions of dollars wiped out in equity holdings all over the world.”

- “As I have been writing, the Fed gets it. Their action ...is actually re-assuring. I have been writing for a long time that they would do whatever it takes to keep the system intact. ...[T]his was the NY Fed stepping in, not the FOMC. The NY Fed is responsible for market integrity, not monetary policy, and they did their job. And you can count on other actions. They are going to change the rules on how assets can be kept on the books of banks. Mortgage bail-outs? Possibly. The list will grow.”
- “Yes, tax-payers may eventually have to cover a few billion here or there on the Bear action. But the time to worry about moral hazard was two years ago when the various authorities allowed institutions to make subprime loans to people with no jobs and no income and no means to repay and then sold them to institutions all over the world as AAA assets. And we can worry in the near future when we will need to do a complete re-write of the rules to prevent this from happening again.”
- “But for now, we need to bail the water out the boat and see if we can plug the leaks. Allowing the boat to sink is not an option. And get this. You are in the boat, whether you realize it or not. You and your friends and neighbors and families. Whether you are in Europe or in Asia, you would have been hurt by a failure to act by the Fed. Everything is connected in a globalized world. Without the actions taken by the Fed, the soft depression that many have thought would be the eventual outcome of the huge build-up of debt would in fact become a reality. And more quickly than you could imagine.”
- “...[R]ecessions are part of the business cycle. There is nothing we can do to prevent them. But depressions are caused by massive policy mistakes on the part of central banks and governments. And it would have been a massive failure indeed to let Bear collapse. I should note that this was not just a Fed action. Both President Bush and Secretary Paulson signed off on this.”
- “The Fed risking a few billion here and there to keep the boat afloat is the best trade possible today. Their action saved trillions in losses for investors all over the world. It is a relatively small price. If you want to be outraged, think about the multiple billions in subsidies for ethanol and the hundreds of billions of so-called earmarks over the past few years to build bridges to nowhere. And think of the billions in lost tax revenue that would result from the ensuing crisis. I repeat, this was a good trade from almost any perspective, unless you are from the hair-shirt, cut-your-nose-off-to-spite-your-face camp of economics.”
- “The Fed is to be applauded for taking the actions they did. And they may have to do it again, as there are rumors that another major investment bank is on the ropes. I hope that is not the case, and will not add to the rumors in print, but I am glad the Fed is there if we need them. It is precisely because the Fed is willing to take such actions

that I am modestly optimistic that we will ‘only’ go through a rather longish recession and slow recovery and not the soft depression that would happen otherwise.”

- “I got a very sad letter today from a lady whose husband is in the construction business an hour from Atlanta. He has had no work for four months and they are rapidly going through their savings. ...He is sadly part of the construction industry which everyone knows is taking a major hit. But without the Fed action, that story would have multiplied many times over, as the contagion of the debt crisis would have spread to sectors of the economy that so far have seen only a relatively small impact. Unemployment would have sky-rocketed over the next year and many more families would have been devastated like the family above. It would have touched every corner of the US and the globe.”
- “Bailing out the big guys? No, the Fed does not care about the big guys, and only mildly pays attention to the stock market, despite what conspiracy theorists think. In the last few years, I have had the privilege of meeting at length with a number of Fed economists and those who have their ear. They are far more focused on the economy, their mandates for stable inflation and keeping unemployment as low as possible. No one who owned Bear stock was protected. This was to protect the small guys who don’t even realize they were at risk. To decry this deal means you just don’t get how dire a mess we were almost in. It is all well and good to be rich or a theoretical purist and talk about how the Fed should let the system collapse so that we can have a ‘cathartic’ pricing event. Or that the Fed should just leave well enough alone. But the pain to the little guy in the streets who did nothing wrong would simply be too much. The Fed and other regulatory authorities leaving well enough alone is part of the reason we are where we are. First, get the water out of the boat and fix the leaks, and then make sure we never get here again.” (*Investors Insight Publishing*, John Mauldin, 03/17/08)
- On March 24<sup>th</sup>, JPMorgan increased its purchase price for Bear Stearns to \$10 a share from \$2. The revised agreement also has JPMorgan shouldering the first \$1 billion of losses from Bear’s assets, reducing the Fed’s guarantee of Bear’s assets to \$29 billion. According to Jeff Miller at Dash of Light, the Fed’s motivation for arranging the sale of Bear “was to avoid the systemic failure that might have started with Bear’s counterparties. The new deal terms accomplish this with a better alignment of risk and reward.” (*Fortune’s Daily Briefing Blog*, 03/24/08)

Treasury Secretary Paulson announces plan giving the Federal Reserve broad new authority to oversee the stability of the financial markets

- Treasury Secretary Henry Paulson has proposed that Congress provide the Federal Reserve with broad new authority to oversee financial market stability, which would allow the central bank to send its examiners into any corner of the financial services industry or any institution, which might pose risk to the overall system. The plan would move the Fed out of the day-to-day supervision of state-chartered banks and shift the agency’s focus on monitoring the stability of the financial markets.

Paulson's proposal is part of Treasury's sweeping blueprint to overhaul the nation's hodgepodge of regulatory agencies, which regulate the financial services industry. The plan would consolidate a large number of banking and securities regulators into a powerful trio of overseers, responsible for everything from banks and brokerage firms to hedge funds and private equity firms. Under the plan, banking supervision, now divided among five agencies, would be consolidated into the Prudential Financial Regulator, which would conduct examinations of any bank or depositor institution protected by either federal deposit insurance or other federal "backstops." The plan would also create a national regulator for insurance companies, an industry which state governments currently oversee.

- While the proposal carefully avoids calling for tighter regulation of Wall Street, it does call for investment banks and hedge funds to have great scrutiny by giving the Federal Reserve some authority over the firms when their practices threaten the entire financial system. Paulson plan also does not recommend tighter rules over the unregulated markets for risk sharing and hedging. Elements of the plan could reduce the power of the SEC, by allowing the stock exchanges greater leeway to regulate themselves, streamlining the approval of new products, and allowing automatic approval of securities products that are being traded on foreign markets. The plan would merge the SEC with the Commodity Futures Trading Commission. In a nod to the subprime mortgage crisis, the plan calls for the creation of a Mortgage Origination Commission (MOC) which would evaluate the effectiveness of state governments in regulating mortgage brokers and protecting consumers and would create licensing standards for state mortgage companies. The MOC would be comprised of representatives from the Federal Reserve and other agencies. Paulson also called on Congress to pass "clarified and enhanced" federal laws that would resolve any jurisdictional issues that exist between state and federal supervisors.
- "We should and can have a structure that is designed for the world we live in, one that is more flexible, one that can better adapt to change, one that will allow us to more effectively deal with inevitable market disruptions and one that will better protect investors and consumers," said Paulson. "The challenge is to evolve to a more flexible, efficient and effective regulatory framework – and that is the purpose of this Blueprint. ...I am not suggesting that more regulation is the answer, or even that more effective regulation can prevent the periods of financial market stress that seem to occur every 5 to 10 years. I am suggesting that we should and can have a structure that is designed for the world we live in, one that is more flexible."
- Virtually every element of Treasury's proposal would have to be approved by Congress and Democratic leaders are already drafting bills to impose tougher supervision of Wall Street investment bankers, hedge funds and derivative markets. While Paulson's proposal to expand the Fed's role echoes ideas proposed by House Financial Services Committee chairman Barney Frank (D-MA), Frank will likely favor a stronger role for the Fed and support the establishment of a regulations for Wall Street firms similar those imposed on commercial banks, especially with regard to capital requirements. Paulson's proposal, which Treasury officials have spent

months designing, is likely to provoke bruising turf battles among agencies and industry groups, which benefit from the current regulatory structure. While administration officials have acknowledged that they do not expect Treasury's proposal to become law this year, they said that they hoped the plan would help frame a policy debate that would extend well after the November elections.

- Arthur Levitt, a former SEC chairman, said his first impression of Treasury's plan was positive. Although the SEC's powers would be reduced, the plan would create a broader agency to regulate business conduct in all financial services, said Levitt. "It's a thoughtful document," he added. "I'm intrigued by the fact that it puts an emphasis on investor protection, and that it establishes an agency specifically for that purpose, which would operate across all markets. I think that's a very constructive first step." (*The New York Times*, Edmund L. Andrews, 03/29/08; *Wall Street Journal*, Damian Paletta, 03/29/08; *Wall Street Journal*, Damian Paletta and Kara Scannell, 03/21/08)

#### Chairman Frank calls for significant changes in the regulation of the financial services industry

- In a March 20<sup>th</sup> speech, House Financial Services chairman Barney Frank (D-MA) said that a new era of business regulation is needed to prevent the excesses that created the subprime mortgage crisis and restore confidence in the financial markets. "We now see a situation that more damage was done by inadequate regulation," said Frank. "What we have is a systemic problem, and that's what we want to address." First, Frank urged Congress to consider establishing a Financial Services Risk Regulator who would be responsible for assessing risks in the financial market and would act to limit risky practices and to protect the integrity of the financial system. Second, Frank urged Congress to consolidate the regulatory system designed to monitor the financial services industry to eliminate duplicative oversight and reassess the industry's capital, margin and leverage requirements. Finally, Frank urged Congress to pass legislation he has introduced to provide at least \$10 billion in loans to states to address the foreclosure crisis and expand FHA loan program to refinance at-risk borrowers into viable mortgages. (*House Financial Services Press Release*, 03/20/08; *InfoBytes*, Buckley Kolar LLP, 03/28/08; *Boston Globe*, Robert Gavin, 03/21/08)
- In the March 27<sup>th</sup> edition of the *Wall Street Journal*, Allan H. Meltzer wrote, "...[House Financial Services Committee Chairman Barney] Frank and Senate Banking Committee Chairman Christopher Dodd are planning more schemes to move the risk [of risky mortgage loans] to the taxpayers from those who made bad decisions, such as buying mortgages that are now in default. As a result, ordinary citizens will ask themselves: Why should I pay my mortgage if my neighbors can get theirs reduced? These proposals have stark long-term consequences. The financial system cannot survive if the bankers make the profits and the taxpayers take the losses. The government has a responsibility to prevent systemic crises and financial collapse. Long ago that job was given to the Federal Reserve. It serves as lender of

last resort to the market. Today, the Fed should not rescue individual firms, but it must keep the payments system from failing. To carry out that responsibility, the Fed has auctioned reserves and exchanged marketable Treasury bills for illiquid mortgages, and it has succeeded so far. Now, it must stop responding to calls for lower interest rates. If the government underwrites all the risks, call it socialism. If it underwrites only the failures, call it foolishness.” (*Wall Street Journal*, Alan H. Meltzer, 03/27/08)

We’re living in desperate times, which require “decisive action and creative leadership”

- According to March 26<sup>th</sup> letters sent to relevant parties by leadership of the Senate Banking Committee and Senate Finance Committee, lawmakers are probing the extraordinary role played by the federal government in facilitating JPMorgan’s buyout of Bear Stearns Cos. Inc. Senate Banking Committee chairman Chris Dodd (D-CT) has scheduled an April 3<sup>rd</sup> hearing to address the financial market turmoil and government’s efforts to deal with it. “While it is imperative to maintain the orderly structure of our markets, the sale agreement between JPMorgan Chase and Bear Stearns raises serious public policy questions regarding the role played by the Federal Reserve, Treasury, and Securities and Exchange Commission as facilitators of this agreement,” said Dodd. Finance Committee chairman Max Baucus (D-MT) and ranking member Charles Grassley (R-IA) are looking into the matter as well. “Economic times are tight on Main Street as well as on Wall Street, and we have a responsibility to all taxpayers to review the details of this deal,” said Baucus. Grassley said that Congress must determine whether taxpayers will lose money on the transaction, examine the precedent set for federal involvement with other overextended financial firms, explore the arrangement’s impact on the marketplace in other ways, and determine whether top executives will fare better than employees not privy to the negotiations. (*Bureau of National Affairs*, Aaron Lorenzo, 03/27/08)
- In a March 28<sup>th</sup> commentary in the *Washington Post*, Steven Pearlstein wrote, “Well, isn’t this rich: [Senators] Max Baucus of Montana and Chuck Grassley of Iowa, chairman and ranking member, respectively, of the Senate Finance Committee are suddenly in a lather that taxpayer funds might be implicated in the Federal Reserve’s rescue of Bear Stearns. Would that be the same Max Baucus and Chuck Grassley who have made careers out of protecting and enhancing the lavish system of import restrictions, price supports and other subsidies that have transformed American farming and ranching into a vast socialist enterprise? You betcha.”
- “Whatever you want to say about the sharpies on Wall Street, they are pikers compared to Max’s and Chuck’s friends down on the farm when it comes to picking the pockets of taxpayers and consumers, or concocting a system in which the farmers get all the gains while the government assumes most of the risk. In case you hadn’t noticed, this last year has been a banner one for farmers, thanks to bountiful harvests and record commodity prices. The average farm household income in 2006 was \$77,654, or about 17 percent higher than the average for nonfarm households. And next year, that’s expected to rise [15.9%] to \$90,000.”

- “But for Max and Chuck, that’s no reason to cut back on farm socialism. No siree. Farmers are expected to pull in \$13 billion in federal subsidies this year. And there will be plenty more once Congress gets around to passing a new five-year farm bill later this spring. In fact, the big concern out in farm country these days is that rapidly rising commodity prices are putting the financial squeeze on ethanol plants and grain elevators. It’s probably only a matter of time before Max and Chuck weigh in with ‘emergency’ legislation providing government loans to these cash-strapped operations, just like the Fed is doing with the investment banks. Only unlike the Bear Stearns shareholders, you can be sure that the farmers who own these businesses won’t lose a dime.”
- “Seriously, folks, this isn’t the time for members of Congress to come sauntering back from another of their vacations and begin second-guessing the battlefield judgments of Fed and Treasury officials who have been working day and night to prevent a meltdown in global financial markets. Despite the bleating from Capitol Hill, there really isn’t much ‘taxpayer money’ at risk in the Bear Stearns deal, in the way most of us understand that term. While the Fed is certainly a government entity, it has about \$800 billion in assets on its balance sheet—Treasury bonds and gold, mostly—along with the power to print as many dollars as it needs or deems appropriate. Its recent interventions into the workings of financial markets have certainly been extraordinary, and carry serious, long-term consequences for inflation and moral hazard. But ‘cost to taxpayers’ ought to be well down on anyone’s list of worries.”
- ... [T]hese are not normal times. They are desperate times that require decisive action and creative leadership of the sort already demonstrated by the Fed, the Treasury and [House Financial Services Chairman] Frank. But most of all they require Max, Chuck and other members of Congress to put aside their grandstanding, their petty prerogatives and their partisan bickering and demonstrate a quality that’s been sorely lacking in Washington in recent years—a capacity for enlightened and constructive followship.” (*Washington Post*, Steven Pearlstein, 03/28/08)

The housing GSEs are called upon to provide liquidity to the mortgage market:

OFHEO eases the GSEs’ surplus capital requirements, freeing up \$200 billion in liquidity for mortgage loans

The Federal Housing Finance Board authorizes the FHLBs to purchase \$150 billion of agency mortgage-backed securities

The housing GSEs are called upon to provide liquidity to the mortgage market

- The Bush administration sent in the cavalry to combat the liquidity crisis in the credit and housing markets, unleashing government-sponsored entities to buy and hold

mortgage-backed securities for which there has been little private market demand. The move marks a new stage in the administration's policy response to the credit crisis in which the federal government has increasingly deployed all of the tools at its disposal, short of outright public purchase of mortgage-backed securities, in an effort to prevent a full-blown freeze of the agency market. According to JPMorgan economist Michael Feroli, the expanded roles of Fannie Mae and Freddie Mac to sustain the flow of funds in the housing market marks the "socialization of housing finance in the United States." A number of analysts believe that unleashing the GSEs indicates that the U.S. is willing to deploy an increasingly broad-based and unorthodox set of policies to fight the credit crisis. "The government of last resort is working with the lender of last resort to shore up the housing and credit markets to avoid Great Depression 2," said Ed Yardeni of Yardeni Associates. "I think the federal government and the Federal Reserve will succeed." (*Financial Times*, Joanna Chung, Krishna Guha and Gillian Tett, 03/27/08)

#### OFHEO eases the GSEs' surplus capital requirements, freeing up \$200 billion in liquidity for mortgage loans

- On March 19<sup>th</sup>, OFHEO relaxed its longstanding 30% capital surplus requirement for Fannie Mae and Freddie Mac, which could free up an additional \$200 billion in liquidity for mortgage loans and allow the GSEs to buy or guarantee about \$2 trillion in mortgages this year. The regulator's move came after the Federal Reserve's emergency actions of making \$200 billion in Treasury securities available to bond dealers in exchange for mortgage-backed securities and facilitating the sale of Bear Stearns to JPMorgan in order to prevent Bear's bankruptcy. Discussions that led to OFHEO's actions included officials from the Treasury Department and the Federal Reserve. Since the regulator's action was not accompanied by any written agreement with the GSEs, Fannie and Freddie are not explicitly obligated to invest their increased capacity in any specific manner. In exchange, the GSEs have promised to raise "significant capital" from investors in the future, but neither company spelled out how much money they might raise or when they planned to raise it. OFHEO director James B. Lockhart, III said that the amount of capital that the GSEs plan to raise will be "significant [but] we haven't agreed to any numbers." He told *Bloomberg News* that the GSEs could raise as much as \$20 billion—"That's the top end of the range," Lockhart added. "There's no specific number. There was a range of numbers. The best way is to say it's significant." Lockhart said that the GSEs must raise additional capital—in the form of common shares, preferred share, or convertible preferred shares—before he will approve any further reduction in their capital requirements. According to the news release, OFHEO said that Fannie and Freddie "have renewed a shared commitment" to work toward passage of GSE regulatory reform. According to a source, the "renewed commitment" language was inserted at the end of the negotiating process and isn't backed by any specific pledges that the GSEs will change their positions.

- In announcing its decision to reduce the capital surplus from 30% to 20%, OFHEO acknowledged that Fannie Mae has complied with all of the provisions mandated by its 2004 Consent Agreement and Freddie Mac had two requirements yet to accomplish—separating its chairman and CEO positions and registering the company with the SEC. Lockhart said that Freddie Mac is likely to meet the remaining two requirements by midyear. “They are well on their way to replacing the CEO,” he said during an interview with *Bloomberg News*. “They have a search underway, so there’re making good progress on that. And there will be a splitting of the duties come summer.” At a news conference, Lockhart dismissed speculation that one or both of the GSEs would require a federal government bailout, calling such talk “nonsense.” Lockhart said that both Fannie and Freddie are financially safe and sound and he pledged to supervise the companies with vigilance and “act quickly to address any deficiencies that may arise.” Lockhart added, “The actions we’re taking today make the idea of a bailout nonsense in my mind. The companies are safe and sound, and they will continue to be safe and sound. ...From our standpoint, we wouldn’t have done this if we felt they didn’t have all the procedures and controls in place in risk management. It’s an important time to do this.”
- Treasury Secretary Henry Paulson said, “Fannie Mae and Freddie Mac are significant participants in the mortgage market and I am encouraged that today’s announcement will make more financing available in this area. Additional capital will enable the companies to help more homeowners and will strengthen the underlying fundamentals of the mortgage market. [OFHEO’s] announcement also reaffirms the commitment of all parties to work toward comprehensive GSE reform legislation as soon as possible. I look forward to working with Director Lockhart, Congress and the GSEs on this important legislation.”
- Fannie Mae and Freddie Mac welcomed OFHEO’s decision to lower their capital requirements. “By reducing our ...capital surplus..., this plan will enable Fannie Mae to harness about \$3 billion in additional capital to stand ready to purchase and guaranty mortgage assets,” said Fannie Mae president and CEO Daniel Mudd. “These additional activities will help us fulfill our Congressionally chartered mission to put private enterprise to work to promote stability, liquidity and affordability in the housing finance system in all cycles, good and bad. We plan to harness this additional capital by making purchases in segments of the mortgage market where liquidity is needed most. These segments include affordable loans; loans that refinance borrowers out of subprime [adjustable-rate mortgages] and into safer prime, fixed-rate products; jumbo-conforming loans; and multifamily mortgages that finance affordable rental housing. More broadly, we will purchase and guaranty additional conventional, conforming mortgage-backed securities to help keep mortgage rates down and ensure stability in the center of the market.”
- Freddie Mac chairman and CEO Richard Syron said, “The recent environment demonstrates the benefits of the GSEs to the U.S. economy. This approach allows us to continue to create these benefits in a way that balances our mission to provide

stability, liquidity, and affordability consistent with safety and soundness while enhancing the interests of shareholders.” Syron added, “We will deliver.”

- Senate Banking Committee chairman Chris Dodd (D-CT) issued a statement voicing his approval of OFHEO’s actions. “This is a balanced agreement because it allows Freddie Mac and Fannie Mae to play an immediate role in restoring liquidity and confidence to the mortgage markets, while ensuring they will be able to sustain the effort in the longer run by requiring them to raise additional capital. I expect the two companies to use the capital not only to help the markets generally, but also to help subprime borrowers in a much more focused manner.” Senator Chuck Schumer (D-NY) said, “One of the most important components to reducing the number of foreclosures is giving more flexibility to Fannie and Freddie. So this is a major step forward that should help mitigate the spread of foreclosures and provide some relief to the credit markets in general.” Senator Mel Martinez (R-CA), a member of the Senate Banking Committee, said, “I think [reducing the GSEs’ capital requirements] is a huge gamble on the backs of the U.S. Treasury.”
- Howard Glaser, a mortgage industry consultant and senior HUD official in the Clinton administration., said, “It’s a great move, but it’s a year or two late. When it comes to [the mortgage industry], all roads have to run through Fannie and Freddie, and OFHEO caught up with that reality today.” Glaser said that OFHEO’s decision will help Fannie and Freddie carry out their intended function of assuring a strong secondary market and ultimately help reduce the cost of mortgages for consumers. The reduced capital requirements for the GSEs “will help stabilize the markets and narrow spreads,” said Glaser. “That means the full value of the rate decreases may be passed along to consumers. It could mean a reduction of a quarter to a half point in the interest rate for a mortgage.” Jim Vogel, the head of fixed-income research at FTN Financial Capital Markets, said OFHEO’s action signals a shift away from fighting over the GSEs’ regulatory structure to a focus on shoring up the housing market. “This is part of the multi-step process... to get more proactive on what’s happening in housing finance,” said Vogel. “It means we are no longer discussing the finer points of regulatory schemes. We are moving forward.”
- Jerry Howard, EVP of the National Association of Homebuilders, said, “While we appreciate [OFHEO’s] action, it falls short of providing the liquidity required to stabilize today’s credit-squeezed mortgage market. We were expecting a much bolder step by OFHEO, with a greater reduction in the capital surcharge in light of the severity of the mortgage credit crunch. To get the most mileage out of these additional funds, Fannie Mae and Freddie Mac must target borrowers who have been shut out of the mortgage market by the financial sector meltdown. This action is a partial step to getting Fannie Mae and Freddie Mac back on the road to meeting their housing mission. Developing a proper balance between their housing mission and the interests of their stockholders is a key provision of the pending GSE regulatory reform legislation, which further underscores the urgent need for quick Senate action on the bill.”

- Critics expressed concern that if the mortgage market continues to decline, Fannie's and Freddie's expanded investment in the mortgage market could put the companies on less than sure footings and ultimately require a huge taxpayer bailout. Thomas H. Stanton, an expert on GSEs who teaches a course on credit risk at Johns Hopkins University, said, "I think it's very dangerous and it's a sign that people are very frightened. At a time in which finance companies are holding questionable assets and facing losses, regulators typically require more capital, not less." Dan Alpert, managing partner of Westwood Capital, said, "Washington believes this is a liquidity crisis. But this is a credit crisis brought on by the falling value of underlying housing assets." Josh Rosner, managing director at Graham Fisher, said, "This will make a psychological difference in the short term, but the agencies are not going to be very aggressive—they have become very risk averse from a credit perspective." In a research note, Rosner wrote, "Within the past 48 hours we have seen the administration decide to throw out all the rules in the rulebook in an attempt to stabilize markets and reduce the risk of systemic contagion. While this approach will fuel optimism in the near term, longer term we expect the OFHEO action and other recent actions to date to fail to achieve their goals. We also expect that the GSEs will use the extra capital to try and grow their way out of their problems by playing the spread instead of doing significantly more business in the higher-credit risk markets."
- "Fannie Mae and Freddie Mac need to bolster their capital now to cover losses through their own portfolios," said Joseph Mason, an associate professor of finance at Drexel University's LeBow College of Business. Peter Wallison, a fellow at the American Enterprise Institute, said the GSEs' reduced capital requirements was risky, given the growing losses at both GSEs. "What doesn't make sense to me is encouraging them to take additional risk when they are already in weak financial condition and suffered losses in two consecutive quarters," said Wallison. Mason expressed doubt that Fannie and Freddie would lend in any mortgage markets which might deepen their losses. "Just like any other investor, they don't want the private paper that's already out there, because they don't have any better information than anyone else about the quality of that paper," said Mason. "This is where ... [the GSEs] quit working for government ends and start working for their shareholders."
- In a recent analyst report, Friedman Billings Ramsey said that the GSEs would need to raise about \$20 billion each to reverse the de-leveraging trend that is occurring in the marketplace, while the banking system would need \$200 billion to \$250 billion. In a note on financial strategy, the firm also said that financial equities will continue to experience downward pressure until fresh capital comes into the system. More significant dividend cuts will also be necessary to bolster the industry's capital level. Friedman Billings does not expect the markets to return to normal until late 2009 or early 2010.
- At *24/7 Wall Street*, Douglas McIntyre wrote, "...Even in this day and age of multi-billion bail-outs, [a \$20 billion equity offering by each GSE] is a lot of money. The companies will have to sell stock or bonds to raise capital. That may push their share prices down again because of dilution. The federal government probably does not

want foreign capital to fund the new requirements. So, who does that leave? Fannie and Freddie could price the securities at such a low point that pension funds and hedge funds might come into a deal. But, Freddie Mac's market cap is already below \$17 billion. Putting another, say \$7 billion into the company could take the firm's share price down to well below \$15. It has a 52-week high of over \$68. The need of the government to solve the housing crisis is acute. Improving the balance sheets of the two companies so that they can do more to help homeowners is probably absolutely necessary to help fix the most critical crisis facing the economy. But, should common shareholders be taken down to almost nothing in the process?"

- In a recent report published by UBS Investment Research, analysts wrote, "As we have looked critically at [Fannie and Freddie], it is clear that there is a conflict between their mission — to guarantee as many mortgages as they can to keep the housing market from going into freefall — and the fact that they are thinly capitalized." Although the companies are currently sitting on \$7.1 billion in excess capital each, the GSEs face "multi-faceted" losses from their exposure to mortgage insurers, continued expansion of their guarantee business, and potential mark-to-market losses within each firm's retained portfolio, said UBS. For example, the fair value of Fannie's exposure to mortgage insurers — estimated by the company to total \$4.6 billion in the fourth quarter — represents more than half of its excess capital. UBS analysts estimated that, net of fourth quarter write-downs already on the books, Freddie Mac could face as much as \$30 billion in write-downs in the first quarter of 2008. And Fannie Mae faces a possible \$15.5 billion in write-downs. The impact of these write-downs on regulatory capital would depend on whether a given security is likely to take a principal loss. [And, Fannie and Freddie are heavily hedged against such losses, as well.] UBS analysts concluded that the fact that those losses are there at all likely means neither Fannie nor Freddie will be rushing out to buy up non-agency paper.
- Early signs in the mortgage market were favorable concerning OFHEO's action with 30-year mortgage rates falling 0.125% and the gap between Treasury securities and agency bonds shrinking to around 2.78% [from a high of 3.68% on March 6<sup>th</sup>] on the day of the regulator's announcement said Vogel. Moreover, the stock prices for Fannie and Freddie rose 8.8% and 15%, respectively on the day of the announcement. (*Wall Street Journal*, Damian Paletta and James Hagerty, 03/20/08; *American Banker*, Steven Sloan, 03/20/08; *Financial Times*, Saskia Scholtes, 03/19/08; *New York Times*, Stephen Labaton, 03/20/08; *Bureau of National Affairs*, Richard Cowden, 03/20/08; *Washington Post*, David S. Hilzenrath, 03/02/08; *Reuters*, 03/17/08; *Treasury Department Press Release*, 03/19/08; *National Association of Homebuilders Press Release*, 03/19/08; *MarketWatch*, Robert Schroeder, 03/19/08; *Associated Press*, 03/19/08; *Housing Wire*, Paul Jackson, 03/21/08; *Bloomberg News*, Dawn Kopecki, 03/28/08; *24/7 Wall Street*, Douglas McIntyre)
- In a March 21<sup>st</sup> editorial, *The Washington Post* wrote, "To understand Wednesday's decision by federal regulators to let Fannie Mae and Freddie Mac set aside less cash to protect against losses, imagine a family that keeps its precious antique silver in a

strongbox on a high shelf, beyond easy reach. The regulators have essentially authorized Fannie and Freddie to pawn some of their family silver. Currently, the two ...GSEs have combined reserves of \$82 billion. This includes an extra amount that [OFHEO] required them to hold while they got their books in order after accounting scandals. Now it is reducing that extra cushion by \$5.8 billion. The newly freed-up money will leverage the purchase and securitization of up to \$200 billion in home loans.”

- “The point, however, is not to save Fannie and Freddie themselves but to use the two firms, which buy mortgages and resell bunches of them to investors in the form of bonds, to ease the difficulties of borrowers more generally. It’s as if our hypothetical family pawned its silver to help the neighbors out of a financial jam. Scouring the federal government’s sphere of influence for every drop of cash that could improve liquidity for securities markets, the Federal Reserve Board and the Treasury Department have prevailed upon OFHEO to release some of Fannie and Freddie’s pent-up capacity. The move is of a piece with other recent Fed actions, including its offer to accept Fannie and Freddie’s mortgage-backed securities and other bonds as collateral for up to \$200 billion in new loans to banks, and its decision to lend to investment banks.”
- “This is risky. If all goes well, freeing up the GSEs will buoy mortgage lending, thus slowing or reversing the slide in housing prices—which is at the root of the credit crunch. But if housing continues to tank, and the GSEs rack up new multi-billion-dollar losses on top of those they have already incurred in recent months, they will have that much less in reserve to fall back on. The GSEs enjoy an implicit federal guarantee, but reducing their capital for a purpose such as this, at a time such as this, goes a fair way toward making that bailout promise an explicit one.”
- “OFHEO says that GSEs are back on a sound financial footing and that the risks can be mitigated by Fannie and Freddie’s promise of a ‘significant’ voluntary increase in their capital. That promise must be kept. **Even more important is for Congress to revamp and fortify OFHEO.** [Emphasis added.] The GSEs’ regulator needs authority to set capital requirements commensurate with the GSEs’ huge role in the mortgage markets and unique, quasi-governmental status. A bipartisan bill has been adopted by the House but has languished in the Senate. Strong reform of government-sponsored enterprises is vital to ensuring that the risks the firms have just been allowed to assume, in an emergency, will not threaten their safety and soundness—or that of the wider economy.” (*The Washington Post*, 03/21/08)
- In a March 26<sup>th</sup> editorial, *The Los Angeles Times* wrote, “When real estate values were rising, would-be buyers had to hope they weren’t investing at the market’s peak and paying more for a house than it would be worth in a year. Now, with values plunging, the question is how much further prices will fall before they start to recover. The risk of jumping too early into a crashing market is the same as arriving too late to a hot one. You don’t have to be shopping for a new house to face this risk. You just have to be a taxpayer.”

- “Last week, federal regulators allowed ... Fannie Mae and Freddie Mac to increase their bets on the slumping U.S. real estate market. The Office of Federal Housing Enterprise Oversight lowered the amount that the two firms must hold in reserve in case of losses, enabling them to buy an additional \$200 billion worth of mortgages with the money they already have. The firms pledged to raise more cash, which they would use to buy or guarantee even more mortgages. They also promised to support tougher regulation and other reforms sought by the oversight office...”
- “The firms’ expansion would pump more money into lenders’ hands, making it easier for consumers to obtain mortgages or refinance homes. Fannie Mae and Freddie Mac were created to provide just that sort of boost to homeownership. (The firms are publicly traded companies but have a line of credit from the Treasury.) Serious accounting and managerial problems at the firms, however, led the oversight office to clamp down four years ago. Its fear was that if the firms stumbled, taxpayers would be forced to bail them out. The mortgages they own or guarantee are worth about \$5.1 trillion, or almost twice as much as the entire federal government spent in fiscal 2007. And unless the market stops sliding -- year-over-year values dropped 11% in January—an increasing number of those homes will be worth less than the amount owed on their mortgages.”
- “Defenders of Fannie Mae and Freddie Mac say that they’ve minimized their risks by avoiding sub-prime loans and other housing market minefields. All the same, Fannie Mae lost billion \$2.1 last year, and Freddie Mac \$3.1 billion. Fannie Mae also has been saddled with a growing number of repossessed homes—more than 33,000 at the end of last year, compared with about 25,000 the year before. **As the firms expand, the least Congress can do is approve the tougher controls sought by their regulators.**” [Emphasis added.] (*The Los Angeles Times*, 03/26/08)
- In a March 20<sup>th</sup> editorial, the *Wall Street Journal* wrote, “How do you turn \$5.9 billion into \$200 billion overnight? By magic. Political magic in the case of Fannie Mae and Freddie Mac—due to their status as publicly traded private companies back-stopped by taxpayer guarantees. ... Fannie and Freddie announced, alongside their chief regulator Jim Lockhart that they would be leveraging up their businesses in the name of riding to the rescue of the mortgage-backed securities market. ... In exchange for this freedom, Fan and Fred have promised to raise ‘significant’ new capital over the next year. We’re told it’s on the order of \$10 billion each. That’s the good news. The bad news is that the companies can leverage any new capital right alongside the old, meaning that the total increase in business—and risk—could be well above the \$200 billion set by Mr. Lockhart.”
- “The oddest argument is that Fan and Fred need to be unleashed to help the mortgage market. That’s what they were supposed to be doing all along, yet so far in this crisis they have themselves become sources of systemic financial fear. After taking big losses in last year’s fourth quarter, investors and counterparties have become nervous that Fan and Fred might face solvency problems similar to those of other mortgage

players. Their refinancing ‘spreads’—the price of their paper—have periodically blown out nearly as far as everybody else’s on Wall Street. This isn’t supposed to happen. The two companies are chartered to liquify the mortgage market, especially at the lower-income end. But of course the low end isn’t where the money is if you are a publicly traded company whose executives need to enhance shareholder value. Thus in this crisis, Fan and Fred have both so far been hunkering down, often not even buying back their own mortgage-backed paper. What good are quasi-socialists if they won’t act like socialists in a capitalist crisis?”

- “[March 19<sup>th</sup>’s] capital expansion merely lets the companies continue their double lives as profitmaking companies backed by taxpayer guarantees—and to do so by taking even greater risk at a very risky time. No wonder their stock prices are up by more than a third in a week... If the politicians really want to double-down on Fan and Fred, the honest way to do it is to provide them the taxpayer money up front.”
- “Here’s one idea: How about issuing the companies some subordinated debt, with an option to convert that paper into Fannie and Freddie stock down the road? Fan and Fred would get the money to return to the mortgage markets, but once the crisis ends at least the taxpayers would get some upside from the risk they are taking now. Yes, this amounts to a form of nationalization, but at least it’s honest socialism. As it stands now, Fannie and Freddie get to gear back up, and if they get into deeper trouble because housing prices keep falling, the taxpayers pick up the tab. If the crisis ends, Fan and Fred’s private shareholders get all the upside and their executives get even richer than they are. If Washington wants to socialize the housing market—as it seems eager to do—let’s do it in the open and put Fannie’s debt on the federal budget so taxpayers can see what they’re buying.”
- “Of course, the last thing Congress wants is all of this to be transparent. The Members benefit from the current private-public confidence game because the two companies ladle them with campaign contributions to protect their privileged status. That’s why Congress continues to dither over reforms that might actually provide a regulator capable of staring down Fan and Fred. With a couple of brave exceptions (Mr. Lockhart, Alabama Senator Richard Shelby), Fannie and Freddie own Washington. It’d be better for the housing markets and taxpayers if Washington finally admitted it and bought Fannie and Freddie.” (*Wall Street Journal*, 03/20/08)

The Federal Housing Finance Board authorizes the FHLBs to purchase \$150 billion of agency mortgage-backed securities

- On March 24<sup>th</sup>, the Federal Housing Finance Board authorized a temporary increase in the FHLBs’ purchase of \$150 billion mortgage backed securities guaranteed by Fannie Mae or Freddie Mac, as part of a government effort to expand the liquidity of the agency market. Specifically, the Finance Board increased the limit on the FHLBs’ investments from six times capital for a two-year period, up from three times capital, which would increase the Banks’ investments by “well in excess” of \$100

billion. The new authority is limited to Fannie Mae and Freddie Mac mortgage-backed securities which are back by loans originated after January 1<sup>st</sup> and comply with the federal bank regulators' guidance on nontraditional and subprime mortgages. The FHLBs must notify the Finance Board before their first acquisition under their new authority. Each Bank must include in the notification a description of the risk management steps taken to support the underlying purchases. Finance Board chairman Ronald Rosenfeld said, "The Federal Home Loan Bank System plays a vital role in helping to finance homeownership and strengthening the economy at large. Increasing the agency MBS investment authority for the banks is another way in which the system can perform its traditional mission." Finance Board member Allan Mendelowitz said, "The whole [mortgage] system was at risk of grinding to a halt. If there was ever a time for us to act, this is it." Treasury Secretary Henry Paulson said, "The targeted decision by the Federal Housing Finance Board to enable the Federal Home Loan Banks to assist temporarily in this period of stress, consistent with safe and sound operations, will bring more liquidity to the mortgage market."

- "It's an opportunity for the Federal Home Loan Banks to supply more liquidity to the secondary markets," said John von Seggern, president of the Council of Federal Home Loan Banks. "I think that's a good thing and the market needs to get that liquidity as soon as possible."
- National Association of Homebuilders' president and EVP Jerry Howard applauded the Finance Board's actions. Howard said, "This prudent action to allow the [FHLBs] to double their holdings of agency mortgage-backed securities for a two-year period will help to alleviate the mortgage credit crunch by potentially injecting more than \$100 billion into the MBS market." Howard also urged Congress to act quickly to enact FHA reform and comprehensive GSE regulatory reform legislation. "A revitalized FHA will be well-positioned to provide reasonably-priced, low-downpayment mortgage solutions to millions of home owners and potential home buyers," said Howard. "Full GSE reform for Fannie Mae and Freddie Mac will enable these financial institutions to greatly relieve liquidity and inventory pressures in the mortgage credit markets."
- However, some FHLBs may be reluctant to expand their investment in agency bonds. For example, Alfred DelliBovi, president of the FHLB-New York, said his bank hasn't been buying many mortgage bonds because they haven't been giving "a return that justifies the [exposure to interest rate] risk." He added, "It's no secret that we haven't been able to find enough mortgages to get to three times capital in the last couple of years."
- Paul Miller, a bank analyst at Friedman Billings Ramsey, said, "I'm a little concerned about everything the federal government's doing because it's taking on more credit risk and bailing out people's risky behavior. The [FHLBs] have been notoriously bad managers of interest rate risk." (*Bloomberg News*, Dawn Kopecki and Jody Shenn, 03/24/08; *National Association of Homebuilders Press Release*, 03/24/08; *Treasury Department Press Release*, 03/24/08; *American Banker*, Rob Blackwell, 03/25/08;

*Bureau of National Affairs*, Richard Cowden, 03/25/08; *Wall Street Journal*, James R. Hagerty, 03/25/08)

OFHEO keeps GSE conforming loan limit capped at \$417,000  
for the foreseeable future

- On March 26<sup>th</sup>, OFHEO issued a final guidance, assuring that the nominal limit on the value of mortgages eligible for purchase by Fannie Mae and Freddie Mac will remain unchanged at \$417,000 [in markets not classified as high cost areas] for “2009 and subsequent years.” OFHEO director James B. Lockhart, III said, “This revised Guidance responds to the comments that we received and OFHEO’s belief that stability in the mortgage market is very important. Not decreasing the limit will eliminate potential operational and implementation issues. This announcement has no impact on the temporary increase in the conforming loan limit for high cost areas recently established in The Recovery Rebates and Economic Stimulus for the American People Act of 2008, which expires on December 31, 2008.” (*Bureau of National Affairs*, Richard Cowden, 03/27/08)

HUD Secretary Alphonso Jackson resigns

- In a brief statement, HUD Secretary Alphonso Jackson resigned his post on March 31<sup>st</sup>. Jackson said, “There are times when one must attend more diligently to personal and family matters. Now is such a time for me.” Jackson, 62, has been under investigation by the Justice Department and HUD’s inspector general concerning allegations that he gave lucrative housing contracts to friends. Recently, the FBI interviewed several of his employees. Congressional relations with Jackson have become fractious in recent months, with lawmakers openly criticizing his leadership and Senators Christopher Dodd (D-CT) and Patty Murray (D-WA) recently calling for Jackson to resign. (*New York Times*, 03/31/08; *Bureau of National Affairs*, Richard Cowden, 03/24/08)

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

Congress gears up for a wide-ranging government response to the mortgage crisis:

Bankruptcy provision remains the “main sticking point”

for passage of a Senate housing assistance bill

The financial services industry is “cautiously positive” over the Democrats’ refi proposal

Chairman Dodd seeks a foreclosure prevention mandate for Fannie and Freddie

House Financial Services Committee schedules April 9th hearing on the FHA

Treasury Secretary Paulson urges Congress to pass FHA and GSE reform

Congress gears up for a wide-ranging government response to the mortgage crisis:

- When Congress returns to Capitol Hill in April, the Senate plans to take up a broad housing bill sponsored by Democratic leaders, which will likely include tax relief for home builders and increased funding for mortgage counseling. In February, Senate Republicans blocked debate on the Democratic bill on a procedural vote of 48-46, largely because of a bankruptcy provision that would have allowed bankruptcy judges to modify the terms of certain mortgages. Democratic leaders quickly seized on the Bush administration’s bailout of Bear Stearn to press their case for a bailout for troubled homeowners. Senate Majority Leader Harry Reid (D-NV) said that President Bush “has shown his willingness to bail out Wall Street at taxpayer expense” but has done nothing for the troubled homeowner. Senator Charles Schumer (D-NY) argued, “The little homeowner who got duped by the mortgage lender deserves no less than the Bear Stearns investor.”
- Republicans are expected to renew their push for passage of three key legislative proposals, including (1) a \$15,000 three-year tax credit for purchasing homes in or near to foreclosure; (2) GSE regulatory reform legislation; and (3) FHA reform legislation. The Bush administration remains opposed to the idea of a tax credit for home purchases, saying it prefers that lawmakers act quickly on other proposals [for FHA reform and GSE regulatory reform] that are languishing in Congress. However, pressure may grow on the administration to revisit this idea, which is especially popular among Senate Republicans. On March 27<sup>th</sup>, Republican aides circulated a survey by *Rasmussen Reports*, showing 53% of the public thinks that the government shouldn’t help homeowners who borrowed more than they could afford, while 67% of Republicans polled said that they opposed such assistance. (*Investors Business Daily*,

Jed Graham, 03/24/08; *Wall Street Journal*, 03/24/08; *Wall Street Journal*, Greg Hitt, 03/22/08; *CQ Today*, Benton Ives, Kathleen Hunter, and Libby George 03/28/08)

- In the March 21<sup>st</sup> *Wall Street Journal*, Kimberly Strassel wrote, "...Democrats, who are now claiming that if the White House is worried enough to prop up Wall Street, it has a downright obligation to prop up Main Street. Presumably Mr. Frank wants a better deal for homeowners than what got handed to Bear Stearns shareholders, but never mind. To its credit, the White House has so far resisted. It batted down a proposal to have the government buy housing stock, on the correct grounds that the market needs to clear itself. It promised a veto of changes in bankruptcy law, on the correct grounds that this would drive up interest rates for future borrowers. In an interview with CNBC's Larry Kudlow last week, President Bush put the damper on the latest plan to insure underwater loans, presumably on the correct grounds that anything Mr. Frank came up with was worrisome: 'Listen, I'm open to new ideas, but I'm not open to ideas that'll make it harder for the market to recover. What we need is –for the market to work its way through,' he said."
- "Working in Mr. Bush's favor is that he's right. It was a housing problem that initially kicked off today's housing finance problem, but the two issues remain distinct. All the evidence suggests the housing market itself is on the slow road to correction. Housing prices are sticky, so this will take some time, but eventually the market will clear. Government can only get in the way. The question of struggling mortgage holders meanwhile remains the same today—even with recent financial turmoil—as it did last year when policy makers started worrying about resets and foreclosures. At the time, the administration made a clear distinction between the few individuals who may have been hit with predatory lending—and the vast majority who either speculated or signed up for an unaffordable home. Its solution was a program in which mortgage servicers and lenders would voluntarily reduce or freeze the interest rates of certain subprime borrowers. Workouts are now on the rise, and experts say the worst subprime defaults are over."
- "The White House knows a bailout now would land it back in a briar patch: Who qualifies for help? Since it is impossible to craft legislation that targets only a victimized few, Democrats will cut checks for everyone, which means the White House would be underwriting shoddy financial planning by some middle-class homeowners. This won't sit well with millions of others who went for that boring 30-year fixed, or are working two jobs to make their payments—as their McMansion neighbors sign up for the government-mortgage-dole. A bailout also puts the administration in the unwanted position of favoring yesterday's unwise borrowers over tomorrow's future homeowners. Federal Reserve head Ben Bernanke—not content with simply taking his own institution into weird and uncharted territory—recently piped up in favor of more government mortgage help. His worry was that Americans might walk away from homes that are now worth less than their mortgages. This is the basis of the Frank proposal, which would require lenders to write down loans to match home values as a condition of getting government help."

- “But the only question for policy makers (if there even is one) is whether a borrower can continue to pay the mortgage he has signed up for—whatever the underlying value. If house prices continue to fall, there’s no guarantee homeowners won’t continue to walk away from even government-insured mortgages—leaving taxpayers with the bill. Mr. Frank’s proposal would also be a straight shot to higher fees and interest rates for future borrowers, since lenders will want to bake in the risk that they might again be forced into writedowns. This won’t do much to get people to purchase empty homes.”
- “Democrats are looking for any nod here. If they can get Mr. Bush to agree even in principle to some form of government relief, they can stuff a bill full of other market-gumming restrictions. They can also crow that they pushed the White House into finally helping homeowners. Having failed to get that Bush nod so far, they are ginning up pressure with a whisper campaign suggesting the administration is secretly coming around to a deal. There’s no evidence to suggest that’s true—yet. As Congress returns from Easter break, the focus will pivot to congressional Republicans, in hopes that election nerves will cause enough to bolt to the Democratic plan to bring the White House along.”
- “Mr. Bush has made the broad case for standing back on most congressional proposals, and he’s been right. But until he draws more specific lines on mortgage relief, Democrats will continue to scatter proposals for government rescue across the Capitol, and up the pressure on Republicans to sign up for at least one. ***This is the time to stop the roll.***” [Emphasis added.] (*Wall Street Journal*, Kimberly Strassel, 03/21/08)

Bankruptcy provision remains the “main sticking point” for passage of a Senate housing assistance bill

- The main sticking point for passage for the Senate bill is the bankruptcy provision which Republicans argue would cause the cost of all mortgage loans to increase. Many Democrats view the provision as a top priority, arguing that it would help thousands of borrowers remain in their homes. Majority Leader Harry Reid (D-NV) said that the Senate would again consider the Senate bill, which includes the bankruptcy provision, when members return from the spring recess. “[Republicans] will have to vote on that again,” said Reid. As long as the provision remains in the bill, many observers say that it appears difficult—if not impossible—for the Democratic lawmakers’ legislation to advance. For elements of the bill to pass the Senate, Democrats would likely have to strip out the bankruptcy provision or allow the Senate to allow a vote on the removal of the provision. In turn, Republicans would likely have to assure Democrats that they won’t demand votes on controversial issues, such as extending the Bush tax cuts, in order to introduce some of their own amendments for the housing bill. (*Wall Street Journal*, Sarah Lueck, 03/28/08)
- On March 19<sup>th</sup>, Representative John Conyers, Jr. (D-MI) held a new teleconference on need for Congress to pass the bankruptcy provision to help African-American

homeowners. Conyers said, "...[W]e're at a crucial point when Bear Stearns is receiving \$400 billion of largesse, and these are—I won't say they're the most predatory of the predatory lenders in the subprime meltdown circumstance, but they certainly are way up there at the top. And this is quite an affront, it seems to me. What we're doing ...is that we're putting more helium into a balloon, but we're not fixing the places where there are leaks, and that this problem can continue to recur. This will not fix this thing permanently."

- "And so I think this is a wonderful opportunity to renew the simple proposition passed out of subcommittee number five, Linda Sanchez [D-CA] chairperson, in which we merely changed the bankruptcy rules to allow a rewrite of the mortgage with a cram-down to its original—what its real cost is from what the sale cost was, because ...much of this process across the country is happening when the balances owed on the outstanding mortgage is larger than the value of the home. So the bankruptcy judge, who in many other circumstances can rewrite the mortgage to a 30-[year] new low interest rate, and the homeowners, the families will stay in their homes and try to make the mortgage notes. Now, this costs taxpayers zero. And so all of this quick action on the part of the Bush administration to prop up these companies that pay their CEOs millions of dollars a year, and then turn to us, and then tell the mortgager, who is now frequently unemployed or certainly delinquent in his payments, but he's got to tough it out in a free enterprise system, makes no sense to me. Solution: Let's start—I will write a fifth letter to all of my colleagues, House and Senate, urging them to let's quickly move on a no-cost financial solution that would repair this, instead of this unilateral activity going on by the secretary of treasury and the president of the United States." (*CQ Transcripts*, 03/19/08)

#### The financial services industry is "cautiously positive" about the Democrats' refi proposal

- *The American Banker* reported that the financial services industry is "largely open to an effort by congressional Democrats to set up a government-backed refinancing program to insert a floor under falling home prices." According to drafts of the proposed bills, "underwater" borrowers who cannot afford their loans would be eligible to have their principal balance reduced and net loan amount refinanced into a long-term, fixed-rate mortgage guaranteed by the FHA. "Our initial reaction is cautiously positive because, one, it's voluntary, two, it does not involve changes to the Bankruptcy Code, and, three, it does attempt to put a floor under the housing market," said Floyd Stoner, the American Bankers Association's head lobbyist. "What the holders of mortgages have to evaluate is: Are they better off utilizing this program or going to foreclosure? There are very real downsides for everyone involved in going to foreclosure." Francis Creighton, a lobbyist for the Mortgage Bankers Association, said, "Generally speaking, what our members have been saying is that the structure seems to be something they can work with. The question is how attractive will this option be."

- According to industry representatives, loan servicers would use the Frank-Dodd plan only in instances when the return for investors would be more profitable than foreclosure and that making the plan more attractive to investors could make it available to more borrowers. “The ultimate question for the servicers is are they taking an action that is in the best interest of the pool and maximizing net present value with any loss mitigation action that they take,” said Scott DeFife, a Securities Industry and Financial Markets Association lobbyist. “That’s always the bottom line.” While the industry is interested in coming up with more economically viable options to foreclosure, representatives are still trying to determine if the plan could work, which hinges partly on market projections which vary widely. “Your view of all this is based on what you see happening in the next 12 months,” said DeFife. “Have we hit bottom, or is the bottom yet to come? ...There are differing opinions on how much worse this gets before it starts to get better, so all of your calculations on whether this is ‘the thing’ or not or is based on what you think is going to happen in the next four quarters. [In most cases,] people think this option provides them a better return than foreclosure.” (*American Banker*, Stacy Kaper, 03/28/08)

#### Chairman Dodd seeks a foreclosure prevention mandate for Fannie and Freddie

- In a housing rescue plan drafted by Senate Banking Committee chairman Christopher Dodd (D-CT), Fannie Mae and Freddie Mac would be required to buy mortgages that have been substantially written down and raise capital to cover the risk of these new mortgages. The proposal would suspend the GSEs’ affordable housing mission until 2013 to allow the GSEs to address the foreclosure crisis in the housing market. Under Dodd’s bill, the Treasury Department and HUD would work with OFHEO to “establish an annual goal for the purchase by each enterprise of distressed mortgages for the purpose of assisting the mortgagor of each such mortgage to keep his or her home by restructuring the distressed mortgages.” The regulators would set standards which would balance the goals of mitigating foreclosures and maintaining the GSEs’ safety and soundness. Distressed mortgages purchased by Fannie and Freddie would be restructured in a way that factored in a borrower’s ability to pay, waived prepayment penalties, wiped out subordinate liens, and included a single, 30-year fixed interest rate. Dodd’s proposal also would provide the OFHEO director the power to adjust capital and reserve requirements, including risk-based capital requirements or minimum capital levels “to support the risks that arise from the purchase of such mortgages.” Dodd estimates that his bill would cover refinancing of about \$400 billion of mortgages. (*American Banker*, Stacy Kaper, 03/26/08)

#### House Financial Services Committee schedules April 9<sup>th</sup> hearing on the FHA

- House Financial Services Committee chairman Barney Frank (D-MA) has scheduled an April 9<sup>th</sup> hearing on using FHA for housing stabilization. The hearing will include federal regulators, academics, economists and representatives of cities and communities that are being negatively impacted by high levels of foreclosures. ([http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/HR\\_04\\_09\\_2008.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/HR_04_09_2008.shtml))

## Treasury Secretary Paulson urges Congress to pass FHA and GSE reform

- In a March 26<sup>th</sup> speech to the U.S. Chamber of Commerce’s second annual Capital Markets Summit, Treasury Secretary Henry Paulson exhorted Congress toward speedy passage of the FHA Modernization bill and to make progress on comprehensive GSE reform legislation. “I know Members of Congress have outlined other ideas, but most are not yet ready for the starting gate,” argued Paulson. During a question and answer session, Paulson said, “I’m saying to Congress, ‘Get these [FHA and GSE bills] done.’” The Treasury Secretary added that some of the other ideas that have surfaced in Congress to address current housing woes are “well-intended, but most of the other ideas that I’ve seen would cause more harm than good.” (*Bureau of National Affairs*, Rachel McTague, 03/27/08)

The presidential candidates propose “solutions” to the housing crisis
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- On March 24<sup>th</sup>, Senator Hillary Rodham Clinton (D-NY) outlined a detailed program to remedy the nation’s housing crisis, which called for \$30 billion in assistance to individual homeowners and communities to help resolve the foreclosure crisis and expand the Mortgage Revenue Bond Program by \$10 billion. She also repeated calls for a 90-day moratorium on foreclosures of subprime mortgages and a five-year freeze on interest rate resets. Clinton pledged to support a proposal offered by Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT) to expand the role of FHA into restructuring and refinancing at-risk mortgages. [Senator Barack Obama is a co-sponsor of the legislation.] She also called on President Bush to appoint a “high –level emergency working group,” comprised of two former chairmen to the Federal Reserve—Alan Greenspan and Paul A. Volcker—and former Treasury Secretary Robert E. Rubin, to recommend ways to restructure at-risk mortgages to help avert foreclosures. Clinton said she would introduce legislation soon which would provide mortgage servicers protection from litigation related to mortgage loans that they restructured. In a speech at the University of Pennsylvania, Clinton argued, “Over the past week, we’ve seen unprecedented action to maintain confidence in our credit markets and head off a crisis for Wall Street Banks. It’s now time for equally aggressive action to help families avoid foreclosure and keep communities across this country from spiraling into recession.”
- Clinton also noted her “green” initiatives, saying, “...I’ve even proposed that we establish a ‘Carbon Reduction Mortgage Association’ or a ‘Connie Mae’—an idea that Vice President Gore first came up with. We’d direct Fannie Mae and Freddie Mac to provide loans to help people build more and retrofit more energy efficient homes. We’d save money over the long run. We’d create millions of ‘green collar’ jobs.” (*Wall Street Journal*, Amy Chozick and Nick Timiraos, 03/25/08; *Bureau of National Affairs*, 03/25/08; *New York Times*, Patrick Healy, 03/25/08; *Washington Post*, Anne E. Kornblut and Jon Cohen, 03/25/08; *Hillary Clinton’s Remarks on the Housing Crisis*, 03/24/08; *Associated Press*, 03/24/08)

- Several members of Clinton’s campaign staff have first hand experience in growth and demise of the subprime mortgage industry. Maggie Williams, Clinton’s campaign chairman, received compensation totaling \$200,000 for serving as a director for subprime lender Delta Financial Corp; Williams served on the board from April 2000 until December 2007, when Delta Financial declared bankruptcy. Clinton supporter and former HUD Secretary Henry Cisneros served on Countrywide Financial’s board of directors from 2001 until October 2007, where he grossed more than \$5 million from his sales of Countrywide stock and \$360,000 in salary. In addition, Countrywide hired the crisis-management public-relations firm headed by Mark Penn, the Clinton campaign’s chief strategist to restore its image and employee morale after the lender reported a \$1.2 billion third-quarter loss and announced massive layoffs.” (*Newsday*, Glenn Thrush, 03/29/08; *The Frontrunner*, 03/29/08; *San Antonio Express-News*, Jennifer Hiller, 02/17/08)
- In a March 28<sup>th</sup> wide-ranging speech on the economy, Senator Barack Obama (D-IL) proposed broadening government regulations of the financial markets and expanding the power of the Federal Reserve to oversee investment banks. Obama said that the current regulatory framework for the financial services industry is disjointed and ineffective and called for a more focused, consolidated regulatory regime to better manage risks in the markets. “When subprime-mortgage lending took a reckless and unsustainable turn, a patchwork of regulators were unable or unwilling to protect the American people,” said Obama in a speech at Cooper Union in Manhattan. The Senator’s plan would allow the Fed to set capital and liquidity requirements for investment banking firms that borrow money from the central bank. “When the Fed steps in, it is providing lenders an insurance policy underwritten by the American taxpayer,” said Obama. “In return, taxpayers have every right to expect that these institutions are not taking excessive risks.” He called for the creation of a “financial market oversight commission” to monitor risks to the financial system, based upon the proposals of House Financial Services Committee chairman Barney Frank (D-MA). Previously, Obama had proposed that the federal government provide \$10 billion for an expansion of the mortgage revenue bond program and \$30 billion in individual aid for financially stressed borrowers. (*Wall Street Journal*, Amy Chozick and Damian Paletta, 03/28/08)
- In a March 25<sup>th</sup> speech, Senator John McCain said, “...Let’s start with some straight talk: I will not play election year politics with the housing crisis. I will evaluate everything in terms of whether it might be harmful or helpful to our effort to deal with the crisis we face now. I have always been committed to the principle that it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers. Government assistance to the banking system should be based solely on preventing systemic risk that would endanger the entire financial system and the economy.”
- “In our effort to help deserving homeowners, no assistance should be given to speculators. Any assistance for borrowers should be focused solely on homeowners,

not people who bought houses for speculative purposes, to rent or as second homes. Any assistance must be temporary and must not reward people who were irresponsible at the expense of those who weren't. I will consider any and all proposals based on their cost and benefits. In this crisis, as in all I may face in the future, I will not allow dogma to override common sense.”

- “When we commit taxpayer dollars as assistance, it should be accompanied by reforms that ensure that we never face this problem again. Central to those reforms should be transparency and accountability. Homeowners should be able to understand easily the terms and obligations of a mortgage. In return, they have an obligation to provide truthful financial information and should be subject to penalty if they do not. Lenders who initiate loans should be held accountable for the quality and performance of those loans and strict standards should be required in the lending process. We must have greater transparency in the lending process so that every borrower knows exactly what he is agreeing to and where every lender is required to meet the highest standards of ethical behavior.”
- “Policies should move toward ensuring that homeowners provide a responsible down payment of equity at the initial purchase of a home. I therefore oppose reducing the down payment requirement for FHA mortgages and believe that, as conditions allow, the down payment requirement should be raised. So many homeowners have found themselves owing more than their home is worth, because many never had much equity in the house to begin with. When conditions return to normal, GSEs ...should never insure loans when the homeowner clearly does not have skin in the game.”
- “In financial institutions, there is no substitute for adequate capital to serve as a buffer against losses. Our financial market approach should include encouraging increased capital in financial institutions by removing regulatory, accounting and tax impediments to raising capital.”
- “I am prepared to examine new proposals and evaluate them based on these principals. But I think we need to do two things right away. First, it is time to convene a meeting of the nation’s accounting professionals to discuss the current mark to market accounting systems. We are witnessing an unprecedented situation as banks and investors try to determine the appropriate value of the assets they are holding and there is widespread concern that this approach is exacerbating the credit crunch.”
- “We should also convene a meeting of the nation’s top mortgage lenders. Working together, they should pledge to provide maximum support and help to their cash-strapped, but credit worthy customers. They should pledge to do everything possible to keep families in their homes and businesses growing. Recall that immediately after September 11, 2001 General Motors stepped in to provide 0 percent financing as part of keeping the economy growing. We need a similar response by the mortgage lenders. They’ve been asking the government to help them out. I’m now calling upon them to help their customers, and their nation out. It’s time to help American

families.” (*John McCain Addresses the Orange County Hispanic Small Business Roundtable, 03/25/08*)

- In a March 27<sup>th</sup> editorial, the *Wall Street Journal* wrote, “This week John McCain and Hillary Clinton both used the housing-market upheaval to offer a window on what their Presidencies would look like. The contrast in philosophy and program is something voters should pay attention to. The media coverage of Mr. McCain’s speech has portrayed his approach as laissez-faire, and the Clinton and Barack Obama campaigns quickly assailed it on those grounds. But that’s true only in the sense that Mr. McCain didn’t endorse any vast, new government rescue of bankers or borrowers. If this is laissez-faire, we’ve come a long way from Adam Smith.”
- “The best part of Mr. McCain’s approach is his description of how we got into this mess. He doesn’t merely blame Wall Street or ‘predatory’ lenders, though he does fault both along the way. Instead, he offers a largely accurate description of how the housing and credit bubbles arose, driven by lax lending standards fed by a belief that housing prices could only go up. Then add some financial innovation that is now being stress-tested—and found wanting. The major flaw in this presentation is that it leaves out the Federal Reserve, whose far too easy monetary policy helped to create the subsidy for mortgage and other debt in the first place. But the virtue of Mr. McCain’s overall diagnosis is that it doesn’t treat all borrowers as victims, and instead assumes that everyone shares some responsibility for getting wrapped up in the housing mania. Refreshingly, too, the Arizona Senator framed his policy response around personal accountability for bad choices. He thus rejected one favorite Bush White House-Democratic idea of the moment, which is to lower or drop the downpayment requirement for loans backed by the Federal Housing Administration. As Mr. McCain pointed out, such no-downpayment loans were part of the mania problem. One reason the FHA has fewer subprime problems than private lenders is that its borrowers had skin in the game.”
- “The Senator is less helpful in asking for some grand meeting of mortgage lenders to ‘help their customers and their nation out.’ If he means a willingness to help some borrowers work through their cash shortfalls, then nearly all lenders are already doing that. But Mr. McCain also offered the dubious analogy to General Motors’s 0% financing offer after 9/11. As we recall, GM was offering that to new-car buyers, not to people who already owned their autos. If Mr. McCain is asking lenders to rewrite their mortgage contracts across the board, he’s getting very close to Hillary Clinton-land.”
- “And speaking of that Eden, Mrs. Clinton called this week for ‘immediate, bold’ action ‘to unfreeze our mortgage markets.’ To that end, she would immediately freeze our mortgage markets. She wants a 90-day moratorium on foreclosures coupled with a five-year rate freeze on adjustable-rate mortgages. This would amount to the broadest price controls in the U.S. economy since the Nixon Administration. Mr. Obama has said this abrogation of contracts would do nothing to help the market clear

and would only drive up borrowing costs. For this accurate observation, the Clinton campaign said Mr. Obama was ‘to the right of the Bush Administration.’”

- “Mrs. Clinton’s proposals do at least fit her far simpler analysis of what went wrong in credit markets: Greedy Wall Street, and predatory lenders who made loans that were “designed to fail.” Her remedy is thus to punish lenders and investors, while forgiving and subsidizing borrowers. For example, she’d pour \$30 billion to left-wing special-interest groups like Acorn so they can get out the vote—er, offer counseling and financial aid for distressed borrowers. She has also discovered a lawsuit she doesn’t like—namely, one from investors who might sue for breach of contract if they are unwillingly stuck with principal writedowns on their mortgage-backed securities. At least she admits there is such a thing as a frivolous lawsuit, which seems to be defined as one in which investors sue to thwart her bailout plan. Mrs. Clinton also proposes a curious triumvirate of grey eminences—Paul Volcker, Alan Greenspan and Robert Rubin—to sit down and in three weeks come up with a more comprehensive rescue plan. Yes, this is the same Mr. Rubin who, as chairman of Citigroup’s executive committee, oversaw the bank’s reckless plunge into mortgage risk. And it is the same Mr. Greenspan who opened the liquidity floodgates as Fed Chairman and so helped to inflate the credit bubble. She got it right in choosing Mr. Volcker, but he’s endorsed Mr. Obama.”
- “Mr. McCain can be a little too righteous when he claims he would “not play election-year politics with the housing crisis.” What he does seem to understand, however, is that most Americans are responsible borrowers who don’t want to underwrite the losses of those who aren’t. In that, he is politically smarter than Senators Clinton and Obama.” (*Wall Street Journal*, 03/27/08)

Should Fannie and Freddie be the government’s vehicle to provide financial support to the residential mortgage market?
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- In a March 28<sup>th</sup> appearance on the *Charlie Rose Show*, Paul Volcker, former chairman of the Federal Reserve, discussed the role that Fannie Mae and Freddie Mac should be taking in the mortgage crisis. Volcker said, “...[One of the questions that comes out of this Bear Stearns bailout] is, I think... the role of the Federal Reserve. It has not in the past been conceived as a place where you put in bad assets, or possibly bad assets, under any conditions. Take risks. I’m not suggesting that you ask esoterically that they have collateral, but that is a new departure. And at some point the government ought to—in my view, the government ought to be taking responsibility for that kind of action, not the Federal Reserve, which is an independent agency designed to provide an ample supply of liquidity to the economy, but not too much to protect against inflation, not to protect particular sectors of the economy from bad loans.
- Charlie Rose said, “So the Federal Reserve should not be doing that, in your judgment. It’s not because it shouldn’t be done, [but that] it’s the role of the federal

government. Volcker responded, “Absolutely. I mean, in this situation, they stepped in and nobody else was there to do it.”

- “Then why couldn’t the federal government step in?” asked Rose. Volcker responded, “Well, the federal government doesn’t have the capacity right at the moment to step in, but I think the reasonable question is shouldn’t—particularly in this mortgage era, this real estate area. There are two big institutions out there, Fannie Mae and Freddie Mac...that were created to deal with the mortgage market. And they are related to the government. They have a credit line with the United States Treasury. They are not entirely private organizations, but they kind of act like private organizations. Here we have a problem in the market. Those institutions are designed to deal with problems in the mortgage market, and they seem to be able to come back because they have been so leveraged themselves that at present it’s hard for them to come in and deal with a crisis in their own back yard, so to speak.
- Rose said, “Ok. But because they were badly managed or whatever the issue was. Volcker responded, “They were just starting to make money.” Rose added, “Ok. But they were not prepared—they didn’t have the resources to do it. Volcker responded, “To deal with this, yes. But they could—you know, that provides one avenue by which the federal government could step in and help. Rose asked, “What’s another avenue? Volcker answered, “That’s the avenue that exists. ...We don’t know any other avenue.”
- Volker reiterated, “[The Fed] stepped into a vacuum. ...And I think quite appropriately. It’s a judgment they had to make. But is this what you want for the longstanding regulatory support system? ...My answer is no... I’m not sure there are going to be any losses ultimately involved in this one with the government or the—certainly not for the Federal Reserve. But you haven’t got time to set up an agency overnight. So therefore, you have to look at and see what you can do with the existing apparatus.”
- Volcker added, “...[N]o longer are consumers ...going to be able to borrow so freely on the houses. They are going to end up spending less. ...[T]hat’s what is going to give you the downturn in the economy. But that’s necessary. And if it can be relatively brief, and if the result is—because of the decline in the dollar and other things—that we do a lot more exporting, then the economy will be on a more sustainable path for the future. And, you know, in a sense the quicker that happens, the better.”
- Rose asked if he was worried that we might not get through this crisis. Volcker responded, “Oh, I think we’re going to get through it. It’s just a question of how and how long and with what difficulty? ...[R]ight now people are so concerned about each other, the solidity of other institutions, it’s very hard to trade for any period of time. And the most important thing I think at the moment, after the actions by the Federal Reserve, it’s not a question of how high the interest rates are, it’s a matter of confidence and the ability to buy and sell assets. And this is where I see somebody

like Fannie Mae and Freddie Mac coming in with government support, if necessary, and buying some of their own paper, which is probably good. ...And they [Fannie and Freddie] may need support. But they have a credit line to the Treasury, which I'm sure they would hate to use. But on the other hand, what is it there for? They've been making a lot of money for 20, 30 years. ...I was in the government when Fannie Mae was a government-owned institution. And it was created to take care of the mortgage market in times of stress. It was privatized for extraneous reasons. It was privatized to get it out of the budget. Ridiculous.”

- Volcker continued, “...And then [Fannie] grew, has its own board of directors. I used to be on the board in the very early years. But it became a big financial institution torn between its fiduciary responsibility and making as much money as it could, and its responsibilities to manage the mortgage market, or protect the mortgage market from distress. And that should be changed...” (*Interview with former Chairman of the Federal Reserve Paul Volcker*, 03/18/08)
- In a March 20<sup>th</sup> commentary in the *Wall Street Journal*, Peter Wallison, senior fellow at the American Enterprise Institute, wrote, “...The GSEs can never be more than fair-weather friends to the government. Instead of countercyclical actors, they are decidedly procyclical, and may be largely responsible for the astounding and unsustainable growth in housing prices that is at the bottom of the current financial crisis. By creating GSEs to operate a secondary mortgage market, Congress created companies that would compound the very human problem of irrational exuberance—when everything is going up they are gleeful buyers; when everything is going down, they sit tight and hope for the best. They will increase their capital only when it is absolutely necessary, and thus never develop the capacity to take the risks that their ardent supporters assumed they would take.”
- “In other words, an expedient that Congress used many years ago to solve its budget problem—while still supporting the housing market—has proved worse than useless. The GSEs have only exacerbated the problem of an overheating market, and have neither the resources nor the appetite to assist in its resolution. If Congress and the administration think that the government should be involved in countercyclical efforts to support the mortgage market, they should nationalize Fannie and Freddie. As real taxpayer-supported government agencies, they could then take the risks that an administration believes are necessary when the housing market begins to falter.”
- “But this would be the wrong way to go. Given the GSEs’ role in stimulating an overheated housing market, it would be better to privatize them entirely and get the government out of the business of subsidizing the market in mortgages. It’s clear that private, shareholder-owned companies are incapable of responsibly performing the government mission now expected of them.” (*Wall Street Journal*, Peter Wallison, 03/20/08)
- In a March 18<sup>th</sup> article in the *Financial Times*, John Dizard wrote, “...[R]ecent history seems to have been forgotten by the government and the financial institutions. The

caps on GSE portfolio growth have been lifted, and Congress and the markets are now asking them to take on the mortgage assets that everyone else wants to sell. Hank Paulson, Treasury secretary, has strongly suggested they prepare for this by raising capital. Freddie Mac's chief executive has already said he does not want to. If this balance sheet growth does happen, the GSEs will be back to assuming the same rate risks that were so alarming four or five years ago, only bigger. And they will be attempting to hedge their rate risks using counterparties that are far more capital constrained than before. I believe it more likely that before we get to that point again, the GSEs will be formally nationalized. The Bush administration is just kicking the can a little further down the road. These 'public-private' mutants will simply become public agencies. There is no way to raise the equity capital for them to remain halfway in the private sector. In any event, the foreign central banks and related institutions have made clear to the US government that it will be held responsible for the GSEs' debt." (*Financial Times*, John Dizard, 03/18/08)

Subprime and beyond
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- According to Fitch Rating, the subprime crunch isn't over—in fact, it's actually picking up speed, as declining home price continue to create significant problems in the mortgage market. According to Glenn Costello, co-head of the U.S. RMBS group at Fitch, the "roll rates" [rolling from current to delinquent status] for 2007 vintage subprime first liens are significantly higher than in previous vintages. The 2007 vintage loans are rolling into default at a greater than 4% rate per month, every month—consistently. [This statistic only includes originations through the third quarter of 2007.] Paul Jackson wrote in *Housing Wire*, "What's worse, we're not just looking at a subprime problem, [there's an even bigger problem with Alt-A originations.] ... What should stand out to you is that the [Alt-A] Q307 vintage was already above a 10 percent annualized monthly default rate by the end of December. Astounding. The culprit, of course, was an acceleration in housing price declines that put many borrowers upside down — and, given the incidence of fraud in most recent Alt-A vintages, a whole bunch of borrowers suddenly found themselves unable to refinance their way into another loan as lenders finally began to tighten their underwriting standards. According to Clayton Holdings, Alt-A delinquencies were 17.4% in February [up from 15.94% in January], while 33.14% of subprime mortgages were delinquent. According to Jackson, the "Alt-A loss severity, in fact, is now even approaching average severity numbers for subprimes across all collateral." According to Clayton Holdings, the loss severity (i.e., the loss a lender is forced to take during foreclosure as a percent of the unpaid principal balance) for subprime first liens increased to 45.80% in February [up from 42.56% in January], in contrast to the Alt-A first lien average severity of 33.66%. Sources suggest that as many as 70% of Alt-A loans originated in recent years have been fraudulent. "It's fraud [that is] now coming home to roost, higher lending limits or not," one source told *Housing Wire*. "Rate resets aren't the problem here, and even if they were, LIBOR is low enough right now that it would ease payment shocks for borrowers." (*Housing Wire*, Paul Jackson, 03/21/08; *Housing Wire*, Paul Jackson, 03/20/08)

- Banks are becoming increasingly concerned about homeowners repaying the \$1.1 trillion of home equity loans which are outstanding. On December 31, 2007, 5.7% of home equity loans were delinquent or in default—up 120 basis points from yearend 2006, according to Moody’s Economy.com. (*New York Times*, Vikas Bajaj, 03/27/08)
- Where is the bottom in the housing market? In John Mauldin’s opinion, we are “nowhere near the bottom.” Today, new and existing home inventories are hovering in the 10-month range—and inventory is likely to increase, as foreclosures put more homes on the market. Speculation in residential real estate has created 3.5 million excess homes which to be filled by *qualified* homeowners, making it a buyer’s market for at least another three to four years. Nationwide, owning a home is nearly twice as expensive as renting. John Burns of John Burns Real Estate Consulting projects that residential real estate sales will probably correct another 30% to 1995 levels. Burns believes that resale stability will “likely” return by 2011. In the meantime, home ownership will fall from a recent high of 69% to 66% in 2009. (*Thoughts from the Frontline*, John Mauldin, 03/28/08)
- Mark Zandi, chief economist for Moody’s Economy.com estimates that there are currently 8.9 million homeowners whose mortgage balances, totaling \$1.9 trillion, exceed the market value of their homes. Ultimately, Princeton economist Paul Krugman believes that housing prices will fall far enough to produce about 20 million people with negative equity in their homes, which represents nearly 25% of U.S. homeowners. Ultimately, Krugman said, “[W]e’re heading for \$6 trillion or \$7 trillion of capital losses in housing.” (*Wall Street Journal*, Bob Davis and Amy Chozick, 03/27/08; *Fortune*, Jia Lynn Yang, 03/17/08)
- Goldman Sachs estimates that that \$460 billion in credit losses will result from collapse of the subprime market, nearly four times the amount that has been recognized to date by Wall Street investment firms, hedge funds, and commercial banks. “There is light at the end of the tunnel, but it is still rather dim,” wrote Goldman analyst Andrew Tilton in a note to investors on March 24<sup>th</sup>. Goldman estimated that residential mortgage losses will account for half the total (\$240 billion), while commercial mortgages will account for as much as 20% (\$92 billion). (*Bloomberg News*, Zhao Yidi, 03/25/08)
- Wall Street has been hit by the biggest round of job cuts—34,000 jobs lost—since the implosion of the dot.com bubble in 2000, which resulted in 39,800 jobs lost. This statistic does not include possible job losses related to the collapse of Bear Stearns on March 17<sup>th</sup>. Banks and brokerage firms account for nearly 35% of all salaries and wages in New York City. The City’s Independent Budget Office predicts that the area could lose another 20,000 financial services jobs over the next two years. According to IBO, for every Wall Street job lost, another three or four jobs will be lost in the City. (*Financial Post*, Janet Whitman, 03/24/08)

- Mortgage insurers have flagged nearly 25% of the nation's zip codes to denote markets in which they are refusing to insure some home mortgages. In recent weeks, mortgage insurers have flagged more than 9,600 zip codes in at least 34 states, where they won't insure home loans for investment properties or second homes or loans with riskier adjustable-rate or interest-only mortgages, or for borrowers who are making down payments of 3% or less. According to *Associated Press*, "The entire states of California, Florida, Arizona, Michigan, Ohio and Nevada—which have seen the highest foreclosure rates and the worst price declines—are blackballed on some mortgage insurer lists." As a result, banks are reverting to strict lending standards not seen in nearly 20 years. Chris Sipe, loan officer with America East Mortgage, Frederick, MD, said, "We're in the midst of an epic, broad sweeping change in the mortgage insurance industry." (*Associated Press*, 03/21/08)
- On March 26<sup>th</sup>, FGIC, the parent of bond insurer Financial Guaranty Insurance Company, said that its exposure to mortgage losses exceeded legal risk limits and that it might raise loss reserves because of litigation related to the German bank IKB. In March, FGIC filed a lawsuit accusing the government-owned IKB of fraud in providing incomplete information on \$1.9 billion of debt that FGIC had agreed to insure. FGIC also said it had a substantially reduced capital and surplus position through December 31<sup>st</sup>, which resulted in the company's insured exposures to exceed the limits required by New York State insurance law. The company reported a \$1.89 billion loss for the fourth quarter, after writing down its exposure to mortgage-backed securities. "This is a bombshell," said *CreditSights* senior insurance analyst Rob Haines. "They are actually in violation of New York insurance law. If they don't remediate this, the state has the ability to take control of the company." According to Haines, FGIC would need to raise about \$2 billion to stabilize the company. On March 18<sup>th</sup>, FGIC announced it had stopped writing new financial guaranty business, joining XL Capital Assurance, Inc., in an effort to preserve capital. (*Reuters*, 03/27/08; *Bond Buyer*, 03/19/08; *American Banker*, 03/20/08)
- MGIC Investment Corp. has increased its planned stock offering by 20% to \$420 million. The company also plans to sell \$325 of convertible debt through a private offering with an option for the initial buyer to acquire up to an extra \$65 million of debt. Moody's has cut MGIC's senior and short-term debt ratings and said it may cut the ratings again, due to the company's higher debt levels and fourth-quarter losses. (*American Banker*, Alison Bisbey Colter, 04/27/08)
- Larger than expected losses in the fourth quarter were reported by insurers MGIC Investment Corp. (\$1.47 billion), PMI Group, Inc. (\$1.0 billion with nearly 77% of its losses attributed to its stake in bond insurer FGIC), and Radian Group (\$618 million). PMI has slashed its dividend 76% to preserve capital. Triad Guaranty Inc said that the filing of its annual report for FY2007 is delayed, while the insurer negotiates with an investor group about raising capital. (*American Banker*, Alison Bisbey Colter, 04/20/08; *Radian Group, Inc. Press Release*, 02/15/08; *PMI Group Press Release*, 03/17/08; *Triad Guaranty Press Release*, 03/17/08; *PRNewswire*, 02/13/08; *Bloomberg News*, 03/18/08)

- The FDIC plans to hire 140 workers in the division which handles bank failures, bringing the units total employees to 360, said John Bovenzi, the agency's COO. Currently, there are 76 banks on FDIC's "problem institutions" list. Gerard Cassidy, managing director of bank equity research for RBC Capitals Markets, projects that between 50 and 150 banks failures will occur by early 2010 with the highest concentration of failures occurring in California and Florida. "The initial round of failures will come from smaller banks with limited access to capital and overexposure to commercial real estate," said Cassidy. "The regulatory focus is not acutely on commercial real estate. The problems are centered around construction loans in residential lending. Home prices and sales are declining. This leaves builders unable to carry debt they took on because they can't sell their homes." (*Associated Press*, Alan Zibel, 03/26/08; *Reuters*, Jonathan Stempel, 02/01/08)

<p>Should regulators suspend marking-to-market of exotic instruments during a time of panic?</p>
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- In the April 7<sup>th</sup> issue of *Forbes*, Steve Forbes wrote, "The Bush administration must take two steps immediately to quickly halt the unending, enervating credit crisis: shore up the anemic dollar and, for the time being, suspend 'marking-to-market' those new financial instruments, such as packages of subprime mortgages. ... The Treasury Department and the Fed should get together with the SEC, the Comptroller of the Currency and other bank regulators and announce that financial institutions for the next 12 months will no longer write down the value of exotic financial instruments (primarily packages of subprime mortgages). Instead, writedowns will occur only when there have been actual losses on those assets. If a mortgage defaults, a bank will then--and only then--recognize the loss."
- "It's preposterous to try to guess what these new instruments are worth in a time of panic. Such assets are being marked down to increasingly arbitrary low levels. But when a bank books such a loss, it must replenish depleted capital, even though cash flows for most financial firms are still positive. Worse, when forced by panicky regulators and lawsuit-fearing accountants to write down the value of these securities, institutions will dump assets in a market where there are temporarily few or no buyers. The result is a spiraling disaster. So let's have a time-out on markdowns until we actually have real experience in what kind of losses are actually going to occur. These two steps would quickly end the panic. Until that happens, expect more trouble." (*Forbes*, Steve Forbes, 04/07/08)
- In a March 28<sup>th</sup> article in the *American Banker*, Edward L. Yingling, president and CEO of the American Bankers Association, also urged policy makers to debate whether accounting policies are exacerbating the freeze-up in our financial markets. Yingling wrote, "...[Mortgage] assets are being marked to market, but what is the right definition of the market, particularly when it is clearly dysfunctional? ...They

are being marked to what they could sell for right now and in a market where buyers have not had time to investigate the underlying assets, where buyers know the securities have to be sold (and many more may have to be sold in the future), where many institutions have little or no choice but to sell, where many potential buyers — publicly traded companies — might have to mark down the securities quickly to below what they paid, and where the public pricing mechanisms — credit market indexes — are widely believed to carry a serious downward bias. For bankers, the problems have been exacerbated by efforts in recent years by accounting purists that often have resulted in reduced reserves for loan losses while downplaying long-term soundness issues.”

- “...There are legitimate concerns about moving away from accounting purity, but it should be recognized that the proper definitions of “market” and “fair value” are debatable, and that there may be externalities that should be identified and discussed. If, in fact, accounting policies and practices are based on erroneous definitions, causing excessive markdowns, creating negative feedback loops, and/or preventing potential purchasers from stepping in, those issues should be debated, and not just by the accounting gurus. The issues go beyond the policies to applications. In the post-Enron, pro-litigation environment, are incentives making valuations too conservative? Such a public discussion should focus not just on accounting in isolation, but also on the market impact...” (*American Banker*, Edward L. Yingling, 03/28/08)
- In a March 28th article in the *American Banker*, Carole Berger, former managing director of TIAA-CREF, wrote that ending mark-to-market accounting for financial institutions that are portfolio holders of assets is a critical step to ending the problems plaguing the capital markets. Berger wrote, “...Historically the [mark-to-market] accounting method has worked very well for investment banks, whose role was not to warehouse mortgages and other loans on their balance sheets, but to act as an intermediary only. For commercial banks, thrifts, and the government-sponsored enterprises, whose role is to fund and invest in these assets, mark-to-market accounting requires them to write down assets to reflect price changes in the secondary market. Conceptually, this sounds like a good idea, but in periods of stress and illiquidity, such as the one we are in now, this accounting treatment requires them to take earnings and capital hits that may not reflect the long-term value of assets. It also makes managers shun these assets.”
- “We can already see what’s happened — as mortgage asset credit quality has started to deteriorate and spreads have widened, banks and the GSEs have taken significant hits to their capital positions. These institutions then have sold more of these assets into an already illiquid market, driving down their value and widening spreads further. This has required further earnings and capital charges. With less capital, these institutions have not been in a position to make loans and provide liquidity to the financial system. And so goes the vicious cycle.”
- “The FASB must recognize that there are financial institutions whose function is to hold assets on their balance sheets and provide liquidity in times of stress. Though

these accounting standards might have been sound, they have proven impractical. They have taken away the GSEs' role of providing liquidity to illiquid mortgage markets and turned them into institutions that need to behave pro-cyclically. It is imperative that mark-to-market accounting be revised for institutions such as banks, thrifts, and GSEs." (*American Banker*, Carole Berger, 03/20/08)

- In a March 28<sup>th</sup> editorial, the *Financial Times* wrote, "It is an alluring idea: solve the credit crunch at a stroke of the accountant's pen. But suspending mark-to-market accounting would only hide banks' losses—which would only add to suspicion about their solvency. The problem is not mark-to-market as such, it is the use of mark-to-market accounting to underpin pro-cyclical bank capital requirements, and it is the capital regime that should be reviewed."
- "Under traditional historic cost accounting, bonds that a bank bought for \$1m would sit on the balance sheet at \$1m until the bank sold them, at which point any profit or loss would be recognized. Under mark-to-market accounting—which became widespread in the 1990s—the value of the bonds is constantly adjusted to reflect the price at which they could currently be bought or sold. Provided there is a market price to mark to, this kind of accounting is far more useful to investors: it tells them what a bank's assets are worth today, not what they were worth 10 years ago or what they might be worth in normal economic times. It forces banks to confront problems rather than deny them – and given that uncertainty about which banks have suffered losses is an important reason why they will not lend to each other, covering up losses will not solve the credit crunch, but rather make it worse."
- "The problem, however, is that mark-to-market accounting is not simply a tool to inform investors. It underlies the balance sheet, and so generates the fundamental number with which a bank is regulated: its capital ratio. The standard Basel requirement is that a bank's target ratio of capital to risk-weighted assets should be 8 per cent. Under historic cost accounting, falling market prices had no immediate effect on capital adequacy, but under mark-to-market they create losses, which force banks either to raise more funds or to cut back on lending. There should be a thorough review of the Basel II capital regime, which has other features that make banks cut lending as market prices fall."
- "Mark-to-market is not perfect. The dozens of assumptions used to value assets with no market price—so-called marking to model—must be thoroughly audited if historic cost accounting is not to be preferable. There may also be the perverse result of banks choosing to hold more illiquid assets in future if they conclude that holding liquid bonds risks mark-to-market losses."
- "Hiding losses would destroy confidence, not create it, so suspending mark-to-market is not the answer to the credit squeeze. But the capital rules that make mark-to-market a problem cannot be changed overnight and, in the meantime, falling bank capital could create a downward spiral of less lending and further falls in asset prices."

The banks either need to raise more capital or they must temporarily be allowed to operate with less.” (*Financial Times*, 03/28/08)

James Bullard named as the president and CEO  
of the Federal Reserve Bank of St. Louis

- James Bullard has been named the president and CEO of the Federal Reserve Bank of St. Louis, effective April 1<sup>st</sup>. Bullard succeeds William Poole, whose 10-year term as president ends on March 31<sup>st</sup>. Bullard, 47, is an 18-year veteran of the St. Louis Fed, where most recently he served as vice president of the Bank’s research division and deputy director of its research division. (*Bureau of National Affairs*, Aaron Lorenzo, 03/26/08)

## ***Fannie Mae***

Fannie Mae’s retained portfolio grows at annualized rate of 1% in February

- Fannie Mae said that its retained mortgage portfolio grew at a 1% annual rate in February to \$721.6 billion, following contractions of 4.8% in January and 0.1% in 2007. Fannie’s “serious delinquency rate” increased 8 basis points in January and 40 basis points from one year ago to 1.06%, the highest delinquency rate in over a decade. The company’s book of business, which includes guarantees of mortgage securities, rose at a 19.5% annual rate in February to \$2.95 trillion. In February, Fannie Mae issued \$69.4 billion in securities for a 21.4% annualized growth rate. The company reported an effective duration gap of positive two months for February, up from positive one month in January. (*Reuters*, Al Yoon, 03/24/08; *Bloomberg News*, 03/25/08)

Fannie Mae tightens its loan restrictions

- According to a March 24<sup>th</sup> memo to lenders, Fannie Mae will no longer allow homeowners to refinance loans that it owns or has packaged into MBSs at typical loan-to-value ratios in areas with falling home prices, if the borrower is going to use proceeds to pay off a second mortgage. In other “changes and clarifications” to the company’s criteria related to its declining market policy, Fannie Mae said that borrowers must receive no cash from transactions and use any equity tapped only to pay off a first mortgage, prepaid interest, and closing costs to qualify for “limited” cash-out refinancings with typical loan-to-value ratios in markets where home prices are falling. Any second mortgages must be “resubordinated,” said Fannie Mae.

However, some banks—such as National City Corp.—have been telling their customers that their second mortgages must be paid off to refinance their mortgages. (*Bloomberg News*, 03/26/08)

- At *Minyanville.com*, Kevin Depew wrote, “Perhaps Fannie Mae hasn’t been listening. How else to explain the fact the company which, as *Bloomberg* notes, ‘was created by Congress to expand homeownership by increasing mortgage financing,’ has actually tightened certain credit standards? According to *Bloomberg*, Fannie Mae will no longer allow homeowners to refinance loans it either owns or has packaged into bonds at typical loan-to-value ratios in areas with falling home prices if they’re going to use proceeds to pay off a second mortgage. Essentially, Fannie is tightening an exception to a policy reinstated four months ago that requires lenders to boost by five percentage points the required size of down payments or borrower equity on new lending, according to *Bloomberg*.”
- “We think Fannie Mae is underestimating the risk of foreclosures and delinquencies in the portfolio of mortgages the company guarantees. In fact, by tightening the lending standards for these types of loans they are basically guaranteeing they are underestimating them. Regardless, this company was created at the tail-end of the Great Depression as a government agency. It was privatized in 1968. Now, 30 years later, amid the worst housing crisis since, yes, the Great Depression, it’s only somehow fitting that the company is headed back from whence it came—to full taxpayer ownership.” ([www.minyanville.com](http://www.minyanville.com), Kevin Depew, 03/26/08)

Fannie Mae awaits the wrecking ball
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- In a March 24<sup>th</sup> article at *Motley Fools*, Rich Duprey wrote, “I bought Fannie Mae more than two years ago. It had a good turnaround story: Battered and bruised because of accounting improprieties like those at ...Freddie Mac, it was simply too big to fail, had new management in place, and possessed cleaner books. Best of all, it was cheap. Trading at less than 7 times earnings, it was at a level it had not seen in decades. Some wits had coined the word ‘Fanron’ to describe the shenanigans uncovered there, but it seemed my thesis for investing was borne out because within a year my shares were trading about 40% higher. Yet I also wondered what would happen when Fannie Mae was no longer able to sell its mortgage-backed securities into the market? It didn’t take long to find out how easy it was to knock down the whole house of cards: The 85-year-old institution Bear Stearns became a penny stock overnight. My 40% gain in Fannie’s shares also became a 50% loss.”
- “However, with Fed Chairman ‘Helicopter Ben’ Bernanke commandeering a jumbo jet to implement his dollar drop onto the capital markets, Fannie Mae enjoyed a wild week, with its stock up 70%. The market approves not only the intervention but also the broad powers it has been given. Perhaps I ought to feel better, but I don’t. Simply put, Fannie Mae is no longer the company I originally bought, and despite a newly resurgent stock, I foresee worse times ahead.”

- “Fannie and Freddie have been given the authority to lower their capital to just 3% of the mortgages they hold, down from 3.25%, allowing them to support about \$200 billion more in mortgage commitments. Regulators agreed to cut Fannie and Freddie’s capital requirements by a combined \$5.9 billion, while allowing them to borrow up to \$33 for every dollar they have on hand. Bear Stearns, by comparison, was leveraged \$34 for every dollar in capital at the end of 2007. Mortgage lenders now own or guarantee about 45% of all U.S. mortgages in existence, but they are expected to buy or guarantee about 80% of all the mortgages made this year. The additional capital they’ll be raising as part of the agreement (*The Wall Street Journal* reports that it could be \$10 billion each) will allow them to buy even more loans above the \$200 billion level just set. Fannie will use part of its additional capital to help distressed borrowers that have resetting ARMs while also funding bigger loans in high-cost areas. Both Fannie and Freddie got temporary Congressional authority to purchase loans of up to \$730,000 in regions with the most expensive homes.”
- “This is not the Fannie Mae I originally bought. It has become overextended, too exposed to subprime mortgages, and too subject to the twin vagaries of rising defaults and falling home prices. When the break comes it will fall harder, faster, and further than it did before. There’s a singular moment when a wrecking ball swings, when it sits poised above its return arc, seemingly able to sustain that position forever. Then gravity resumes and the ball hurtles down again to slam into a building facade, shattering brick and splintering timber. That singular moment is where Fannie Mae is now. It is suspended above a wrecked housing market that is waiting for the ball to fall forward again and smash into the brick-and-mortar of reality. It’s something I’m not sure I want to be part of any longer.” (*Motley Fools*, Rich Durpey, 03/24/08)

Fannie Mae expands its pilot program’s use of law firms to avert foreclosures
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- Fannie Mae is expanding a pilot program, announced in February, which uses law firms to restructure mortgage payment plans and approve the sale of properties for less than is owed for troubled borrowers. Fannie is now allowing 39 law firms in 15 states to work out repayment and forbearance plans. Participating law firms can earn an incentive fee of up to \$600 for negotiating a deal with borrowers that cuts the losses for the mortgage holder. (*The Philadelphia Inquirer*, 03/24/08)

## ***Freddie Mac***

### Freddie Mac's retained portfolio shrinks by annualized 12.4% in February

- Freddie Mac announced that its retained mortgage portfolio shrank by an annualized 12.4% in February to \$709.5 billion. The company's mortgage delinquencies rose six basis points to 0.71% in January, its highest delinquency rate in at least three years. Freddie's delinquency rate for January was up 46 basis points from a year ago. The company's retained portfolio purchases totaled \$7.9 billion in February, significantly lower than January's \$13.5 billion, while its retained portfolio sales totaled \$6.2 billion, below the company's sales of \$7.6 billion in January. Freddie Mac reported net mortgage purchase agreements of \$14.8 billion in February, substantially higher than the company's \$600 million in January. During the month, Freddie issued nearly \$43 billion in mortgage-backed securities, compared to the paltry \$29.4 billion issued in January. Freddie's duration gap remain unchanged at zero months. (*Reuters*, Julie Haviv, 03/25/08)

### Freddie Mac names Wachovia as a "fully-delegated" underwriter

- Freddie Mac has named Wachovia Multifamily Capital Inc as the second "fully delegated" underwriter for the Targeted Affordable Housing™ model. Wachovia is only the second company, after Centerline Capital Group, to achieve this status. The Wachovia unit can now underwrite multifamily loans on Freddie Mac's behalf. Kimball Griffith, Freddie Mac vice president of affordable sales and investments, said, "Delegated Underwriting lets us serve targeted affordable borrowers by tapping more effectively into the delegated Seller/Service's capacity to originate and underwrite, in exchange for a risk-sharing relationship with us." Daniel Cunningham, head of Affordable Housing at Wachovia Multifamily Capital, said, "Wachovia sees Delegated Underwriting as an extremely valuable tool for our affordable housing activities. Together through Delegated Underwriting, Wachovia and Freddie Mac will be able to expand efforts and provide more rapid deployment of capital for the entire spectrum of affordable housing products, including bond credit enhancement, preservation and Low-Income Housing Tax Credit deals of all types." (*Reuters*, 03/18/08; *Multi-Housing News*, 03/19/08)

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

### **FHLB merger talks a test of wills and patience**

- *American Banker* reported that the merger negotiations between the FHLB-Chicago and FHLB-Dallas have showed signs of slowing over the issue of the value of the Chicago Bank. Sources say that the FHLB-Chicago has “applied the brakes,” after the FHLB-Dallas requested updated financial statements for the Chicago Bank through the end of January. Previously, the FHLB-Chicago had said it was worth at least \$800 million. However, the Bank’s value has likely declined as falling interest rates have reduced the value of its \$34.6 billion mortgage program. The process of determining the value of the FHLB-Chicago has long been viewed as the most daunting challenge in the Banks efforts to strike a merger agreement.
- The Federal Housing Finance Board, which had expected to receive a merger proposal from the two FHLBs the week of March 17<sup>th</sup>, may elect to install new management at the Chicago Bank if a deal is not reach in coming months, said a “source familiar with the situation.” The Finance Board’s goal is to encourage a speedy decision by the Banks, said the source. (*American Banker*, Steven Sloan, 03/20/08)

### **FHLB-Atlanta declares its first quarter dividend**

- The FHLB-Atlanta’s board of directors has approved an annualized dividend rate for the first quarter of 6.0%, payable on April 1<sup>st</sup> to members who held capital stock in the Bank from January 1<sup>st</sup> to March 31<sup>st</sup>. (*FHLB-Press Release*, 03/27/08)

### **FHLB-Indianapolis announces appointment of new community interest director**

- The Federal Housing Finance Board has appointed Chirstine A. Coady to serve on the FHLB-Indianapolis board of directors for a term ending December 31, 2010. Coady is the president and CEO of Michigan Interfaith Trust Fund, Lansing, MI. She has also served for two terms on the City Council of Mason, MI. (*PrimeNewswire*, 03/20/08)

### **Mick Gutttau elected chairman of the Council of Federal Home Loan Banks**

- Mick Gutttau, chairman of the FHLB-Des Moines, has been elected to a two-year term as chairman of the Council of the Federal Home Loan Banks. Gutttau, who succeeds Timothy Chrisman, chairman of the FHLB-San Francisco, is currently the chairman and CEO of Treynor State Bank, Treynor, IA. (*BusinessWire*, 03/20/08)

## New York Life joins the FHLB-New York

- New York Life Company has been approved for membership in the FHLB-New York. Michael Edward Sproule, EVP and CFO of New York Life, said, “Membership with the [FHLB-New York] gives New York Life an additional source for reliable liquidity to maintain our strong capital position and help accommodate our policyholders’ changing needs. We are happy to partner with such a strong wholesale lender with over 75 years of service to the financial industry and we look forward to a long and prosperous relationship.” Alfred DelliBovi, president of the FHLB-New York, said, “New York Life is one of the premier financial institutions in the United States, and we are pleased to welcome them as a new member to the Home Loan Bank family of community financial institutions.” (*PR Newswire*, 03/18/08)

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

### Has the ethanol bubble begun to implode?

- Ethanol, once hailed as the “green fuel” which could reduce America’s dependence on foreign oil, is in a major slump nationwide. Sacramento’s Pacific Ethanol Inc. illustrates the swift decline of an industry, which has been battered by too much supply, too-expensive corn, and rapidly increasing costs for plant construction. Across California, profit margins have vanished, new plants have been canceled and a number of existing facilities have struggled to survive. California’s first major plant, which opened in 2005 [in Tulare County], has suspended operations. In a March 18<sup>th</sup> SEC filing, Pacific Ethanol revealed a \$14.4 million loss for the fourth quarter caused by major construction-cost overruns, which has triggered defaults on its bank loans and thrust the producer into a liquidity crisis. The company has delayed release of its FY2007 financial results. To survive, Pacific Ethanol plans to rely heavily on a \$40 million cash infusion from an affiliate of its construction contractor in a transaction which has yet to close. Concurrently, the company’s stock has slumped from a high of \$44.50 a share [in mid-2006] to \$4.61 on the day that it announced the fourth quarter loss. In early 2006, company insiders sold more than \$100 million of Pacific Ethanol’s stock.
- On balance, demand for ethanol has not increased adequately to support the glut of new production which has come on line. On January 24<sup>th</sup>, the Renewable Fuels Association said that 145 refineries operational, while 57 refineries were under construction and six facilities being expanded. “There is much less room for error than there was in the past,” said Todd Alexander, a New York lawyer who represents

lenders and developers in the ethanol industry, including Pacific Ethanol's banks. "Some of the marginal facilities ...are running into liquidity issues." In an industry where new plants cost \$100 million apiece, smaller companies such as Pacific Ethanol will suffer the most until the industry stabilizes, said investment analyst Eitan Bernstein. In addition, the finance industry's credit crisis is making funding sources more and more difficult to locate. Investors also are becoming more sanguine about the industry as well, following the release of new studies suggesting biofuels, especially corn ethanol, are less green than advertised. Ted Sullivan, an analyst with Lux Research, said that investors are even wondering whether ethanol and biodiesel will continue being supported by the government. (*Sacramento Bee*, Dale Kasler, 03/20/08; *The Fresno Bee*, Jeff St. John, 03/19/08; *National Public Radio*, 03/18/08, *Renewable Fuels Association*, 03/24/08)

#### Farm Credit CEOs' compensation jumps 30% in 2007

- In 2007, the compensation of the chief executive officers of the five FCBs, which fund the 94 FCS associations, along with the CEO of the Federal Farm Credit Banks Funding Corporation, increased 30.3%, to \$6.73 million for 2007 from \$5.16 million for 2006. According to *Farm Credit Watch*, the big winners included CoBank's Bob Engel, whose compensation increased 52.5% to \$2.41 million for FY2007, and Larry Doyle, CEO of the Farm Credit Bank of Texas, who received \$1.02 million of compensation last year, representing a 46.3% increase from FY2006. (*Bert Ely's Farm Credit Watch*, Bert Ely, March 2008)

#### Farm Credit System's loans to large agribusinesses increased 56% in FY2007

- *Farm Credit Watch* reported, "According to the FCS's 2007 Annual Information Statement, the FCS increased its focus last year on lending to large, creditworthy borrowers, those least in need of the FCS's taxpayer subsidy. While total FCS lending increased 15.8% during 2007, to \$142.9 billion at the end of the year, its large loans—those over \$25 million—increased 55.8%, to \$16.9 billion while the FCS's largest loans—those over \$250 million—more than doubled, rising to \$4.32 billion from \$2.01 billion at the end of 2006. The number of FCS loans exceeding \$25 million also increased, to 223 at the end of 2007 from 191 the year before. At the other end of the scale, small FCS loans—those under \$250,000—rose 8.7% during 2007, half the growth rate of total FCS lending, while loans in the \$250,000 to \$500,000 category grew slightly faster, by 10.8%. Loans under \$500,000 are the ones most likely to be made to young, beginning, and small (YBS) farmers and ranchers, the only FCS borrowers likely to need the taxpayer subsidy the FCS distributes through its below-market interest rates. Compared to the 115% increase in loans over \$250 million, the increase in these much smaller loans was only 9.3%."
- "These loan data seriously understate FCS lending to large borrowers while greatly overstating the FCS's YBS lending because the FCS does not publish lending data

aggregated by borrower even though it aggregates that data so it can monitor its total credit exposure to borrowers. The FCA should require the publication of the distribution of FCS lending by the total amount lent to a borrower, even if that data would politically embarrass the FCS. At least the FCS reports the total amount lent to its ten largest borrowers—\$3.55 billion at the end of 2007, up [25%] from \$2.83 billion at the end of 2006. The FCS also reported that it had seven credit exposures at year-end 2007 falling between \$563 million and its self-imposed lending limit of \$750 million (hardly YBS borrowers), up from five such exposures the year before. This is another indication that the FCS increasingly focuses on lending to large agribusinesses. Despite that lending limit, for the second year in a row, the FCS let its total credit exposure to a single borrower rise above \$750 million, an indication of poor risk control by the FCS and the FCA.” (*Bert Ely’s Farm Credit Watch*, Bert Ely, March 2008)

Farmer Mac reports net income of \$4.4 million for FY2007
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- For the fiscal year ended December 31, 2007, Farmer Mac reported \$4.4 million of GAAP net income or \$0.42 per diluted share, compared to \$29.8 million or \$2.68 per diluted share for the year ended December 31, 2006. For fourth quarter 2007, the agency reported a GAAP net loss of \$9.3 million or \$0.90 per diluted share, compared to a loss of \$8.6 million or \$0.82 per diluted share for third quarter 2007 and net income of \$7.6 million or \$0.70 per diluted share for fourth quarter 2006. Farmer Mac’s GAAP losses for last two quarters of 2007 were attributable to mark-to-market reductions in the fair values of financial derivatives associated with the significant decline in interest rates in the latter half of 2007. Farmer Mac uses financial derivatives to hedge interest rate risk on its assets and liabilities, but the mark-to-market fair value changes on those assets and liabilities are not recorded in income. During the fourth quarter, the agency’s core earnings were up 51%, driven by an increase in net interest income attributable to Farmer Mac’s significantly improved short-term funding costs, relative to the rates on related investments, loans, and Farmer Mac Guaranteed Securities, as well as ongoing fee income from the Corporation’s \$8.5 billion guarantee portfolio.
- Farmer Mac president and CEO Henry D. Edelman stated, “Reflecting the effectiveness of Farmer Mac’s ongoing credit risk management and the strength of the U.S. agricultural economy, 90-day delinquencies in Farmer Mac’s guarantee portfolio remained at notably low levels as of December 31, 2007, in terms of both dollars and percentages. Those delinquencies totaled \$10.6 million, representing just 0.21% of the portfolio. To date, the credit issues that have arisen in the housing and consumer sectors of the economy have not affected the agricultural economy in general or Farmer Mac’s guarantee portfolio in particular. Focusing on core earnings, we are extremely pleased with Farmer Mac’s strong financial results in fourth quarter 2007 -- up 51 percent compared to fourth quarter 2006. This increase was achieved notwithstanding the volatility of the capital markets during the last quarter and helped bring our 2007 full-year results up 15 percent compared to 2006. Farmer Mac’s net interest income and guarantee fee income were major drivers of core earnings in

fourth quarter 2007. While it is not possible to predict how long Farmer Mac's short-term borrowing spreads will continue to be as favorable as they now are, relative to yields on our program and non-program assets, Farmer Mac's guarantee fee income should continue to grow commensurate with outstanding business volume."  
(PRNewswire, 03/17/08)

#### Farmer Mac and National Rural Announce \$400 Million Secured Note Transaction

- Farmer Mac has purchased \$400 million of five-year, LIBOR-indexed secured notes, issued by the National Rural Utilities Cooperative Finance Corporation (National Rural). The transaction advances Farmer Mac's role and commitment as an investor in rural America and is consistent with parameters established by the FCA. The transaction provides National Rural with another source of liquidity for its rural utility cooperative members that serve rural communities and support agriculture in 47 states. (*Farmer Mac Press Release*, 03/28/08)

## ***Postal Service***

#### Postal liberalization may be the most viable option for the USPS

- In a March 25<sup>th</sup> article in the *Star Gazette* [Elmira, NY], Don Soifer wrote, "Earlier this month, the U.S. Postal Service announced that it would raise rates for most of its products, including first class stamps. This represents the second rate hike in as many years. It's also a step toward the annual price increases the agency has predicted since it was granted greater financial autonomy at the end of 2006. Instead of trying to cope with rising costs simply by increasing prices on captive consumers each year, however, the postal service could take a few pointers from its peers across the Atlantic. European posts are in the midst of a historic—and potentially consumer-friendly—movement toward postal liberalization."
- "...Indeed, consumers have much to gain from a liberalized postal marketplace. A 2005 study by Ecorys Research and Consulting suggested that full liberalization would cut prices by 20 to 25 percent while improving service for consumers. Some policymakers in Europe are getting the message. A number of countries, including Britain, Finland and Sweden, have already opened their postal markets completely to competition (i.e., for letters weighing less than 50 grams) or privatized former state monopolies. But state-owned Swedish Posten and British Royal Mail, for instance, still deliver 90 percent of their countries' mail, with only a few significant competitors."

- “To be fair, progress will take time, as private companies work to build the infrastructure necessary to provide increased services. ...Despite bumps in the road, Europe’s postal liberalization has real potential to deliver for consumers. The example is instructive for postal leaders in America, where labor unions are relentlessly fighting against efforts by Postal Service management to cut costs.”
- “Instead of avoiding real reform by consistently raising prices for ordinary consumers, the United States ought to look to Europe for inspiration in finding ways to adapt to the rigors of a changed postal market.” (*Star Gazette*, Don Soifer, 03/25/08)

USPS can’t account for at least \$33.4 million in expenses  
due to weak controls and lax oversight

- According to two reports issued by the Inspector General’s office, the Postal Service can not account for at least \$33.4 million in facilities’ repair and vehicle expenses in 2007 because of weak internal controls and lax oversight. The USPS cannot assure that any of the \$27.6 million in maintenance and repair expenses examined by the IG’s auditors were used for that purpose. Some supervisors were unaware that they were responsible for overseeing these expenses, while other employees had limited knowledge that the repairs that they certified were properly completed by contractors. In the March 3<sup>rd</sup> report, the auditors concluded, “The safety and serviceability of the Postal Service facilities, employees and customers are at increased risk. [Without established controls over contractors,] there is an increased risk of fraud and abuse.” A second audit found that postal vehicles serving city routes in 15 states had more than \$5.8 million in questionable expenses. Some vehicles were logged for having traveled millions of miles in a single accounting period, while others were recorded as having gone a negative number of miles, according to the March 4<sup>th</sup> report. (*Bloomberg News*, Neil Roland, 03/26/08)

## TVA

NRC cites TVA for “quality assurance” violations

- The Nuclear Regulatory Commission has cited TVA for “quality assurance” violations in it’s application to build and operate a new nuclear plant in Scottsboro, AL. According to the NRC, the agency used a 1988 computer model, supported by data from 1963, to forecast how fast the Tennessee River could rise after heavy rains near the proposed plant. The 20-year old model failed to reflect modifications to the upstream Chickamauga Dam, the effects of a new Chickamauga Lock or even

valleywide flooding in 2003. TVA said it will work to resolve the issue with NRC.  
(*Associated Press*, 03/28/08)

Environmental group to fight TVA's proposed Bellefonte nuclear plant

- On March 19<sup>th</sup>, the Bellefonte Efficiency and Sustainability Team (BEST) launched a campaign to inform the public about the potential for radioactive leaks and wastes and issues of security, high construction costs and a reduced water supply are its main concerns, related to TVA's proposed Bellefonte plant. "I'm wondering if TVA has lost its mind in trying to introduce new nuclear power plants into its system," said Dr. Ross McCluney, a founder of BEST and principal research scientist at the University of Central Florida. "Nuclear reactors are very expensive to build and operate safely," said McCluney. "The real threat of terrorism means that every nuclear reactor has the equivalent of a terrorist bull's eye painted on it." Louis Zeller, a science director for BEST, argued that nuclear plants have the potential for contaminating the environment and endangering people. TVA's claim that the new design will be safer because it uses fewer pumps for cooling "is like changing the hood ornament on a '57 Chevrolet," said Zeller, who argued that wind energy is a safer alternative to nuclear power. BEST representatives plan to attend the Nuclear Regulatory Commission's public meeting on April 3<sup>rd</sup> to express their opposition to the proposed Bellefonte nuclear reactor.
- TVA spokesman John Moulton responded that the utility's nuclear plants "are very controlled and regulated." Moulton said, "We closely and continually monitor any potential radioactive release." Moreover, TVA's storing of nuclear waste "is a very safe and proven technology and that research is now being done on reprocessing spent fuel," he added. (*Huntsville Times*, David Brewer, 03/19/08)

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