

The **GSE** REPORT™

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Major Events

Concerns about Fannie Mae's and Freddie Mac's solvency
trigger crisis in agency mortgage-backed securities market

Federal Reserve injects additional liquidity into the banking system
and accepts agency mortgage-backed securities as collateral

Did the Fed's bailout of Bear Stearns cross the line on "moral hazard"?

The federal government will "do what it takes"

Concerns about Fannie Mae's and Freddie Mac's solvency trigger crisis in agency mortgage-backed securities market

- In a February 29th speech at the U.S. Monetary Forum, William Poole, president of the Federal Reserve Bank of St. Louis, said, "...I am more skeptical of the financial strength of the GSEs, and believe that we could see substantial problems in that sector. According to the S&P Case-Shiller home value data released earlier this week, as of December 2007 average prices had declined by 15 percent or more over the past 12 months in Phoenix, San Diego, Miami and Las Vegas. We can add Detroit to the danger list as the home price index for that city is down by almost 19 percent over the 24 months ending December 2007. With house prices falling significantly in a number of large markets, many prime mortgages issued a few years ago with a loan-to-value ratio of 80 percent may now have relatively little homeowner equity, which increases the probability of default and amount of loss in event of default."
- "...GSE losses will depend on the variance as well as the mean of changes in national home prices. Losses in markets with home prices falling more than the national average will not be offset by gains in markets with price changes above the national average. I do not have a new message here; we have known for a long time that advance preparation and a strong balance sheet are the keys to riding out a financial storm. As I have emphasized before, the Federal Reserve can deal with liquidity pressures but cannot deal with solvency issues. I do not have any information on the GSEs that the market does not also have. Nevertheless, in assessing the risk of further credit disruptions this year, **I would put the GSEs at the top of my list of sources of potentially serious problems. If those problems were realized, they would be a direct result of moral hazard inherent in the current structure of the GSEs.**" [Emphasis added.] (*Panel Discussion on Balancing Financial Stability, Price Stability and Macroeconomic Stability: How Important is Moral Hazard?*, William Poole, 02/29/08)

- In a March 10th article in *Baron's*, Jonathan Laing asked if Fannie Mae is the next government bailout—triggering fears on Wall Street about the financial health of the GSEs and widening concerns about U.S. mortgage market. Laing wrote, “...[Fannie’s] balance sheet appears larded with iffy assets and understated liabilities. Of late, however, Fannie’s prospects have darkened notably. The company lost \$2.6 billion last year as a surge of red ink in the final two quarters more than wiped out a nicely profitable first half. And by late last week, credit-market jitters had penetrated the once-unassailable hushed precincts of the market in Fannie debt. In the wake of margin calls on collateral at the investment concern Carlyle Capital, yields on guaranteed mortgage securities issued by Fannie and ...Freddie Mac rose to their highest level over U.S. Treasuries in 22 years, [while] credit default swaps ...have ballooned out to 2% of the insured amount from 0.5% just four months ago.”
- Laing noted that Fannie Mae CEO Daniel Mudd attributed much of the company’s 2007 loss to falling market values for derivatives. Laing added, “But, if the truth be known, a considerable portion of Fannie’s losses also came from speculative forays into higher-yielding but riskier mortgage products like subprime, Alt-A ...and dicey mortgages requiring monthly payments of interest only or less. For example, Fannie’s \$314 billion of Alt-A—often called liar loans because borrowers provide little documentation—accounted for 31.4% of the company’s credit losses while making up just 11.9% of its \$2.5 trillion single-family-home credit book. Fannie was clearly looking for love—and market share—in some of the wrong places. Likewise, *Barron's* has found other areas that may bode ill for Fannie’s prospects. Its balance sheet is larded with soft assets and understated liabilities that would leave the company ill-equipped to weather a serious financial crisis. And spiraling mortgage defaults and falling home prices could bring a tsunami of credit losses over the next two years that will severely test Fannie’s solvency.”
- “Should Fannie or the similarly hobbled Freddie Mac buckle, the government would no doubt bail them out and honor their debt and mortgage guarantee obligations. Fannie common and preferred shareholders would likely suffer grievously in such a scenario. Fannie, for its part, insists it’s more than adequately capitalized to withstand any future stress. The company also contends that as a result of tightening its standards and making fewer risky loans, the quality of its book of business will improve mightily.”
- “But some financial leaders aren’t so sure. At a [February 29th] conference..., William Poole, president of the St. Louis Federal Reserve Bank, said that the GSEs ...appeared to be insufficiently capitalized to handle the kind of losses suffered by U.S. major banks in the past six months. ...Poole has long been skeptical—correctly it turns out—of Fannie and Freddie’s ability to serve both God (their social mission of promoting liquidity and affordability) and Mammon (the shareholder and lush management compensation). At Fannie, a generation of Democratic Party insiders, such as James Johnson, Jamie Gorelik and Franklin Raines, made substantial fortunes in Fannie’s executive suite. As Fannie Mae’s top regulator, James Lockhart, pointed

out in recent congressional testimony, the absence of debt-market discipline (the government guarantee makes Fannie and Freddie all but impervious to credit downgrades) makes pell-mell growth irresistible to shareholders and managers. Have a hunch, bet a bunch.”

- “Soft assets” on Fannie Mae’s balance sheet include \$13 billion of deferred tax assets and \$8.1 billion of Lower Income Housing Tax Credit partnerships, whose values are dependent upon the company generating earnings to employ these tax credits. On the liability side of Fannie’s balance sheet, Morgan Stanley analyst Kenneth Posner questioned how Fannie established its fair market value of its guaranty obligation (1.5% of its guaranteed book—\$15.4 billion) at year end, which is double the value established by Freddie Mac (0.74% of book). Laing wrote, “Had Fannie taken a similar hit, its fair-value net worth would’ve shrunk by some \$20 billion to a paltry \$16 billion, compared with its juiced-up regulatory capital of \$45.4 billion. Fannie stands by its estimate and says it doesn’t know how Freddie arrived at its own.” Further, Fannie was “inordinately easy on itself” during the fourth quarter, in which it wrote down its \$74 billion of non-agency subprime and Alt-A mortgage-backed securities by a “mere 6%” (\$4.6 billion) with only \$1.4 billion of the write-down constituting a permanent impairment. If Fannie had written off the full \$4.6 billion, the majority of the company’s “excess capital” (\$3.9 billion) would have been “torched.”
- Laing wrote, “The very survival of Fannie as a going concern hinges on the size and speed of the credit losses it faces in the years ahead. Merrill Lynch’s Kenneth Bruce sees Fannie suffering losses on its current book of around \$32 billion over the next decade. Yet, he still expects the company to manage recovery earnings per share of between \$2.50 to \$4 between 2009 and 2011. His forecast, however, is based on spirited 8% average annual growth in Fannie’s credit book over the decade. Although Fannie has just been cleared to deal in mortgages of up to \$700,000, from \$420,000 now, 8% growth could be hard to come by if the company’s capital remains stretched.”
- “Problems at Fannie Mae and Freddie Mac can have big implications. The agencies support some 55% of all mortgage originations, after a dip in 2004-2006, and account for half of all outstanding mortgages. In our view, the rapid decline in home prices and soaring level of foreclosures might cause the wave of credit losses to hit far sooner and with greater ferocity than many imagine, potentially submerging the income Fannie is expecting to harvest from volume growth and higher lending fees...”
- “To be sure, Fannie has a better book of mortgages than most institutions. Fannie requires a layer of credit insurance on much of its high-loan-to-value mortgages. The GSEs have long insisted on higher underwriting standards on the loans they purchase in the secondary market. Yet using conservative default rates of 40% on its \$133 billion subprime book, 12.5% on its \$314 billion of Alt-A mortgages and 4% on its remaining \$2 trillion of prime home mortgages, **Fannie could well be facing**

cumulative credit losses of over \$50 billion. [Emphasis added.] That's after assuming Fannie will realize recoveries of 60% on its subprime and Alt-A loans and 70% on its prime loans. Should Fannie founder over the next couple of years, the government would have no choice but to step in and back all of its debt and guarantee obligations. Too much of the paper is owned by our major creditors, such as China and Japan."

- "Perhaps, both Fannie and Freddie can go back to the capital markets to raise more equity, as they did last fall when both sold a combined \$13 billion of preferred stock. Both have said they may take such action should circumstances demand it. But with both stocks in steep decline—Fannie's is down 65% since last fall—offerings would bring punishing dilution and growing investor skepticism."
- "Just maybe a bailout of Fannie, in effect a nationalization, would be a good thing. A retooled Fannie could pursue its important social mission without the distraction of trying to please Wall Street. Of course, it's doubtful if this happens that the shareholders would be along for the ride." (*Baron's*, Jonathan R. Laing, 03/10/08; *Financial Times*, 03/11/08)
- Market prices for Fannie Mae and Freddie Mac mortgage-backed securities plunged as supply outstripped market demand, signaling that the GSEs' ability to prop up the mortgage lending system had weakened. Troubled investment funds have been dumping agency securities to cover losses on less marketable securities, said Kevin Cavin, a mortgage strategist for FTN Financial Capital Markets. "[L]everaged investors, namely the hedge fund community, who have had to sell their most liquid and highest quality assets ...to meet margin calls from their lenders because their weakest quality assets ...have seen extremely sharp declines in market value and there are few if any buyers of those securities," said Cavin. In a note to clients, UBS AG government bond strategist William O'Donnell wrote that the markets have become "utterly unhinged," as a lack of liquidity has "led to stunning air-pockets in price levels." On March 6th, the difference in yields on the Bloomberg Index for Fannie Mae's current coupon, 30-year fixed rate mortgage and 10-year government bond notes widened from 21 basis points [in 1986] to 237 basis points. The widening spreads prompted speculation that the federal government may step in to support securities guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae, said Tom di Galoma, head of Jeffries & Co.'s U.S. Treasury trading department. Treasury quelled the market consternation by issuing a statement to the *Wall Street Journal* that explicit-backing rumors were "absolutely not true." Douglas A. Dachille, chief executive of First Principles Capital Management said, "The implications are quite onerous because this was the one market that was functioning, and moreover, this is the market that the administration was counting on to maintain its liquidity so that it could help all these troubled homeowners. If this continues, this is going to be very bad for home prices."
- "It is a strong attempt to stabilize a crisis," said Henry Kaufman, president of Henry Kaufman & Co. in a Bloomberg Radio interview. "It is a further recognition that this

credit crisis is deeper and wider, and has been exceedingly opaque, in contrast to earlier credit crises.” In a March 7th JP Morgan report, analyst Christopher Flanagan wrote, “A systemic crunch is underway, driven primarily by bank write-downs in subprime mortgages. We should characterize this situation as a systemic margin call [which may deplete banks of \$325 billion of capital].”

- Concurrently, Fannie Mae’s and Freddie Mac’s shares plunged as fears on Wall Street grew that mortgage defaults would ultimately force both companies to raise additional capital. Bearish reports from Credit Suisse and *Barron’s* fueled investors’ anxiety. [For FY2008, Credit Suisse analyst Moshe Orenbuch nearly doubled his projected loss for Freddie to \$2.6 billion—or \$4 a share—and forecast a \$3.4 billion loss (\$3.50 a share) for Fannie Mae.] Keefe, Bruyette & Woods’ chief equity analyst Frederick Cannon argued that Fannie and Freddie “would be best off by raising capital,” which would allow the companies to buy MBS whose yields have soared to attractive levels. Barclays Capital global strategist Tim Bond said, “The agency crisis was a Tsunami event. The market was starting to question the solvency of the bodies that stand at the top of the credit pile [Fannie and Freddie]. These agencies together wrap or insure \$6 trillion of mortgages. They cannot be allowed to fail because it would cause a financial disaster. The fact that this sector has blown up has caught everyone’s attention in Washington.”
- To shore up investor confidence [on March 11th], OFHEO director James B. Lockhart, III issued a statement saying: “[Fannie Mae’s and Freddie Mac’s] public mission remains critical in the face of current market uncertainties. Each Enterprise has sufficient capital at this time, but raising capital would put them in an even better position to support the mortgage market as will quick passage of comprehensive GSE reform legislation.” (*Washington Post*, David S. Hilzenrath, 03/07/08; *American Banker*, Kate Berry, 03/11/08; *Wall Street Journal*, James R. Hagerty, 03/11/08; *Bloomberg News*, Jody Shenn, 03/06/08; *Associated Press*, Peter Eavis, 03/12/08; *Fortune’s Daily Briefing Blog*, 03/06/08; *London Daily Telegraph*, Ambrose Evans-Pritchard, 03/13/08; *Reuters*, Walden Siew, 03/08/08; *Bloomberg*, Scott Lanman, 03/12/08)
- Despite OFHEO’s assurances, Wall Street analysts continued to speculate how much capital the GSEs would ultimately need to raise, so that Fannie and Freddie could play a bigger role in stabilizing the mortgage market. Lazard Asset Management analysts suggested that Fannie and Freddie should raise as much as \$50 billion each, which would more than double their existing capital levels. In an *Associated Press* article, Peter Eavis speculated that Fannie and Freddie may have to issue “in excess of \$10 billion of new stock this year” to “put market fears to rest” about the GSEs’ “ability to support the troubled housing market” and allay concerns about the GSEs’ viability. (*Wall Street Journal*, Peter Eavis and David Reilly, 03/12/08; *www.BreakingNews.com*, Antony Currie, 03/14/08)

Federal Reserve injects additional liquidity into the banking system and accepts agency mortgage-backed securities as collateral

- On March 7, the Federal Reserve announced it was making \$200 billion available to financial institutions in an effort to ease a crisis of confidence in the marketplace. Specifically, the Fed said it will increase the amounts that banks could borrow at the Term Auction Facility to \$100 billion in March [up from \$60 billion in January and February]. The Fed said it would make another \$100 billion available through term repurchase agreements, collateralized by Treasury, agency debt, or agency-backed mortgage-backed securities. And on March 11, the Federal Reserve announced that it would swap \$200 billion worth of Treasury bills for \$200 billion of mortgage-backed securities held by major investment banks that are members of the “prime broker” network on Wall Street. The move by the Federal Reserve Board to accept agency MBS is seen by many in the market as strengthening the implicit government guarantee of Fannie Mae and Freddie Mac. Although senior Fed staffers insisted the plan was aimed at stabilizing the market rather than specific firms, the move gives GSEs critical support at a time when market turmoil has left debt and equity investors questioning the companies’ underlying health, said observers. “The government is going to strengthen its implicit guarantee despite the fact that, as we know, this administration and the Fed have not been very favorably disposed toward Fannie and Freddie,” said former Fed vice chairman Alan Blinder. “But in this situation, I think those attitudes are in the process of being reversed. You can think of the Fed’s action as one step in that reversal.” Arun Raha, the vice president and senior economist at Swiss Re, said, “The Fed’s backing them now. That they’re willing to accept ... [agency MBS] as collateral means they’re making them more liquid.” An industry source, who spoke on condition of anonymity, called the Fed’s move a “stealth bailout.” The source added, “They are directly supporting those two companies. It’s very positive for Fannie and Freddie.” In a note to clients, UBS wrote, “We believe this represents an attempt to inject liquidity into creditworthy segments of the mortgage market that have come under pressure despite limited credit deterioration.” (*Washington Post*, Steven Pearlstein, 03/12/08; *Federal Reserve Press Release*, 03/07/08; *Bloomberg*, Scott Lanman, 03/12/08; *Thomson Financial*, 03/11/08; *Washington Post*, Neil Irwin and David Cho, 03/08/08; *American Banker*, Steven Sloan, 03/12/08)
- In a March 12th editorial, the *Wall Street Journal* wrote, “There is some moral hazard in the Fed accepting MBSs as collateral, though the Fed says its balance sheet remains strong. There is even greater risk if Members of Congress begin to look to the Fed as a way to buy up these MBSs on a permanent basis as a way to ‘rescue’ the mortgage market. Thus it is very important that this new program, along with the Fed’s Term Auction Facility, end as soon as they have served their purpose of easing liquidity strains.”

- “The good news is that yesterday’s exercise showed signs of working. The flight to the safety of Treasuries eased, while spreads in mortgage securities narrowed considerably. Even better, market expectations for another big cut in the fed funds rate next week fell. If these surgical strikes work, maybe the Fed won’t continue to run the risk of tempting inflation and a dollar rout with ever easier monetary policy.” (*Wall Street Journal*, 03/12/08)

Did the Fed’s bailout of Bear Stearns cross the line of “moral hazard?”

- On March 14th, Bear Stearns Cos. Inc. went on life support, forced to accept an extraordinary bailout package from the Federal Reserve Bank and J.P. Morgan, after being deserted by its clients and counterparties. Bear Stearns said it received an unspecified amount of short-term [28-day] financing from the Federal Reserve Bank of New York, through J.P. Morgan, after its liquidity “deteriorated significantly” during the prior 24 hours. J.P. Morgan is working with Bear to secure permanent financing or “other alternatives” for the firm. “You’ve got a run on the bank situation where no one will accept any Bear Stearns collateral no matter what it is,” said Brian Barish, president of Cambiar Investors LLC. “This is the nastiest episode I have seen in decades.” According to Egan Jones analysts, “Bear needs to raise \$3-to-\$5 billion of equity within the next couple of days to address concerns; it needs support or firms will withdraw from doing business with Bear. Bear shares are down again today [March 14th], this time because of concerns about viability [caused by banks’ insistence on higher margin levels].”
- “What is different this time is that the dominoes are falling in so many different sectors, markets, industries and countries -- all at the same time and there is yet no end in sight,” said Sherry Cooper, BMO Capital Markets’ chief economist. (*Reuters*, Dane Hamilton and Joseph Giannone, 03/14/08; *MarketWatch*, Alistair Barr, 03/14/08)
- On March 16th, J.P. Morgan reached an agreement to acquire Bear Stearns for \$2.00 a share in a stock transaction, which has been approved by both companies’ boards. To facilitate the merger, the Fed has agreed to fund up to \$30 billion of Bear Stearns’ less liquid assets, according to JPMorgan. [Concurrently, the Fed also approved a cut in its emergency lending rate to financial institutions to 3.25% from 3.50%, effective immediately.] The merger isn’t subject to any conditions, other than shareholder approval, and is expected to close before the end of the second quarter. The Federal Reserve and OCC have approved the proposed merger transaction. Effective immediately, J.P. Morgan will guarantee the trading obligations of Bear Stearns and its subsidiaries and will provide management oversight for the firm’s operations. (*Wall Street Journal*, Dennis K. Berman, Susanne Craig, and Kate Kelly, 03/17/08; *Associated Press*, Jeannine Aversa, 03/17/08)
- In a March 16th article in the *New York Times*, Gretchen Morgenson wrote, “What are the consequences of a world in which regulators rescue even the financial

institutions whose recklessness and greed helped create the titanic credit mess we are in? Will the consequences be an even weaker currency, rampant inflation, a continuation of the slow bleed that we have witnessed at banks and brokerage firms for the past year? Or all of the above? Stick around, because we'll soon find out. And it's not going to be pretty."

- "Agreeing to guarantee a 28-day credit line to Bear Stearns, by way of JPMorgan Chase, the Federal Reserve Bank of New York conceded ...that no sizable firm with a book of mortgage securities or loans out to mortgage issuers could be allowed to fail right now. It was the most explicit sign yet of the Fed's 'Rescues 'R' Us' doctrine that already helped to force the marriage of Bank of America and Countrywide. But why save Bear Stearns? The beneficiary of this bailout, remember, has often operated in the gray areas of Wall Street and with an aggressive, brass-knuckles approach. Until regulators came along in 1996, Bear Stearns was happy to provide its balance sheet and imprimatur to bucket-shop brokerages like Stratton Oakmont and A.R. Baron, clearing dubious stock trades. And as one of the biggest players in the mortgage securities business on Wall Street, Bear provided munificent lines of credit to public-spirited subprime lenders like New Century (now bankrupt). It is also the owner of EMC Mortgage Servicing, one of the most aggressive subprime mortgage servicers out there."
- "Bear's default rates on ...Alt-A mortgages that it underwrote also indicates that its lending practices were especially lax during the real estate boom. As of February, according to Bloomberg data, 15 percent of these loans in its underwritten securities were delinquent by more than 60 days or in foreclosure. That compares with an industry average of 8.4 percent. Let's not forget that Bear Stearns lost billions for its clients last summer, when two hedge funds investing heavily in mortgage securities collapsed. And the firm tried to dump toxic mortgage securities it held in its own vaults onto the public last summer in an initial public offering of a financial company called Everquest Financial. Thankfully, that deal never got done."
- "Recall, too, that back in 1998, when the Long Term Capital Management hedge fund required a Fed-arranged bailout, Bear Stearns refused to join the rescue effort. Jimmy Cayne, then chief executive at the firm, told the Fed to take a hike. And so, Bear Stearns, a firm that some say is this decade's version of Drexel Burnham Lambert, the anything-goes, 1980s junk-bond shop dominated by Michael Milken, is rescued. Almost two decades ago, Drexel was left to die."
- Bear Stearns and Drexel have a lot in common. And yet their differing outcomes offer proof that we are in a very different and scarier place than in the late 1980s. 'Why not set an example of Bear Stearns, the guys who have this record of dog-eat-dog, we're brass knuckles, we're tough?' asked William A. Fleckenstein, president of Fleckenstein Capital in Issaquah, Wash., and co-author with Fred Sheehan of *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve*. 'This is the perfect time to set an example, but they are not interested in setting an example. We are Bailout Nation.'"

- “And so we are. After years of never allowing any of our financial institutions to fail, they have become so enormous that nobody will be allowed to sink beneath the waves. Otherwise, a tsunami would swamp the hedge funds, banks and other brokerage firms that remain afloat. If Bear Stearns failed, for example, it would result in a wholesale dumping of mortgage securities and other assets onto a market that is frozen and where buyers are in hiding. This fire sale would force surviving institutions carrying the same types of securities on their books to mark down their positions, generating more margin calls and creating more failures.”
- “As of last Nov. 30, Bear Stearns had on its books approximately \$46 billion of mortgages, mortgage-backed and asset-backed securities. Jettisoning such a portfolio onto a mortgage market that is not operative would, it is plain to see, be a disaster. But, who knows what those mortgages are really worth? According to Bear Stearns’s annual report, \$29 billion of them were valued using computer models ‘derived from’ or ‘supported by’ some kind of observable market data. The value of the remaining \$17 billion is an estimate based on ‘internally developed models or methodologies utilizing significant inputs that are generally less readily observable.’ In other words, your guess is as good as mine.”
- “To some degree, what happened at Bear, of course, was a classic run on the bank...As fears about Bear’s financial position heightened, its customers began demanding their cash and big hedge funds that were using the firm as an administrative back office or lender moved their accounts elsewhere. In addition, institutions that had bought credit default swaps from Bear Stearns, insurance policies that protect against corporate bond defaults, were scrambling to undo those trades as the firm’s ability to pay the claims looked dicier.”
- “‘For the government to print money at the expense of taxpayers as opposed to requiring or going about a receivership and wind-down of any insolvent institutions should be troubling to taxpayers and regulators alike,’ said Josh Rosner, an analyst at Graham Fisher & Company... ‘The Fed has now crossed the line in a very clear way on ‘moral hazard,’ because they have opened the door to the view that they are required to save almost any institution through non-recourse loans — except the government doesn’t have the money and it destroys the U.S.’s reputation as the broadest, deepest, most transparent and properly regulated capital market in the world.’”
- “And here is the unfortunate refrain. Investors, already mistrusting many corporate and government leaders, were once again assured that nothing was wrong — right up until the very end. So is it any wonder investors react to every market rumor of an impending failure with the certainty that it’s true? In too many cases, the rumors turned out to be true, notwithstanding the attempts at reassurance by executives and policy makers. Only last Monday, for example, Bear put out a press release saying, ‘there is absolutely no truth to the rumors of liquidity problems that circulated today in the market.’ The next day, Christopher Cox, the chairman of the [SEC], said he

was comfortable that the major Wall Street firms were resting on satisfactory ‘capital cushions.’ Three days later, it was bailout time for Bear.”

- “HERE is the bind the Fed is in: Like the boy who puts his finger in the dike to keep sea water from pouring in, the Fed finds that new leaks keep emerging. Regulators must do whatever they can to keep the markets open and operating, and much of that relies upon the confidence of investors. But by offering to backstop firms like Bear, who were the very architects of their own — and the market’s — current problems, overseers like the Fed undermine a little bit more of that confidence.”
- “Another worry? How many well-capitalized institutions remain at the ready to take over those firms that may encounter turbulence in the future? Banks just do not have the capital that is needed to rescue troubled firms. That will leave the taxpayer, alas. As usual.” (*New York Times*, Gretchen Morgenson, 03/16/08)

The federal government will “do what it takes”

- In a series of [Sunday] news show appearances on March 16th, Treasury Secretary Henry Paulson said that the Bush administration would “do what it takes” to stabilize the chaotic markets and minimize the economic damage to the financial system. Paulson defended the Federal Reserve’s extraordinary step to provide emergency financing to Bear Stearns—calling the central bank’s intervention “the right decision.” Paulson sought to send a calming message to the financial markets by saying, “The government is prepared to do what it takes to maintain the stability of our financial system. That’s our priority.” He added, “We’re very aware of moral hazard. But our primary concern right now—my primary concern—is the stability of our financial system, the orderliness of the markets. And, that’s where our focus is.” The financial system “is more fragile than we would like it right now,” said Paulson. The Treasury Secretary appeared on ABC’s *This Week*, *Fox News Sunday*, and CNN’s *Late Edition*. (*Associated Press*, 03/16/08).

Fannie Mae and Freddie Mac exceed their capital requirements for the fourth quarter

- On March 11, OFHEO reported that Fannie Mae and Freddie Mac were adequately capitalized on December 21, 2007. According to the regulator, Fannie Mae’s capital level exceeded its 30% minimum surplus requirement by 9.3% [or \$3.9 billion] for the fourth quarter, while Freddie Mac’s capital level was 10.0% [or \$3.5 billion] over its required minimum for the period. “Both Enterprises’ percentages reflect significant increases over the depressed third quarter results due to the issuances of significant preferred stock during the fourth quarter to offset continuing market and credit-related losses,” said OFHEO in a statement. The agency noted that Freddie Mac’s capital surplus dipped below the required minimum on November 30, but was brought back into compliance when the company issued \$6 billion in preferred stock during the first week of December. Both GSEs increased their capital

during the quarter in moves seen as “prudent” given the market conditions, said OFHEO. The agency indicated it is considering “the gradual decreasing of the GSEs’ capital surcharge if the enterprises meet certain safety and soundness conditions. The approach and timing of this decrease will also include consideration of the financial condition of the company, its overall risk profile and current market conditions,” said OFHEO director James B. Lockhart, III. (*Bureau of National Affairs*, 03/12/08; *Reuters*, 03/11/08; *Housing Wire*, Paul Jackson, 03/11/08)

Freddie Mac has no plans for plans to raise capital that would dilute shareholder equity
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- During a March 12th conference call with investors, Freddie Mac chairman and CEO Richard Syron said that the company will put shareholders’ interests first and resist pressure to raise more capital. During the session, CFO Anthony S. Pizel repeatedly told investors, “There is no dilutive capital raise planned.” Pizel said that there may be room to raise more capital without offering common stock. “[There are] opportunities to have discussions with our regulators broadening what qualifies as capital to be much more like other financial institutions,” he added. “We think we have enough [capital],” said Syron. “...This company will bow to no-one on our responsibility to the shareholders. As long as we are what we are, it’s clear what our fiduciary responsibility is [i.e., protecting the shareholders’ interests].”
- Pizel said that Freddie Mac’s earnings should improve by a “good margin” in 2008 “We should see all-in guarantee fees climb into the mid-30s [basis points] later this year [versus high-teens in 2007],” said Paul Mullings, vice president of single-family housing. Freddie Mac has been criticized for increasing its fees, which has made credit more expensive and potentially slowed the recovery in housing. Pizel dismissed concerns that the company’s auditors would require further write-downs of nonprime mortgage-backed securities, saying so far there are “no points of contention” with the auditors on this issue. Further, Pizel argued that Freddie is reporting profits under tax accounting, so suggestions that the company will need to write-off accumulated tax breaks are erroneous.
- Syron said that he has urged HUD officials to change the federal rules that enable too many low- and moderate income Americans to buy homes that they can’t afford. He called it “perverse to put people in homes that they end up losing.” Syron added that HUD officials seemed receptive to his suggestions that the agency’s affordable-housing goals be modified to reflect this concern. Describing the housing market as undergoing a “hundred-year storm,” Syron said, “We have absorbed a little more than half [the decline in housing prices]. ...We are not pretending that home prices have reached bottom.” He said housing prices are likely to decrease 15% [rather than Freddie’s original estimate of 10%] and some areas, particularly on the East and West coasts, will be hard hit.
- While Freddie Mac’s management applauded the Federal Reserve’s recent efforts to improve trading liquidity of agency MBS, the market conditions for agency paper are

likely to be dicey for months to come. Patricia L. Cook, Freddie Mac's chief business officer, said while the Fed's action was "short-term help, it doesn't solve the long-term problem. The longer-term issue is where do those mortgages ultimately end up." When asked about speculation that the Treasury Department might explicitly guarantee Freddie's debt, Syron said, "As a matter of policy, we think it would be wrong ... We think our debt is strong."

- Syron told reporters that Freddie Mac will "be in the market shortly, very shortly" for a new chief executive officer, which would enable the company to split the roles of CEO and chairman as mandated by OFHEO. (*American Banker*, Harry Terris, 03/13/08; *Financial Times*, Saskia Scholtes, 03/12/08; *Washington Post*, David S. Hilzenrath, 03/13/08; *Bloomberg*, Jody Shenn and James Tyson, 03/12/08; *FOX Business*, Ken Sweet, 03/12/08; *Bloomberg News*, Jody Shenn and James Tyson, 03/12/08; *Bloomberg*, Jody Shenn, 03/12/08)
- Management's insistence to put shareholders' interests ahead of public interests' with regard to capital raising was in stark contrast to the policymakers' calls for GSEs and all financial institutions to raise capital. In a March 4th speech, Federal Reserve chairman Ben Bernanke said, "...The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, ...could do a great deal to address the current problems in housing and the mortgage market. New capital raising by the GSEs, together with congressional action to strengthen the supervision of these companies, would allow Fannie and Freddie to expand significantly the number of new mortgages that they securitize. With few alternative mortgage channels available today, such action would be highly beneficial to the economy. I urge the Congress and the GSEs to take the steps necessary to allow more potential homebuyers access to mortgage credit at reasonable terms." In March 13th remarks at the National Press Club, Treasury Secretary Hank Paulson called on financial institutions—including Fannie and Freddie—to raise more capital and reduce their dividends to shore up their balance sheets. "We are encouraging financial institutions to continue to strengthen balance sheets by raising capital and revisiting dividend policies. We need these institutions to continue to lend and facilitate economic growth." In a March 11th interview with the *Wall Street Journal*, OFHEO director James B. Lockhart, III said that "raising capital would put [Fannie and Freddie] in an even better position to support the mortgage markets." (*Prepared remarks of Federal Reserve Chairman Ben S. Bernanke*, 03/04/08; *Fortune Magazine*, Colin Barr, 03/13/08; *Fortune's Daily Briefing Blog*, 03/12/08)
- In a March 13th press release, Jerry Howard, EVP and CEO of the National Association of Home Builders, said, "As a congressionally chartered enterprise, Freddie Mac has two significant and equal responsibilities – that of serving its housing mission and its shareholders. With the housing market in the midst of its worst downturn in decades and millions of Americans facing foreclosure or unable to obtain financing to buy a home, Freddie Mac CEO Richard Syron said [on March 12th] that his chief interest is making money for his shareholders. It is now painfully obvious that the company has strayed light years away from its other vitally important

congressionally mandated mission of ensuring an adequate flow of credit for housing and home buyers.”

- “This underscores the need for Congress to act now to enact comprehensive reform of the GSEs and strengthen the regulatory oversight over these institutions so that they can return to an aggressive pursuit of their housing mission. Today’s mortgage credit crunch has profound implications not just for housing, but for the overall economy, which, at best, is teetering on the brink of recession. It is deeply discouraging that a company that should be doing everything within its power to restore liquidity to the marketplace has instead decided to neglect that responsibility.” (*National Association of Homebuilders Press Release, 03/13/08*)

President’s Working Group on Financial Markets outlines recommendations to ease credit market turmoil

- On March 13, Treasury Secretary Henry Paulson outlined the recommendations of the President’s Working Group on Financial Markets (PWG) designed to ease the existing credit market turmoil, which address the need for new regulations governing credit rating agencies, the mortgage origination and securitization process, and improved risk management practices by financial institutions. “We must have better policies, processes and mechanisms to understand and manage complexity, to discourage its excess, and to better understand and manage risk,” said Paulson. All of the PWG’s recommendations share the collective goals of strengthening transparency and disclosure, risk awareness, risk management, capital management, regulatory policies and market infrastructures in order to strengthen and improve capital markets’ efficiency and enabling sustainable economic growth. “We will pursue implementation in a measured way, so as not to impose burdens which might exacerbate the present situation,” said Paulson
- Credit rating agencies should amend their rating processes to ensure integrity and transparency, said Paulson. The agencies should also implement changes suggested by the SEC review of conflict-of-interests issues, he added. In addition, the agencies should distinguish ratings on structured products from those for corporate and municipal securities. The agencies also should require securitized credit issuers to scrutinize originators of assets that are either securitized or used as collateral for structured credit products. The PWG plans to form a private sector committee to work toward implementing these recommendations and develop more, as necessary.
- The PWG’s recommendations for the mortgage origination process include (1) having all states implement strong, nationwide licensing standards for mortgage brokers; (2) encouraging state and federal regulators to strengthen and make consistent government oversight of entities that originate and fund mortgages; and (3) having the Federal Reserve issue stronger consumer protection rules and mandate enhanced consumer protection disclosures. Paulson added that the Treasury Department would soon issue additional recommendations to improve the mortgage loan origination

process. The Treasury Secretary said that market participants' behavior in the securitization process must also be changed, but acknowledged that no easy solution exists for this problem. Specifically, Paulson called for better disclosure on mortgage on mortgage-backed securities, improved investor analysis, and enhanced regulatory participation.

- Paulson urged financial institutions to identify and rectify any weaknesses in their risk management practices. The PWG would support the formation of a private sector group to reexamine the guiding principles set forth by the Counterparty Risk Management Policy Group regarding risk management, monitoring, and transparency.
- The Treasury Secretary noted that the industry has taken some steps to support the expansion of the over-the-counter derivatives market, as a result of recent price volatility and surging trading volumes. "We need a dedicated industry cooperative [to address this issue]," said Paulson. Such a system should be reliable and scalable, capture all significant processing events over the entire lifecycle of trades, be capable of handling all major asset classes and product types, and use automation, he said. The Federal Reserve Bank of New York will take a lead role in working with market participants on standards for trade data and trade resolution, and the development of cash settlement protocols as part of standard documentation.
- All relevant regulatory agencies should ensure that investors improve due diligence and should review capital requirements, said the Treasury Secretary. "We are encouraging financial institutions to continue to strengthen balance sheets by raising capital and revisiting dividend policies," said Paulson. "We need these institutions to continue to lend and facilitate economic growth." Specifically, he requested that the Basel Committee on Banking Supervision review the Basel II capital requirements for re-securitizations and off-balance sheet commitments, and complete its liquidity management guidance update.
- Paulson said that the PWG's recommendations are part of a larger effort by the Bush administration to review the financial regulatory structure, which will be released as a regulatory blueprint in coming weeks. Participants in the PWG include the chairs of the Federal Reserve Board, the SEC, the Commodity Futures Trading Commission, and the Secretary of Treasury. The high-level, interagency structure of the committee made it difficult for special interests to influence the group, said Paulson, who kept in contact with representatives in the private sector. Because few outsiders participated, the Treasury Secretary acknowledged that the group "has a lot of work to do" in persuading private firms to agree to new policies. "We obviously will take the next steps ... and if we need additional authorities, we'll go get them," said Paulson. In an interview, Paulson said, "It's clearly going to take a while to put these recommendations in place and to implement them. We must implement these recommendations with an eye toward not creating a burden that exacerbates today's market stresses."

- The PWG’s recommendations received a decidedly cool reaction from a number of banking sources. “People won’t be spending a lot of time to implement them if or when the market turns around,” said Gil Schwartz, a partner at Schwartz & Ballen. “I don’t think any of these recommendations would solve anything.” Joshua Rosner, a managing director at Graham Fisher & Co., said, “[I] really didn’t see anything that new in there. I didn’t see anything implementable and anything much more than a status update.” Chris Cole, regulatory counsel for the Independent Community Bankers of America, said that PWG’s plan “reflects the fact that at this point, the administration seems to have run out of tools to work with, and I think they seem to be reluctant to go on to the next step, which would be greater government intervention.” Observers also said that the plan appeared short on key details. For example, it called for increased disclosure by credit ratings agencies — and called on regulators to review their use of ratings in rules and guidance — but the Treasury provided few specifications on how they should be changed. “It’s fairly vague at this point exactly what Treasury wants to do,” said Chris Low, chief economist for FTN Financial. (*Bureau of National Affairs*, Aaron Lorenzo, 03/14/08; *Washington Post*, David Cho and Jeffrey H. Birnbaum, 03/14/08; *American Banker*, Cheyenne Hopkins, 03/14/08; *Financial Times*, Krishna Guha and James Politi, 03/14/08)

Fannie Mae and Freddie Mac

Democratic leaders announce legislative plans to stem home foreclosures

President Bush warns about Congress against the temptation of limiting “the number of foreclosures [by] ...putting bad law in place”

Treasury Secretary Paulson says most of the bailout proposals
“would do more harm than good”

Subprime crisis is the *private sector’s* problem

The only real solution is for housing values to hit bottom

Democratic leaders announce legislative plans to stem home foreclosures

- On March 13th, House Financial Services Committee chairman Barney Frank (D-MA) and Senate Banking Committee Chairman Chris Dodd (D-CT) introduced similar legislative proposals to address the subprime mortgage crisis. While no legislation has been introduced and details remain to be worked out, Frank said that he and Dodd have a “conceptual agreement” on their proposals. “While we are not in identical places now, we are in very similar places,” said Frank. Dodd agreed by saying, “ We need to move aggressively—cautiously, prudently, and thoughtfully, but

aggressively—in order to regain our financial footing and ensure a crisis of this magnitude does not occur again.” During a joint press briefing, Frank and Dodd indicated that they will move these legislative proposals through their respective committees shortly after Congress returns on March 31st from its upcoming spring recess.

- Frank outlined his proposal (the program) aimed to stem mortgage foreclosures by allowing the FHA to insure and guarantee refinanced mortgages that have been significantly written down by mortgage holders and lenders. According to *InfoBytes*, “The program would permit the FHA to provide up to \$300 billion in new guarantees that would help to refinance at-risk borrowers into viable mortgages. In exchange for the acceptance of a substantial write-down of principal, the existing lender or mortgage holder would receive a ‘short’ payment from the proceeds of a new FHA loan if the restructured loan would result in terms that the borrower can reasonably be expected to pay. The existing lender or mortgage holder will have a cash payment and no further credit exposure to the borrower. Under the program, a borrower or existing loan servicer of an eligible loan would contact an FHA-approved lender, who would determine the size of a loan that would be consistent with the requirements of the program and that the borrower could reasonably repay. If the current lender or mortgage holder agrees to a write-down that is sufficient to meet the requirements of the program and make the new loan affordable, the FHA-lender will pay off the discounted existing mortgage. In addition to a first lien, the program gives the government a soft second lien to help defer the government’s costs and prevent unjust enrichment (e.g., borrower flipping). When the borrower sells the home or refinances the loan, the borrower will pay from any profits the higher of (1) an ongoing exit fee equal to 3 percent of the original FHA loan balance; or (2) a declining percentage of any profits (e.g., from 100 percent in year one to 20 percent in year five and 0 thereafter). After year five only the 3 percent exit fee will apply. The bill would also provide for a ‘bulk refinance’ facility, under which lenders seeking FHA approval could offer bulk loan refinancing. Finally, the bill would provide \$10 billion in loans and grants to states for the purchase and rehabilitation of vacant, foreclosed homes.”
- Frank’s plan would replace an earlier proposal which would have created a federal entity for the purchase of distressed mortgages. Dodd offered a much less detailed legislative proposal [relative to Frank’s plan], but indicated that he hoped his bill would assist in the refinancing of up to \$400 billion in distressed mortgages. Both proposals target subprime borrowers who can’t afford their loans after their rates reset and prime borrowers who are “under water” as a result of home prices falling below their loan balances, according to a committee spokesman. To screen out borrowers who may try to intentionally default, the program will be limited to those with a debt-to-equity ratio of more than 40% as of March 1, 2008. Speculators and investors will not qualify for this program, which applies only to mortgages originated between January 1, 2005 and July 1, 2007. The linchpin for both proposals is that mortgage servicers or others holding delinquent mortgages must accept a significant write-down of the principal value. For example, the participating mortgage holder would have to accept a write-down providing a 5% loan loss reserve for the FHA [which is

insuring the loan], waive all penalties and fees related to the existing loan, and cover all up-front fees associated with the new loan. New loans could not be written with a loan-to-value ratio exceeding 90% of the current appraised value. Frank warned that the success of the program would hinge on the cooperation of the financial services industry which must be prepared to recognize its losses on these loans. “It depends on how realistic the lenders are going to be,” said Frank. “Someone said, ‘Are you asking them to take a haircut?’ I said, ‘No, a lobotomy.’ We are beyond haircut.”

- Dodd said, “Instead of cheerleading, and reacting with tepid measures, the administration should act boldly and decisively to prevent the looming foreclosure crisis from having catastrophic consequences for our economy and our markets.” Frank said he hopes that Federal Reserve chairman Ben Bernanke’s comments on March 4th, urging lenders to accept broader loan writedowns, would help encourage the Bush administration’s support of his proposal. “If the president continues to insist that we don’t do anything beyond Hope Now, then you are going to have a longer and deeper economic problem than is necessary,” said Frank. “I’m hoping that Chairman Bernanke ...will have an impact.” (*InfoBytes*, Buckley Kolar, LLP, 03/14/08; *CQ Today Midday Update*, 03/14/08; *Bureau of National Affairs*, Richard Cowden, 03/14/08; *CQ Today*, Benton Ives, 03/13/08; *American Banker*, Stacy Kaper, 03/06/08; *American Banker*, Stacy Kaper, 03/06/08)
- Senators Barack Obama (D-IL) and Hillary Clinton (D-NY) both issued statements endorsing Frank’s and Dodd’s legislative proposals. Obama said the proposal is a “responsible and fair way to help bring an end to the foreclosure crisis facing the country” Clinton said, “This approach is not a bailout. It is a sensible way for all actors—lenders, investors, servicers, and borrowers—to share responsibility, keep families in their homes, and stabilize our communities and our economy.” (*American Banker*, Stacy Kaper, 03/14/08)
- On the March 14th *CBS Morning Show*, Moody’s *Economy.com* chief economist Mark Zandi said that the time is right for the federal government to invest [i.e., bail out] in the housing market. “They’re very difficult to tackle - but I think they [lawmakers] are coming forward with plans that eventually will have some benefit,” said Zandi “But they do need to do more. I do think this is a very large problem, and it’s going to require a big answer— probably taxpayer money at the end of the day and I think we’re headed down that path. ...But I think we’re at a point where if we don’t try to alleviate the problems in the housing and mortgage markets, take some of the pressure off people who are losing these homes, that the economy will be in recession, and we’ll lose more in taxpayer money because of the lost tax revenue, than it would cost to help them out. So I think we’re at that point.” (*Business & Media Institute*, Jeff Poor, 03/14/08)

President Bush warns Congress against the temptation of limiting “the number of foreclosures [by] ...putting bad law in place”

- In a March 14th speech before the Economic Club in New York, President George W. Bush said, “...[A] root cause of the economic slowdown has been the downturn in the housing market, and I want to talk a little bit about that today. After years of steady increases, home values in some parts of the country have declined. At the same time, many homeowners with adjustable rate mortgages have seen their monthly payments increase faster than their ability to pay. As a result, a growing number of people are facing the prospect of foreclosure. Foreclosure places a terrible burden on our families. Foreclosure disrupts communities. And so the question is, what do you do about it in a way that allows the market to work, and at the same times helps people? Before I get to that, though, I do want to tell you that we fully understand that the mounting concern over housing has shaken the broader market, that it’s spread uncertainty to global financial markets, and that it has tightened the credit, which makes it harder for people to get mortgages in the first place.”
- “The temptation for people, in their attempt to limit the number of foreclosures, is to put bad law in place. And so I want to talk about some of that. First of all, the temptation of Washington is to say that anything short of a massive government intervention in the housing market amounts to inaction. I strongly disagree with that sentiment. I believe there ought to be action, but I’m deeply concerned about law and regulation that will make it harder for the markets to recover—and when they recover, make it harder for this economy to be robust. And so we got to be careful and mindful that any time the government intervenes in the market, it must do so with clear purpose and great care. Government actions ...have far-reaching and unintended consequences.”
- “I want to talk to you about a couple of ideas that I strongly reject. First, one bill in Congress would provide \$4 billion for state and local governments to buy up abandoned and foreclosed homes. ...[I]f your goal is to help Americans keep their homes, it doesn’t make any sense to spend billions of dollars buying up homes that are already empty. [W]hen you buy up empty homes you’re only helping the lenders, or the speculators. The purpose of government ought to be to help the individuals, not those who, like—who speculated in homes. This bill sends the wrong signal to the market.”
- “Secondly, some have suggested we change ...the bankruptcy code, to give bankruptcy judges the authority to reduce mortgage debts by judicial decree. I think that sends the wrong message. It would be unfair to millions of homeowners who have made the hard spending choices necessary to pay their mortgages on time. It would further rattle credit markets. It would actually cause interest rates to go up. If banks think that judges might step in and write down the value of home loans, they’re going to charge higher interest rates to cover that risk. This idea would make it harder for responsible first-time home buyers to be able to afford a home.”

- “There are some in Washington who say we ought to artificially prop up home prices. ...[I]t’s not going to help first-time home buyers, for example. A lot of people have been priced out of the market right now because of decisions made by others. The market is in the process of correcting itself; markets must have time to correct. Delaying that correction would only prolong the problem.”
- “[T]hat’s why we oppose those proposals, and I want to talk about what we’re for. We’re obviously for sending out over \$150 billion into the marketplace in the form of checks that will be reaching the mailboxes by the second week of May. We’re for that. We’re also for helping a targeted group of homeowners, namely those who have made responsible buying decisions, avoid foreclosure with some help. We’ve taken three key steps. First, we launched a new program at the Federal Housing Administration called FHA Secure. It’s a program that’s given FHA greater flexibility to offer refinancing for struggling homeowners with otherwise good credit. In other words, we’re saying to people, we want to help you refinance your notes. Over the past six months this program has helped about 120,000 families stay in their homes by refinancing about \$17 billion of mortgages, and by the end of the year we expect this program to have reached 300,000 families.”
- “...Hank Paulson put together what’s called the HOPE NOW Alliance to try to bring some reality to the situation, to focus our help on helping creditworthy people refinance—rather than pass law that will make it harder for the market to adjust. This HOPE NOW Alliance is made up of industry—is made up of investors and service managers and mortgage counselors and lenders. And they set industry-wide standards to streamline the process for refinancing and modifying certain mortgages. Last month HOPE NOW created a new program. They take a look ...at the risks, and they created a program called Project Lifeline, which offers some homeowners facing imminent foreclosure a 30-day extension. The whole purpose is to help people stay in their houses. During this time they can work with their lender. And this grace period has made a difference to a lot of folks. An interesting statistic that has just been released: Members of the Alliance report that the number of homeowners working out their mortgages is now rising faster than the number entering foreclosure. The program is beginning to work, it’s beginning to help. The problem we have is a lot of folks aren’t responding to over a million letters sent out to offer them assistance and mortgage counseling. And so one of the tasks we have is to continue to urge our citizens to respond to the help; to pay attention to the notices they get describing how they can find help in refinancing their homes. We [have] toll-free numbers and websites and mailings, and it’s just really important for our citizens to understand that this help is available for them.”
- “We’ve also taken some other steps that will bring some credibility and confidence to the market. Alphonso Jackson, Secretary of HUD, is proposing a rule that requires lenders to provide ...standard, easy-to-read summary statements explaining the key elements of mortgage agreements. ...There needs to be complete transparency. And to the extent that these contracts are too complex, and people made decisions that

they just weren't sure they were making, we need to do something about it. We need better confidence amongst those who are purchasing loans.”

- “And secondly, yesterday Hank Paulson announced new recommendations to strengthen oversight of the mortgage industry, and improve the way the credit ratings are determined for securities, and ensure proper risk management at financial institutions. In other words, we've got an active plan to help us get through this rough period. We're always open for new ideas, but there are certain principles that we won't violate. And one of the principles is overreacting by federal law and federal regulation that will have long-term negative effects on our economy.” (*Prepared Comments by President George W. Bush, 03/14/08*)

Treasury Secretary Paulson says most of the bailout proposals “would do more harm than good”

- In a March 3rd speech to the National Association of Business Economists, Treasury Secretary Henry M. Paulson, Jr. said, “...[M]any in Washington and many financial institutions have been floating proposals for a major government intervention in the housing market, with U.S. taxpayers assuming the costs of the riskiest mortgages. Today, 93 percent of American homeowners—51 million households—pay their mortgages on time. Many are on tight budgets, sacrificing other things in order to make that payment. Only 2 percent are in foreclosure. Most of the proposals I've seen would do more harm than good—bailing out investors, lenders or speculators who, instead of getting a free-pass, should be accountable for the risks they took. **Let me be clear: I oppose any bailout.** [Emphasis added.] I believe our efforts are best focused on helping homeowners who want to stay in their homes.”
- “Second, this is a shared responsibility of industry, government and homeowners. We in government are working to expand options through the FHA, and we've worked with the industry to reach as many homeowners as possible to let them know that help is available. There is more that government and industry can do, and our efforts will continue to evolve. Homeowners have responsibilities as well. If borrowers won't ask about solutions, there is only so much that can be done on their behalf.
- Third, the current public discussion often conflates the number of so-called 'underwater' homeowners – that is, those with mortgages greater than the value of their house – with projections of foreclosures. Let's be precise: being underwater does not affect your ability to pay your mortgage, nor create a government responsibility for assistance. Homeowners who can afford their mortgage should honor their obligations—and most do. Obviously, being underwater is not insignificant to homeowners in that position. But negative equity does not necessarily result in foreclosure. Most people buy homes as a long-term investment, as a place to raise a family and put down roots in a community. Homeowners who can afford their payments and don't have to move, can choose to stay in their house.

And let me emphasize, any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligations. We know that speculation increased in recent years; a resulting increase in foreclosures is to be expected and does not warrant any relief. People who speculated and bought investment properties in hot markets should take their losses just like day traders who speculated and bought soaring tech stocks in 2000.”

- “...We have a two-pronged policy approach that focuses on these two sources of rising foreclosures. First, we worked with Congress to enact a broad stimulus plan to support the economy, to maintain and create jobs so there will be fewer who suffer that income loss ... Second, a private sector alliance – HOPE NOW – has adopted a broad set of tools focused on assisting struggling borrowers who want to keep their homes. This morning they released data demonstrating the results of their efforts through the month of January. HOPE NOW announced that since July more than 1 million struggling homeowners received a work-out – either a loan modification or a repayment plan that helped them avoid foreclosure. Of those, 638,000 were for subprime borrowers. This data does not include refinancings, which also provide borrowers with affordable, long-term mortgages. According to today’s information, HOPE NOW’s progress is accelerating. In January, there were 167,000 work-outs, up 11 percent from December. Loan modifications alone increased 19 percent from December to January. By comparison, foreclosure starts increased just 5 percent during the same period. I am encouraged that the number of borrowers receiving help is rising faster than the number entering foreclosure.”
- “...As the HOPE NOW alliance continues to report results, we will evaluate progress and make adjustments. We will also continue to listen to new ideas. I believe we have the right program in place – an evolving private sector effort to reach borrowers and find affordable mortgage solutions wherever possible. We will continue to pursue FHA modernization and GSE reform in Congress, to expand access to affordable mortgages. And I will continue to focus on the broader effort to keep our economy strong as we weather this necessary housing correction.” (*Remarks by Treasury Secretary Henry M. Paulson, Jr., 03/03/08*)
- In a press release, Senator John McCain (R-AZ) said he is opposed to any broad role for the government in rescuing the mortgage market. “While it is the government’s role to help the honest, hard-working homeowner in this time of distress, it is not the government’s role to bail out investors who should understand that markets are about both return and risk, or lending institutions who didn’t do their job,” said McCain. “It’s important that managers and investors are held accountable for their own decisions. And we need to monitor the impact of the many, many important steps that have already been taken. We don’t want to do something in the short term that damages our economy in the long term.” (*American Banker, Joe Adler, 03/12/08*)
- In a March 3rd editorial, the *Washington Post* wrote, “...The public should not have to pay for even a carefully calibrated bailout except as a last resort. For now, the wisest

approach is to give the Bush administration more time to push the financial services industry into modifying the loans of needy and capable borrowers. Though loan modifications have been modest so far, the program has been in operation for only a couple of months. New progress reports are due out soon. If, after a fair chance, the administration's policy fails, there may be no choice but to try it Congress's way..." (*Washington Post*, 03/03/08)

Subprime crisis is the *private sector's* problem

- In a March 14th edition of the *American Banker*, John L. Douglas contrasted the subprime crisis to the failure of the savings and loan industry in the late 1980s. Douglas wrote, "When viewed in isolation, the subprime crisis is a problem for the private sector, which is well into the process of identifying losses. By and large those losses will be sustained without the need for governmental assistance. Massive triage efforts are under way, both with institutions and individuals, as the markets grapple with how to address the losses. The major banks and investment banks are being recapitalized, and broad-based loan modification programs for borrowers have begun (but are still far too modest, given the scope of the problem)."
- "The bottom line is that the government is less a player in the subprime crisis and will have less of a role in solving the problem. It has no direct financial responsibility, as it did with the deposit insurance funds [in failure of the savings and loan industry]. It also lacks direct tools to address the problems. But this is not to say the government will not try to help. Without direct responsibility or direct tools, the government is foundering, looking for something, anything it can do. But unlike in the S&L crisis, the government will play less of a role in allocating blame. We will see no government agencies with legal budgets of hundreds of millions of dollars to identify and punish wrongdoers. The private sector is fully capable of initiating its own litigation to allocate responsibility for the losses."
- "The social, political, and economic ramifications of the subprime crisis are also different. ...[W]hile the S&L crisis was essentially a commercial real estate issue, the subprime crisis is primarily a residential real estate issue. Families are being forced out of their homes, and consumer confidence is weak, creating serious economic concerns. The government will have an almost irresistible desire to do something to alleviate both problems. Stimulus packages, rate cuts, and jawboning all seem to be part of the ritualistic process. These efforts may help the economy, but unless and until housing values become calculable and predictable, expect no miracles in the financial sector. ...Borrowers, lenders, and investors all erred. There is a price that must be paid for those errors, and the sooner, the better. (*American Banker*, John L. Douglas, 03/14/08)

The only *real* solution is for housing values to hit bottom

- In the March 5th *Washington Post*, Robert J. Samuelson wrote, “Up to a point, there’s a case for providing relief to some mortgage borrowers. In many cases, everyone would gain if lenders and borrowers renegotiated loan terms to reduce monthly payments. Losses to both would be less than if their homes went into foreclosure and were sold. The Treasury has organized voluntary efforts. Some measures being considered by Congress (for example: overhauling the FHA) might help. But other proposals—particularly empowering bankruptcy judges to reduce mortgages unilaterally—would perversely hurt the housing market by raising the cost of mortgage credit. Lenders would increase interest rates or down payments to compensate for the risk that a court might modify or nullify their loans.”
- “The understandable impulse to minimize foreclosures should not be a pretext to prop up the housing market by rescuing too many strapped homeowners. Though cruel, foreclosures and falling home values have the virtue of bringing prices to a level where housing can escape its present stagnation. Helping today’s homeowners makes little sense if it penalizes tomorrow’s homeowners. An unstoppable free-fall of prices seems unlikely. Slumping home construction and sales have left much pent-up demand. What will release that demand are affordable prices.” (*Washington Post*, Robert J. Samuelson, 03/05/08)
- In a March 12th *Wall Street Journal* article, Holman W. Jenkins wrote, “...To get to a real solution, speculators and investors need to believe that home prices are hitting bottom, that any mortgage debt they might buy today for 80 cents on the dollar today won’t be worth 30 cents tomorrow. Then the vultures will pile in: The transfer of wealth from the overleveraged banks and hedge funds to those who kept cash handy will be shocking, ugly and cathartic -- but it will also be relatively quick. Credit markets will begin to function again. The economy will grow. ...All the Fed can do, meantime, is to make it a tad less painful for banks to hold onto the unmarketable mortgage securities that have been burning down their books.”
- “...[M]eanwhile, the call for a housing bailout is becoming deafening, nigh irresistible. But the seized-up credit markets won’t be unseized by trying to induce debtors to cling to houses they now see as throwing good money after bad. By definition, the only haircut lenders rationally want to take is the minimum required to keep owners on the fence about walking away. Not much better are bailout plans that try to keep borrowers in their homes by shifting some of their equity losses to the taxpayer. The market has utterly changed from the market in which these recent purchasers made their purchase decisions. They’ve been renting their homes and don’t really lose much through foreclosure. Let them go.”
- “...[W]e have another problem. Nobody in their right mind would recommend having a financial crisis in the middle of a presidential campaign, but here we are. Warren Buffett, appearing at a Hillary Clinton event in December, spoke soothing words to the investor class on CNBC, saying no Democrat would be so foolish as to ‘kill the golden goose’ of the U.S. economy. He quickly amended his statement: Most were not so foolish.”

- “Yes, exactly. It behooves us to recognize that bad economic times are not always uncongenial to every kind of political career. Bad times can be useful to those whose path to power is paved with demagoguery. Bad times can allow the aggregation of bureaucratic power at the expense of the private sector in ways that are not possible in good times. Millions of Americans have negative equity in their homes, but did not bite off more mortgage than their incomes could support. These people are still paying their mortgages and never imagined doing anything else. Millions of others have positive equity in their homes despite seeing painful declines in their home value. Now all these homeowners are to be taxed to benefit more irresponsible borrowers? This could be a nastier political fight than now foreseen, especially as Democrats try to soften up a big swath of the homeowners middle class for higher taxes by anathematizing them as the ‘rich.’”
- “And that’s just the start. To the goal of forestalling foreclosure and keeping marginal borrowers in their homes at any cost, politicians are turning the full investigative heat of the states and FBI on the mortgage-lending and home-selling industries. This will not help the liquidity of the housing market and the \$11 trillion in securities derived from it. And coming along are potential shocks on top of the housing shock: expiration of the Bush tax cuts, arrival of Democratic health-care promises, new taxes on energy consumption in the name of global warming. Pent-up demand from certain constituencies exists for these policies—and usually faces healthy resistance from a public that believes it has a stake in the economic status quo.”
- “Harder to calculate is how our politics will respond when the wish-list arrives on a wave of ‘us versus them’ demagoguery aimed at voters demoralized over economic setbacks and a crash in home prices. That’s another reason Washington’s real goal should be to accelerate foreclosures, making them cheaper and less onerous for all concerned, so the market can hit bottom and buyers and sellers can have confidence in prices. Otherwise, look out below.” (*Wall Street Journal*, Holman W. Jenkins, 03/12/08)
- In a March 17th article on *TownHall.com*, Star Parker wrote, “...[T]he task today must be to restore a sense of reality to the patient rather than moving in with him. Unfortunately, what many of our friends from the Democratic Party are proposing is closer to the latter. A return to reality means bolstering the integrity of law and contracts and the restoration of a sense of personal responsibility on the part of all market participants. A healthy housing market depends on this. But so does our whole free society. Proposals such as allowing bankruptcy judges to rewrite mortgage terms contributes to chaotic fundamentals as opposed to remedying this.”
- “Similarly, massive government intervention, whether it be through moratoriums on foreclosures and interest-rate freezes, like Democratic presidential contender Hillary Rodham Clinton wants, or government takeovers and refinancing of loans, closer to what we're hearing from her rival for the nomination, Barack Obama, creates new

distortions and free-lunch illusions. It may sound nice for the government to hold up prices and fend off foreclosures. But where is the justice for those who sat this out?”

- “It is true that only about half of black families own their homes, compared to three-quarters of white families. A drop in home prices to a new low could put homeownership within reach for those who could not afford it previously. Must the innocent and responsible pay the price for those who decided to climb out on a limb? Let’s not forget now that our resilient and prosperous free society is built on law and personal responsibility. Pain is a normal part of life. It tells us something is wrong. What is critical is that we get the right message about the nature of the problem.” (*Townhall.com*, Star Parker, 03/17/08)

GSE regulatory reform hearing turns to broader debate on subprime bailout

- On March 6th, the Senate Banking Committee held its second hearing in a month on GSE regulatory reform legislation, but appeared to be no closer to passing a bill. Instead, Chairman Christopher Dodd (D-CT) seemed more interested in discussing broader measures that could be taken to address the turmoil in the mortgage and credit markets. Dodd said that the March 6th hearing would be the last one held by his panel on GSE reform. While Dodd has not introduced a GSE regulatory reform bill, he said that he hopes the committee will vote on a bill soon. Dodd had hoped to introduce a GSE reform bill before Congress recesses in late March, but added, “I’m not terribly optimistic that’s going to happen.” Minority leader Richard Shelby (R-AL) did not attend the hearing, due to a conflict with an Appropriations Committee hearing.
- “The GSE soap opera has gone on for far too long,” said Senator Robert Bennett (R-UT), whose son works for Fannie Mae. “We’ve had the hearing on the restating of earnings and have had conversations that come close to being public floggings of the executives of the GSEs, and ironically, when the subprime crisis hits, the GSEs emerge as the heroes because they’re the only ones with money left. It’s time we bring this soap opera to a close.” Bucking sentiment within his party, Bennett endorsed a permanent increase in the conforming loan limit in high cost markets, which Congress temporarily increased as part of a recent stimulus package. “I don’t think the housing market, as we work our way through this problem, is ever going to go back to where the lower [conforming loan] rate makes sense,” said Bennett. “Therefore, a permanent increase in that rate makes sense in the long term to me.” Dodd appeared to be skeptical of a suggestion by Vincent Malta, the chairman of the National Association of Realtors Public Policy Coordinating Committee, that conforming loan limits be set at \$625,000 nationwide and \$729,750 in high-cost cities. “I’m not suggesting as high as you’re probably in favor of, Mr. Malta, but I think an increase is probably called for,” said Dodd.
- Dodd also expressed concerns about the GSEs’ recent increases in fees and geographic restrictions on credit that appeared to be similar to those of banks, which

“redlined” minority communities. “Both Fannie Mae and Freddie Mac have announced plans to raise costs or limit access to credit in areas that may be in the most need of affordable credit,” Dodd said. “These kinds of plans will exacerbate the credit cycle, rather than mitigate its negative effects.” According to a committee aide, Fannie and Freddie plan to establish higher down payments and fees, by metropolitan area and then by ZIP code within metropolitan areas, for people with lower credit scores. Malta said NAR members have expressed concerns about the impact of the changes on mortgage affordability in lower-income areas. Setting fees “by ZIP code is totally inadequate,” said Malta, adding that the fee requirements should be assessed “property by property, not ZIP code.”

- Dodd said that the FHA and GSE bills don’t go far enough and more needs to be done to deal with the subprime mortgage crisis. “I’m certainly going to get the FHA and GSE bill, and again, I don’t disagree that these are important signals to send,” said Dodd. “But ... to some degree, FHA will provide some help. It would be a mistake to exaggerate what FHA reform is going to do. I’m worried people think that will solve the problem. It doesn’t.” (*American Banker*, Steven Sloan, 03/07/08; *Bureau of National Affairs*, Richard Cowden, 03/07/08)
- During a March 4th Senate Banking hearing, bank regulators offered cautious endorsements of Democrats’ efforts to develop contingency plans in the event of a deterioration in the housing market, but insisted that is far from clear that a bailout will be needed. “We should be looking at all options,” FDIC chairman Sheila Bair said in response to a question from Senator Chris Dodd (D-CT) on the need for a bailout. “The jury is still out on whether we should set up something quite major, but your thinking is right. ... Greater level of government intervention is something we should be thinking about.” Bair also warned that any further government involvement risked the perception of a “moral hazard” and could present opportunities for “gaming the system” at a high cost to taxpayers. Comptroller of the Currency John Dugan said that while he agreed with Bair’s comments, additional government intervention may not be necessary. “The population of people getting foreclosed on their homes is still a relatively small part of the overall population of mortgage holders,” said Dugan. OTS Director John Reich and Fed Vice Chairman Donald Kohn argued that expanding existing government programs would be preferable to creating new ones. “We’re looking at existing programs, how to make them better, perhaps expanding the FHA program is probably more efficient, more effective,” said Kohn. The regulators used their appearance before the committee to urge bankers to account for loan losses promptly, beef up capital and not to rely on rating agencies for accurate asset valuations. (“*American Banker*, Stacy Kaper, 03/05/08)

FHA reform deal is “close”

- By early April, the House and Senate are likely to pass FHA reform legislation, which aims to provide safe mortgage alternatives to subprime borrowers and make home ownership more accessible and affordable. Senate Banking Committee chairman Christopher Dodd (D-CT) and House Financial Services Committee chairman Barney Frank (D-MA) said that the differences between the two chambers on their respective bills could be resolved in short order. “I think we are fairly close to having an FHA reform bill that we will be able to adopt quickly,” said Dodd. (*CNNMoney*, Jeanne Sahadi, 03/10/08)
- During a hearing on HUD’s budget before the House Financial Services Committee, HUD Secretary Alphonso Jackson opened the door to shifting the administration’s stance on the loan limits which FHA can insure. During the hearing, Representative Gary Miller (R-CA) said he and Representative Frank (D-MA) were the leading advocates for increasing the FHA loan limit to \$729,500. “Wouldn’t in the long run it help a lot of people in the future be able to buy a home?” asked Miller. “Wouldn’t it be a good program to continue permanently rather than on a short-term basis?” Jackson responded, “Absolutely, I think it would be a major plus.” In earlier comments before the panel, Jackson said that bringing the loan limit back to its previous level “would have a devastating effect.” Previously, Jackson had opposed raising the limit to \$729,750 on a permanent basis. (*American Banker*, Stacy Kaper, 03/12/08)

Other legislative “solutions” for the subprime mortgage crisis

- House Financial Services Committee chairman Barney Frank (D-MA) said he is moving legislation forward designed to shield loan servicers from investor lawsuits, as a means of encouraging them to renegotiate more mortgages. According to a draft, the bill would protect loan servicers that “accept a short payment for the property, agree to a short sale of the property, or agree to or implement a modification or workout plan for residential mortgage loans, if the servicer reasonably believes it will realize a net present value greater than it would realize through foreclosure.” The clear liability protection would apply to loan modifications or workout plans that (1) remain in effect for at least five years or until the borrower sells or refinances the property; (2) avoid negative amortization; and (3) do not require the borrower to pay any fees or additional points. It is anticipated that this bill would be incorporated into a broader bailout plan that will be introduced after Congress’s spring recess. (*American Banker*, Stacy Kaper, 03/04/08)
- Majority Leader Harry Reid (D-NV) said the Senate would again consider a Democrat-backed housing stimulus plan which includes bankruptcy provisions, when members return from their two-week spring recess. Reid said that Republicans would

“have to vote on that again”—adding that he will be advancing the same bill that the chamber considered in February. (*CQ Today*, Benton Ives, 03/12/08)

- In a March 5th memorandum to the members of Senate Judiciary Committee, 12 trade groups urged lawmakers to reject the mortgage cram down provisions, currently being considered. The groups wrote, “We are writing to reiterate our strong opposition to legislation that would reopen the bankruptcy code and grant new powers to bankruptcy judges to change the terms of a primary mortgage. The two bills, S. 2136 and S. 2133, that are on the Committee’s agenda for the Executive Business Meeting on Thursday, March 6, would increase the cost of buying a home, and thus would price many Americans out of the housing market and make owning a home more expensive for others. We urge you to vote against the bills.” The letter’s signatories included the American Bankers Association, American Financial Services Association, American Insurance Association, Consumer Bankers Association, Consumer Mortgage Coalition, Independent Community Bankers of America, Mortgage Bankers Association, National Association of Home Builders, Securities Industry and Financial Markets Association, The Financial Services Roundtable, The Housing Policy Council, and U.S. Chamber of Commerce. (*Memorandum to the Senate Judiciary Committee Members*, 03/05/08)

Federal Reserve Chairman Bernanke urges banks to reduce mortgage balances to stem rising tide of delinquencies and foreclosures

- In a March 4th speech at the Independent Community Bankers of America’s annual convention, Federal Reserve chairman Ben Bernanke said, “Reducing the rate of preventable foreclosures would promote economic stability for households, neighborhoods, and the nation as a whole. Although lenders and servicers have scaled up their efforts and adopted a wider variety of loss-mitigation techniques, more can, and should, be done. The fact that many troubled borrowers have little or no equity suggests that greater use of principal writedowns or short payoffs, perhaps with shared appreciation features, would be in the best interest of both borrowers and lenders. This approach would be facilitated by allowing the [FHA] the flexibility to offer refinancing products to more borrowers.”
- Bernanke suggested that modernizing FHA is a “potentially important step” to facilitate greater use of short payoffs. Bernanke said, “Going beyond the current proposals for modernization, permitting the FHA greater latitude to set underwriting standards, and risk-based premiums for mortgage refinancing—in a way that does not increase the expected cost to the taxpayer—would allow the FHA to help more troubled borrowers. A concern about such an approach is that servicers might refinance only their riskiest borrowers into the FHA program. A combination of careful underwriting, the use of risk premiums, and other measures could help mitigate that risk.” (*Bureau of National Affairs*, Drew Douglas, 03/05/08)

- At www.biz.yahoo.com/Minyanville, Kevin Depew wrote, "...[A]ccording to Bernanke[’s March 5th speech], principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure. In other words, adjust the mortgage principal downward to reflect the declining home value. Wait a minute, wouldn’t that put yet more pressure on home prices in areas where a significant number of homeowners seek and receive principal writedowns? It sure would. Moreover, as Bernanke notes, ‘Lenders tell us that they are reluctant to write down principal. They say that if they were to write down the principal and house prices were to fall further, they could feel pressured to write down principal again.’ And of course, on the off chance home prices rise the lender would not share in the gains.”
- “So what is this speech about? Is it really about urging principal writedowns that even Bernanke himself admits probably won’t work, or is something else going on? We’re going to go out on a limb and say, ‘something else.’ The real conclusion is reached at the very end of Bernanke’s speech: ‘The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, likewise could do a great deal to address the current problems in housing and the mortgage market,’ Bernanke said. ‘New capital-raising by the GSEs, together with congressional action to strengthen the supervision of these companies, would allow Fannie and Freddie to expand significantly the number of new mortgages that they securitize.’”
- “That almost sounds like it would be a good thing. In at least one sense, it would be a good thing, but only by default. Bernanke concludes; ‘With few alternative mortgage channels available today, such action would be highly beneficial to the economy.’ That’s certainly true, but only in a grimly ironic sense. It’s government-enabled expansion of Fannie Mae and Freddie Mac that led to a situation where there are ‘few alternative mortgage channels available today’ in the first place.”
- “So Bernanke’s ultimate conclusion is this: ‘I urge the Congress and the GSEs to take the steps necessary to allow more potential homebuyers access to mortgage credit at reasonable terms.’ It takes either a massive degree of denial or a broad imagination to accept that sentence at face value. **What Bernanke is really urging is the full-scale nationalization of the GSE’s.** [Emphasis added]. We can continue to pretend that these companies are going to be just fine, but the reality is it is impossible to fit together the pieces—raising massive amounts of new capital in the face of a yet-to-peak-wave of mortgage resets and housing price declines while simultaneously expanding their mortgage securitizations—without taking what Bernanke calls ‘congressional action to strengthen the supervision of these companies’ to mean, essentially, nationalization of the housing market. Fannie and Freddie stocks are down about 6% so far today [March 4th]. Perhaps the reality is now setting in that nationalization doesn’t benefit shareholders.”
(www.biz.yahoo.com/Minyanville, Kevin Depew, 03/04/08)

OFHEO releases the GSEs' temporary jumbo conforming loan limits

- On March 6, OFHEO released the maximum conforming loan limits which will be in effect through year-end, as a result of The Economic Stimulus Act of 2008. The maximum for temporary jumbo conforming loan limits, which apply to loans originated in the period between July 1, 2007 and December 31, 2008, are as high as \$729,750 for one-unit homes in the continental United States. Two, three and four-unit homes have higher limits as well. Alaska, Hawaii, Guam and the Virgin Islands also have higher maximum limits. Seventy-one Metropolitan and Micropolitan Statistical Areas are affected including 224 counties and cities not in counties. In addition, there are 21 counties outside of Metropolitan or Micropolitan areas that show increases, plus Guam and four municipalities in the Marianas Islands. The newly increased limits range from \$417,500 in Greeley, Colorado to the highest of \$793,750 in Honolulu, Hawaii. Data for the counties and MSAs that are affected by the news loan limits is available at www.ofheo.gov/media/hpi/AREA_LIST.pdf. (OFHEO Press Release, 03/06/08)
- Freddie Mac CFO Anthony Pizsel told reporters that his company is accepting a “wider” range of jumbo loans than those being accepted by Fannie Mae. In general, Fannie Mae said it would require down payments of at least 20% on jumbo adjustable-rate mortgages for home purchases by borrowers with credit scores above 700. In contrast, Freddie Mac said that it would finance jumbo ARMs with 10% down. For borrowers with credit scores ranging from 660 to 700, Freddie Mac will require at least 25% down payments of borrowers [versus Fannie Mae’s 20% downpayment requirement]. Freddie Mac will allow certain cash-out refinancings up to \$100,000, while Fannie Mae limits cash-outs only to cover mortgage points, closing costs and \$2,000 in cash. “The reason you have two of us is so you get competition,” Freddie Mac’s chairman and CEO Richard Syron. Barclays Capital estimates that up to \$500 billion in jumbo mortgage may be eligible for the GSEs’ jumbo mortgage program. (*Bloomberg News*, Jody Shenn, 03/12/08; *Reuters*, Al Yoon, 03/13/08)

Freddie Mac requests written comments on new appraisal code

- On March 14th, Freddie Mac requested comments from the mortgage industry regarding the implementation of the Home Valuation Code of Conduct, which sets out standards designed to enhance appraiser independence. The Code, which is being adopted as part of the company’s March 3rd agreement with the New York Attorney General and the OFHEO, will establish requirements governing appraisal selection, solicitation, compensation, conflicts of interest, and independence. To implement the Code with minimal disruption to the market and, as required under the agreement, Freddie Mac is requesting comments on operational and implementation issues, as well as possible unintended consequences or risks in connection with the Code’s

requirements. Written comments must be submitted to Freddie Mac by April 30, 2008. (*Freddie Mac Press Release*, 03/14/08)

- The agreement on appraisal standards between New York Attorney General Andrew Cuomo and Fannie Mae and Freddie Mac will likely reshape the appraisal industry and may lead to other “back door” changes to other segments of the mortgage industry, said an observer. For years, Cuomo and his predecessor, Eliot Spitzer, were stymied by preemption rules in their quest to impose more regulation on financial institutions. Cuomo effectively circumvented this roadblock by getting the GSEs to set new standards, which determine which loans the enterprises would purchase. Many are concerned that Cuomo or other state officials will try to use a similar approach to changing lending standards and other aspects of the financial services industry. “It’s an interesting development that the attorney general was able to do this - and it’s a little bit scary about what might be next,” said Charlotte Bahin, an attorney with Lord Bissell & Brook LLP.
- “It’s going to have a huge impact—like legislation would,” said Jim Amarin, president-elect of the Appraisal Institute. “That it is de facto legislation in a sense, because Fannie and Freddie are asking for a particular requirement of their banks who are selling loans to them. That, for all intents and purposes, has the same weight legislation would.” Gil Schwartz, a partner at Schwartz & Ballen LLP and a former Federal Reserve Board lawyer, said, “To the extent that they are implementing the agreement, anyone who wants to sell them assets has to apply to their standards. That’s a very effective back door to get at federal institutions. I think he’s gotten the most bang for the buck.” (*American Banker*, Cheyenne Hopkins, 03/10/08)

Federal judge strikes down HUD rule limiting seller-funded downpayment assistance

- On March 5th, U.S. District Court Judge Paul A. Friedman struck down a regulation by HUD that would limit downpayment assistance for government-insured mortgages, saying the agency decided to adopt the regulation based on information that never appeared in the proposed rule. The judge ruled that HUD had violated the Administrative Procedure Act, by not allowing comments on the information [pertaining to the agency’s internal analysis of the FHA loan portfolio]. Barring an appeal, Friedman’s ruling means that HUD will have to start the rulemaking process all over again. (*Bureau of National Affairs*, R. Christian Bruce, 03/12/08)
- Separately, the U.S. District Court for the Eastern District of California in Sacramento held that HUD must reassess the rule it adopted in October which limited downpayment assistance for FHA-insured loans. Further, the court ruled that HUD Secretary Alphonso Jackson must be excluded from any discussions regarding the proposed rule. In the lawsuit, the plaintiffs argued that Jackson had “exhibited ‘an unalterably closed mind’ during the proposed rule’s 90-day comment period in 2007, by telling a member of the press that the proposal was a fait accompli. According to the ruling, “Given that Secretary Jackson was not actually involved in the initial

rulemaking proceeding, disqualifying him from further participation in this matter will likely impose little or no burden on the agency,” the ruling said. “[W]hile the agency received voluminous comments in response to the rule, it is unknown whether any prospective commenters were chilled by Secretary Jackson’s statement.” The court ruling was issued on Monday, March 3. (*Bloomberg News*, Marc Hochstein, 03/03/08)

- In a March 10 editorial, the *Washington Times* wrote, “The business of real estate is not for the faint of heart. And while the American Dream to own the American Dream remains a laudable goal on the road to wealth building it is not a free for all for every Tom, Dick and non-credit worthy Harry to take advantage of. The current housing conundrum is case in point.”
- “Just as [HUD] announced a temporary increase in housing loan limits, the nonprofit AmeriDream was praising a district court ruling that strikes down HUD rules on downpayment assistance. It seems quite the paradox — that the very rules designed to prevent bad loans from being pushed into FHA — which has been the culprit of late — have been struck down. Under new guidelines issued last week in response to the Economic Stimulus Act of 2008, homeseekers in high-cost areas such as New York, Los Angeles, San Francisco and Washington, can qualify for FHA loans up to \$729,750. The downpayment requirement was lowered from 3 percent to 1.5 percent.”
- “It’s an unpopular caveat the administration fought against but essentially caved into given the Dec. 31, 2008 expiration date. In order for FHA to insure these loans and keep interest rates low, it is required to do things like check credit-worthiness, verify incomes and make sure scrupulous lenders aren’t ‘gifting’ their applicants in a way to skirt downpayment assistance rules. The rules permit sellers to contribute up to 6 percent of the sales price toward the buyer’s actual closing costs, prepaid expenses, discount points and other financing concessions — and allows FHA-insured borrowers to rely on downpayment assistance from family members, employers, governmental entities, or charitable organizations.”
- “But ‘gifters’ of these downpayment loans can’t be the same person selling you your house. It’s what many of us in the media refer to as ‘a conflict of interest.’ AmeriDream brought suit against HUD alleging that this ‘gifting’ regulation prohibits seller-funded downpayment assistance and would ‘deprive thousands of aspiring homebuyers of purchasing their own home.’ Really? When did it become OK to attempt to purchase a home at any cost, without regard to where the ‘assistance’ or ‘gift’ was coming from, even if that gift comes coming from a scrupulous lender? Fighting a rule to prevent homebuyers from ending up in the very situation the government is now bailing them out of is not only irresponsible but morally reprehensible. As we’re now finding out, these ‘gifts’ that are given can come at a pretty hefty price. Homebuyers bear a greater responsibility to know what they can afford, save until they can and stay away from that gift horse.” (*Washington Times*, 03/10/08)

Subprime and beyond

- According to the Federal Reserve, Americans' equity in their homes has fallen below 50 percent for the first time on record since 1945. Homeowners' equity slipped to a revised lower 49.6% in the second quarter of 2007 and declined further to 47.9% in the fourth quarter—the third straight quarter it was under 50%. Homeowners' total equity also fell for the third straight quarter to \$9.65 trillion from a downwardly revised \$9.93 trillion in the third quarter. (*Associated Press*, 03/06/08)
- Home mortgage foreclosures increased to a record high during at the end of 2007, while delinquent mortgages rose to the highest level since 1985, according to the Mortgage Bankers Association. New foreclosures had increased to an all-time high of 0.83% during the fourth quarter, up from 0.54% for the corresponding period for 2006. The percentage of loans already in foreclosure hit a new high of 2.04%, up 85 basis points from the previous year. The overall delinquency rate was 5.82% on December 31, 2007, the highest delinquency rate since 1985 when delinquencies hit 6.07%. In aggregate, 7.86% of all home mortgages are delinquent or in foreclosure at year end 2007, said MBA chief economist and senior vice president Doug Duncan. California and Florida are the “key drivers” in the national foreclosure rates, added Duncan. California accounts for approximately 20% of all subprime mortgages in the country and 30% of all new foreclosures. (*Bureau of National Affairs*, R. Christian Bruce, 03/07/08)
- In February, 3,960 bankruptcy petitions were filed per day nationwide, up 18% from January and 20% from a year earlier, reported the Automated Access to Court Electronic Records. February was the busiest month for bankruptcy filings since Congress overhauled the bankruptcy law in 2007. (*New York Times*, Jenny Anderson, 03/05/08)
- Standard & Poor's estimates that subprime write-downs could reach \$285 billion—\$20 billion [or 13.25%] higher than its estimate six weeks ago. S&P also said, “The end of write-downs is now in sight for large financial institutions.” S&P credit analyst Scott Bugie wrote, “The positive news is, in our opinion, the global financial sector appears to have already disclosed the majority of write-downs of subprime asset-backed securities. [However,] we believe that any near-term positive impact of reducing subprime risk in the financial system via increased disclosure and write-downs will be offset by worsening problems in the broader U.S. real-estate market and in other segments of the credit markets.” (*Wall Street Journal*, Andrew Edwards, 03/14/08)
- According to March 13th posting on *Fortune's Daily Briefing Blog*, “...[A] Bloomberg report earlier this week suggests that part of the reason the subprime writedowns have begun slowing is that S&P and rival Moody's have been slow to downgrade triple-A subprime securities, for fear of creating bigger problems for the

banks. Moody's and S&P have been tightening their standards in the wake of last summer's subprime debacle, but Tuesday's Bloomberg report suggests the companies still have a long way to go to gain back their credibility. 'A bond sold by Deutsche Bank in May 2006 is AAA at both companies,' Mark Pittman wrote, 'even though 43% of the underlying mortgages are delinquent.' Details, details." (*Fortune's Daily Briefing Blog*, 03/13/08)

- A new study concludes that subprime mortgage losses will total approximately \$400 billion, which will trigger a \$2 billion contraction in lending and other assets by banks and other lenders. The authors, David Greenlaw of Morgan Stanley, Jan Hatzius of Goldman Sachs Group Inc., Anil Kashyap of the University of Chicago and Hyun Song Shin of Princeton University, concluded that the resulting constriction of credit could reduce economic growth by as much as 1.5%. The authors found that about half of the mortgages are held by leveraged institutions, such as banks, thrifts, securities dealers and Fannie Mae and Freddie Mac. Based upon recent experience, the authors estimate that these institutions on average will want to increase their capital-to-asset ratios 5% because of the loans' increased risk. (*Wall Street Journal*, Greg Ip, 03/01/08)
- While subprime loans may be Wall Street's big focus, Alt-A mortgages are casting a bigger shadow on the horizon, said Fannie Mae economist Molly Boesel. "If things keep going as they've been going, most of these borrowers will be underwater," Boesel said at the Independent Community Bankers of America conference. Of the approximately \$70 billion negative amortization Alt-A adjustable-rate mortgages scheduled to reset in 2010, over 90% of the borrowers are already in a negative equity situation [with average loan balance for these mortgages is 5% higher than the balance of the original loan]. Geographically, these loans are concentrated in California, Florida and Arizona, said Boesel. (*Dow Jones Newswires*, Michael R. Crittenden, 03/05/08)
- On March 5th, Fitch Ratings said its outlook for the title insurance industry had turned negative, following net losses reported by four out of the five publicly-traded national title underwriters for FY2007. "As title insurance is a cyclical business, ratings are assigned at a level that can withstand a normal industry cycle," said Fitch analyst Doug Pawlowski. "However, the current downtrend may be unusually severe and longer in duration than past cycles, and create significant pressure on some company ratings." Gerald Glombicki, director of Fitch's insurance rating group, said, "There is some concern that ...reserve deficiencies coupled with operating losses will affect capital adequacy within the title industry." Fitch expects to complete a loss reserve adequacy and risk-based capital analysis for the industry this spring. (*Housing Wire*, Paul Jackson, 03/05/08)
- MGIC Investment Corp announced plans to sell additional shares of its common stock and said it also may seek additional capital in other forms, following its \$1.47 billion loss for the fourth quarter. By mid- to late March, MGIC will determine the

size of the offering and finalize its plans to raise other forms of capital. (*American Banker*, Harry Terris, 03/05/08)

Fannie Mae

Fannie Mae CEO Mudd on 10-day visit with investors in Asia and Europe

- Fannie Mae CEO Daniel Mudd is on his regularly-scheduled annual meeting overseas investors in Asia and Europe. Mudd's trip will include visits to Russia, Switzerland, China, and Japan. (*Wall Street Journal*, David R. Hagerty and David Wessel, 03/11/08; *Reuters*, 03/10/08)

Fannie Mae's annual shareholders meeting to be held on May 20th

- Fannie Mae has scheduled its 2008 annual meeting on Tuesday, May 20th at 10:00 a.m. for shareholders of record on March 21st. Shareholders will have an opportunity to vote on the election of directors, the ratification of the company's independent auditors, and other matters brought before the meeting. (*Fannie Mae Press Release*, 03/10/08)

Fannie Mae hires new chief auditor

- Fannie Mae has hired Jacqueline Wagner as its SVP and Chief Audit Executive, who will report directly to the company's board of directors. She succeeds S. Jean Hinrichs. Previously, Wagner served as SVP and chief auditor for American Express Company since 2002. She is the former chair of the Institute of Internal Auditors, Inc. (*Reuters*, Patrick Rucker, 03/07/08; *Fannie Mae Press Release*, 03/07/08)

Freddie Mac

Freddie Mac declares 1st quarter dividends

- On March 7th, Freddie Mac declared a quarterly dividend of \$0.25 a share for common stock, payable March 31st to owners of record as of March 17th. The company also declared dividends on its preferred stock in accordance with the terms and conditions of each issue. (*Freddie Mac Press Release*, 03/07/08)

Federal Home Loan Banks

Surge in FHLB Advances is expected to continue into 2008

- Recent spikes in FHLB Advances are expected to continue well into 2008, as bankers rely more heavily on the System to provide liquidity for resident mortgages, as well as commercial real estate and small business loans. “We are reflective of many of the Federal Home Loan banks in that our advances last year increased 84% [to \$40.5 billion outstanding at yearend], almost all in the second half,” said Richard S. Swanson, the president and CEO of the FHLB-Des Moines. “CD rates tend to be sticky, and a lot of banks are reluctant or slow due to customer relationships in reducing pricing on their deposits. FHLB advances are now at a significant cost advantage to brokered CDs, and in some markets to regular deposits.” He added, “My sense is that total advance levels at our bank and probably throughout the system will probably decline in 2008, but that is because as the capital markets start to settle, some of the largest banks in the system will shift back. [But] demand from small to midsized community banks will continue to increase.” (*American Banker*, Rob Garver, 03/11/08)

41 House Members seek action on a bill allowing FHLBs to guarantee tax-exempt bonds

- In a letter to Representative Charles Rangel (D-NY), chairman of the House Ways and Means Committee, and Ways & Means Committee Ranking Member Jim McCrery (R-LA), 41 members of the House of Representatives, including House Financial Services Committee Chairman Barney Frank (D-MA) and Ranking Member Spencer Bachus (R-AL), asked leadership to advance a bill allowing the FHLBs to guarantee tax-exempt bonds through the legislative process. The bill, sponsored by Representative Sander Levin (D-MI), would “bring greater stability to

the municipal finance market,” wrote the House members. (*American Banker*, Stacy Kaper, 03/04/08)

Merger negotiations of the FHLBs of Chicago and Dallas continue

- According to the *American Banker*, the FHLB-Chicago has determined that it is worth “at least \$800 million,” a crucial hurdle to moving forward with a potential merger with the FHLB-Dallas. The Dallas Bank must now determine if the accounting is a fair assessment of the FHLB-Chicago’s value. If the FHLB-Dallas accepts the Chicago Bank’s accounting, the Banks’ formal merger proposal could reach the Federal Housing Finance Board for its review and approval in a matter of weeks. According to sources, other issues, such as personnel structure for the consolidated bank, have yet to be resolved. In January, the FHLB-Chicago disclosed employment agreements with its three top executives which provide for salary continuation for three years if they are terminated “for good reason,” which could include relocating the Bank’s office more than 50 miles from its current site. In the filing, the Chicago Bank also disclosed that it had cut the incentive compensation for CEO Mike Thomas by more than half to \$300,000. (*American Banker*, Steven Sloan, 03/06/08)
- The FHLB-Dallas declared its first quarter dividend of an annualized 4.5%, payable March 1st. The dividend yield is roughly equivalent to the average effective federal funds rate for the fourth quarter of 2007.[The FHLB-Chicago is restricted from paying dividends to its members under the Consent Agreement that it entered into with the Federal Housing Finance Board.] (*PrimeNewswire*, 03/12/08)

FHLB-Pittsburgh names new chief risk officer

- The FHLB-Pittsburgh has named Marshal S. Auron as its Chief Risk Officer, succeeding J. Michael Hemphill, who is retiring on March 17th. As CRO, Auron will lead the Bank’s Corporate Risk Management Department, sit on the Bank’s Management Committee, chair its Risk Management Committee and serve as Secretary of the Finance and Risk Management Committee of the Bank’s Board of Directors. John R. Price, president and CEO of FHLB-Pittsburgh, said, “During his more than 15 years with us, Marshal has contributed to our success on the credit money desk, in risk/return management and most recently, as head of business research and development. His leadership skills in strategic planning are well recognized. Marshal’s relations with customers, his experience in risk management and his keen organizational and analytical abilities make him eminently qualified to serve as Chief Risk Officer.” (*FHLB-Pittsburg Press Release*, 03/06/08)

Farm Credit System / Farmer Mac

With a looming credit crisis, is it time for the Farm Credit System to take the lead in financing the ethanol industry?

- In an article appearing in the April *Ethanol Producer Magazine*, Ken Auer, president and CEO of the Farm Credit Council, argued that the FCS continues to be a significant and growing source of capital for the ethanol industry, particularly during this period of disruption in the credit markets. “As of the end of the third quarter of 2007, the outstanding loans and loan commitments to the industry was something like \$4.2 billion,” said Auer. “That represented something like a \$900 million to \$1 billion increase over the end of 2006. So in 2007, the system continued to play a role in providing capital to the industry. We do that directly as well as working with other financial institutions.” According to a recent FCS study, the ethanol industry will need an additional \$105 billion in capital over the next 15 years to meet the ethanol production goals in the Energy Bill. “Our view has always been that that sort of increase in capital requirements was going to require a broad base of financial institutions to participate in that marketplace,” said Auer. “As of right now, Congress has not seen fit to expand the flexibility of the system. It is up to Congress whether they want to pursue that or not.” He added, “The commercial banks have said they can and would do it all [meet the industry’s financing needs]. That is a fine thing to say, but considering what has been happening in the credit markets lately, it’s kind of a fantasy land they will continue to extend themselves *in a risky business*.” [Emphasis added.]
- According to the *Ethanol Producer Magazine*, “Bigger [ethanol] plants, which have been getting more expensive per gallon of capacity to build, are making it harder for ethanol developers to gather enough farmer equity to allow the projects to qualify for FCS financing. ‘What has become clear as the capital needs of these plants has increased, farmers have been saying they can’t put up the full capital,’ Auer says. ‘They have to find additional outside investors. Where farmer ownership could once have been 55 percent, now it could be 30 percent. When that happened, the FCS could no longer directly finance those projects.’ There was a proposal in the House of Representatives to allow FCS to finance ethanol projects irrespective of the level of farmer ownership. That provision was included in the House version of the Farm Bill that came out of the Agriculture Committee. However, that provision was struck from the bill on the floor of the House.”
- “If ethanol producers want the FCS to be more active in the industry, they will have to help persuade Congress that changes need to be made,” Auer says. “FCS continues to be very supportive of the industry. We continue to be very interested in working with the industry. To the extent that the current law prevents that, we need help to convince Congress we need greater flexibility to provide credit to the industry.”

Congress needs to be hearing from the industry if it would like the FCS to have greater flexibility.” (*Ethanol Producer Magazine*, Jerry W. Kram, April 2008)

- “Renewable fuels was once an economic issue and it was once an environmental issue. But it is now a national security issue—period,” said Barry Flinchbaugh, an agricultural economist at Kansas State University. Every political candidate running for office in the 2008 cycle has now jumped on the “renewable fuels bandwagon,” now that it is “politically incorrect to oppose renewable fuels,” said Flinchbaugh. While higher corn prices seem to be on everyone’s mind, Flinchbaugh warned, “Don’t complain about \$4 corn; no one sympathizes with you. And if you go on record opposed to ethanol, you will be branded unpatriotic.” (*Farm & Ranch Guide*, Sue Roesler, 03/13/08)

Ethanol rush threatens starvation on a “global scale”

- At a March 6th conference in London, Professor John Beddington, the UK government’s Chief Scientific Adviser, said that the rush to produce biofuels is threatening the world’s food production. “It’s very hard to imagine how we can see the world growing enough crops to produce renewable energy and at the same time meet the enormous demand for food,” said Beddington. “The supply of food really isn’t keeping up.” By 2030, population growth will require a 50% increase in food production and by the year 2080 food production will need to double to meet demand for food. “The shift to biofuels production has diverted lands out of the food chain,” Josette Sheeran, executive director of the World Food Programme, told the European Parliament in Brussels. “Food prices, such as palm oil in Africa, are now set at fuel prices. It may be a bonanza for farmers—I hope it is true—but in the short term, the world’s poorest are hit hard.” (*The Times* [UK], Lewis Smith and Francis Elliott, 03/07/08)
- Over the past two years, prices for U.S. crops, such as corn, wheat and soybeans, have doubled or even tripled, in large part because of the ethanol boom and steadily weakening dollar which have fueled a surge in exports. According to the U.S. Department of Labor [which compiles inflation data], grocery costs have jumped 5.1% in the last 12 months, marking the worse grocery inflation since the early 1990s. (*New York Times*, Andrew Martin and Michael M. Grynbaum, 03/15/08; *American Banker*, Marissa Fajt, 03/13/08)
- U.S. federal tax breaks for biodiesel exporters undercut competitors in Europe, undermining trans-Atlantic trade ties and “clouding” an otherwise strong U.S.-EU commercial relationship, said Ambassador John Bruton, the European Union’s ambassador in Washington. Exports of U.S. biodiesel, which are 30% cheaper, grew ten-fold in 2007, and comprised 20% of the European market. The EU estimated that the U.S. spends \$200 to \$300 million a year to support biodiesel exports. “We don’t really believe it’s the job of U.S. taxpayers to subsidize European motorists,” said

Bruton. “We don’t think it’s the best use of U.S. tax funds; we also believe it is likely to damage to European biodiesel industry.” (*Reuters*, 03/12/08)

The law of unintended consequences

- In the March 9th edition of the *Boston Globe*, Jeff Jacoby wrote, “What do ethanol and the subprime mortgage meltdown have in common? Each is a good reminder of that most powerful of unwritten decrees, the Law of Unintended Consequences—and of the all-too-frequent tendency of solutions imposed by the state to exacerbate the harms they were meant to solve. Take ethanol, the much-hyped biofuel made (primarily) from corn. Ethanol has been touted as a weapon in the fashionable crusade against climate change, because when mixed with gasoline, it modestly reduces emissions of carbon dioxide. Reasoning that if a little ethanol is good, a lot must be better, Congress and the Bush administration recently mandated a sextupling of ethanol production, from the 6 billion gallons produced last year to 36 billion by 2022.”
- “But now comes word that expanding ethanol use is likely to mean not less CO₂ in the atmosphere, but more. Instead of reducing greenhouse gas emissions from gasoline by 20 percent—the estimate Congress relied on in requiring the huge increase in production—ethanol use will cause such emissions to nearly double over the next 30 years. ...Bottom line: The government’s ethanol mandate will generate a ‘carbon debt’ that will take decades, maybe centuries, to pay off. Actually, that’s not quite the bottom line. Jacking up ethanol production causes other problems, too. Deforestation. Loss of biodiversity. Depletion of aquifers. More ethanol even means more hunger: As more of the US corn crop goes for ethanol, the price of corn has been soaring, a calamity for Third World countries in which corn is a major dietary staple.”
- “Senator Charles Grassley of Iowa bloviates that ‘everything about ethanol is good, good, good,’ but it plainly isn’t, isn’t, isn’t. The fate of ethanol, including how much of it is produced, should be determined by the decentralized process of free exchange - by the voluntary interactions of countless consumers and producers, buyers and sellers, each acting according to his best judgment and in his own best interest. Instead, Congress and the president, convinced as always that they know best, imposed a single, inflexible, ham-fisted directive from above. The result is that the carbon dioxide they aimed to reduce will be increased, and many people will suffer unnecessary misfortune.”
- “The subprime mortgage collapse is another tale of unintended consequences. The crisis has its roots in the Community Reinvestment Act of 1977, a Carter-era law that purported to prevent ‘redlining’—denying mortgages to black borrowers - by pressuring banks to make home loans in ‘low- and moderate-income neighborhoods.’ ...[T]o earn high ratings, banks were forced to make increasingly risky loans to borrowers who wouldn’t qualify for a mortgage under normal standards of

creditworthiness. The Community Reinvestment Act, made even more stringent during the Clinton administration, trapped lenders in a Catch-22. ‘If they comply,’ wrote Loyola College economist Thomas DiLorenzo, ‘they know they will have to suffer from more loan defaults. If they don’t comply, they face financial penalties . . . which can cost a large corporation like Bank of America billions of dollars.’ Banks nationwide thus ended up making more and more subprime loans and agreeing to dangerously lax underwriting standards - no down payment, no verification of income, interest-only payment plans, weak credit history. If they tried to compensate for the higher risks they were taking by charging higher interest rates, they were accused of unfairly steering borrowers into ‘predatory’ loans they couldn’t afford.”

- “Trapped in a no-win situation entirely of the government’s making, lenders could only hope that home prices would continue to rise, staving off the inevitable collapse. But once the housing bubble burst, there was no escape. Mortgage lenders have been bankrupted, thousands of subprime homeowners have been foreclosed on, and countless would-be borrowers can no longer get credit. The financial fallout has hurt investors around the world. And all of it thanks to the government, which was sure it understood the credit industry better than the free market did, and confidently created the conditions that made disaster unavoidable.”
- “‘No man’s life, liberty, or property is safe,’ warned Mark Twain, ‘while Congress is in session.’ Mark Twain was a humorist, but that was no joke.” (*Boston Globe*, Jeff Jacoby, 03/09/08)
- In the *Star Ledger*, Paul Mulshine wrote, “...[T]he only thing green about ethanol is the cash it puts in congressmen’s campaign coffers. Rarely has a program been so completely debunked so quickly. ...It’s still the perfect solution as far as Congress is concerned. Ethanol is wasteful, expensive and entirely pointless. Inside the Beltway, that’s known as hitting a trifecta.” (*The Star Ledger* [NJ], Paul Mulshine, 03/16/08)

2008 Farm Bill saga continues

- In a March 14th editorial, the *Wall Street Journal* wrote, “When it comes to picking taxpayer pockets, no one—not the trial lawyers or even AARP—has it over the farm lobby. How’s this for clout? Though last year was one of the best ever for farm incomes -- up 44% to \$87.5 billion -- farmers are about to score the most lavish subsidies in American history. The House and Senate are now ironing out differences between their bills, and it’s all but certain that farmers will get about \$26 billion over the next five years in subsidies. Soybean and wheat farmers are slated to receive higher price supports, though bean prices hit a 34-year high last year and wheat prices have soared to a new record.”
- “Corn producers will get subsidies of \$10.5 billion over five years, which is on top of the deal of a lifetime these farmers were handed when Congress expanded ethanol subsidies. The handouts make growing corn so profitable that last year some 15.3

million acres were converted to new corn production, according to the USDA. That has a cascading effect on other prices, as farmers convert bean acreage to more lucrative corn fields and feed prices for meat producers climb.”

- “There’s also a new \$5.1 billion emergency ‘trust fund’ for farmers, with almost all the money directed to Georgia, Minnesota, North Dakota and Texas. New Hampshire Senator Judd Gregg predicts that ‘if a large wind comes up and blows a mailbox over in North Dakota, it’s going to be declared an emergency because somebody’s going to want to get their hands on that billion dollars.’ Credit for that one goes to self-styled ‘deficit hawk’ Kent Conrad, the free-spending North Dakota Democrat. So sweeping is the American Farm Bureau’s victory that of the 22 crops that now receive price supports, 18 receive a more generous payment scheme under the Senate bill and 12 in the House bill.”
- “All of this will be highly problematic for America’s trade negotiators. Brazil has already won a World Trade Organization complaint against the U.S. for providing illegal subsidies to cotton farmers. That ruling allows Brazil to apply \$4 billion in retaliatory tariffs on American goods. Several similar suits are pending against the U.S., and these complaints were filed before any of these latest hikes in price supports.”
- “The giveaways are so large that the House version is the first farm bill ever that would raise taxes to pay for it—by \$14 billion, mostly on the U.S. subsidiaries of foreign companies. This only discourages new foreign investment in the U.S. at a time when the weak dollar is already chasing it away. It’s a sign of how insidious these welfare programs are that the Farm Bureau, traditionally an anti-tax outfit, recently signed off on the tax hikes in return for the subsidies.”
- “Both bills also allow farmers to keep exploiting a loophole that lets them cash in twice. First, they can lock in loan subsidies at the lowest possible price for their crops; then later they can sell those same crops at a higher market price. The government pays the farmer the difference between the two prices, and the farmer gets the maximum price at market. Hence, when corn prices plunged in 2005 after a bumper crop and Gulf Coast supply disruptions after Hurricane Katrina, many farmers locked in an estimated \$3.8 billion in subsidy payments at low prices. But they also cashed in when they sold the crops later after prices rebounded.”
- “And speaking of cashing in, Congress has also spurned the Bush Administration’s sensible proposal to establish a \$200,000 income ceiling in order to receive subsidies. Instead, full-time farmers will be able to earn up to \$1 million per farm (\$2 million for a married couple) and still be eligible for a USDA handout. That means you can be in the top 0.2% in income in the U.S. and still get a subsidy check from Uncle Sam. Yet Robert Goodlatte of Virginia, the Republican who helped craft the House bill, says with a straight face that the bill is ‘real reform and a real safety net for the farmer.’ Yes, thank heavens for that millionaire safety net.”

- “The only good news is that President Bush is threatening to veto this budget buster over its taxes, trade distortions and subsidies for the rich. The veto threat is at least causing the Members to think twice, and may actually improve the bill. But the best outcome would be if this monster died of its own, greedy weight.” (*Wall Street Journal*, 03/14/08)
- On March 14th, President Bush said he would ask Congress to pass a one-year extension of the Farm Bill, if Congress is unable to pass a new law by April 18th. While he would prefer for Congress to pass a new Farm Bill, Bush said, “The government has a responsibility to provide America’s farmers and ranchers with a timely and predictable farm program — not multiple short-term extensions of current law. Without a predictable policy, agriculture producers will be unable to make sound business decisions with respect to this year’s crop.” Bush said that he is willing to sign the 30-day extension of the current Farm Bill which Congress recently passed. Negotiations on the \$280 billion five-year Farm Bill have been stymied by a stalemate over how to pay for about \$10 billion in new spending in the bill. Bush insists he will not sign a bill that includes new taxes. The President has also pushed for significant restructuring of agricultural subsidies, a hard sell among lawmakers who represent big farming districts. (*CQ Today Midday Update*, 03/14/08)

Farm Credit Council manages one of the largest agricultural PACs in Washington
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- In *The Farm Credit Council Recognizing Twenty-Five Years of Service to the Farm Credit System* [brochure], the FCC wrote, “...Today’s Farm Credit Council is well established as an effective advocate and successful national trade association. It is recognized as the Washington voice for the Farm Credit System. It manages one of the largest agricultural political action committees in Washington and supports the operations of The Farm Credit System’s Foundation.” (*The Farm Credit Council Recognizing Twenty-Five Years of Service to the Farm Credit System*, March 2008)

Postal Service

U.S. economic woes hit the USPS

- The Postal Service has placed a hiring freeze at its headquarters and headquarters field units because of the agency's projected financial losses. In a March 7 memo, EVP Anthony Vegliante announced the freeze to postal executives and said that the agency would only consider hiring employees who are vital to continuing successful programs, raising new revenue and cutting costs or other critical needs. "We need to balance our investments in programs and resources we manage with our challenging 2008 budget," wrote Vegliante. (*Federal Times*, Stephen Losey, 03/11/08)

Postal reform is working

- Despite steep financial losses in the past year, Postmaster General John Potter and members of a Senate panel said the postal reform legislation passed in December 2006 is succeeding. Potter testified that the USPS lost \$5.1 billion in FY08 and may lose more than \$1 billion in 2008, as a result of slowdowns in the financial, credit and housing sectors coupled with the agency's rate increase last year drove businesses in those fields to reduce mailings. Potter has pledged to avoid layoffs and move aggressively to contract out mail delivery routes at the USPS—steps that could deliver big savings to the agency, but are strongly opposed by postal unions and many members of Congress. To offset declines in business, he said the Postal Service is moving to cut expenses and identify areas to add revenue.
- After praising the Postal Reform Act, Potter suggested that Congress make additional legislative changes. "There is not enough flexibility in the law," he said. The Postal Service needs more freedom to adjust prices on products like money orders, international mail and Express Mail packages whose rates are capped, said Potter. The Postmaster General suggested shifting these products to the group without caps, which would allow the Postal Service to better compete with private carriers. Potter also asked Congress to remove the regulations that prevent the USPS from negotiating rates based on volume and other factors with private mail transporters.
- Homeland Security and Governmental Affairs Financial Management Subcommittee Chairman Thomas Carper (D-DE), said, "I am concerned about the impact the economic slowdown is having on the Postal Service's bottom line, but pleased with how consumer reforms are being implemented." (*Congressional Daily AM*, Dan Friedman, 03/06/08)
- As a result of postal reform, the USPS has started offering price incentives, such as volume-related discounts for competitive mail products such as Express Mail and Priority Mail, effective May 12th. In May, the agency will start offering commercial

volume pricing, minimum volume rebates, online price breaks, and other pricing incentives. (*DMNews.com*, Ellen Keohane, 03/12/08)

PRC releases its five-year Strategic and Operational Plan

- On March 7th, Dan G. Blair, Chairman of the Postal Regulatory Commission, released the Commission's first Strategic and Operational Plan, which details the agency's vision and goals over the next five years. "This Plan outlines the strategies and activities that the Commission will use to help ensure transparency and accountability of the U.S. Postal Service and to foster a vital and efficient universal mail system," said Blair. The Plan incorporates responsibilities established by the Postal Accountability and Enhancement Act (PAEA) and will guide the Commission as it implements the key provisions of the Act. By emphasizing the operational work that must be accomplished over the next five years, the Commission will evaluate its progress and performance on the strategic goals outlined in the Plan.
- The report identifies seven key strategic goals, with short-term and on-going strategies, which include:
 - Modern Rate and Product Regulation – Establish and maintain a predictable, transparent, and effective system of rate and product regulation;
 - Service Performance Evaluation – Ensure appropriate and transparent U.S. Postal Service performance standards and measurements to promote an efficient, effective and responsive mail service;
 - Financial Accountability and Compliance – Ensure transparent, accurate and informative U.S. Postal Service data reporting sufficient for evaluation of financial performance;
 - Complaint Process – Ensure U.S. Postal Service accountability through a fair and open public complaint process that provides appropriate and timely resolution; and
 - Public Participation and Government Relations – Ensure the Commission is visible and readily accessible to all stakeholders. (*Postal Regulatory Commission Press Release*, 03/07/08)

Sale of Forever Stamps are up sharply

- After the Postal Service announced plans to increase the price of a first-class letter on May 12th, sales of the Forever Stamps, valid for postage regardless of any rate increase, jumped by \$95 million. In February, the agency sold \$275.2 million of Forever Stamps, up from \$179.3 million in January. (*Associated Press*, 03/12/08)

USPS approved 99.5% of law enforcement's request for postal information
over past three years

- According to U.S. Postal Inspection Service data, postal officials approved more than 10,000 law enforcement requests to record information during criminal inquiries. In 2004, 2005 and 2006, postal officials granted at least 99.5% of law enforcement's requests. (*USA Today*, Kevin Johnson, 03/05/08)

TVA

Partisan battle in Congress leaves two TVA nominees in limbo

- The nine member TVA board of directors has been functioning with only six members, because Democratic leaders have blocked confirmation votes on three pending board nominations because of concern about the lack of Democrats on the panel "If [Senator Reid] wants to play politics, play it somewhere else and leave the TVA alone," said Senator Lamar Alexander (R-TN). "The people of the Tennessee Valley need to know that the Democratic leader is holding up the TVA board. He's damaging our capacity to grow new jobs and have clean air." Reid spokesman Jim Manley said that when the Republicans restructured the TVA board two years ago by expanding it from three full-time members to nine part-time members, they eliminated Democratic representation from the board. "Contrary to what Senator Alexander said, it's the Republicans playing politics by abolishing Democratic representation on the board," said Manley. "Senator Reid continues to be in conversations with the White House and [Senate Minority Leader Mitch] McConnell (R-KY) to move a long list of nominees, which they have been holding up." TVA president Tom Kilgore said that the six board members "are doing a great job, but it's not a full complement." He added, "We need a full complement." (*Chattanooga Times Free Press*, Herman Wang, 03/08/08; *Knoxville News-Sentinel*, Michael Collins, 03/07/08)
- On March 14, the Senate filled one of the three vacancies on the TVA Board by unanimously confirmed Thomas C. Gilliland to TVA's board of directors. Gilliland, the first Georgia member on the TVA board, is EVP, Secretary and General Counsel for United Community Banks, Inc., the third-largest bank holding company in Georgia. TVA Chairman Bill Sansom said Gilliland's experience as a banker and attorney "will be invaluable to TVA." (*Associated Press*, 04/13/08; *The Weekly.com*, 03/14/08)

TVA takes “realistic approach” to meeting future energy demands in the TVA Valley

- At a March 6th meeting of the Congressional TVA Caucus, Senator Lamar Alexander (R-TN) and Representative Bud Cramer (D-AL) said the utility should aim to use power more efficiently while continuing to build new nuclear plants. “Today, the TVA is taking a realistic approach to providing electricity to the Tennessee Valley which includes plans to reduce electricity use by consumers and build new nuclear plants at the same time,” said Alexander. “This reality-based strategy will permit TVA to buy less electricity in the market while also lowering the emissions of sulfur, nitrogen, mercury and carbon dioxide, and I congratulate the TVA on these efforts.”
- As part of its 2007 Strategic Plan, TVA is developing long term strategies to use less power by cutting 1,250 megawatts of electricity by 2012 and adding new, clean and safe nuclear power by bringing online the Browns Ferry Unit 1 plant in May 2007 and the Watts Bar Unit 2 in Tennessee, scheduled to be online by 2013. The agency also has applied with the NRC for approval for the Bellefonte plant in Alabama. “In 2012, 42% of TVA electricity will be clean electricity and that will put TVA among the nation’s leaders in clean energy,” said Alexander. “If we are serious about climate change and having large amounts of low-cost, reliable power so we can compete for good jobs here in the Tennessee Valley region, then our only options for growth in the near future are conservation and nuclear power. I think that the Watts Bar Unit two plant and the proposed Bellefonte plant are a step in the right direction.”
- Activists have urged TVA to expand its Green Power Switch program in which customers pay a small premium each month for renewably generated electricity, which represents less than 1% of the utility’s annual electric capacity. John Wilson, research director with the Southern Alliance for Clean Energy, said TVA should try to achieve 20% of power demand from renewable energy by 2020—15% at the minimum. “It is very doable [by adding wind turbines, supporting small hydroelectric generators and using the TVA Valley’s vast biomass potential, particularly in Tennessee and Mississippi], said Wilson. Stuart M. Dalton, director of generation at the Electric Power Research Institute, said there is not enough wind in the Southeast to become a major renewable energy source and large-scale solar electric systems are not a viable short-term solution. While biomass may be TVA’s “strongest near-term regional option,” the utility shouldn’t expect to get much more than 9% of its energy mix from renewables by 2020. “I think TVA’s best strategy is to set your own goals and act on them, even if TVA is exempted from the [federal] mandates,” said energy consultant Ed Holt. “I think the political pressure will still be enormous and your credibility as stewards of natural resources might be called into question if you don’t at least meet those mandates that are placed on others.” (*State News Services*, 03/06/08; *Associated Press*, Duncan Mansfield, 03/06/08)

North Carolina to spend \$5 million on lawsuit against TVA

- North Carolina's senior deputy attorney general James Gulick said that North Carolina may spend as much as \$5 million on outside legal help during its lawsuit against TVA, alleging that the utility's coal-fired plants harm the state's health, environment, and economy. Gulick told the Council of State that more money will be needed to hire outside experts and take depositions. "This is a complex case," said Gulick. "They are a very stubborn and efficient opponent." To date, the Council has approved \$1.5 million to pay for outside assistance. The federal trial scheduled to begin in July in Asheville, NC. (*Associated Press*, 03/04/08; *News and Observer*, Ryan Teague Beckwith, Benjamin Niolet and Bill Krueger, 03/05/08)

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