

# The **GSE** REPORT™

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## *Major Events*

Senate Banking Committee passes the Federal Housing Finance Regulatory Relief Act  
by a vote of 19-2

- On May 20<sup>th</sup>, the Senate Banking Committee reported out its housing rescue bill, in the form of a manager's amendment to the Federal Housing Finance Regulatory Reform Act of 2008, by a vote of 19-2. The manager's amendment contained the compromise worked out by Chairman Christopher Dodd (D-CT) and ranking minority member Senator Richard Shelby (R-AL), following an intense round of discussions. In a media briefing, Dodd said that the bill achieves the Committee's three goals of (1) keeping people in their homes and re-instilling confidence in the mortgage markets; (2) establishing an affordable housing fund in perpetuity and using the first years of the fund for mortgage workouts; and (3) establishing a strong, appropriate GSE regulator for the housing GSEs.
- Under the bill's provisions, a new GSE regulator would be created who would establish criteria to govern the GSEs' portfolio holdings. The regulator would be given the power to temporarily increase a GSE's minimum capital level when such an increase is deemed to be 'necessary and consistent with prudential regulation and the safe and sound operations of a regulated entity;' when the regulator determines that the capital increase is no longer justified by circumstances or facts, the temporary increase of the GSE's capital must be rescinded. Under the bill, the GSE director must issue regulations which establish (1) standards for imposing an order requiring a temporary capital increase; (2) standards and procedures the director will use to determine when to rescind the increase; and (3) a reasonable time frame for periodic review of the increase to determine when to rescind the order. The bill also establishes an ombudsman's office within the GSE regulatory agency.
- The bill would "absolutely not" give the GSE regulator unilateral power to curtail and control the housing GSEs, said Dodd. "It's a strong regulator," he said. "Two things [the bill] does not do: It does not give the regulator power to engage in systemic risk issues ...and secondly, you cannot force these GSEs to raise capital for any reason whatsoever and there were those who wanted to go that route. It doesn't do that." Instead, the regulator has the ability through regulation "to raise capital but where safety and soundness is involved and even do so by order, but only so long as the problem exists and then the snapback provisions are included," said Dodd. "And dealing with new product and portfolio issues as well there are changes that are needed here but they are relatively modest in change and the strong regulator is very much in place and that's been needed."
- The bill would establish a new conforming loan limit in high-cost markets for Fannie Mae and Freddie Mac at 132% of the conforming loan limit—\$550,000. Under the bill, the GSEs would be prohibited from holding loans purchased with principal

obligations greater than the standard conforming limit on their portfolios, either as whole loans or mortgage-backed securities, except to the extent that such loans are held for securitization.

- The Housing Trust Fund [HTF—previously named the Affordable Housing Block Grant Program] would designate 75% of its funds to benefit “extremely low income families” and the remaining 25% would benefit “very low-income families.” During the first year, all HTF funds will be used to offset the costs of the HOPE for Homeowners Program. In year two, 50% of the fund would be used to offset the costs of the HOPE program and 25% in 2011. Provisions for the HOPE program include requirements that (1) borrowers provide a certification, saying that they did not intentionally default on any debt, not just their current mortgage; (2) borrowers be held liable to repay the FHA any benefits achieved through the mortgage reduction based upon the borrower’s representations; (3) all applicants document their income and not be owners of a second home; (4) appraisals be prepared by an appraiser certified by the state [where the property is located] or by a nationally recognized appraisal organization and have a “demonstrated verifiable education in FHA appraisal requirements.”
- Within the FHLB provisions, the bill would retain the current law’s provisions which allocate member directorships for the FHLBs’ boards, except in the case of a merger of two or more FHLBs. The bill would modify the list of exemptions applicable to the FHLBs in the Securities and Exchange Act of 1934 to conform to existing SEC regulations. Under the bill, the director of the FHLB Board would have one year to report to Congress the degree to which the loans and securities used as collateral for FHLB advances are consistent with the interagency guidance on nontraditional mortgage products. The bill would also allow the FHLBs to use affordable housing program funds to refinance single-family first mortgages to applicants, who have incomes at or below 80% median area incomes.
- The bill would establish a national licensing system for all loan originators and authorize the Treasury Department’s Office of Financial Education to take expanded steps to improve home ownership counseling services. It also would require a study of ways to improve default risk evaluation through the use of technology and standardization.
- The Banking Committee’s debate during markup centered on three key issues—the GSE regulator’s product approval powers; the jumbo loan provisions; and the GSEs’ code of appraiser independence. Senator Chuck Schumer (D-NY) expressed concern that the bill’s provision giving the GSE regulator authority to approve new products seemed to require all new GSE products to go through a public comment period, which might stymie innovation. Schumer argued that the GSEs should have the option of implementing some products directly, while putting others out for public comment. Schumer also said he wanted to rework the jumbo loan provisions, which as currently worded would require the GSEs to securitize and sell the jumbo loans, rather than hold them in portfolio. Effectively, he said, this requirement prevents the

GSEs from backing these loans, because there's currently no market for these loans. Unless this wording is changed, Schumer argues this provision would crimp the recovery of the residential real estate market in high cost regions. The Senator said he would work with Chairman Dodd to prepare a floor amendment on these issues.

- Senator Elizabeth Dole (R-NC) expressed disappointment that an amendment instituting a code of appraiser independence was not included as part of the manager's amendment. Dole called on the Committee to address the issue of appraisal standards, which was addressed by a settlement between the New York Attorney General, OFHEO, and the GSEs in lieu of Congressional action. Shelby called appraisal standards a critical issue and agreed that the Committee should take up the challenge. Dodd agreed, saying the panel has a number of issues to revisit—including appraisal standards. In the mean time, Dodd argued, the settlement agreement should remain in place until Congress could implement "something better." Otherwise, he argued, if the agreement were struck without enacting a substitute, the mortgage underwriting system would be left in "free fall." Dodd also noted that the revised bill would have a lower cost of approximately \$500 million, while covering the same number of mortgages (500,000), because of changes made in bill—particularly the shortened time span of just three years.
- Dodd said he hopes to have floor action on the Federal Housing Finance Regulatory Reform Act of 2008 after the Memorial Day recess and have a final bill on the president's desk before the July 4<sup>th</sup> recess. The Chairman expects a number of other legislative pieces, including FHA reform legislation and a \$7,000 home buyer tax credit, will be rolled into the House-Senate conference, given the limited time remaining of "maybe six weeks" left in this congressional session. Shelby said he was optimistic about the bill's fate, saying he expects a "big, big vote" in favor of the bill on the Senate floor. When asked by reporters if the vote would be large enough to override a veto, Shelby said he didn't think the president would veto the bill. Shelby also told reporters that while he is sympathetic to Hurricane Katrina victims, fixing the housing crisis must come first. "We've got a nationwide housing crisis here," said Shelby. During an interview on CNBC, Shelby said, "This is a victory for taxpayers. I think it's a win-win, a double win for all of us." Senator Mel Martinez (R-FL) said he is confident that the Senate version will be acceptable to the House—saying, "I think the wisdom of the Senate will prevail."
- House Financial Services Committee Chairman Barney Frank (D-MA) said Chairman Dodd "deserves a great deal of praise for getting this bill through the [Banking] committee by such as significant vote." Frank said he is concerned that the Senate's bill diverts money from the affordable housing fund, which the House bill dedicates to hurricane recovery in New Orleans during the first year. In a speech to the New Democratic Network, Frank said, "A fight is brewing over the affordable housing fund. More broken promises to the people of New Orleans is not something that is high on my list." Frank added, "We can find ways to pay for this without taking the money away from New Orleans." "We are in agreement on a whole lot of things." Frank noted, "The loan limits will be an issue, because that's very important to the

speaker and all of California.” He added, “[It’s] highly likely that we will be able to compromise on a significant housing package” and predicted that in conference lawmakers could achieve a “mutually agreed housing package sometime next month [June].” Minority leader Spencer Bachus (R-AL) applauded the bill’s inclusion of a national licensing system for mortgage originators. “Elimination of unscrupulous brokers and lenders from the mortgage market has been a goal since I first started working on subprime lending issues three years ago,” said Bachus. “The licensing and registration of mortgage originators will provide a major protection for families seeking fair and equitable financing ...inclusion of this title in the Senate GSE bill is a much needed step towards enactment of this important provision.”

- In a May 21<sup>st</sup> statement, Treasury Secretary Henry M. Paulson, Jr. said, “We have long called for strong, comprehensive GSE reform. This is the most significant component of the legislation passed [by the Senate Banking Committee] today, creating a world class financial regulator with appropriate authorities to oversee the GSEs’ operations. Fannie Mae and Freddie Mac are guaranteeing a greater share of mortgages than ever before. It’s never been more critical that markets have confidence in how these companies are overseen and regulated. As we all know, one element critical to reaching the end of this correction will be the cost of mortgage finance—the price of a mortgage will impact how many buyers come into the market and when they do so. Investor confidence in the secondary mortgage market is vital to the continued flow of affordable mortgage capital for American homebuyers. And a strengthened regulator for the two largest sources of mortgage finance is vital to the confidence of all mortgage market participants and regulators.” Dana Perino, the White House Press Secretary, said that the president is “very encouraged that the bill appears to create a strong and independent [GSE] regulator,” but stopped short of saying he would support the Senate bill.
- On May 20<sup>th</sup>, OFHEO director James B. Lockhart, III said, “We congratulate Chairman Dodd, Ranking Member Shelby and Members of the Senate Banking Committee for approving a bipartisan, balanced GSE regulatory reform bill that will strengthen the nation’s housing finance system by enhancing oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. The GSE portion of the legislation should give the new regulator the tools necessary to ensure the safety and soundness of the GSEs so they fulfill their congressionally established mission of providing stability, liquidity and affordability to the housing market. We are hopeful that the full Senate will act quickly on this important legislation.”
- In a May 20<sup>th</sup> speech to investors, Freddie Mac CFO Anthony Pizsel said that the Senate’s GSE regulatory reform bill contains “no death blow” to GSEs and his company is “generally supportive” of the housing rescue legislation. Pizsel added, “The rulemaking will determine what the flexibility is that we have. It’s going to take a couple of years, quite frankly, to work through.” In a media interview, Fannie Mae CEO Daniel Mudd said, “We continue to want to have a strong credible regulator. This is another step forward in the progress.” Mudd warned Congress, “Given the housing market we’re in, it’s very important Congress think very carefully about the

right balance between the right regulatory powers and the abilities of the companies to respond to the market, expedite the recovery, turn a profit for their shareholders and be successful.’’

- Moshe Orenbuch, a Credit Suisse Group analyst, warned investors that the new GSE regulator’s ability to change capital requirements may reduce the companies’ profitability. “If the legislation gives these broad capital powers to the regulator, it is likely that the regulator will determine that the GSEs should be less leveraged,’’ wrote Orenbuch. In a research note, Bear, Stearns analysts fretted that the bill would hurt GSE shareholders by giving the regulator too much power to “arbitrarily change capital requirements and force asset sales.’’ Barclays Capital analyst Rajiv Setia said that in order to secure the mortgage rescue plan, “the Democrats essentially gave in on the GSEs.’’ However, Setia views a tougher regulatory regime for Fannie and Freddie as a “huge long-term positive’’ for the markets, since it should restore confidence in the GSEs’ devalued debt and assuage fears of another mortgage market crisis.
- The American Bankers Association applauded bipartisan passage of the Senate Banking Committee bill. “The independent regulator created by this legislation will have authority to approve the products that Fannie Mae and Freddie Mac offer and to ensure that they adhere to their mission and are operating in a safe and sound manner,’’ said Robert Davis, ABA’s EVP for mortgage finance and public policy. “This is equivalent to the authority the banking regulators have and will help to ensure that the enterprises can provide much needed liquidity to the mortgage market and partner with banks of all sizes in meeting out nation’s housing and community development needs.’’ The bill’s authorization of a temporary FHA program to provide relief to distressed homeowners is “a careful response to a serious problem,’’ said Davis. Independent Community Bankers of America also praised the compromise bill, which recognizes the distinct nature and independence of the FHLBs, and for provisions that enhance “the FHLBs’ support of small business, agricultural and community development activities of community financial institutions.’’ The National Association of Realtor’s president Richard Gaylord, said his association is “pleased with the general direction of this bill,’’ which is good for both the housing market and homeowners. Gaylord added, “We continue to strive for permanent increases to the conforming loan limits at the higher level passed by the House.’’ Jerry Howard, CEO of the Association of Homebuilders, said, “This is a wonderful compromise [between the GSE critics and Fannie’s and Freddie’s supporters].’’
- Tom Stanton, a fellow at Johns Hopkins University and author of several books on the housing GSEs, said the Senate’s bill would be a “huge improvement’’ over existing law, since it gives a new GSE regulator the power to increase the capital requirements for Fannie and Freddie. Stanton worries, however, that the two enterprises will use their political clout to resist tough regulatory restrictions. Fannie and Freddie officials have made it clear that they will lobby for “tweaks’’ to be made to the wording of the bill so as to avoid [in their view] onerous restrictions. Freddie

Mac spokesman David Palombi said, “It is essential that we achieve statutory balance between capital levels and our responsibility both for funding long-term, fixed rate mortgages ...and providing stability to the U.S. housing market.” (*Bureau of National Affairs*, Thecla Fabian, 05/21/08; *The Economist*, 05/24/08; *Wall Street Journal*, James R. Hagerty and Damian Paletta, 05/21/08; *American Banker*, Stacy Kaper, 05/20/08; *Bureau of National Affairs*, Thecla Fabian, 05/20/08; *Washington Post*, Lori Montgomery, 05/21/08; *Bloomberg News*, Jody Shenn and Dawn Kopecki, 05/20/08; *Reuters*, 05/20/08; *OFHEO News Release*, 05/20/08; *U.S. Treasury News Release*, 05/21/08; *American Banker*, Stacy Kaper and Steven Sloan, 05/21/08; *CQ Today* [Print Edition], Benton Ives, 05/20/08; *Bloomberg News*, Alison Vekshin, 05/19/08; *Wall Street Journal*, Joseph Schuman, 05/20/08; *Bureau of National Affairs*, Bill Swindell, 05/20/08; *CongressDaily*, Bill Swindell and Keith Koffler, 05/20/08)

- In a May 21<sup>st</sup> editorial, the *Washington Post* wrote, “If you think the credit markets are shaky now, imagine what would happen if either Fannie Mae or Freddie Mac—or both—defaulted. These two giant ...[GSEs] are in the vital business of guaranteeing mortgage-backed securities. And, as of the end of March, they had combined credit outstanding of \$5.3 trillion, according to their regulator, ...[OFHEO]. This gargantuan amount of money is equal to the publicly held debt of the entire U.S. government. Fannie and Freddie are not, officially, government agencies; they are shareholder-owned. But they enjoy an implicit federal guarantee, which means that taxpayers would eventually be on the hook for any obligations they could not meet.”
- “It will probably never come to that, but lately the prospect of a Fannie-Freddie default has become just a bit too thinkable for comfort. The housing bust is costing both entities billions of dollars in losses, yet Congress and the Bush administration are pushing them to provide more liquidity to the market. As they increase market share, they assume more and more of the overall risk posed by falling housing prices. Though both are raising fresh capital, their exposure to mortgages dwarfs their shareholders’ equity. Each enterprise’s core capital represents less than 2 percent of the sum of its mortgage assets plus guaranteed mortgage-backed securities, according to OFHEO.”
- “We can’t think of a housing-related policy objective more vital than ensuring the future stability of these behemoths. For too long, reform of the GSEs has been hostage to partisan politics in Congress. Yesterday, however, there was a breakthrough: The Senate Banking Committee adopted a bipartisan bill negotiated by committee Chairman Christopher J. Dodd (D-CT) and ranking Republican Senator Richard C. Shelby (AL) [, which ...] would create a new, unified and more independent regulator for the GSEs and 12 Federal Home Loan Bank Boards. Crucially, the new agency would have broad discretion to proactively increase minimum capital requirements for the GSEs. This would be a somewhat tougher regulatory regime than the House has recently approved—and a dramatic improvement over current law, which lets the GSEs maintain reserves far lower than

those maintained by other financial institutions. The thinner their cushion, the greater the risk to taxpayers.”

- “The GSE reform measure comes attached to a mortgage bailout proposal similar to a \$1.7 billion House plan about whose fairness and efficiency we have expressed doubts. The Senate version, though, is smaller and, its authors believe, significantly less expensive. It is funded not by taxpayer dollars but through revenue from a fee that is charged on Fannie and Freddie’s transactions; the revenue previously was set aside for low-income housing. This mechanism raises fairness concerns, but it would be phased out over three years—after which the money would go to rental units for the poor. Given the overriding importance of reforming the GSEs, the Senate bill represents an acceptable compromise.” (*Washington Post*, 05/21/08)

Freddie Mac cuts its first quarter losses by \$2.6 billion through accounting changes
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- Freddie Mac reported a smaller than expected loss of \$151 million [\$0.55 a share], after making accounting and policy changes which reduced charges by at least \$2.6 billion. According to Wall Street analysts, Freddie Mac would have reported a loss of at least \$1.7 billion without the use of the two new accounting rules. Freddie said that a change in the way it values Level 3 assets that aren’t traded under FAS 157 reduced credit losses by \$1.3 billion, and a separate rule allowing the company to pick and choose which assets to measure contributed an equal amount as well. On March 31<sup>st</sup>, Freddie reported a 23% increase in Level 3 assets to \$156.7 billion from \$31.9 billion at year-end. The new accounting applications had a “significant positive effect” in reducing volatility in the value of the company’s \$738 billion portfolio and the securities and derivatives used to hedge against credit and interest-rate risk, said Freddie. CEO Richard Syron said the company’s new accounting better reflects “the underlying performance of our business” in a declining real estate market. He added, “It’s clear that we have not yet hit bottom in the housing market.” Overall, Freddie Mac still expects a 15% peak-to-trough drop in U.S. housing prices. Josh Rosner an analyst for Graham Fisher & Co., said, “They put a lot of lipstick on this pig, including several accounting changes that have given them a one time step-up.” Rosner predicted that ultimately Freddie will have to raise much more capital to offset future loan default costs.
- At March 31<sup>st</sup>, Freddie Mac’s fair value of assets fell to negative \$5.2 billion from \$12.6 billion the previous quarter—an \$17.8 billion decline during the first quarter. If the company had not changed its valuation methods, its fair value of assets would have decreased by \$4.6 billion to a total negative \$9.8 billion. Freddie Mac increased its forecast for credit losses to 16 basis points for 2008, up from its previous estimate of 12 basis points, and 20 to 25 basis points in 2009. During the first quarter, Freddie’s management and guarantee revenue rose 26% to \$786 million, while net interest income rose 3%. In its revised guidance for 2008, Freddie said that guarantee revenue will rise up to 20% during the year, while net interest income will grow up to

50%. Freddie reported \$1.45 billion of credit-related expenses in the first quarter, up more than fivefold from the same period last year

- At March 31<sup>st</sup>, the company had \$38.3 billion of core regulatory capital, approximately \$6 billion above its 20% mandatory surplus. Freddie Mac is “moving ahead” with its registration with the SEC, which it hopes to complete by August. After its registration is completed, the company plans to raise capital in the form of \$5.5 billion of common stock and non-convertible preferred stock [combined]. Syron said, “We are confident that the capital we are raising will both allow us to achieve our mission to both the public and to shareholders.” OFHEO said it intends to reduce Freddie’s excess capital requirement from 20% to 15% after the company sells its capital and to reduce the surplus to 10% in September, after the GSE registers with the SEC and fulfills other requirements remaining in its Consent Agreement.
- In a *Wall Street Journal* interview, Freddie Mac CFO Buddy Pisz was asked when he expects the company to return to profitability. While declining to provide a forecast, Pisz said the company expects to return to profitability in the “near future.” He added, “There is still uncertainty. But we are in the zone.”
- Some analysts on Wall Street cheered Freddie Mac’s first quarter results. Howard Shapiro, analyst with Fox-Pitt Kelton, upgraded Freddie to outperform from in line. Shapiro wrote, “We believe [Freddie Mac] has turned the corner and is now a revenue growth story. This does not mean we have seen the worse in credit costs, but it does mean that revenue growth will be significantly stronger than the growth in credit costs.”
- In the *Wall Street Journal*, Peter Eavis noted, “...[Freddie Mac’s] cushion for losses fell sharply in the quarter, giving it one of the weakest balance sheets in the financial sector and leaving it more vulnerable to future hits from the housing crunch.” On March 31<sup>st</sup>, Freddie’s assets exceeded its \$16 billion of shareholder equity by 50.2 times –compared to Fannie Mae’s leverage ratio of 21.7 times and the 20 largest U.S. lenders’ ratio of under 12 times. Friedman, Billings, Ramsey & Co. analyst Paul Miller said investors should be concerned that Freddie Mac hasn’t set aside enough reserves, which will push credit losses to future quarters. “They’re not provisioning in front of it so those losses are going to flow through their income statement for years,” said Miller. “Therefore we don’t think that the earnings pickup over the next two or three years is going to be that meaningful.” Miller believes that Freddie Mac will not realize meaningful earnings growth until 2012, at the earliest, and that the company will need to raise additional capital to offset future losses. During the first quarter, Freddie Mac set aside \$1.24 billion against future credit losses—roughly 40% of the reserves set up by Fannie Mae for the period, which totaled \$3.07 billion. On May 16<sup>th</sup>, *TheStreet.com* wrote, “Built on foundations like these, Freddie Mac may still be the quintessential mortgage pit.”

- Following the company’s earnings release, Moody’s Investor Services downgraded Freddie Mac’s financial strength to B-plus from A-minus, projecting that the company will have up to \$7.5 billion in loan losses over the next 24 months.
- “Both [Fannie Mae and Freddie Mac] are clearly going to be insolvent by the end of the year, but everyone knows that Congress will do anything to keep them afloat, because if Fannie and Freddie go under, the entire global financial system will melt down,” said Christopher Whalen, a founder of Institutional Risk Analytics. “These companies’ earnings don’t matter. Their accounting hardly matters. People buy the stock because they believe the federal government will bail them both out if things get really bad.”
- In a May 15<sup>th</sup> interview with *Financial Times*, Senator Richard Shelby (R-AL) said, Fannie Mae and Freddie Mac were “thinly capitalized, highly leveraged, and pose a systemic risk to taxpayers. (*Financial Times*, Saskia Scholtes, 05/15/08; *OFHEO News Release*, 05/14/08; *The Street.com*, 05/16/08; *Wall Street Journal Online*, Donna Kardos, 05/14/08; *Bloomberg News*, Dawn Kopecki, 05/20/08; *Fortune*, Colin Barr, 05/14/08; *New York Times*, Charles Duhigg, 05/15/08; *Wall Street Journal*, James R. Hagerty and Aparajita Saha-Bubna, 05/15/08; *Washington Post*, David S. Hilzenrath, 05/15/08; *Wall Street Journal*, Peter Eavis, 05/15/08; *Bloomberg News*, Dawn Kopecki, 04/14/08; *Reuters*, 05/15/08)

Home price decline is “about half way through,” said Fannie Mae CEO Mudd

- At Fannie Mae’s annual shareholder meeting on May 20, Fannie Mae CEO Daniel Mudd said that the housing market is “about halfway through” its market adjustment and could fall as much as 25% from their highs in mid-2005. “This year and next will be tough as home prices find bottom,” said Mudd. If shareholders are willing to endure “near-term pain,” they’ll be rewarded by the company’s high growth and profitability after the housing market recovers. “[Fannie Mae] has the best opportunity in years to grow and add shareholder value, simply by doing our job,” said Mudd. “That job is to stay in the market while others have fled and keep money flowing from investors to housing.” Fannie Mae chairman Stephen Ashley said, “Today’s market has reinforced Fannie Mae’s relevance.” At the annual meeting, shareholders elected 12 directors proposed by the company’s board of directors and approved the appointment of Fannie’s outside auditor, Deloitte Touche, LLP. (*Associated Press*, Marcy Gordon, 05/20/08; *Reuters*, 05/20/08; *Bloomberg News*, Dawn Kopecki, 05/20/08; *Associated Press*, 05/20/08)

Fannie Mae and Freddie Mac ramp up their mortgage purchases in April

- Fannie Mae and Freddie Mac increased their [combined] purchases of mortgage assets after raising capital and receiving regulatory relief on their capital

requirements. Freddie Mac increased its mortgage portfolio by an annualized rate of 4.2% in April to \$728.4 billion, the largest increase since September 2005. Fannie Mae's mortgage holdings increased at a 9.8% annualized rate \$737.5, the fastest increase in mortgage growth in six months. Net commitments in April for future mortgage purchases totaled \$30.6 billion for Fannie Mae, while Freddie Mac's net commitments totaled \$43.5 billion.

- The GSEs' purchase commitments reflect that the pace of growth in mortgage purchases will continue into May, said Citigroup analysts Brett Rose and Bard Henis. "Right now, Fannie and Freddie's re-emergence in the market is Washington's most effective policy measure to date," said Jim Vogel, head of agency debt research at FTN Financial Group. "It's good news for the mortgage markets, as two strong buyers have finally emerged," said Howard Shapiro, a Fox-Pitt Kelton ("FPK") and Cochran Caronia Waller analyst. Shapiro added that the new assets offer the GSEs high margins relative to cost of debt used to fund their portfolios. According to a May 20<sup>th</sup> UBS AG report, Fannie and Freddie may add \$150 billion of assets in coming months, as a result of the companies' capital raising, dividend cuts, and reductions in their capital requirements, which would still save the GSEs some room for bond guarantees and loan loss provisions.
- According to Fannie Mae's latest Monthly Volume Summary, the company's serious delinquency rate on single-family loans which it owns or guarantees rose to 1.15% in March—an 85.5% increase from 0.62% a year earlier. Freddie Mac reported a single-family delinquency rate of 0.77% in March—an increase of 92.5% from 0.40 a year earlier. (*Bloomberg News*, Jody Shenn, 05/23/08; *Reuters*, 05/23/08)

HUD nominee Steven Preston appears to be poised for confirmation by the U.S. Senate
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- Steven Preston, President Bush's nominee for Secretary of HUD, appears to be poised for confirmation by the U.S. Senate. At his May 22<sup>nd</sup> confirmation hearing, Senate Banking Committee members warned Preston that he will be expected to implement a new foreclosure prevention program designed to help struggling homeowners keep their homes. "We need a strong voice for helping families facing foreclosure," said Committee Chairman Chris Dodd (D-CT). "Hopefully you view this program with a fresh set of eyes and are able to be a strong and effective voice within the administration for this." Although members pressed Preston to endorse the panel's foreclosure prevention plan, the nominee was careful not to get ahead of the White House, which has yet to formally endorse the legislation. Dodd and ranking member Richard Shelby (R-AL) told Preston that it is crucial that he implement the program ambitiously. Preston, who has run the Small Business Administration since 2006, received no harsh grilling before the committee and Dodd made only a passing reference to Preston's lack of housing experience. The Committee did not vote on Preston's nomination. (*American Banker*, Stacy Kaper, 05/23/08; *Bureau of National Affairs*, 05/23/08)

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

Fannie and Freddie are a “point of vulnerability for the financial system”

- In his prepared remarks at the 44<sup>th</sup> Annual Conference on Bank Structure and Competition on May 16<sup>th</sup>, OFHEO director James B. Lockhart, III said that Fannie Mae and Freddie Mac are “a point of vulnerability for the financial system” with the GSEs’ “thin” core capital representing less than 2% of their mortgage assets and guaranteed mortgage-backed securities, and their fair value leverage being “extreme.” Lockhart continued, “With that leverage, the Enterprises could pose significant risk to taxpayers as well as to financial institutions and other investors.”
- “The legislation that created OFHEO in 1992 requires the agency to set very low minimum capital requirements and greatly limits OFHEO’s flexibility with respect to risk-based capital requirements,” said Lockhart. “That approach, under which we operate today, has significant weaknesses. OFHEO must use a stress test model that omits key Enterprise risks, including operations and basis risks.” The current model doesn’t account for severe interest-rate stress emanating from low-rate environments nor does it account for credit stress as severe as the current downturn, he said. Instead, Lockhart argued that a more modern, Basel-II type approach to capital modeling was needed going forward. “Legislation needs to be enacted soon that would reform supervision of Fannie Mae and Freddie Mac, and, specifically, give a new agency authority to set capital requirements comparable to the authority the bank regulatory agencies possess,” said Lockhart.
- The OFHEO director said he ultimately favors the creation of a capital and portfolio rules that are counter cyclical, which would result in the GSEs raising capital and tightening their portfolios in strong economic periods, but would allow more flexibility during periods of stress. He noted that OFHEO’s recent moves to reduce the GSEs’ excess capital requirements were “designed to make the capital ratios of the Enterprises more countercyclical while creating incentives for them to raise more capital [totaling over \$25 billion after Freddie Mac completes its announced capital raise].” He added, “...OFHEO had to strike a balance between enabling Fannie Mae and Freddie Mac to perform their mission during a period of weakness in the housing and mortgage market, and the objective of limiting the risk the Enterprises pose to taxpayers and the financial system. The Enterprises’ very high leverage made striking that balance quite a challenge. The combination of OFHEO’s actions, the Fed’s and J.P. Morgan Chase’s actions with respect to Bear Stearns, and the Fed’s new liquidity facilities had the desired effect of quickly reducing MBS-to-Treasury spreads ...although they still exceed prior market spreads by 100 basis points.”
- Lockhart also questioned if Fannie Mae and Freddie Mac erred in recent years by buying too many mortgage backed securities backed by subprime and exotic

mortgages without appropriately pricing the risk of potential losses. “[G]iven the Enterprises’ balance sheets, they might have refrained earlier than September 2007 from purchasing AAA-rated private-label MBS backed by subprime and Alt-A loans that did not meet the bank regulators’ guidances on subprime and nontraditional mortgages,” said Lockhart

- In response to Lockhart’s comments, Freddie Mac spokesman David Palombi said his company was helping shore up a crippled U.S. housing market and has a “strong capital position.” Palombi argued, “I’d say we’ve been a primary point of stability for the financial system.” (*Bloomberg News*, Dawn Kopecki, 05/16/08; *Wall Street Journal*, James Hagerly, 05/17/08; *American Banker*, Steven Sloan, 05/19/08; *HousingWire*, Paul Jackson, 05/19/08; *Prepared Remarks by OFHEO Director James B. Lockhart, III*, 05/16/08)
- In a May 13<sup>th</sup> letter to OFHEO Director James B. Lockhart, III, Senators Chuck Hagel (R-NE), John Sununu (R-RI), Elizabeth Dole (R-NC) and Mel Martinez (R-FL) questioned the capital position of Fannie Mae in light of its \$2.2 billion loss for the first quarter. In a question-laden letter, the Senators asked Lockhart, “Are you concerned the \$6 billion Fannie has promised to raise in capital will not support new lending and greater mortgage market liquidity, but instead go to cover more of its losses?” The lawmakers also expressed concern over \$9.3 billion in unrealized losses on securities held in Fannie’s portfolio, asking “If Fannie doesn’t recover the full value of these securities, how would that affect its capital position?” They also asked, “Can you assure Congress that Fannie is valuing its portfolio correctly? Are you confident that Fannie is owning up to the full extent of its losses? ...Do you believe that Fannie is engaging in conduct that could result in a depletion of core capital?” The Senators’ concerns echo recent warnings from USB Investment Research analysts, who argue that Fannie Mae and Freddie Mac face “severe” capital pressures. (*HousingWire*, Paul Jackson, 05/13/08; *Correspondence to the Honorable James B. Lockhart, III*, Senators Chuck Hagel, John Sununu, Elizabeth Dole, and Mel Martinez, 05/12/08)

Fannie Mae scraps its LTV restrictions in “declining markets”
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- Under growing pressure from consumer groups, Fannie Mae announced that it had eliminated prior loan-to-value restrictions in “declining markets,” set forth in its December 2007 “Maximum Financing in Declining Markets Policy” which required higher down payments for markets in which home values were falling. Instead, Fannie Mae’s new underwriting and down payment standards will apply to all mortgages, regardless of geographic location. Starting June 1<sup>st</sup>, Fannie Mae will accept up to 97% loan-to-value ratios for conventional, conforming mortgages loans processed using its Desktop Underwriter automated underwriting system and 95% LTV for such loans which are manually underwritten across the country. Shortly after Fannie Mae announced that it was rescinding its December 2007 policy, Freddie

Mac said that effective June 1<sup>st</sup>, it is eliminating a similar policy which the company has had in effect since 1993.

- “As another part of our ‘Keys to Recovery™’ initiative, we are today announcing that we will be equalizing the down payment requirements for borrowers in all parts of the country, regardless of local market conditions,” said Marianne Sullivan, SVP, Single-Family Credit Policy and Risk Management. “This new down payment policy reinforces our goal to support successful home-owning, not just home-buying, as we seek to bring liquidity to all communities and help the housing market recover.”
- More than 80 housing advocate groups sent letter to Fannie Mae’s CEO Daniel Mudd and Freddie Mac’s chairman and CEO Richard Syron asking that the companies withdraw their declining markets policy. The National Association of Realtors and National Association of Homebuilders argued that the GSEs’ policy was exacerbating the housing crisis. The Oak Park Regional Housing Center, a Chicago housing advocacy group, argued that the GSEs were engaging in a form of discrimination called redlining through their declining market policy.
- Representative Barney Frank (D-MA), chairman of the House Financial Services Committee, said Fannie Mae went “a little too far” with its declining market policy and its revised policy is a step in the right direction. OFHEO director James B. Lockhart, III, said Fannie’s new policy is a “sound” move that could help uncover pent-up demand for mortgages. “They’re doing it in a controlled and good manner,” said Lockhart. “It’s still sound underwriting and makes sense in this type of market.”
- “[Fannie Mae’s new policy] basically shows you that they have a public purpose mission that doesn’t always help the shareholders,” said Credit Suisse analyst Moshe Orenbuch. “All things being equal, lowering down payments in areas that have experienced declines in home prices has got to be more risky.”
- Borrowers in declining markets may still find it hard to obtain loans with low down payments, because they will still have to find a private mortgage insurance company, who will provide them insurance, said Brian Simon, SVP for Freedom Mortgage Corp., Mount Laurel, NJ. For example. MGIC currently restricts loan-to-value ratios to 95% for borrowers with credit scores of 680 or more and 90% for borrowers of credit scores ranging from 620 to 680. At Radian and PMI Group Inc., the companies declining markets policy maxes out at LTV ratios of 95% and 90%, respectively. (*Bloomberg News*, Jody Shenn and Dawn Kopecki, 05/16/08; *Reuters*, 05/16/08; *Bloomberg News*, Jody Shenn, 05/16/08; *Bureau of National Affairs*, Thecla Fabian, 05/20/08; *Housing Wire*, Paul Jackson, 05/16/08; *American Banker*, Allison Bisbey Colter, 05/22/08)

- Despite efforts in the recently-enacted Economic Stimulus Package to revive the jumbo market by temporarily increasing the conforming loan caps for Fannie Mae and Freddie Mac in high cost markets, the costs of jumbo mortgages continued to range between 100 and 150 basis points higher than “regular” conforming loan rates over recent months, versus a 25 basis point spread in the past. In a hearing on the jumbo loan market, House Financial Services Committee chairman Barney Frank said, “[The higher caps] produced less activity than I thought they would.” Ranking member Spencer Bachus added, “Beneficial effects [from the higher caps] have been slow to materialize.”
- The underlying problem appears to be investors, who buy the mortgages in the secondary market, still consider the new jumbo conforming loans to be riskier than traditional conforming loans and assign a higher risk premium on the jumbos. “The ultimate investors [were] not comfortable with the prices of the new jumbos,” said Rob McDonald, director of FIT Consulting. “The secondary market participants needed to accept the prices that Fannie and Freddie were offering. ...If there’s a credit squeeze, despite the higher credit profiles, there’s hesitancy on the part of mortgage backed securities buyers. This gets to the correlation between the subprime secondary mortgage markets and conforming secondary markets.”
- The new jumbos MBS are a different kind of security, which the GSEs decided in February to exclude from “TBA-eligible.” According to market participants, the exclusion of jumbos from the TBA market makes them a somewhat unknown security. “No one is sure what their performance will be, so no one is sure how to price them, said Keith Gumbinger with HSH Associated. Gumbinger said, “[Fannie and Freddie] said, ‘The conforming market is the only one that is really functioning. Don’t mess it up by adding jumbos to it.’ Indeed, jumbo mortgages do perform differently than conforming loans, since jumbo borrowers are much more likely to pay off their loans early. Investors are also more wary of other risk factors, including a greater geographic concentration, since they’re available in only about 70 metro market areas. “Look at the markets where these are offered,” said Gumbinger. “It’s where home prices are falling. An investor will say, ‘I’ll buy them but I have to get more yield out of them.’”
- In early May, Fannie Mae announced that they would set the price of jumbos as though the loans were being sold in the TBA market and retain the loans in their portfolio. As a result, the spreads between conforming and jumbo conforming loans have narrowed to below 50 basis points in recent weeks, said Gumbinger. During the week of May 12<sup>th</sup>, the conforming 30-year, fixed rate mortgage averaged 6.17% compared to the jumbo conforming loan rate for the week of 6.61% for a 44 basis point spread, he added. By comparison, the spread had been as high as 130 basis points. Meanwhile, interest rates for non-conforming jumbo loans have not improved much, said Gene Choi, president of Commodore Mortgage Group.

- In testimony before the House Financial Services Committee, representatives of the mortgage, real estate and securities industries told lawmakers that the jumbo conforming loan limit needed to be made permanent to have a significant impact on the housing credit market. Thus far, the increase in the temporary conforming loan limit has had little impact in the mortgage market because the higher threshold has “not been in effect long enough to have a substantial impact on the housing market,” said Vince Malta, chairman of the National Association of Realtors public policy coordinating committee. Heather Peters, deputy secretary for business regulation and housing for the State of California, said, “There’s just not enough time to develop an efficient market between now and the end of the year. The market cannot develop without certainty.”
- Patricia Cook, EVP and chief business officer for Freddie Mac, said, “Currently there is little investor demand for securities of jumbo mortgages. By buying for our portfolio, we are able to price more aggressively and bring down rates for borrowers. ...In the long run, this is not sustainable. If Congress decides to permanently increase the conforming loan limits, loans meeting the higher conforming loan limit will need to become eligible for TBA securities.” Cook warned that jumbo mortgages would be harder to obtain and would cost more, if Congress allows the higher lending limits for GSEs to expire at year-end. Making the conforming limit permanent is essential for the secondary market to begin accepting the jumbo conforming loans, said Thomas Lund, EVP of Fannie Mae’s single-family mortgage business. He added, “The temporary nature of the law is a major hindrance to the development of an efficient, liquid market for jumbo-conforming loans.” (*Wall Street Journal*, James R. Hagerty, 05/23/08; *American Banker*, Steven Sloan, 05/23/08; *CNNMoney.com*, Les Christie, 05/22/08; *Bureau of National Affairs*, Mike Ferullo, 05/23/08)

<p>The Home Valuation Code of Conduct is widely viewed as one-sided and harmful the mortgage industry</p>
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- The Home Valuation Code of Conduct (HBCC), which was agreed to in a March settlement between the New York Attorney General Andrew Cuomo, Fannie Mae, Freddie Mac and OFHEO, is largely viewed by the mortgage industry as a one-sided agreement, which is harmful to the mortgage industry and lacks proper controls that are really needed to ensure the appraiser’s independence. Many industry trade groups contend that the agreement was in substance a power grab by a state-level official, while federal regulators decry not being involved in the process.
- Although Cuomo characterizes the agreement as an attempt to “clean up appraisal fraud in the mortgage industry,” banking representatives argue that the agreement will instead have unintended consequences for borrowers and the industry alike. Bank of America Corp. and Wachovia Corp., in particular, publicly said they oppose the current HVCC agreement. BofA spokesman Terry Franscisco said that, while his bank supports the spirit behind the agreement, the HVCC is “overly broad” and would have “unintended consequences” for borrowers — namely higher mortgage

costs — as currently constructed. Wachovia, who said it has policies and procedures in place to ensure independent appraisals, argued that the agreement will have the effect of pushing good appraisers out of the business.

- In a comment letter on HBCC, Michael T. Orman, national president of The National Association of Independent Fee Appraisers (NAIFA) wrote, "...[D]espite [the HVCC's] laudable intent, we find that the current structure of the agreement may lead to unanticipated and potentially damaging results for borrowers, the public, real property appraisers, and users of real property appraisals. ...While we support the efforts of the broader appraisal community to address the shortcomings of the agreement, we believe the agreement is attempting to solve a problem for which a solution already exists. Should the agreement move forward, however, NAIFA, along with many other related appraisal and financial organizations, believe significant changes to the agreement as written are necessary."
- One of those solutions includes banking regulations set forth by the Federal Financial Institutions Examination Council (FFIEC) and its member regulatory agencies, the Office of Comptroller of the Currency and the Office of Thrift Supervision. "Regrettably, these regulations are not flowing through the proper channels, to the end user and the loan originators, nor have the users been trained to implement the regulations," wrote Orman. His letter also outlines proposed changes to the agreement involving the Home Valuation Code of Conduct (HVCC). "The HVCC reflects a strong attempt to support the independence of appraisers who are to provide an unbiased, supportable valuation of real property," adds Orman. "However, some parts of the HVCC appear to neuter the intent of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)." NAIFA also takes issue with additional aspects of the agreement, including the proposed Independent Valuation Protection Institute (IVPI) and the agreement's accepted use of Appraisal Management Companies (AMCs).
- Although Senator Richard Shelby (R-AL) has indicated support of the bill to address appraisal standards [which would supersede the NY AG's agreement] and has suggested that the Senate Banking Committee take up the debate, "[it] is tough to predict at this point" if the panel will ultimately take up the appraisal issue, according to *HousingWire's* source. (*PRNewswire*, 05/15/08; *HousingWire*, Paul Jackson, 05/21/08)

The IRS broadens the REMIC rules to allow loan modifications
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- In Revenue Procedure 2008-28 issued on May 16<sup>th</sup>, the IRS broadened the REMIC rules to allow mortgages that are not yet in default to be modified without jeopardizing the vehicle's tax status for loan modifications through 2010. The IRS has requested public comment on whether the clarifications should apply to modifications after 2010 and where other provisions should be changed. Public comments must be submitted by July 15<sup>th</sup>. In a July 2007 guidance, the American

Securitization Forum had suggested to servicers that they “avoid materially adverse tax or accounting consequences” when modifying subprime mortgage, which discouraged many servicers to reach out to borrowers before they went into default. The IRS’s revenue procedure will now allow servicers to modify performing loans when “the holder or servicer reasonably believes that there is significant risk of foreclosure of the original loan.” However, under the guidance, the modifications of performing loans must put the holder in a “less favorable position,” and may only be done when less than 10% of the initial pool aggregate balance is already delinquent.

- “This is another example of how something extremely technical can make a real difference for the borrower,” said Stephen Edwards, a partner in the Atlanta law firm Kilpatrick Stockton LLP. “[The revenue procedure] will give some comfort to servicers” that the IRS will not challenge the tax status of REMICs, said Edwards. Charles Adelman, a tax partner with Cadwalader, Wickersham & Taft LLP, said the IRS’s ruling dovetails with efforts by the Treasury Department to help borrowers keep their homes. “This is consistent with the Treasury’s objectives,” said Adelman. “The government is saying, ‘We won’t put stones in your path if you try to prevent foreclosures.’” (*American Banker*, Kate Berry, 05/23/08; *HousingWire*, Paul Jackson, 05/20/08)

U.S. mortgage crisis was created by an eight-year bubble in housing prices
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- According to a staff study released by Representative Jim Saxton (R-NJ), ranking member of the Joint Economic Committee, an unprecedented bubble in U.S. housing prices began to inflate in the first quarter of 1998 and then popped in the second quarter of 2006. According to the study, “The most important cause of the housing bubble was a massive credit expansion. An overly accommodative U.S. monetary policy from the second quarter of 2002 through the third quarter of 2006 when compared with the Taylor rule encouraged financial institutions to expand credit aggressively by reducing their short-term funding costs. At the same time, stable inflationary expectations and the exchange rate policies in the People’s Republic of China and other Asian economies restrained long-term U.S. interest rates. U.S. housing prices soared as low long-term interest rates further stimulated the already strong demand among households for housing, while financial institutions enthusiastically supplied the necessary residential mortgage credit.”
- “A number of well-meaning federal policies had the unintended consequence of encouraging financially marginal households that could not qualify for traditional fixed-rate fully amortizing residential mortgage loans to take out riskier alternatives (including adjustable-rate subprime residential mortgage loans with interest-only periods or negative amortization features) to buy homes just as housing prices neared their peak. Essentially, both these borrowers and their creditors were relying on rising housing prices rather than the borrower’s income to repay these loans. After the bubble popped, delinquency and default rates increased to alarming levels among these borrowers.”

- “The IMF forecasts housing-related credit losses will be \$565 billion, while total credit losses will be \$945 billion. As a result, the IMF concludes that the combination of the aftermath of the housing bubble and the credit crunch arising from the global financial crisis has tipped the U.S. economy into a recession. Whether or not this IMF forecast proves correct, economic growth in the United States has slowed dramatically during the last two quarters.” The full study is available at <http://www.house.gov/jec/>, by clicking on press release #110-43 dated May 22, 2008. (*The U.S. Housing Bubble and the Global Financial Crisis: Housing and Housing Related Finance*, Ranking Republican Member Jim Saxton, May 2008)

“Walkways” from all walks of life
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- People from all walks of life are facing the risks of foreclosure, including the “rich and famous” and now even a member of Congress. According to Associated Press, Jose Canseco [46], the former American League MVP player who retired in 2001, recently told *Inside Edition* that it didn’t make financial sense for him to keep his 7,300 square-foot home in Encino, CA. He said, “I do have a judgment on my home and it to me is a very strange because it didn’t make financial sense to me to keep paying a mortgage on a home that was basically owned by someone else. ...I just decided to let it go...” (*Managing REO*, Jennifer Harmon, 05/14/08)
- *Capitol Weekly* [Sacramento, CA] reported that a Sacramento home owned by Representative Laura Richardson (D-CA) was auctioned on May 7<sup>th</sup>. [The auction was officially recorded on May 9<sup>th</sup> and the deed and sale were recorded on May 19<sup>th</sup>, said James York, a Sacramento real estate broker who purchased the property.] In January 2007, Richardson obtained 100% financing for the purchase of her 1,600 square foot, three bedroom home for \$535,000, but soon fell behind on her mortgage payments. While running for the U.S. Congress in a special election in the spring of 2007, Richardson apparently stopped making her payments on the home, but loaned her Congressional campaign \$60,000 (according to the Center for Responsive Politics). Ultimately, Richardson, who had not made a payment since November, had nearly \$600,000 in unpaid loans [held by Washington Mutual] and fees related to this property, which included nearly \$9,000 of unpaid property taxes. The home was sold for \$388,000, resulting in a loss of nearly \$200,000 for Washington Mutual Bank. Richardson also defaulted on loans on her home in Long Beach and a property in San Pedro. She was able to bring her payments up to date on her Long Beach home relatively quickly, but her San Pedro property has “lingered” in the foreclosure process for almost eight months and still has a pending auction date.
- In an interview with *Associated Press*, Richardson said that her house in Sacramento was sold into foreclosure without her knowledge and contrary to an agreement with her lender. Washington Mutual declined to comment on the matter, saying the company had “not received consent from Ms. Richardson that would allow us to discuss her loan situation.” The Congresswoman said her experiences could help her

craft legislation to make sure others don't experience what she did during the foreclosure process. Richardson sees a need to add steps to inform property owners before their property can be sold. "We have to ensure that lenders and lenders have the tools with proper timing to resolve this," she said. (*Daily Breeze* [Los Angeles, CA], Gene Maddaus, 05/23/08; *Capitol Weekly* [Sacramento, CA], Anthony York, 05/22/08; *Roll Call*, Emily Heil and Elizabeth Brotherton, 05/22/08; *Associated Press*, Erica Werner, 05/24/08)

### Subprime and beyond...

- During the first quarter, U.S. housing prices were 1.7% lower on a seasonally adjusted basis than the fourth quarter of 2007, the largest quarterly decline on record, said OFHEO. Over the past year, prices fell 3.1% according to OFHEO House Price Index—the largest decline in the index's 17-year history. Prices fell in 43 states with eight states reporting declines of more than 3% and California and Nevada prices falling more than 8%. The states with the highest appreciation included Wyoming (6.3%) and Utah (5.6%) (*OFHEO Press Release*, 05/22/08; *Wall Street Journal*, Ruth Mantell and Brian Blackstone, 05/22/08)
- The National Association of Realtors reported that 100 of the 149 key metropolitan statistical areas posted price declines during the first quarter, as compared to 77 MSAs during the fourth quarter of 2007. In April, the sales of existing homes dropped by 1% to a seasonally adjusted annual rate of 4.89 million units, while housing inventory rose a 10.5% to 4.55 million existing homes available for sale for an 11.2 month supply at the current sales pace. (*HousingWire*, Paul Jackson, 05/13/08; *HousingWire*, Paul Jackson, 05/23/08)
- According to Fitch Ratings, global banks have written down nearly 80% of their losses on subprime mortgages and related assets. By Fitch's calculations, subprime losses will reach \$401 billion, of which half is held by banks—\$200 to \$275 billion—and the remaining is held by financial guarantors, insurance companies, asset managers, and hedge funds. While Fitch suggests that the subprime mortgage crisis may be nearing an end, there appear to be larger credit problems the Alt-A and I-O mortgage portfolios ahead for the market. (*HousingWire*, Paul Jackson, 05/14/08)
- Standard & Poor's reports that delinquencies for Alt-A mortgages, rated between 2005 and 2007, have risen as high as 17% in some cases, more than 6 percentage points higher than previous estimates. Lower quality subprime mortgages' delinquencies soared as high as 37% for mortgages originated in 2006—6 percentage points higher than originally estimated. "The 2007 issuance year continues to be the worst-performing vintage in terms of cumulative losses," said S&P. Serious delinquencies, 90 days late or more, and foreclosures are also rising, said the agency. (*Reuters*, 05/22/08)

- U.S. foreclosure filings reach a record high in April, rising nearly 65% from the previous year. According to RealtyTrac, 243,353 households—nearly one in 519—received a foreclosure filing in April, up 4% from March. Foreclosure filings include notices of default, auction sales and bank repossessions. In April, 54,574 homes were fully repossessed by banks, according to RealtyTrac’s report. (*CNNMoney.com*, Kenneth Musante, 05/14/08)
- The delinquency rate for commercial mortgage-backed securities rose 0.43% at the end of the first quarter, an increase of 27% from year end, according to Standard & Poor’s. Multifamily properties led the rise in delinquencies, accounting for 55% of the CMBS delinquencies. Apartment CMBS delinquencies were up 34% to \$1.49 billion on March 31<sup>st</sup>. (*National Real Estate Investor*, Poonkulali Tangavelu, 05/13/08)
- Home equity loan portfolios continue to deteriorate. On May 13<sup>th</sup>, Bank of America said it now expects its home equity loan losses to exceed its ceiling estimate of 2.5% provided in April. On March 31<sup>st</sup>, BofA’s HEL portfolio totaled \$118 billion, of which 39% of its portfolio was collateralized by properties in California and Florida. Separately, Washington Mutual, one of the nation’s largest home equity lenders, has terminated or suspended \$6 billion in available home-equity lines of credits the bank had extended to its customers. (*National Mortgage News*, 05/15/08; *HousingWire*, Paul Jackson, 05/13/08)
- Mortgage fraud was rampant in 2007 with the total number of related Suspicious Activity Reports increasing 31% to 46,717, according to the FBI. In 2007, the top ten mortgage fraud states were Florida, Georgia, Michigan, California, Illinois, Ohio, Texas, New York, Colorado, and Minnesota, said the FBI. “We could be headed for 70,000 [fraud reports] for this year, [representing a 50% increase over 2007]” said FBI spokesman Stephen Kodak. (*FBI Press Release*, 05/13/08; *CNNMoney.com*, 05/13/08)
- While some Wall Street analysts are optimistic that mortgage crisis is ebbing, others are pessimistic that housing woes will remain a long-term problem. In a May 9<sup>th</sup> report issued by Goldman Sachs, the firm’s economists estimated that losses from the mortgage market could top \$500 billion. “We still believe that overall mortgage credit losses will end up being larger than generally believed,” wrote Goldman Sachs’ chief U.S. economist Jan Hatzius. “Excess supply in the housing market is still growing; home prices are already falling at rates that are very rapid by standards of previous housing downturns around the world; and U.S. loan-to-value ratios are much higher than those in previous downturns. Ultimately, a painful adjustment needs to take place, certainly in the housing and credit markets, and likely in the broader economy as well.” Oppenheimer & Co analyst Meredith Whitney expects the credit crisis to extend well into 2009 and beyond, resulting in three years of multi-billion dollar revenue reversals. By the end of 2009, Whitney said that over \$170 billion of reserve builds will flow through bank earnings in addition to the “business as usual” loan loss provisions. “Either in the form of write-downs or reserve builds, we believe

the effect is the same: revenue reversal from years worth of inherently flawed underwriting,” she added. Morgan Stanley analysts estimated that U.S. and European banks may have to write down an additional \$90 billion to \$180 billion in troubled assets, signaling that the banks have made only 66% of the write-downs needed on their asset values and may need to raise even more capital. (*Reuters*, 05/13/08; *Reuters*, 05/09/08; *Reuters*, 05/20/08)

- The growing risk of house price correction and risks posed by subprime and nontraditional mortgages continue to effect mortgage and bond insurers, which in turn, increases the counterparty credit risk for Fannie Mae and Freddie Mac. MBIA, the largest player in the troubled bond insurance industry, reported a first quarter loss of \$2.4 billion, which included a \$3.6 billion unrealized loss on credit derivatives that the company had insured. MBIA’s paper losses on insured derivatives would have been \$7.1 billion, but for an offsetting gain of \$3.6 billion on the declining value of its own credit guarantees.
- PMI Group, Inc. reported a \$274 million loss for the first quarter, after writing off the remaining value of its 42% ownership of FGIC. During the period, FGIC “contributed” \$124.2 million in losses to PMI. Losses from PMI’s mortgage insurance business totaled \$172.5 million during the first quarter. PMI said that 8.78% of its 794,323 primary policies in force were in some stage of default on March 31<sup>st</sup>, a 10.7% increase from year-end 2007. Specifically, 42.95% of PMI’s 2/28 hybrid ARMS were in some stage of default on March 31<sup>st</sup>, up 18% from a year-ago, while nearly 21% of PMI-insured subprime loans are in default. (*Wall Street Journal*, Kevin Kingsbury and Donna Kardos, 05/12/08; *Wall Street Journal Online*, Donna Kardos, 05/12/08; *New York Times Dealbook Blog*, 05/12/08; *HousingWire*, Paul Jackson, 05/12/08)
- Triad Guaranty Inc. posted a first quarter loss of \$150 million, following a \$171.4 million jump in loan loss reserves for the period. In early May, Fitch Ratings downgraded Triad to junk status, based on the insurer’s average severity on paid claims that topped \$42,600 during the first quarter, up from \$31,300 a year ago. The average severity on modified pool claims jumped to \$65,000, up 174% from \$23,700 in the first quarter of 2007. Of the company’s \$11.1 billion of (net) primary risk in force, Triad has \$1.4 billion in option ARMs; 12.3% of its primary risk was collateralized by properties that were second homes or investment properties. More than 21,900 its properties were in some form of foreclosure on March 31<sup>st</sup>, up 30% from year-end 2007. After filing its Form 10Q for the first quarter, Freddie Mac informed Triad that its insurance subsidiary is suspended as an approved mortgage insurer, subject to an appeals process which the insurer intends to vigorously pursue. Triad had announced plans to start a new mortgage insurance company with Lightyear Capital LLC and move its existing insurance operations into runoff. (*PRNewswire*, 05/22/08; *HousingWire*, Paul Jackson, 05/23/08; *The Business Journal* [Greensboro/Winston-Salem, NC], 05/23/08; *HousingWire*, Paul Jackson, 05/13/08)

- At a May 21<sup>st</sup> meeting with roughly 70 bankers in a Washington hotel, Treasury Secretary Henry Paulson thanked the executives for the work they've done to modify and restructure troubled mortgages. He also "gently" challenged them to do more to move faster and streamline more refinanced loans so that more borrowers avoid foreclosure. One attendee described the general ambiance as "very cordial." (*Wall Street Journal's Real Time Economics* [blog], Damian Paletta, 05/22/08)
- FDIC chairman Shelia Bair recently told reporters that efforts to stem the rising number of foreclosures are a "train wreck," hampered by a lack of resources and the continued deterioration of the real-estate market. "There are more loan lines and I think servicers are doing more but it's just not keeping pace," said Bair. "They're overwhelmed, and the counselors are overwhelmed ...it's a train wreck." (*Wall Street Journal's Real Time Economics Blog*, 05/21/08)
- On May 19<sup>th</sup>, HUD announced that the FHA Secure loan product, launched by FHA in August, has helped 200,000 homeowners refinance their mortgage and avoid foreclosure. "The Bush Administration's FHA Secure product has quickly proven to be a responsible solution for 200,000 American families who are in the right house, but the wrong mortgage," said FHA Commissioner Brian D. Montgomery. "These homeowners have found affordable relief from their exotic loans, and FHA is on pace to help a total of half million families keep their homes by year's end." (*HUD Press Release*, 05/15/08)

<p>Stabilizing our vastly complex banking system will be arduous—but necessary, says Former Federal Reserve Chairman Paul Volker</p>
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- In a May 14<sup>th</sup> statement before the Joint Economic Committee, former Federal Reserve Chairman Paul Volker said that Congress faces the urgent task of putting into a place a 21<sup>st</sup> century regulatory system that can oversee the safety and soundness of a financial system that has changed fundamentally over the last two decades. Acknowledging that there are no "quick and facile answers" to the systemic risks in today's massively complex and opaque financial and banking system, Volker said the committee's deliberations will "help lay the ground work" for future legislation that is urgently needed. Profound changes in the financial system have increasingly blurred the lines between commercial banks, lightly-regulated investment banks, hedge funds, and other entities, leading to the need for a new type of regulatory system with a strong international component.
- Today's crisis in the credit markets has resulted from changes in the nature of financial intermediation over the past two decades, said Volker. "We have moved from a heavily regulated and protected commercial bank-dominated world to a more open market system, with individual credits packaged and repackaged and traded in impersonal markets. Large commercial banks have themselves taken on important characteristics of investment banks, but the investment banks and hedge funds that have come to dominate the trading, if regulated at all, have not been closely

supervised with respect to their safety and soundness.” The new, heavily “engineered” system has been designed to dissect and combine credits in a manner designed to diffuse risk and to encourage an allocation of those risks to those most able to handle them. “The result in practice has been enormous complexity, and with the complexity has come an opaqueness,” he said, resulting in close examination the risks of particular credits, such as subprime mortgages, too often being “lost.”  
*(Bureau of National Affairs, Thecia Fabian, 05/15/08)*

<p>The three new Democratic Members of Congress to join the House Financial Services Committee</p>
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- On May 22<sup>nd</sup>, House Speaker Nancy Pelosi announced that the House Democratic Steering and Policy Committee voted to recommend that Representatives Travis Childers (D-MI), Don Cazayoux (D-LA) and Jackie Speier (D-CA) serve on the Financial Services Committee. The full Democratic Caucus will vote on the nominations in coming weeks. *(Press Release from the office of House Speaker Nancy Pelosi, 05/22/08)*

## ***Fannie Mae***

### Fannie Mae: The lifeguard that can't swim

- In *Barron's*, Jonathan Laing wrote, “[In a March 10<sup>th</sup> cover story,] we pointed out that Fannie ...was likely to face many quarters of crippling losses that would all but deplete its capital. We surmised that the U.S. government might be forced to nationalize the company in order to fulfill its implicit guarantee of Fannie’s huge corporate and guaranteed debt obligations. ...The latest earnings report did nothing to change our gloomy view. For example, in the first quarter Fannie was forced to torch its ‘fair value’ net worth by \$23.6 billion to a paltry \$12.2 billion. After subtracting \$14.3 billion in net worth attributable to Fannie’s preferred stock, that left common shareholders with negative equity of about \$2 billion. That’s surely not much protection against future losses on Fannie’s \$3-trillion credit book. That net-worth hit occurred in an area that our [March 10<sup>th</sup>] story highlighted. By our reckoning, Fannie had badly overestimated the net value of its business of guaranteeing mortgage securities, in light of the heavy losses showing up there. Its accountants apparently agreed, to the tune of the \$26 billion reduction in the value of the business that Fannie took in the first quarter.”
- “In the March-quarter numbers, Fannie also mentioned some \$9.1 billion in unrealized losses, some \$8 billion of which it failed to run through its income statement on the grounds that they were merely temporary. These losses come from subprime and Alt-A ...securities that are likely to prove anything but temporary. Finally, some funky assets on Fannie’s balance sheet that we’d discussed in our original story have only grown since. To wit, Fannie in its latest numbers reported that deferred-tax assets had jumped from \$13 billion to \$17.8 billion in the quarter. Yet as losses continue, these tax offsets to future income will have to be written down sharply, thus crushing both Fannie’s future earnings and net worth.”
- “Bulls on Fannie look to improved profits the company is realizing on newly booked business in both its guarantee business and investment portfolio. Likewise they are counting on government regulators to be lenient with the company because of its importance in providing liquidity to the ailing home-mortgage market. After all, Fannie was able to ‘grow’ its way out of near oblivion after the savings and loan debacle in the 1980s. Such a turnaround now would be far more difficult, given the virulence of the current credit cycle and housing-price crisis. As one report last week noted acidly, Fannie has become the lifeguard that can’t swim.” (*Barron's*, Jonathan Laing, 05/12/08)

### Fannie Mae sells an additional \$2.0 billion of preferred stock

- On May 13<sup>th</sup>, Fannie Mae priced an additional \$2.0 billion shares of non-cumulative,

non-convertible, perpetual fixed-rate preferred stock with a dividend yield of 8.25% per annum. Fannie Mae will have the option to redeem all or part of this issue on or after May 20, 2013. Merrill Lynch & Co. acted as joint lead manager and physical book-runner, along with Citigroup Global Markets, Morgan Stanley, UBS Securities LLC, and Wachovia Capital Markets, LLC. On May 8<sup>th</sup>, Fannie sold \$2.6 billion in convertible preferred stock and \$2.6 billion in common stock, bringing the GSE's total capital raise to \$7.2 billion in May.

- Fitch has placed Fannie's common shares on Rating Watch Negative and rated the company's newly issued preferred shares AA-. Standard & Poor's took Fannie Mae's debt and preferred stock ratings off watch for a possible downgrade, but lowered the GSE's risk-to-the-government rating to A+ from AA-, due to the company's difficult earnings outlook and slim capital position. "Fannie Mae is facing the most challenging housing and mortgage cycle in more than three decades, and at a time when its core earnings are weakened both from higher credit-related expenses and significant spread widening on both agency and non-agency mortgage-backed securities," said S&P. "Given the highly stressed housing and mortgage markets, it is very unlikely that the outlook would return to stable before 2009." (*Fannie Mae Press Release*, 05/13/08; *Reuters*, Al Yoon, 05/13/08; *BusinessWire*, 05/15/08; *Fortune's Daily Briefing Blog*, 05/19/08)
- Howard Glaser, a former HUD official in the Clinton administration, said, "There [are] real concerns about the degree of risk that FHA is taking on. And everyone is calling on Fannie and Freddie to do more to stabilize the mortgage marketplace, but at what point does imposing new costs on those companies undermine their financial safety?" (*New York Times*, Charles Duhigg and David M. Herszenhorn, 05/21/08)
- According to analysts at Societe Generale SA, the U.S. government's support of Fannie Mae for investors poses 'a worry' for investors in Treasuries, in the absence of an economic recovery. "[The] measure of the contingent liability of the U.S. government is rising very sharply," wrote Societe Generale analysts, after Standard & Poor's Corp. downgraded Fannie's risk-to-the-government rating by one notch. The Societe Generale analysts wrote: "The S&P action will have no impact on the market today but is clearly a worry for Treasuries in a year or two if there is no economic recovery." (*Bloomberg News*, 05/21/08)

Fannie Mae – a good business with normal business standards
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- According to the *Washington Post's Washbiz Blog*, Fannie Mae CEO Daniel Mudd described his efforts to shake up the culture at Fannie Mae and make changes. Mudd said, "We needed clarity of expectations, openness and complete accountability. There was a massive amount of gunfire going on out there. Too many weird reasons were competing for doing things. So, helmets on again. Here we go. We can prove to people we are a good business with normal business standards." (*Washington Post's Washbiz Blog*, Dan Beyers and Terri Rupar, 05/13/08)

## Back in the game

- James Johnson, who spent eight years as Fannie Mae’s CEO building up one of Washington’s most-effective lobbying operations, has been selected by Senator Barack Obama to organize his vice-presidential search. Johnson, 64, has been a fundraiser for the Obama campaign. In an effort to tamp down any talk about a search for his running mate, Obama told a reporter on May 22<sup>nd</sup>: “I haven’t hired [Jim Johnson].... He is a friend of mine.”
- Johnson, who has performed vice-presidential searches in 2004 for Senator John Kerry and 1984 for Walter Mondale, is currently vice chairman of Perseus LLC, a merchant bank and private-equity fund. More recently, Mr. Johnson has served on corporate boards, including Goldman Sachs Group, KB Home, Target Corp., Temple-Inland Inc., and UnitedHealth Group. (*Wall Street Journal*, T.W. Farnam, 05/24/08)

## Some things never change

- *Washington Post*’s Jeffrey Birnbaum reports, “Lorraine A. Voles, until recently communications director for the congressional office of Sen. Hillary Rodham Clinton (D-NY), has joined Fannie Mae as a senior vice president. The move is a reunion of sorts. Voles, who was communications director to Al Gore when he was vice president, worked previously at the public relations firm Porter Novelli. There, her boss was Charles V. Greener, who is now Voles’s boss at Fannie Mae. Greener had been the mortgage finance giant’s senior vice president in charge of communications and is now chief of staff to Fannie Mae chief executive Daniel H. Mudd. Voles is taking his old job. Before he joined Porter Novelli, Greener was a spokesman for the Republican National Committee. That’s right: A former mouthpiece for Clinton and Gore is working quite happily for a former GOP spokesman—for a second time. Only in Washington. One big happy family here in the Imperial City. Those who are paid to fight the red-blue wars, fight. Those who are paid to lobby both sides against the taxpayers, lobby. And as the McCain campaign is demonstrating, the most effective players can switch roles on a moment’s notice. It’s relevant to note that Ms. Voles and Mr. Greener are now working for Fannie Mae, one of the most skilled rent-seekers in Washington and a pioneer in hiring top players from both parties. As a Cato study noted a few years ago, ‘The special governmental links that apply to Fannie Mae and Freddie Mac yield little that is socially beneficial, while creating significant potential social costs.’ And as an earlier Cato study (by financial analyst Vern McKinley, now a candidate for Congress) noted, ‘Fannie Mae and Freddie Mac preserve their privileged status through a multi-million-dollar lobbying effort that includes massive “soft money” campaign contributions and the payment of exorbitant salaries to politically connected executives and lobbyists.’ Ten years later, that’s still the bottom line.” (*Cato@Liberty*, 05/21/08)

## ***Freddie Mac***

A 15% decline in home values would create  
an \$18 billion present value shortfall for Freddie Mac

- During a May 15<sup>th</sup> presentation at Lehman Brothers, Freddie Mac EVP and CFO Buddy Pizsel said that the company expects to see the shakeout in the mortgage industry result in substantial growth and a return to profitability in 2009. Freddie is projecting a 15% to 20% growth in revenue this year, resulting from both its growing loan volume and increased fee income which has benefited from four price increases in the last 12 months. In response to a question from the audience, Pizsel said the company's models indicate a 15% fall in home values would result in an \$18 billion present value shortfall on the company's portfolio. If home values fell 22%, the company's present value shortfall is projected to increase to \$30 billion. (*Lehman Brothers Financial Services Conference*, Buddy Pizsel, 05/15/08; *Associated Press*, Marcy Gordon, 05/20/08)

Foreign central banks ramp up their support of Freddie Mac debt

- Central banks around the world bought \$3.88 billion of Freddie Mac's two- and five-year debt offering totaling \$8 billion on May 21<sup>st</sup>, potentially bringing the banks' holdings of GSE debt to record levels. [As of May 14<sup>th</sup>, foreign central banks held \$931.9 billion of agency and MBS issued by Fannie, Freddie and other GSEs.] Foreign central banks' demand for GSE debt may become more crucial in coming months as Fannie Mae and Freddie Mac seek to expand their support of the mortgage market. "It has become clearer and clearer, given the role the GSEs are now playing in stabilizing the mortgage markets, that links to the government are stronger than ever," said Rajiv Setia, a Barclays Capital strategist. (*Reuters*, Al Yoon, 05/21/08)

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

### **FHLB System's advances increased 4% to \$913 billion in first quarter**

- According to the FHLBanks Office of Finance, the FHLB System's advances rose 4.3% to \$913 billion, representing 69% of the system's total assets. On March 31<sup>st</sup>, the FHLB System had total assets of \$1.323 trillion, up 4.0% from year-end 2007. As of May 9<sup>th</sup>, less than 1% of the FHLB System's \$157.6 billion of mortgage-backed securities had been downgraded with a stable outlook, of which \$109 million had been downgraded below investment grade, and less than 1% were on negative/outlook but not downgraded. Additionally, less than 2% of the FHLBs' mortgage backed securities investments were categorized as subprime at origination by the originator. On May 9<sup>th</sup>, less than 1% of the FHLB System's non-MBS investment securities had been downgraded with a stable outlook or on negative watch/outlook. The FHLB System reported a 12.2% increase in net income to \$697 million for the first quarter, compared with \$621 million for the first quarter of 2007. (*FHLBanks Office of Finance Press Release, 05/14/08*)

### **Federal Housing Finance Board approves an allocation of elective directorships**

- Each year, the Federal Housing Finance Board allocates the elective directorships of each FHLB among the states in each Bank's district. The principal factors governing the allocation include (1) the amount of FHLB stock owned by member institutions in each state; (2) a grandfather provision for additional directorships for certain states; and (3) the Finance Board's discretion to increase the size of the board of any FHLB whose district is comprised of five or more states. On May 14<sup>th</sup>, the Finance Board announced that it would preserve the current number of directorships at nine of the 12 FHLBs, and would increase the number of directors by two at the FHLB-Boston and FHLB-San Francisco, and decrease the size of the FHLB-Des Moines by one elective directorship. (*Federal Housing Finance Board Press Release, 04/14/08*)

## ***Proposed Government-Sponsored Entity***

Congress considers creating a new GSE to fund national infrastructure needs

- On May 8<sup>th</sup>, a joint hearing was held by the House Committee on the Budget and the House Committee on Transportation and Infrastructure to focus on the nation's infrastructure needs, funding mechanisms, and alternative investment devices, including the establishment of a new government-sponsored entity to spur needed infrastructure investment. A second hearing was held on May 8<sup>th</sup> by the Senate Committee on Environment and Public Works to examine these issues. CBO and OMB officials testified before the House panel that alternative funding mechanisms, from sale/leaseback to third-party financing to tax credit bonds, are a more expensive, less transparent way to acquire and use capital assets relative to conventional appropriations and Treasury borrowings. In general, federal taxpayers are often the least efficient source of funding, after the direct beneficiaries of the investment and local and state taxpayers. Several proposed bills would make additional financial mechanisms available for infrastructure, including (1) the proposed Build American Bond Fund that would provide \$50 billion in new funding; (2) the National Infrastructure Development Act Bill that would establish a loan program administered by a government-sponsored entity to fund infrastructure projects; and (3) The National Bank Act which would create a national infrastructure bank as a revolving fund. While each funding mechanism has various merits, each option is form of debt that bears interest. Since government financing is generally lower than that of the private sector, financing mechanisms such as bonding may be more expensive than full up-front financing. Ultimately, Congress will need to decide which option, or combination of options, best meets the needs of the nation, based upon the level of federal involvement that Congress decides to pursue in investing in infrastructure needs. (*Congressional Transcripts of the Joint Hearing of the House Transportation and Budget Committee, 05/08/08*)

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

Congress overrides the presidential veto of the 2008 Farm Bill
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- Hours after passage of the 2008 Farm Bill, President George W. Bush vetoed the \$290 billion Farm Bill as promised, only to be over-ridden by both the Senate [by a vote of 82-13] and House [316-108]. The election year bill “invests” \$10.361 billion in nutrition programs; creates a standby \$3.8 billion disaster relief fund for farmers and ranchers; allocates an additional \$40 billion for farm subsidies of which \$30 billion would be given to farmers to idle their land and to other environmental programs; devotes \$1.3 billion for organic agriculture; extends \$7.9 billion of new funding for conservation programs; provides an additional \$2.4 billion for Environmental Quality Incentives Program; provides \$320 million in loan guarantees for construction of commercial-size plants producing advanced biofuels and \$300 million in mandatory funding for payments to support production of advanced biofuels; and allocates an additional \$1 billion in renewable energy research, development and production.
- At Townhall.com, Sabrina L. Schaeffer wrote, “President Bush [vetoed] the [Farm Bill], because it ‘has too much spending and not enough reform.’ ...[T]his frustration is not limited to conservative, pro-taxpayer groups. The left-leaning international anti-hunger organization Oxfam released a similar statement claiming the bill continues to favor a ‘system that rewards those who need help the least.’ Even the reliably liberal *Los Angeles Times* editorial board supported Bush’s promised veto, in part because of the ‘accounting shenanigans’ Congress is relying on to balance the books. With this bill, Congress takes another step toward abandoning even the pretense of a budget, as it is to exceed the spending limit by nearly \$10 billion.”
- “The 2008 Farm Bill will hurt Americans at every turn by inhibiting competition, limiting consumer choice, burdening individuals with higher food prices, and exacerbating the rising cost of fuel. During a period of economic uncertainty, American families need more spending flexibility, not less. As is too often the case, however, Congress’s concern with special interests and political support trumps sound economic policy. If Congress really wants to bring something home to the American people this Memorial Day, they should go back to the drawing board and institute real reform to the Farm Bill.” (*Townhall.com*, Sabrina L. Schaeffer, 05/22/08; *Associated Press*, Mary Clare Jalonick, 05/15/08; *Environment News Service*, 05/19/08; *ABA Ag Banker*, 05/16/08; *Bloomberg News*, Alan Bjerga, 05/22/08)

## FCA contemplates broader role for Farm Credit lenders in agricultural community

- Although the Farm Credit System didn't get an expansion of their lending powers in the 2008 Farm Bill, the FCA is proposing to broaden members' powers through a proposed rule which would allow members to make both debt and equity investments in a range of projects, including schools, hospitals, and infrastructure in rural communities. The commercial banking industry fiercely opposed the proposed rule, arguing that the System's expanded powers would divert FCS lenders from their core mission of lending to farmers into lines of businesses already being served by banks.
- Ken Auer, the president and CEO of the Farm Credit Council, argued that small community banks aren't necessarily meeting all of the needs of rural communities, since many are too small to finance large projects such as hospitals. "This rule provides another way [for Farm Credit lenders] to provide a flow of capital into rural areas," said Auer. "This is not about helping the Farm Credit institutions, but helping the rural communities." The proposed rule would make permanent a pilot program implemented in 2005, which allowed FCA institutions to buy bonds for health-care services, infrastructure improvements, quality-of-life projects, and other economic opportunities that are "meaningful to rural residents" and contribute "to a strong agriculture," according to FCA chairman Nancy Pellett in a press release issued last week. Under the rule, FCS lenders would be able to make equity investments in rural-area venture capital firms and make other types of investments, which could be approved upon request by FCA.
- Mark Scanlan, director of the Independent Community Bankers of America's Office of Agriculture and Rural Policy, said, "This is basically a huge power grab. This is a shift away from being a government-secured enterprise focusing on farmers and ranchers into a generalized rural-America lender." John Blanchfield, director of the American Bankers Association's Center for Agriculture and Rural Banking, said, "[FCS institutions] can get into some reasonably good-sized cities [with populations of 50,000 or less] under that rule" relative to the restriction on the Farm Credit System's home loans to communities with populations of 2,500 residents or less. (*American Banker*, Robert Barba, 05/22/08)

## Bush administration designates Leland A. Strom to serve as chairman of FCA

- On May 13<sup>th</sup>, President George W. Bush announced his intention to designate Leland A. Strom as chairman of the Farm Credit Administration's board of directors. Strom, who was nominated by the President to serve a six-year term ending December 12, 2010, also serves as chairman of the board of directors of the Farm Credit System Insurance Corporation. He has more than 30 years of experience in the agriculture industry. (<http://www.fca.gov/about/board/strom.html>; *Public Papers of the Presidents*, 05/19/08)

Farm Credit System would be regulated by the GSE regulator  
under the Treasury Department's proposal

- The Treasury Department's blueprint for financial regulatory reform recommends a separate regulator that would conduct "prudential oversight" of all government-sponsored enterprises, including the Farm Credit System. Under an optimal structure, the GSE regulator would provide "a flexible framework for regulating many of the wholesale financing activities of Fannie Mae, Freddie Mac, the [FHLB] System, and Farmer Mac, while also addressing the retail lending activities of the Farm Credit System," said the blueprint (on page 168). "That regulator should limit the GSEs' activities to those necessary to accomplish their public purpose." According to ABA Ag Banker, "[The American Bankers Association] has long advocated that the FCS should be included under any GSE regulator created by reform legislation the Congress is currently considering." (*ABA Ag Banker*, 05/16/08)

The commercial banking industry continues to serve the credit needs of rural America

- According to a study by American Bankers Association, the banking industry was the major provider in 2007 with \$114.3 billion in total farm loans, including \$69 billion in small farm loans under \$500,000 and \$28.4 billion in micro-small loans under \$100,000. According to the report, the nation's 2,307 farm banks' agriculture loans grew 9% to \$51.7 billion in 2007. (*ABA Ag Banker*, 05/16/08)

Farmer Mac reports \$8.3 million GAAP loss for first quarter

- Farmer Mac reported an \$8.3 million loss [0.84 per diluted share] for the first quarter of 2008, compared to a \$3.9 million profit for the first quarter of 2007. The agency's loss was attributable to changes in fair values of financial derivatives associated with the significant decline in interest rates in the latter half of 2007 and first quarter of 2008. Farmer Mac's core earnings were \$10.5 million [\$1.06 per diluted share] for the first quarter of 2008, a 69% increase over corresponding period for 2007 of \$6.2 billion.
- Farmer Mac President and CEO Henry D. Edelman said, "We are pleased with our continued strong performance as evidenced by our first quarter core earnings results. To date, the credit issues that have arisen in the housing and consumer sectors of the economy have not affected the agricultural economy in general, or Farmer Mac's guarantee portfolio in particular. Reflecting the effectiveness of Farmer Mac's ongoing credit risk management and the strength of the U.S. agricultural economy, 90-day delinquencies in Farmer Mac's guarantee portfolio remained at notably low levels as of March 31, 2008, in terms of both dollars and percentages. Those delinquencies totaled \$11.0 million, representing just 0.22 percent of the portfolio.

...Throughout 2007 and first quarter 2008, Farmer Mac's long-term interest rate sensitivity remained low, despite the significant change in the yield curve during that time. Farmer Mac's effective duration gap was plus 0.8 months as of March 31, 2008, compared to plus 0.7 months as of March 31, 2007." (*Farmer Mac Press Release*, 05/12/08)

## ***Postal Service***

USPS finds its ethanol powered fleet is getting fewer miles per gallon and costing the agency more to operate

- From 1999 to 2005, the USPS purchased more than 30,000 ethanol-capable [flex fuel] trucks and minivans, making it the biggest American buyer of alternative-fuel vehicles. The Postal Service's trucks, derived from Ford Motor Co.'s Explorer sport-utility vehicle, have bigger engines than the Jeeps they replaced, which has led to an increase in the agency's gasoline consumption by more than 1.5 million gallons. A recent USPS study concluded that the new vehicles got as much as 29% fewer miles to the gallon and only about 3.3% of the vehicles (1,000) were using the corn-based fuel because there weren't enough places to buy it. "You're getting fewer miles per gallon, and it's costing us more," said Walt O'Tormey, the Postal Service's vice president of engineering, who indicated that the agency pushed back its planned \$4 billion investment in new delivery vehicles until 2015 and is considering the purchase of hybrids, electric and hydrogen fuel cell vehicles. (*Bloomberg News*, Peter Robison, Alan Ohnsman and Alan Bjerga, 05/21/08; *Wall Street Journal Environmental Capital Blog*, Keith Johnson, 05/21/08)

Senators urge USPS to issue the Purple Heart stamp on permanent basis as a forever stamp

- In a May 14<sup>th</sup> letter to Postmaster General John Potter, Senator Jim Webb (D-VA) and a bipartisan group of seven senators urged the USPS to issue the Purple Heart stamp on a permanent basis as a "forever" stamp to honor service members and veterans who have received this award. "This is a most appropriate way to honor past and future recipients of our nation's oldest military decoration," said Webb. (*Press Release from Senator Jim Webb*, 05/14/08)

# TVA

TVA reports net income of \$73 million for second quarter ended March 31<sup>st</sup>

- TVA reported net income of \$73 million for the three months ended March 31<sup>st</sup> on total revenues of nearly \$2.5 billion, up 7.6% from the same period in the prior year, and power sales up 3.7% on increased sales to industrial and federal customers. The utility's operating expenses totaled \$2.1 billion for the second quarter, an increase of 8.4% over the same period in the prior year, due mainly to higher fuel and purchase power expenses. Hydroelectric power, TVA's least expensive form of energy generation, was 44% of normal during the second quarter, forcing the utility utilize other forms of energy at a higher cost.
- "TVA still faces challenges related to fuel, purchased power and reduced hydroelectric generation for the remainder of the year," said TVA president and CEO, Tom Kilgore. "Drought conditions continue to impact our financial results. Although rainfall totals for the first six months of the fiscal year were about 80 percent of normal, the amount of water reaching the rivers and reservoirs was less than 50 percent of the normal amount. Reduced hydro generation continues to drive up the total cost of power."
- As a result of rising fuel costs, TVA's board of directors approved an increase in power rates of 2%—roughly \$1 to \$3 more a month for the average TVA household—effective July 1<sup>st</sup>. The utility's increase follows a 12% increase in overall electric rates approved by its board of directors three months ago. (*TVA Press Release*, 05/13/08; *Chattanooga Times Free Press*, Dave Flessner, 05/19/08)

## Fighting fire with fire

- In a procedural move on May 22, Senators Lamar Alexander (R-TN) and Bob Corker (R-TN) objected to an appointment made by Majority Leader Harry Reid (D-NV) to the Institute of Peace to protest Reid's refusal to allow votes on the reappointment of TVA nominees Bishop William Graves and Susan Richardson Williams, both Republicans whose terms expired May 18th. The Senators' actions prevented the chamber from taking a floor vote on a slate of 80 appointments, including the President's nomination of Steve Preston as secretary of HUD. "I dislike very much having to do this, but the Democratic leader left me no choice," said Alexander. "I dislike more letting him run over the people of Tennessee this way by locking up two valuable TVA board members in the middle of an energy crisis." Corker said the objection was a last resort to protest Reid's politicization of the TVA board composition. "The Environment and Public Works Committee that is controlled by the majority leader's party unanimously approved the reappointment of both nominees, and yet the majority leader, through his refusal to let the Senate vote on

these qualified nominees, is taking us to the lowest possible level as it relates to partisan issues,” said Corker. Reid has demanded Democratic representation on the TVA board and has held up the reappointments of Graves and Williams to reinforce his position. Reid’s spokesman Jim Manley called the Senators’ retaliatory action “stunning.”

- President Bush has nominated Michael Bemis, of Mississippi, to replace the lone Democrat on the board, Skila Harris, who retired this week when her term expired. Bemis, a Republican, has more than 20 years of experience in the energy industry, including stints at Exelon Corp., Entergy, London Electricity PLC, Louisiana Power & Light, Mississippi Power & Light and Arkansas Power & Light. If confirmed by the Senate, Bemis would serve on the TVA board through 2013. (*Chattanooga Times Free Press*, Herman Wang, 05/22/08)

TVA’s board adopts conservation policy calling for half of the utility’s power needs being generated from renewable and clean energy sources by 2020
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- On May 12<sup>th</sup>, TVA’s board of directors adopted a broad environmental policy, which pledges to reduce the utility’s carbon footprint and meet its growing power demand through energy efficiency, renewable energy and less-polluting power. On the eve of the agency’s 75<sup>th</sup> anniversary, the board adopted an environmental policy, which calls for meeting half of TVA’s power needs from renewable and clean energy sources by 2010. Specifically, the policy calls for reducing TVA’s production of energy produced from coal-fired power plants from 64% to below 50% of the next 12 years. “We’re going to do what we can to make sure these (carbon emissions) are less than they are today by 2020,” said TVA president Tom Kilgore. “TVA will strive to have at least 50 percent of its generation portfolio be from low-carbon and zero-carbon sources.” To achieve a goal of reducing peak demand by 1,400 megawatts [the equivalent of the power generation capability of a new nuclear plant and hydro dam], TVA will work with its distributors to develop new rate structures, smart meters, education programs and energy audits over the next four years. The policy also calls for the utility to protect the 181,000 acres of land it controls for wildlife and natural resources.
- TVA director Skila Harris, the first woman and only remaining Democrat on the utility’s board, pushed for the adoption of this policy before her departure from the board on May 19<sup>th</sup>. “It’s better than I ever envisioned,” said Harris, whose nine-year term is coming to a close. “... It almost brings me to tears, I swear, because I never thought that TVA would think it important enough to spend the time and resources to come up with a statement ... that basically says this is what we believe in terms of the environment at TVA.” Previously, Harris worked in the Carter and Clinton administrations and served as an aide to both Vice President Al Gore and his wife, Tipper. (*Associated Press*, 05/19/08, *Associated Press*, Duncan Mansfield, 05/15/08; *Chattanooga Times/Free Press*, Dave Flessner, 05/20/08)p

- In an May 18<sup>th</sup> editorial commemorating TVA’s 75<sup>th</sup> anniversary, the *Northeast [Mississippi] Daily Journal* wrote, “...TVA’s electricity [has] revolutionized community life [in TVA’s seven-state service area]. ...TVA remains one of the most powerful marketing assets for places like Tupelo, Corinth, New Albany, Booneville, Amory, West Point, Columbus and other energetic communities in Northeast Mississippi. TVA’s certified megasites at Blue Springs and near Columbus have been magnetized by regional leadership, attracting thousands of 21st-century jobs and billions in investment. Besides manufacturing, the reservoir lakes created by TVA’s dams drove development of a tourism and recreation industry that was unthinkable before the river was controlled.”
- “Nothing is overstatement in terms of measuring the importance of TVA in the continuing economic development of the seven-state region it serves. TVA is the nation’s largest public utility, and its operation as a part of the national commonwealth should continue, even as it adapts to technological innovations and steadily increasing demands for power. We agree with former TVA Chairman Glenn L. McCullough, Jr., a Tupelo resident and native Mississippian: TVA’s sustainability must be melded with the growing of a strong, green economy in the valley region. Continuing innovation and efficiencies will help TVA endure as its region prospers and the authority reaches toward 100 years of service.” (*Northeast Daily Journal*, 05/18/08)

TVA is vulnerable to cyber attacks, says GAO
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- TVA is vulnerable to cyber attacks that could sabotage critical systems that provide electricity to more than 8.7 million people, according to a GAO report released on May 21<sup>st</sup>. According to GAO, TVA’s Internet-connected corporate network, which is linked with systems used to control power production, has pervasive security weaknesses which could be used by attackers to manipulate or destroy vital control systems. GAO warned that TVA’s corporate networked computers also lacked security software updates and anti-virus protection, and that firewalls and intrusion detection systems on the network could be easily bypassed and failed to record suspicious activity. “In addition, physical security at multiple locations did not sufficiently protect critical control systems,” concluded GAO. “As a result, systems that operate TVA’s critical infrastructures are at increased risk of unauthorized modification or disruption by both internal and external threats.” In the utility’s written response included in the GAO report, the TVA agreed with all 19 of the agency’s recommended actions.
- In testimony at a Congressional hearing, TVA’s chief operating officer Bill McCollum said TVA is already addressing most of the security concerns highlighted by GAO. “TVA is committed to assuring that the infrastructure entrusted to our responsibility meets or exceeds the best accepted practices in government and in the electric utility industry,” said McCollum. (*Washington Post*, Brian Krebs, 05/21/08; *Chattanooga Times Free Press*, Dave Flessner, 05/21/08)

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