

The **GSE** REPORT™

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Major Events

“Tale of Two Freddie’s”

- In his June 6th speech at the Freddie Mac Annual Shareholders’ Meeting, company chairman and CEO Richard Syron said, “Freddie Mac is living a kind of paradox these days. In some ways it has been the best of times for us; in some obvious ways, the worst of times. This ‘Tale of Two Freddie’s’ began last year – and it included the same severe deterioration in credit and the housing markets that has affected every company in our sector. Our ‘best of times’ included substantially remediating our accounting and internal controls, getting current in our financial reporting, driving ahead toward SEC registration and taking other needed steps forward. Becoming timely and registering with the SEC has been our focus for a long time and it’s great for everyone to finally be getting there.
- “...Clearly, weakening house prices and punishing deterioration of credit hurt our results, along with those of other market participants. Our 2007 net losses amounted to roughly \$3.1 billion on a GAAP basis. These results reflected mark-to-market losses of \$8.1 billion and a higher provision for credit losses. ... We know we have to do better, even in the most adverse market environment.”
- Syron outlined the steps that the company has taken in response to this historic housing downturn, which included (1) getting registered with the SEC and completing the company’s major remediation of internal controls; (2) significantly improving and simplifying Freddie’s accounting to meliorate its consistency and transparency; (3) raise the GSE’s prices and tighten its credit terms, while continuing to subsidize its affordable housing business; (4) bolstering the company’s capital base; and (5) continuing to serve GSE’s mission of providing stability, liquidity, and affordability to the mortgage market.
- Syron assured shareholders, “We believe our 2008 results will be better than 2007 – and that in the current ‘Tale of Two Freddie’s’ that I described, the ‘best of times’ in terms of our revenue growth and profitability are yet to come.” Although credit continues to weaken and Freddie’s provisions for losses continue to grow, Syron argued that conditions are “manageable” because of the company’s current loss reserves totaling more than \$7 billion, the asset quality of Freddie’s book of business, and potential of the company’s “revenue engine.” Freddie projects a 15% to 20% revenue growth from its guarantee business, which will generate strong growth in net interest income. The company also anticipates an increase of \$5 billion to \$6 billion to its 2008 loan loss provision to reflect deteriorating credit and house prices. On balance, Syron argues that the company’s credit costs are “manageable under any realistic scenario and mitigated by our revenue growth going forward.”

- “...I know you’re not satisfied with Freddie Mac or your investment in the company, and neither am I,” Syron told shareholders. “The senior management team will not be satisfied until you, our owners, receive a fair return for the capital you have invested, the risks you have borne, the patience you have shown.”
- During the meeting, Freddie Mac’s stockholders re-elected 10 directors to the company’s board of directors and elected Jerome P. Kenney, retired vice chairman of Merrill Lynch, to fill the directorship of the retiring Shaun O’Malley. Shareholders also approved the re-appointment of PricewaterhouseCoopers LLP as the GSE’s independent auditor for fiscal year 2008 and an amendment and restatement of the 2004 Stock Compensation Plan.
- In a meeting of the board of directors immediately following the stockholders’ meeting, Richard Syron was re-elected chairman of Freddie Mac’s board. Also, Thomas Johnson was elected lead director, taking over for the retiring O’Malley. The board also declared a quarterly dividend of \$0.25 per share for common stock, payable on June 30th to shareholders of record as of June 16th, and approved quarterly dividends on the company’s preferred stock in accordance with the terms of the issues. (*Richard F. Syron’s speech to the Freddie Mac Annual Stockholders’ Meeting*, 06/06/08; *Wall Street Journal*, Aparajita Saha-Bubna, 06/06/08; PRNewswire, 06/06/08; *Freddie Mac Press Release*, 06/06/08)

Senate confirms Steven Preston to serve as HUD Secretary
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- The Senate unanimously confirmed former SBA Administrator Steven Preston to serve as HUD Secretary, succeeding Alphonso Jackson, who stepped down in late March. Preston’s approval came as part of a package of 80 other nominations to various boards, commissions, and executive branch posts. In a press statement, President Bush said, “[Preston] will aggressively work to ensure that the Department remains focused on its mission of making housing more affordable and helping Americans keep their homes. Steve is also a consensus builder who will build on our efforts to work with Congress on responsible legislation addressing our Nation’s housing policies.” (*Bureau of National Affairs*, 06/06/08; *CQ Today Online News*, 06/05/08; *HousingWire*, Amy McAlister, 06/06/08)

Attorney General Cuomo reaches “landmark” agreement with the three principal credit rating agencies, which will reform the residential MBS market

- On June 5th, New York Attorney General Andrew Cuomo announced that he has reached landmark agreements with Standard & Poor’s, Moody’s Investor Services, and Fitch, Inc., which will fundamentally reform the residential mortgage-backed securities market (RMBS). According to Cuomo, the agreements will dramatically increase the independence of the credit rating agencies, ensure that crucial loan data is

provided to agencies before loan pools are rated, and increase the transparency in the RMBS market.

- Under the agreements, the credit rating agencies will fundamentally alter how they are compensated by investment banks for providing ratings on loan pools. The ratings firms also will all require [for the first time] that investment banks provide due diligence data on loan pools for review prior to the issuance of ratings. This requirement will ensure that this data, which was not previously disclosed to the rating agencies, will be received and reviewed by the agencies before any securities are rated. The agreement also requires the credit rating agencies to establish a fee-for-service structure, under which they will be compensated regardless of whether the investment bank ultimately selects them to rate an MBS. [Previously, an agency was only paid if the investment bank selected them to rate the transaction.] The agreement also expands the agencies' disclosure of information about all securitizations submitted for their review. In the future, credit rating agencies will establish a set of criteria for reviewing individual mortgage originators and the lender's origination process and will publish their annual reviews of originators on the agencies' websites. The ratings of individual lenders and the origination process will be fed into the overall ratings process for new deals. Credit rating agencies also will require a series of reps and warranties from investment banks and other "financially responsible" parties about the loans securitizing the RMBS. Credit rating agencies will perform an annual review of their RMBS business to identify and eliminate any practices which could compromise their independence in the rating process.
- In a statement, Cuomo said, "The mortgage crisis currently facing this nation was caused in part by misrepresentations and misunderstanding of the true value of mortgage securities. The tremendous reach of this crisis cannot be understated -- our entire economy continues to feel aftershocks from the collapse of the mortgage industry. By increasing the independence of the rating agencies, ensuring they get adequate information to make their ratings, and increasing industry-wide transparency, these reforms will address one of the central causes of that collapse. The reforms agreed to today by S&P, Moody's, and Fitch should begin to restore investor confidence during what is a very troubling time for the mortgage industry, and I applaud the firms for their cooperation with our investigation." As part of the agreement, the New York AG's office said it has terminated its inquiry into the major credit agencies which began in August 2007. According to sources close to the investigation, it's believed that all three agencies will assist the AG's office in its ongoing investigation into the practices of investment banks responsible for issuing MBS and related securities.
- While Cuomo touted the agreement as a major step forward for the mortgage industry, investors speaking to *HousingWire* were "incensed at the deal." On MBS investor said, "[The rating agencies] commit highway robbery, and get off scot-free because they're going to name the make and model of the car they drove to do it? Unbelievable." Reaction to the credit agency reforms was also mixed. "We need this sort of reform, yes," one fund manager told *HousingWire*. "But to allow the

Moody's of the world to increase their revenue base, dictate the future terms of engagement, while getting a hall pass for prior misconduct, it just doesn't pass the smell test."

- Separately, the SEC announced it will hold an open meeting on June 11th to propose new rules for credit rating agencies. SEC chairman Christopher Cox said his agency's staff has spent months examining the credit rating agencies and plans to propose new rules, based upon their findings. New regulations could include requiring better disclosure of past ratings, limiting conflicts of interest and requiring rating agencies to differentiate between corporate bonds and more complex structured finance products, said Cox. The SEC chairman lauded Cuomo for working with his agency to come to the agreements with the credit rating agencies. "The attorney general's actions, as well as the comprehensive new rules for all nationally registered credit rating agencies that the Commission will consider next week, are motivated by our mutual desire to promote ratings with integrity and curb the questionable practices that contributed to the credit market turmoil," said Cox. (*Press Release from the Office of Attorney General Andrew Cuomo*, 06/05/08; *Reuters*, 06/04/08; *HousingWire*, Paul Jackson, 06/05/08; *CNNMoney*, David Goldman, 06/05/08)

Fannie Mae and Freddie Mac

House and Senate leaders take the unusual step of negotiating a bill to address the housing crisis before the Senate adopts its final version

How can Congress address the real estate speculators—or should they?

The seven flaws of the Dodd-Shelby Housing Bill

Editorial boards speak out on the housing bill

House and Senate leaders take the unusual step of negotiating a bill to address the housing crisis before the Senate adopts its final version

- In an effort to short-circuit a long, drawn out legislative process that might drag into the late summer, House and Senate leaders are taking the unusual step of meeting behind closed doors to draft what they hope would be the final version of legislation to address the nation's housing crisis, before the Senate adopts its own version. Negotiations began the week of June 2nd, after leadership decided that they would not wait for action by the full Senate, where parliamentary procedures could delay passage of the bill.
- Senate Banking Committee chairman Chris Dodd (D-CT), House Financial Services Committee chairman Barney Frank (D-MA) and their staffs have begun initial discussions to identify the outstanding issues to be resolved on the housing bill. The largest issue to be resolved appears to be the Senate's proposal to use the affordable housing fund to cover the cost of a FHA program to refinance subprime loans, which CBO estimates will total \$1.7 billion over five years. Frank is reluctant to divert the funds, which the House version proposed to dedicate to rebuilding efforts in hurricane-stricken Louisiana and Alabama during the first year. He proposes to find other avenues to fund the legislation, including using extra revenue from lifting the cap on FHA reverse mortgages which could generate approximately \$300 million annually. An agreement must also be reached on conforming loan limits for loans purchased by Fannie Mae and Freddie Mac and insured by FHA in the House bill (up to \$729,900) and Senate measure (\$550,000).
- Treasury Secretary Henry Paulson said he supports the provisions in the Dodd-Shelby housing bill which create a stronger GSE regulator, but has reservations about other aspects of the bill. "Some parts of the legislation are modestly helpful and others are not helpful," said Paulson. "It's a big part of my job to work to get the strongest possible housing bill possible on the president's desk so he can sign it and we can get GSE reform"

- In media interviews, Fannie Mae CEO Daniel Mudd outlined his objections to provisions in the Senate bill. Specifically, Mudd objects to the Senate’s provisions which would allow the new GSE regulator to limit the enterprises’ holdings of jumbo mortgages in portfolio. “You can securitize all you want, but if there aren’t investors there to invest in the loans, the securitization is unhelpful,” he said. “So you have to recognize that the way the capital markets work, you need the originator, you need the securitizer, and you need the investor.” Mudd also said that Senate’s proposal to divert private profits [through the AH fund] for a government program, such as FHA, is “upside down.” Mudd argued, “[The FHA] sits on the full faith and credit of the government. We were explicitly set up not to sit on the full faith and credit of the government, so now we’re taking money out of the private market and using it to defray the cost of a government program. The logic seems to be getting a little circuitous.”
- Mudd also had concerns about the Senate’s provisions that give the GSE regulator approval authority over new products and power to set the GSEs’ capital requirements. In an interview with *American Banker*, Mudd urged Congress to specify the powers that they are giving the new GSE regulator. He said, “The more that’s elaborated in the legislation, the better. The whole mortgage finance market is built around how much capital we hold.” He called on Congress to give “appropriate consideration ... [to the] very fine balance that needs to exist between capital, the ability to operate the business, and the mission requirements.” Mudd concluded, “We still have to be able to operate as successful private companies with a public purpose.”
- Freddie Mac chairman and CEO Richard Syron said that the Senate’s proposal to use affordable housing funds to cover the cost of the FHA loan program will reinforce a perception in the marketplace that Fannie Mae and Freddie Mac are backed by the federal government. “It makes it more confusing and I think to some extent increases the degree of integration,” said Syron. “We have a lot of confusion in the United States about what are these enterprises, are they private-sector enterprises or are they enterprises that the government stands very strongly behind?” He added, “You’ve got the private GSEs defraying the cost of a full-faith and credit program. [As a competitor of FHA, paying their loan losses] is a little hard to think about in a capitalistic system. You could say we are an instrumentality in some sense of the government. We ought to figure this out because I actually, candidly, don’t think that the current degree of confusion about shareholder rights, mission and safety and soundness benefits anyone.”
- Howard Glaser, a mortgage industry consultant and senior HUD official in the Clinton administration, said, “The concern is that the regulator, acting arbitrarily, could diminish the role of Fannie and Freddie in the housing markets in a time when they are needed. There will be legislators who want a higher level of confidence that the regulator does not have free rein.” Specifically, some are concerned about wording in the Senate bill that directs the GSE regulator to consider “the ability of the enterprises to provide a liquid secondary market” and “the portfolio holdings in

relation to the overall mortgage market” when setting policy. Analysts argue that the language would give the regulator wide latitude to rein in the GSEs, particularly their mortgage portfolios. “Embedded in there is the idea of whether ... [portfolios] could drag down the overall mortgage market,” said New York University professor Lawrence White. “That’s the hook that gets you from the language to the idea that it’s adding systemic risk.” Jim Vogel, the head of fixed-income research at FTN Financial, said, “We are creating a regulator here that is so powerful that they can try to open any door and have a good shot at succeeding.” Paul Miller, an analyst at Friedman, Billings, Ramsey, said, “You can sit there and say, ‘It’s not systemic risk,’ but we don’t think we have a liquid housing market right now, so you’ve got to raise more capital to have that liquid market, or you’ve got to shrink those portfolios, because they’re too big.” (*American Banker*, Steven Sloan, 06/02/08; *Washington Post*, Jeffrey H. Birnbaum, 06/07/08; *American Banker*, Steven Sloan, 06/05/08; *Bloomberg News*, Dawn Kopecki, 06/06/08; *CongressDaily*, Bill Swindell, 05/23/08; *Reuters*, David Lawder, 05/30/08)

How can Congress address the real estate speculators—or should they?

- In the June 9th issue of *The Weekly Standard*, Lawrence W. Lindsey, visiting scholar at American Enterprise Institute, wrote, “...[M]ost of the legislative [proposals] ... ignore the vacant home problem... Congressmen don’t want to appear to be helping speculators, liars, or cheats. The trouble is, a good part of the problem was caused by people who might be considered speculators, liars, and cheats. Speculators by definition bought vacant properties in the hope of ‘flipping’ them for a higher price. A vacant home is therefore a good sign of speculative activity. Moreover, some studies of foreclosed homes indicate that a majority of the foreclosures involved misrepresentations by the borrower. The most typical misrepresentation was that the borrower intended to live in the property; an owner-occupied property generally receives a lower interest rate than one that will be rented out.”
- “The case of Democratic congresswoman Laura Richardson from California illustrates a number of these problems. According to reporting by *Capitol Weekly* (‘The Newspaper of California Government and Politics’), the *Wall Street Journal Online*, and *DailyBreeze.com*, Richardson was delinquent on three personal home mortgages. Her Sacramento home was recently sold at auction, and as of May 23 foreclosure was pending on a home in San Pedro. A home in Long Beach went into default on March 28—no payment had been made since November—but Richardson ‘was able to bring her payments up to date.’ Her lender on the Sacramento mortgage, Washington Mutual, lost some \$200,000, and the home’s buyer agreed to pay the \$9,000 in property taxes she had in arrears on the property. On the San Pedro house, she owed \$367,436 on a \$359,000 loan made in 2005 and hadn’t made a payment since last June. The Long Beach home was the collateral for a \$100,000 loan she in turn lent to her campaign for a state assembly seat in 2006, and though she raised enough to pay herself (and presumably the bank) back, she plowed that money into her 2007 race for Congress.”

- “Richardson’s situation—while unusual in that she changed jobs and cities three times in a short space of time—highlights a number of the problems Congress must wrestle with. She had three vacant homes, and news reports of neighbor complaints suggest they weren’t being kept up or taxes paid. Reportedly, one home loan was used for ‘consumption’—political campaigns—that involved no improvement in the value of the collateral, a bit like taking out a home equity loan for a trip to Vegas. The home values declined drastically—27 percent over 17 months in the case of the Sacramento home, whose ultimate buyer was a speculator. Until recently, congressional action and most press coverage of the housing market has adopted the premise that innocent home buyers are struggling to meet payments so as to stay in the family home. But on a scale of 1 to 10 where 1 represents a person victimized by an unscrupulous lender and 10 is the delinquent owner of three vacant homes, most people defaulting on a mortgage fall in the range of 5 to 8.”
- “...The housing market crash is far from over, and its ramifications will be with us for some time. The combination of excessively easy credit, a rapid run up in prices, and overbuilding set the stage for the current mess. Prices must fall to correct oversupply, and that, in turn, will further adversely affect both consumer confidence and financial solvency. The unique nature of the problem makes a precise ending hard to predict. But it seems likely that some combination of speculative buying, inflation, and purchases by both foreigners and government entities will correct the situation. Now is not the time for ideology, of either the left-wing variety (soak the rich, punish speculators, and conduct a witch hunt through the financial community) or the right-wing variety (stave off government involvement of any form). Pragmatism is a conservative virtue. It is time for everyone to start practicing it.”
(*The Weekly Standard*, Lawrence B. Lindsey, 06/09/08)

The seven flaws of the Dodd-Shelby Housing Bill

- In a *Heritage Foundation Commentary*, David C. Jon outlined seven flaws in the Dodd-Shelby housing bill. Jon wrote, “[1]...Like the Frank [housing rescue] plan, [the Dodd-Shelby proposal] is essentially a government buyout of problem mortgages disguised as a refinancing plan. It is an extremely bad precedent, as lenders will quickly request that this guarantee be made available for all loans to borrowers with poor credit histories or lower incomes. Until now, the mortgage market has operated under free market-oriented principles with a moderate level of government regulation, but this program would be a slippery step toward government micromanagement. As a significant number of the loans now facing problems were made by irresponsible mortgage brokers using inaccurate and even false data, it would also signal that there are no real consequences for poor lending practices.”
- “[2.] Many of these refinanced mortgages will be likely to default. **The Congressional Budget Office (CBO) estimates that fully one-third of refinanced mortgages under H.R. 5830 (the Frank legislation) will subsequently default, and those numbers have been criticized by some as being overly optimistic.**

[Emphasis added.] The risk of default is historically best measured by the size of a down payment. The smaller it is, the more likely that the borrower will walk away from the loan. While the Dodd plan essentially gives refinanced homeowners an amount equal to 10 percent of the current value of the house, this is a gift, and the homeowner has none of his or her own money at risk. Experience with similar “gift equity” programs already causing problems for the FHA shows that these loans have a default rate that is two to three times that of loans where the borrower has made a cash down payment.”

- “[3.] The plan would reward two different groups of homeowners: those who took out a speculative loan they never had a chance of repaying in hopes of flipping the house in a rising market and those who fell into trouble through no fault of their own. In doing so, it sends a message that it is acceptable to renege on an obligation because a government buyout will cut your losses.”
- “[4.] Even if legislation were passed tomorrow, it is not possible to implement this plan rapidly. FHA says that it does not currently have the people necessary to implement such a plan. It will take time to hire and train them. In addition, mortgages must be refinanced individually. It will take a great deal of time to refinance the 1 million [to] 2 million loans that supporters say could benefit. While supporters talk of refinancing loans in bulk, this is not possible under current laws or industry practice, nor is it advisable.”
- “[5.] The estimate for the number of homeowners who would be helped by the Dodd–Frank plan continues to drop. First, supporters claimed that about 2 million homeowners would have loans refinanced. Since then, that number has steadily dropped, and now the CBO says that only 500,000 loans worth about \$85 billion would be refinanced over the next four years.”
- “[6.] Borrowers with legitimate problems are already being assisted by the voluntary Hope Now program. In the first quarter of 2008 alone, the Hope Now program assisted over 500,000 homeowners—the same number that the CBO says the Dodd–Frank plan will assist over the next four years. The Hope Now program is certain to help even more homeowners than Dodd–Frank in coming quarters because it is already up and running. Dodd–Frank merely duplicates the existing private program at a cost of billions of dollars and transfers all risk of default to the taxpayers.”
- “[7.] Dodd–Frank will not stop foreclosures, even for many who would otherwise qualify. During the time it will take to put the program in place, mortgage servicers will be legally bound to follow the terms of the existing contract for fear that the refinancing might fall through, including taking steps toward foreclosure. Further, as CBO points out, many lenders will refuse to take part because it would require them to accept heavy losses in order to participate. Other lenders who hold second mortgages on the same property could also block refinancing.”

- Jon concludes, “...The continued pressure on Congress to ‘do something’ about the large number of mortgages that are either in default now or at risk of defaulting once their interest rates rise to market levels should not be allowed to get in the way of extremely important legislation to improve the regulation of GSEs or to improve the FHA. Unfortunately, the Dodd–Frank refinancing program is not likely to assist homeowners who are having trouble paying their mortgages any more than the House-passed bill would. Instead, Congress should focus on the other critical parts of the package and quickly take steps to modernize and strengthen the GSE regulator and to improve the FHA. Those are steps that will help to ensure that future housing problems do not develop into crises that could threaten the stability of the overall financial system or require massive taxpayer-funded bailouts.” (*Heritage Foundation Commentary*, David C. Jon, 06/02/08)

Editorial boards speak out on the housing bill

- As Congress continues its work on a housing rescue bill, newspaper editorial boards are speaking out on the issue. In a June 1st editorial, the *New York Times* wrote, “Congress took another step toward easing the affordable housing crisis when the Senate banking committee approved a bill to create a Housing Trust Fund at the national level. The Senate should now emulate the House, which has already passed its version of the trust fund. But it should first kill off an ill-considered provision that diverts money from affordable housing construction in the storm-stricken Gulf Coast region to a foreclosure prevention program that might not need it. ...The Senate version would divert money from the fund to a foreclosure prevention program that could well do without these dollars. Dunning impoverished people who cannot afford prevailing rents is not the way to help homeowners who may or may not need it.” (*New York Times*, 06/01/08)
- In a May 29th editorial, the *Orlando Sentinel* wrote, “Congress has been dragging its feet for months on producing a reasonable and politically viable plan to ease the housing crisis. Last week, a Senate panel finally took a stride in the right direction. The Senate’s housing committee overwhelmingly approved a bipartisan plan that could help up to 500,000 homeowners facing foreclosure refinance their loans without direct cost to taxpayers. Central Florida has been one of the hardest-hit markets in the housing crisis, which has seen more than 1.5 million homeowners nationwide fall into foreclosure and home prices plummet 14 percent over the past year. Many homeowners who can’t afford payments on their adjustable-rate mortgages can’t sell or refinance because they owe more than their homes are worth. As foreclosures mount, prices keep falling. The damage spreads beyond struggling homeowners to their communities and the broader economy.”
- “... The Senate plan has the advantage of broad bipartisan support. The House plan, which would put taxpayers on the hook for defaults on FHA-backed refinancings, is mainly backed by Democrats. President George W. Bush has threatened to veto it. Congress needs to act soon to pass a plan more like the Senate’s, and put the brakes

on rising foreclosures and falling housing prices. It needs to contain the damage to the U.S. economy.” (*Orlando Sentinel*, 05/29/08)

- In a June 3rd editorial, the *Virginian-Pilot* (Norfolk, VA) wrote, “During the late, great housing boom, more than a million Americans allowed their eyes to grow bigger than their bank accounts and took on mortgages they couldn’t afford. Now Congress is on the verge of stepping in, with tax dollars, to extricate homebuyers—as well as lenders and mortgage investors—from their up-to-their-eyeballs debt. The rescue coincides with a wave of foreclosures and bankruptcy filings, as well as growing concern that the government must intervene before even more people slide over the financial precipice. Unfortunately, the proposed House and Senate solutions are, at best, hold-your-nose measures.
- Each contains sensible provisions that tighten regulations and attempt to stave off a repeat in the years ahead. But both proposals include too many troubling components—beginning with the premise that it’s OK to take money from taxpayers who’ve managed their housing costs wisely and use it to aid borrowers, lenders and others who’ve behaved irresponsibly. Both rescue plans would authorize the [FHA] to back several billion dollars worth of new loans to individuals who are facing foreclosure but are unable to refinance their mortgages because of credit problems or a loss in equity. To a degree, those measures are crafted to protect taxpayers from footing the full bill for the bailout. For instance, borrowers who receive help would have to share part of the proceeds with the government if they later sell their homes.
- Lawmakers are fighting over how to pay for the program. The House and Senate want to charge a new fee via Fannie Mae and Freddie Mac to create a low-income housing fund. Under the Senate version, money would be diverted from that program for five years to help borrowers now in distress. The House version diverts the first year’s fees to people displaced by Hurricane Katrina. It’s hard to argue they’re less deserving than people who bought houses larger than they could really afford. Also troubling is a Congressional Budget Office report indicating that more than one-third of the estimated 500,000 beneficiaries of the FHA aid are still likely to default—and stick taxpayers with a \$1.7 billion bill.
- A strong case can be made that some borrowers—particularly those who were steered to risky loans by unscrupulous brokers when they actually qualified for less expensive, conventional mortgages—should get a helping hand. But the rescue mission shouldn’t begin until the risk to taxpayers is further minimized or, preferably, eliminated entirely. (*Virginian-Pilot*, 06/03/08)
- In a May 27th commentary in *Barron’s*, Thomas G. Donlan wrote, “...The latest version of the housing rescue bill has a ‘Hope for Homeowners’ section that permits lenders to reduce mortgage loan balances, and then hand the borrowers off to the Federal Housing Administration, which would give them 30-year, fixed-rate affordable mortgages, to be held by Fannie, Freddie and their foolish friends in the banking industry. Sponsors claim that loading Fannie Mae and Freddie Mac with

millions of risky new loans to refinance the mortgage mess will not cost the taxpayers anything because Fan and Fred will collect new fees to originate the mortgages, giving them a financial cushion. This is just prolonging the agony and creating more of it. Let's get U.S. real estate back on the firm foundation of contract between landlord and tenant. (*Barron's*, Thomas G. Donlan, 05/27/08)

- In a guest column appearing in the *Kansas City Star*, Mark Hirschey, a professor of business at the University of Kansas wrote, "It's an election year, and both Democrats and Republicans are scrambling to get widespread support for a massive housing bailout that stands to benefit voters in the pivotal states of California, Florida and New York. That can be tricky when addressing voters, taxpayers and campaign contributors from Kansas and the 46 other states. Perhaps that's why politicians refer to California, Florida and New York as 'high cost' areas, not pivotal voter states, at the epicenter of the current nationwide 'housing crisis.' Obviously, as everyone now knows, the government has to do more to help 'needy' homebuyers in 'high cost' areas."
- "...[N]obody in California, Florida or New York asked Kansas taxpayers to share profits when home prices soared from 1995 to 2006. Why should Kansas taxpayers pick up the tab when home prices retreat from historic highs? Obvious beneficiaries of housing bailouts also include investment bankers and hedge-fund managers. On Wall Street, investment bankers reaped millions of dollars in fee income as mortgage loans were packaged together for resale to institutional investors. If you want to minimize current and future damage, let those who earned millions of dollars for innovative financial engineering bear responsibility for any losses."
- "The Taxpayer Relief Act of 1997 allowed joint filers to exclude up to \$500,000 of income from the sale of a home once every two years. That's a big incentive to speculate in high-dollar real estate markets. Congress lit the fuse for the current explosion in home prices; pouring more taxpayer dollars on overpriced real estate will not help those prices fall. In short, Kansas taxpayers are being asked to bail out foolish and/or fraudulent homebuyers, lenders, Wall Street, hedge funds, state regulators and Congress. That's a bad idea." (*Kansas City Star*, Mark Hirschey, 06/03/08)

New GSE sheriff will want to "clean up the town"
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- In a May 27th article in the *Wall Street Journal*, David Reilly and Peter Eavis examine how the new GSE regulator will want to put Fannie Mae and Freddie Mac on a firmer financial footing, so the GSEs will be strong enough to support the housing market in the future. As OFHEO director James B. Lockhart said recently in a speech, Fannie Mae and Freddie Mac "have continued to be a point of vulnerability for the financial system because they are so highly leveraged relative to their risks." The authors point out that Fannie's and Freddie's capital is a "mirage, thanks in part to the inclusion of deferred tax assets." On March 31st, Fannie Mae had deferred tax assets of \$17.8

billion, which accounted for 45% of total shareholder equity. To utilize these assets [which generally have lives of about 20 years], Fannie will have to generate about \$50 billion in profit—or [roughly] on average, \$2.5 billion in net income each year. Similarly, Freddie Mac reported \$16.6 billion of deferred tax assets, which slightly exceeded the company's total equity on March 31st. Freddie would have to generate \$47 billion in earnings to utilize these assets. When it becomes likely that a company will not utilize its deferred tax assets, they typically write-down a portion of these assets; however, neither Fannie nor Freddie have elected to do so.

- The new GSE regulator may also need to examine Fannie's and Freddie's unrealized losses, of which \$5.4 billion and \$13.2 billion, respectively, were unrealized losses on debt securities which were 12 months old or older. The age of these losses suggest that they are "more than temporary." Another area requiring the regulator's attention is the GSEs' reserves for loan losses. With past-due loans soaring, it does not appear that Fannie and Freddie have adequately increased their loan loss reserves. On March 31st, Freddie had \$22.8 billion of nonperforming assets, up from \$18.5 billion on December 31, 2007. On March 31st, Freddie's loan-loss reserve of \$3.9 billion was 17.1% its nonperforming assets and about 16% of its past-due loans. Since lenders typically reserve 20% to 40% of the value of a loan when it becomes delinquent, a new GSE regulator should want the GSEs to increase their loan loss reserves to provide more protection against further credit deterioration. The authors conclude, "A regulator that pursues these kinds of changes, and thereby strengthening Fannie and Freddie, could at least be one positive to emerge from the housing crisis." (*Wall Street Journal*, David Reilly and Peter Eavis, 05/27/08)
- On May 27th, Lehman Brothers widened its 2008 loss estimates for Freddie Mac and Fannie Mae to \$1.65 and \$2.39 loss per share, respectively. Lehman increased its loss estimates 10% for Freddie Mac (from \$1.50) and 7.2% for Fannie Mae (from \$2.23). For Freddie Mac, the investment banker projects a 14% year-over-year growth in 2008, 10% in 2009 and 8% in 2010. For Fannie, Lehman projects a 17% growth in 2008 and 9% in 2009 and 2010. As credit costs normalize, the companies' rising revenues should support significant earnings power long-term. (*Reuters*, 05/27/08)

One reform with "legs"—broker licensing

- Under the housing reform bills moving through Congress, a corner of the mortgage market that would face reform is the mortgage brokerage space. Under the Senate Banking Committee's version, a provision of the bill would set a national standard for mortgage brokers and allow states to impose even tougher requirements. "We are concerned about the language because it is so vague that it is very unclear how anyone could comply, and that of course poses litigation risk," said Floyd Stoner, head lobbyist for the American Bankers Association. "We remain concerned about the provision because we need to protect a clear national standard." In a separate bill addressing predatory lending, the House sets such a standard.

- The Office of Comptroller of the Currency, a staunch defender of federal preemption powers, has suggested some “tweaks” the language of the Senate provision, authored by Senator Mel Martinez (R-FL). In interviews with the *American Banker*, Martinez said, “I would hope it doesn’t change,”...“This ought to set a minimal standard ... Already many states regulate mortgage brokers so if they are regulated on a higher level I don’t want this bill to then provide a lower level of regulation.” Under the provision, employees of national bank and federal thrifts who originate mortgages, along with independent mortgage brokers and mortgage originators, would be required to undergo background checks, to be registered with their regulator, to have their fingerprints submitted to a new national fingerprint registry, and to be licensed by HUD and by the state where they do business. Licensing standards would include a background check, a completion of 20 hours in pre-licensing education, and eight hours of non-repetitive education annually. According to the provision, “Nothing in this title may be construed to preempt the law of any state, to the extent that such state law provides greater protection to consumers than is provided under this title. ...[The bill] establishes a means by which residential mortgage loan originators would, to the greatest extent possible, be required to act in the best interests of the consumer.” (*American Banker*, Stacy Kaper, 05/29/08; *CNet News*, Declan McCullagh, 05/23/08)

Comptroller of the Currency says the GSEs’ appraisal standards may violate the law
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- In a letter to OFHEO director James B. Lockhart, III, Comptroller of the Currency John Dugan urged the agency to scrap appraisal standards that Fannie Mae and Freddie Mac had agreed to with New York Attorney General Andrew Cuomo (NYAG) in March. Dugan warned, “Provisions of the National Bank Act would prevent this de facto regulation from being applied to, or enforced against, national banks. ... We see no legal basis for OFHEO to share or delegate rulemaking authority to the NYAG, or to subject its ability to regulate the GSEs’ safety and soundness to the veto or consent of the NYAG, as has happened here. Nor do we see a basis for OFHEO, using its safety and soundness authority with respect to the GSEs, to assume the role of dictating the corporate and internal organizational structures of lenders that sell mortgages to the GSEs. ... While OFHEO may well have a safety and soundness basis to require the GSEs to apply various checks on appraisals obtained in connection with loans sold to them, OFHEO crosses the line into regulation of entities outside of its domain when it dictates requirements—as here—on the corporate structures and internal organizations and operations of banks and other lenders that sell loans to the GSEs.”
- Since the GSEs dominate the mortgage market, Dugan said most lenders would have to change their appraisal practices. He argued that Cuomo does not have the authority to dictate national bank practices. “State authorities may not interfere with national banks’ real estate lending authority under federal law by coercing third parties not to do business with them,” wrote Dugan. “Because the provisions of the

code obstruct, impair, or condition the exercise of national real estate lending powers, they are nullified by operation of the Supremacy Clause” of the National Bank Act.

- Dugan also argued that the consequences of the settlement would undermine, rather than enhance, the quality of appraisals, and would raise the costs for both lenders and borrowers and disrupt the mortgage appraisal process. “A disruption of this type is not only unnecessary, but it comes when the housing and mortgage markets are under significant stress,” wrote Dugan. “By impeding availability of sound mortgage credit, the code directly conflicts with various ongoing federal efforts to restore credit availability and confidence in the housing and mortgage markets.” Dugan continued, “Whatever OFHEO might think about the comments received, it is paralyzed from acting on them, because the agreements subject its ability to react to the consent of the NYAG. This outcome — the imposition of binding requirements without the opportunity for meaningful participation by the lenders who are directly affected by them and without the ability to react to comments received — violates fundamental requirements [of the Administrative Procedures Act].”
- If oversight of the appraisal process is to be revamped, Dugan suggested that Congress should make that call, not OFHEO or a state attorney general. Dugan’s letter is the most recent sparring between the OCC and the New York Attorney General’s office over jurisdiction and preemption authority, which the comptroller’s office has steadfastly and successfully protected to date.
- In an interview with *American Banker*, Julie Williams, OCC’s senior deputy comptroller and chief counsel at the OCC, said, “[Lenders] may want to evaluate the prospect of litigation, and there could be some congressional involvement.” Williams also was critical of OFHEO for “promulgating standards with such significant and widespread application pursuant to this private settlement process.” Steve O’Connor, senior vice president of government affairs for the Mortgage Bankers Association, said, “Clearly, to the extent that a party out there is contemplating litigation, [Dugan’s letter] would bolster their prospects of a successful outcome. I think this letter will have a significant impact, because it’s a federal banking regulator weighing in on the substance and process of the agreement, saying it’s ill conceived and should be voided, and I think that’s a powerful statement.”
- OFHEO spokeswoman Stefanie Mullin said, “We appreciate their thoughtful comments. OFHEO is reviewing the letter from Comptroller Dugan and notes the concerns the OCC raised with the enterprise appraisal code that remains under consideration and, especially, the unintended consequences pointed out in the letter.”
- Industry observers said that Dugan’s letter may provide some traction on Capital Hill for consideration of an amendment proposed by Senator Elizabeth Dole (R-NC), which would require new appraisal standards be set by federal regulation, as opposed to state regulation. However, Senator Chuck Schumer (D-NY) has voiced strong opposition to such an amendment and strong support for Cuomo’s efforts. Schumer said, “Attorney General Cuomo is doing the right thing here. This agreement cracks

down on abuses that federal regulators, to this day, have not seen fit to address.” In a May 28th interview, Lockhart said, “I don’t think we need to get into” the jurisdictional issues. From my standpoint that’s not the issue. The issue really is, can Fannie and Freddie create a code for appraisers that is helpful, and that’s where they’re going.” (*American Banker*, Cheyenne Hopkins, 05/28/08; *Reuters*, 05/27/08)

Federal Reserve study concludes that the best way to help troubled borrowers is to make the mortgage payments “temporarily affordable” but not reduce the mortgage balance

- In a May 30th study released by the Federal Reserve of Boston, Christopher L. Foote, Kristopher Gerardi and Paul S. Willen wrote, “Millions of Americans have negative housing equity, meaning that the outstanding balance on their mortgage exceeds their home’s current market value. Our data show that the overwhelming majority of these households will not lose their homes. Our finding is consistent with historical evidence: we examine more than 100,000 homeowners in Massachusetts who had negative equity during the early 1990s and find that fewer than 10 percent of these owners eventually lost their home to foreclosure. This result is also, contrary to popular belief, completely consistent with economic theory, which predicts that from the borrower’s perspective, negative equity is a necessary but not a sufficient condition for foreclosure. Our findings imply that lenders and policymakers face a serious information problem in trying to help borrowers with negative equity, since it is difficult to determine which borrowers actually require help in order to prevent the loss of their homes to foreclosure. We review several policy proposals. Proposals to address this information problem either drastically limit the effectiveness of the policy, or lead to serious moral hazard problems. We argue that the most promising policy proposals focus on making mortgage payments temporarily affordable, without permanently reducing the outstanding balance owed. ... Forbearance programs that allow borrowers to delay, but not to avoid eventually repaying the mortgage in full can help at-risk borrowers without generating serious moral hazard problems, involving assistance, funded at the public’s expense, to those who do not need it.” The study can be found at <http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.htm>. (*Federal Reserve Bank of Boston Public Policy Discussion Paper No. 08-3*, Christopher L. Foote, Kristopher Gerardi and Paul S. Willen, 05/30/08)

OTS Director Reich proposes (again) that all mortgage originators should report to a single regulator – the OTS

- During a May 29th speech to the New Jersey League of Community Bankers, OTS Director John Reich reiterated his position that all mortgage originators should fall under a single federal regulator—the OTS, which has the “most experience of any regulatory agency for oversight and supervision of mortgage banking operations.” Reich said, “We must establish a level playing field with the same rules for all competitors in the home mortgage sector, so standards do not fall to the lowest

common denominator.” Reich proposed a partnership between federal and state regulators to set and enforce minimum mortgage standards with the goal of uniform nationwide regulation of all lenders and brokers. “I think it has become clear that we need federal oversight to ensure that mortgage banks and brokers compete by the same set of standards as insured depository institutions,” said Reich. He argued that all mortgage originators should comply with “basic credit principles, such as a reasonable assessment of the borrowers’ ability to repay.” The OTS Director’s proposal to expand OTS’s role in the mortgage market was a direct “shot” at Treasury Secretary Paulson’s proposal to disband OTS and the thrift charter as part of a broad reorganization of the regulatory framework for the U.S. financial markets. (*Dow Jones Newswires*, Michael R. Crittenden, 05/29/08; *Bureau of National Affairs*, Thecla Fabian, 05/30/08)

Obama tours Western swing states, promoting his housing plans

- Senator Barack Obama (D-IL) has been promoting his plans to address the housing crisis in a tour of Western swing states, which have been hardest hit by the mortgage crisis. At a May 22nd roundtable discussion at the College of Southern Nevada in North Las Vegas, Obama outlined his plans to provide a \$30 billion economic-stimulus package to help homeowners, which included a \$10 billion foreclosure prevention fund to help homeowners stay in their homes and \$10 billion in relief to state and local governments hit hardest by foreclosure. He also said he would modify bankruptcy law so families could have the terms of their mortgages re-negotiated and would provide middle-class Americans a 10% mortgage tax credit. Obama said he strongly supports the Dodd-Shelby housing rescue bill, which his opponent, Senator John McCain (R-AZ), has yet to endorse. “[Senator] John McCain has struggled to come up with a real plan to address the housing crisis,” said Obama. In April, McCain called for aggressive federal intervention to stabilize the mortgage market and \$3 billion to \$10 billion in federal assistance. (*Wall Street Journal*, Amy Chozick, 05/28/08)

FASB mulls the “reputational risk” in securitizations

- At a June 4th meeting, the Financial Accounting Standards Board said that banks that sponsor asset-backed securities may soon have to tell investors about the risks involved in the transactions they’ve put together, even if the risks only relate to their reputations. FASB member Thomas Linsmeier argued that a sponsor of a securitization should always be assumed to have a significant variable interest in the deal. “If an entity sponsors an SPE [special purpose entity], I think the original belief ought to be that they are getting some benefit out of the creation of the SPE,” said Linsmeier. “I think it would be better that users understand who that sponsor is and what their potential involvement is in all cases.” Even if the bank has acted only as a sponsor and received a fixed fee on the transaction, the sponsor faces other exposure such as an implicit guarantee to back the securitization or a risk to its reputation. “If

you're a sponsor, presumptively you've got reputational risk, so tell us about the deals you've done," said FASB member Leslie Seidman. Board chairman Robert Herz said he wants the final rule to have a "much stronger point about reputational risk." FASB's pending rule change on QSPEs could take effect as early as 2009.

- Previously, accounting rules have required securitizations to be placed on a sponsor's books if the sponsor could determine it bore the majority of the risks or rewards associated with the issue. However, banks have surprised investors by revealing that they faced bigger-than-expected risks from the off-balance sheet assets they created during the credit crisis over the past 12 months. For example, Citigroup, Inc. took \$49 billion of structured investment vehicles onto its balance sheet last year, which few investors were aware existed. (*Reuters*, Emily Chasan, 06/04/08)

A closer look at "reputational" risk

- In a May 29th *Market Commentary*, Joseph R. Mason, associate professor of finance at Drexel University's LeBow College of Business, wrote, "While banks transferred interest rate risk ...into default risk, they also sought to move risk off their balance sheets in various manners. The most obvious of these was loan sales, but those didn't leave the bank upside risk in the event that loans performed very well. Hence, securitization, through all its variations of RMBS, SIVs, ABCP, and ABS, was a far more attractive alternative. But repeated reliance on securitization necessitated forming a model wherein no securitized investor would lose, or else they would not invest next period. Hence, banks helped develop accounting and regulatory rules that allowed them to replace non-performing loans in the pools with good loans so that investors would always be made whole except in the rare occasion that the bank failed, too. In essence, therefore, banks claim to have turned default risk into reputational risk, but the dollar amount of risk is the same."
- "Furthermore, the 'reputational' risk is really only run-of-the-mill operational risk in that the bank is found to have obligations that extend beyond its contractual relationships. Even the best minds applied to Basel II have struggled with operational risk, ultimately settling on an ad hoc approach that will have to be revised (shortly). In SIVs and ABCP, banks also assumed hard-to-measure liquidity risk, which was also treated very lightly in Basel II because, like operational risk, liquidity risk is not well-understood. Banks and non-banks also took market risk on the funding (liability) side when they sold short maturity liabilities to fund long maturity investments. Because such risk is ill-understood in the banking sector, regulated commercial banks rely crucially upon a government safety net to maintain stability. It should not be surprising, therefore, that such stability was lacking in the non-regulated sector during the most recent crisis."
- "In summary, risk is fungible. It can not only be bought and sold, but it can also be transformed into more or less easily measured forms that, if arbitrage boundaries hold (as they should), contain the same dollar exposure. If we fail to learn this key lesson

of the last several decades of deregulation then we have failed as researchers, regulators, and indeed, market participants. Remaining vigilant regarding those fundamental principles of risk will be a key function of regulatory functions in the modern financial marketplace.” (*Market Commentary*, Joseph R. Mason, 05/29/08)

One really big Ponzi scheme

- In a June 4th *Market Commentary*, Joseph R. Mason, associate professor of finance at Drexel University’s LeBow College of Business, wrote, ... [T]he fundamental problem with securitization is that there is no natural home for junior and equity residuals created in securitizations. Hence, those portions were securitized and re-securitized and re-re-securitized like a game of hot potato: whoever was left holding them in the end got burned. As a result, banks hedged the exposures with even more complex hybrid and synthetic securities, even though the investment characteristics of those securities have not been tested.”
- “Hence, ...the present market difficulties are a crisis of structured finance, not just subprime mortgages. Regulators therefore have before them the task of catching up with roughly thirty years of financial industry development before fostering liquidity and stability in all manner of complex debt that has come to dominate the system. Until they do so, the industry will be subject to some **\$60 trillion of unreported illiquid counterparty risk** [emphasis added], an amount far too vast to be resolved by bailouts. I hope we see some movement soon.” (*Market Commentary*, Joseph R. Mason, 06/04/08)

Subprime and beyond

- “The decline in housing prices is still accelerating and is going to overshoot on the downside the same way it overshoot on the upside. We are not yet halfway in the decline in housing prices. There will be at least 12 more months of increases in foreclosures.”— George Soros, May 21, 2008 at the London School of Economics (*American Banker*, Allison Bisbey Colter, 05/29/08)
- A dismal jobs report showing the jump in the unemployment rate from 5.0% to 5.5% in April dashed hopes of a recovery of the housing market in 2008 and raised concerns that job losses may drive mortgage default rates even higher. Wells Fargo & Co. senior economist Scott Anderson said the jobs report confirms that the downturn in the housing market will be prolonged. Anderson expects house prices to continue to decline in 2009 with home sales bottoming out at the end of 2008 or first quarter of 2009. “This is what we were afraid of—a weakening of the jobs market which will compound problems in the housing market, said Anderson. As a result of the up-tick in unemployment and an (one-day) \$11-a-barrel up-tick in oil prices, the Dow Jones Industrial average was down 395 points or 3.1%, as banks’ and mortgage insurers’ sold-off strongly. (*National Mortgage News Daily Briefing*, 06/06/08)

- The Mortgage Bankers Association reported that home mortgage foreclosures and seasonally adjusted delinquency rates reached a 29-year high in the first quarter of 2008. On March 31st, the seasonally adjusted delinquency rate for single-family mortgages rose to 6.35%, up 42 basis points from December 31, 2007 and 151 basis points from one year ago. The increase in the overall delinquency rate was driven by increases in the number of loans 60 and 90 days past due, primarily in California and Florida. On March 31st, the percentage of loans in the foreclosure process was 2.47%, an increase of 43 basis points from year-end 2007 and 119 basis points from one year ago. The percentage of loans on which foreclosure actions were started during the quarter was 0.99% on a seasonally-adjusted basis, 16 basis points higher from December 31st and 41 basis points higher from a year ago.
- “While the foreclosure start rates were up for all types of mortgages, a reflection of the decline in home prices, the magnitude of the national increases is clearly driven by certain loan types and certain states,” said Jay Brinkmann, MBA’s Vice President for Research and Economics. “For example, while subprime ARMs represent 6% of the loans outstanding, they represented 39% of the foreclosures started during the first quarter. Prime ARMs represent 15% of the loans outstanding, but 23% of the foreclosures started. Out of the approximately 516,000 foreclosures started during the first quarter, subprime ARM loans accounted for about 195,000 and prime ARM loans 117,000, but the increase in prime ARM foreclosures exceeded subprime ARM foreclosures with increases of 29,000 and 20,000 respectively over the previous quarter.”
- According to MBA, “The problems in California and Florida are extraordinary and they are the main drivers of the national trend. The quarterly rate of foreclosure starts on subprime ARM loans in California was 9.24%. This rate, combined with Florida’s rate of 8.25%, drove up the national average foreclosure start rate to the point where 43 states were below the national average of 6.32%. California saw a total of approximately 109,000 foreclosure starts and Florida 77,000. The next highest states were Texas, Michigan and Ohio with between 24,000 and 20,000 each.” (Mortgage Bankers Association *Press Release*, 06/05/08)
- According to recent news reports, celebrities in the danger of losing their homes to foreclosure include former professional baseball player Jose Canseco, singer/entertainer Michael Jackson, television personality Ed McMahon, former heavyweight boxing champion Evander Holyfield, and Representative Laura Richardson (D-CA). Foreclosures have even hit the Hamptons, where five towns on the East End reported 415 lis pendens [the first legal foreclosure notice], an increase of 30% over the last six months, and 42 foreclosure auctions were held between October to March for an increase of 40% over the past six months. (*Newsday.com*, Randi F. Marshall, 06/03/08; *CBSNews.com*, 06/05/08; *National Mortgage News*, Paul Muolo, 06/06/08)

- Mortgage losses increased as loan delinquencies soared at commercial banks, thrifts and credit unions during the first quarter of 2008. According to FDIC, U.S. banks and thrifts set aside a record \$37.1 billion to cover loan losses and other credits during the first quarter, as the industry's earnings fell 46% to \$19.3 billion during the first quarter. The number of "problem" banks with aggregate assets of \$26.3 billion, increased from 76 to 90 [on March 31st], while the number of "problem" thrifts increased from 12 to 17 [at the beginning of June]. FDIC chairwoman Sheila Bair, said, "While we may be past the worst of the turmoil in financial markets, we're still in the early stages of the traditional credit crisis you typically see during an economic downturn. What we really need to focus on is the uncertainty surrounding the economy . . . and again it is all about housing." Similarly, loan losses grew 34% at credit unions during the first quarter, as mortgage delinquencies continued to increase. (*Financial Times*, Joanna Chung and Saskia Scholtes, 05/30/08; *Dow Jones Newswires*, Michael R. Crittenden, 06/05/08; *Credit Union Journal*, Ed Roberts, 06/04/08)
- Standard & Poor's reduced the ratings of MBIA and Ambac Financial from AAA to AA, citing concerns over a lack of business prospects and continuing declines within the residential mortgage market. "The rating actions on the companies reflect our belief that these entities will face diminished public finance and structured finance new business flow and declining financial flexibility," said S&P. "In addition, we believe continuing deterioration in key areas of the U.S. residential mortgage sector and related CDO structures will place increasing pressure on capital adequacy." (*HousingWire*, Amy McAlister, 06/05/08)
- Separately, Standard & Poor's reduced its outlook for bank and brokerage stocks, citing the weakening U.S. economy and potential for more writedowns and rising credit losses. The rating agency cut its ratings on investment banks Lehman Brothers, Merrill Lynch, and Morgan Stanley, and cut its outlook on [commercial banks] Bank of America, Citi, and JPMorgan Chase. "The outlooks on the large financial institutions sector in the U.S. are now predominantly negative," said S&P, citing "continued weakness in the investment banking business [for Lehman, Merrill, and Morgan Stanley], ...[given the] vulnerabilities of the wholesale and less diversified model of funding for the specialized investment banks." (*Fortune's Daily Briefing Blog*, 06/02/08)
- On May 30, the HOPE NOW Alliance announced the highest monthly number of loan workouts—182,901 in April—since the formation of the Alliance in July 2007. "The numbers clearly demonstrate that HOPE NOW is succeeding in helping homeowners avoid foreclosures and stay in their homes," said the Alliance's executive director Faith Schwartz. As of April 30th, the group had participated in 1,558,854 mortgage workouts since the Alliance was formed. (*Bureau of National Affairs*, Thecla Fabian, 06/02/08)
- The Federal Reserve of New York is testing a pilot program, called the "Lawyers' Foreclosure Intervention Network," which would recruit and train lawyers to counsel

distressed homeowners on a pro bono basis. The NY Fed said it is encouraging financial institutions “to waive, to the extent possible, conflicts of interest that might arise [for participating lawyers]. The number of legal aid attorneys specialized in this area of law is small, particularly compared with the growing need for legal advice from distressed homeowners.” (*American Banker*, Marc Hochstein, 05/28/08)

- U.S. Attorney General Michael B. Mukasey ruffled a few feathers on Capitol Hill, when he repeated his earlier stance that he does not plan to form national task force to investigate the mortgage crisis and related mortgage fraud. At a June 5th press conference, Mukasey called the mortgage problem local in nature and didn’t warrant the same type of response the Justice Department mustered to the 2002 collapse of Enron. The AG steadfastly asserted that state-level responses to the mortgage problem are more effective. House Financial Services chairman Barney Frank (D-MA) called Mukasey’s position “disappointing.” He added, “Enron didn’t cause a worldwide recession. This has more victims.” Senate Banking Committee chairman Christopher Dodd said, “[M]illions of borrowers were lured into mortgages they could not afford by unscrupulous lenders and brokers. The administration ought to be aggressively pursuing the perpetrators of these abusive practices.” (*HousingWire*, Paul Jackson, 06/06/08)
- In a speech to the New Jersey League of Community Bankers, OTS director John Reich outlined some of the lessons learned from the housing crisis, which includes the importance of a proactive media plan by the mortgage industry. Reich said, “Negative information, even if untrue, is spread instantaneously and can lead to a loss in confidence. There is typically little recourse if short sellers, press, Internet bloggers, analysts, or others make statements based on limited or incorrect information that causes an adverse impact.” (*American Banker*, Joe Adler, Stacy Kaper, and Cheyenne Hopkins, 06/02/08)
- In *National Mortgage News*, Paul Muolo writes, “If you’re wondering why Americans can’t afford downpayments anymore consider this: According to the National Foundation for Credit Counseling, 36% of adults have *no* savings outside of retirement...” (*National Mortgage News*, Paul Muolo, June 6-7, 2008)

OFHEO is awarded the prestigious “CEAR” award for fiscal responsibility and accountability

- On May 28th, OFHEO was awarded the Certificate of Excellence in Accountability Reporting (CEAR), the highest standard of federal fiscal accountability reporting, by the Association of Government Accountants. This award is given to federal government entities whose Performance and Accountability Reports (PARs) demonstrate “the highest standards of clarity in communicating financial information and demonstrating accountability.” OFHEO director James B. Lockhart, III, said, “As regulator of two of the world’s largest financial institutions, OFHEO works to set an example of the highest levels of fiscal responsibility, transparency and

accountability. In this time of turmoil in the mortgage market, the successful remediation of these companies from their accounting problems is a critically important result. The CEAR Award shows that we have helped lead by example and I am honored to accept this award on behalf of our dedicated staff.” (*OFHEO Press Release*, 05/28/08)

Senate Banking Committee appears poised to confirm three new SEC members, but Chairman Dodd sees “little urgency” to move on nominations to the Federal Reserve

- The Senate Banking Committee appears to be on track to confirm three new members—two Democrats and one Republican—to the Securities and Exchange Commission. Committee chairman Christopher Dodd (D-CT) said, “I’d like to move forward if we can—as soon as we can [on the SEC nominations].” The two Democratic nominations include Elisse Walter, a SVP of regulatory policy and programs at the Financial Industry Regulatory Authority, and Luis Aguilar, a partner with the Atlanta, GA law firm, McKenn Long & Aldridge. The Republican nominee is Troy Paredes, a law professor at Washington University. (*CQToday*, Benton Ives, 06/03/08; *Bureau of National Affairs*, Richard Hill, 06/04/08)
- When asked by reporters whether the May 28th announcement that Federal Reserve Governor Frederick Mishkin would step down at the end of August increased the urgency for Senate action on Fed nominees, Dodd responded, “Not necessarily.” In response, White House spokeswoman Emily Lawrimore called it “irresponsible” for the Fed to be left with only four sitting governors. “During a time of economic uncertainty, now is not the time for Senator Dodd to allow narrow partisan interests weaken this critical agency,” said Lawrimore. (*Dow Jones Newswires*, Michael R. Crittenden, 06/03/08; *Bureau of National Affairs*, Aaron Lorenzo, 05/29/08)

Steven B. Harris is named to the Public Company Accounting Oversight Board

- Steven B. Harris, a former Senate Banking Committee senior staff member, was named as a member of the Public Company Accounting Oversight Board (PCAOB) effective June 9, said SEC chairman Christopher Cox. Harris is currently SVP and special counsel for APCO Worldwide. From 1981 to 2007, Harris served on the Senate Banking Committee staff. (*Bureau of National Affairs*, 06/05/08)

Fannie Mae

Fannie Mae boosts its mortgage counseling program

- Fannie Mae is extending its temporary program to reimburse mortgage servicers for counseling costs through the end of the year. Previously, the program was scheduled to end on May 31st. The company also is increasing the maximum amount of reimbursement from \$100 to \$150 per case, effective June 1st, to servicers participating in the HOPE Now Alliance. (*Reuters*, Al Yoon, 05/27/08; *American Banker*, Allison Bisbey Colter, 05/29/08)

Fitch Ratings downgrades \$9 million of Fannie Mae REMIC pass-through certificates

- On June 2nd, Fitch Ratings affirmed \$44.2 million and downgraded \$9 million of Fannie Mae REMIC pass-through certificates. Fannie Mae's current corporate ratings of AAA/F1+ are not affected by the downgrades on Fannie Mae's REMIC Trust series 1998-W3, because the company's exposure to the trust is insignificant. The ratings action reflect the relationship of credit enhancement to future loss expectations affecting the specific transaction. (*BusinessWire*, 06/02/08)

Friends of Angelo: Former Fannie Mae executives Jim Johnson and Franklin Raines

- While most of Countrywide Financial's mortgages are made through its vast network of loan officers, brokers and call centers, a select few have gotten their mortgages a special way—through Countrywide's CEO Angelo Mozilo. These "friends of Angelo" (or FoA) include two former Fannie Mae chairmen—James Johnson and Franklin Raines. In an investigative report, *Wall Street Journal (WSJ)*, reporters Glenn R. Simpson and James R. Hagerly question if Johnson and Raines received below market rate loans (relative to prevailing rates at the time the mortgages were issued) from Countrywide. If so, a Fannie Mae spokesman told the *WSJ* that the GSE's code of conduct [in place since the early 1990s] "requires the disclosure of potential conflicts of interest and prohibits acceptance of substantial gifts, including loans with preferential terms, from an organization seeking to do business with the company without prior review and approval by the company." One former Countrywide executive told the *WSJ* that the lender sometimes gave "moderate" concessions on rate for customers whose loans were handled by Mozilo and other top officers.
- According to records reviewed by the *WSJ*, Johnson received more than \$7 million in loans from Countrywide since 1998 with the first loan issued before his departure from Fannie Mae. Johnson borrowed \$392,950 on a row house in Washington's Dupont Circle with a five-year balloon with a fixed rate of 6.375%. At the time, rates

for such loans ranged from 6.2% to 6.5%, according to a survey of lenders by HSH Associates. Subsequent borrowings by Johnson from Countrywide included (1) a five-year, 5.25% balloon loan for \$1.3 million for a home in Palm Desert, CA in November 2001, when prevailing rates averaged 6.0% to 6.2%; (2) a five-year, 3.875% balloon loan for \$971,650 for a house in upper northwest Washington, DC in June 2003, when prevailing rates averaged 4.3% to 4.9%; (3) a \$5 million home equity line of credit in January 2006 on Johnson's residence in Ketchum, ID; and (4) a \$1.01 million home equity line of credit along with an executed \$1 million promissory note in connection with the Ketchum, ID residence. Brian Brooks, Johnson's lawyer, told the *WSJ* reporters, "It appears that the arrangements you cite are well within the band of standard industry practices with regard to price and structure of loans to borrowers of Mr. Johnson's background."

- Raines, who succeeded Johnson as chairman and CEO of Fannie Mae at the end of 1998, was a repeat customer of Countrywide during his tenure with the GSE. In December 1999, Raines obtained a \$1 million loan on his house in upper northwest Washington, D.C. and refinanced the loan in November 2001. Property records don't reflect the loans' interest rate(s) for either mortgage. In April 2003, Mr. Raines refinanced his mortgage again with Countrywide, obtaining a 10 year balloon loan with a rate of 5.125%. According to HSH, the prevailing rate for such a 10-year balloon was 5.5% to 5.7%. On July 31, 2003, Raines refinanced the mortgage and obtained a rate of 4.125%, when prevailing rates averaged about 5.1% to 5.4% [according to HSH data]. The *WSJ* reporters wrote, "While [Raines'] rate appears low, the variables in rate setting make it impossible to determine from publicly available information whether he got better terms than other borrowers with similar characteristics." (*Wall Street Journal*, Glenn R. Simpson and James R. Hagerty, 06/07/08)

Jim Johnson: "chairman of the universe" [and kingmaker]

- In a June 3rd article in the *MinnPost.com*, Doug Grow wrote a profile of Jim Johnson, former chairman of Fannie Mae who recently became "tightly tied to the presidential campaign of Barack Obama." Grow wrote, "...Following the failed 1984 presidential bid [for Walter Mondale in which he served as campaign chairman], Johnson went about the business of making money. He joined with diplomat Richard Holbrooke in founding Public Strategies, which gave political advice to business clients. Later, he did similar work with Sherman Lehman in D.C. Holbrooke and Johnson remain together now, as vice chairmen of Perseus, an international merchant bank and private equity fund management company."
- "In 1990, Johnson went to work for [Fannie Mae] and quickly became its \$5 million-a-year chairman. His compensation rose to a reported \$21 million by his final year, 1998. But Johnson did more than make a lot of money at Fannie Mae. He increased his connections — and his access to power — by establishing Fannie Mae foundations that spread around millions of dollars. Homeless shelters, colleges,

hospitals all benefited from Fannie Mae Foundation money. Given Fannie Mae's largess, it's likely no coincidence that Johnson was chairman of the Kennedy Center and the Brookings Institution at the time he was heading Fannie Mae. During this period, he was known in D.C.'s inner circles as 'chairman of the universe.'"

- "In a 1997 article critical of Fannie Mae's lavish ways, *Slate* called Johnson 'Washington D.C.'s Medici,' a reference to the Italian family that, beginning in the 13th century, produced popes, prospered in banking and sponsored the arts throughout Europe. '... But he is not a philanthropist with his own money,' the *Slate* article said. 'The fount of Johnson's generosity is Fannie Mae's foundation... What makes Fannie Mae special is that it is essentially the taxpayers' money that Johnson is giving away.' When he left his job at Fannie Mae, which long has had a reputation as a cushy landing spot for the political class in Washington, he was serenaded by 16 members of the Benson High [MN] band, which had been flown to D.C. at Fannie Mae's expense. He also received a number of perks, including a \$600,000 annual consulting fee."
- "It should be noted that Johnson got out of Fannie Mae while the getting was good. Since his leaving, the massive, quasi-public home mortgage organization has been buffeted by negative headlines. Accounting scandals, dating back to Johnson's era, have been followed by recent news that Fannie Mae has lost more than \$3 billion in the housing slump. Johnson never has been accused of being part of Fannie Mae's accounting irregularities."
- Johnson, 64, who was once a member of Friends of Hillary, now has the job of vetting potential vice presidential candidates for Obama, a duty he performed for Walter Mondale in 1984 and John Kerry in 2000. Grow wrote, "...[T]he selection of Johnson to be a part of the inner circle seems to run contrary to Obama's campaign theme of 'change.' Johnson represents Washington power as it's always been. He's the consummate insider. He's very rich, very connected and very much behind the scenes. Johnson's wealth and politics appear to be related..." (*MinnPost.com*, Doug Grow, 06/03/08)

Freddie Mac

Freddie Mac teams up with Virginia Governor Timothy Kaine to offer mortgage clinics

- Freddie Mac has agreed to help the Virginia Foreclosure Prevention Task Force offer complimentary mortgage clinics to state residents, designed to counsel troubled borrowers on loss mitigation options and provide borrowers access to certified housing counselors. “In this time of uncertainty in the housing industry, Freddie Mac provides much needed stability and liquidity to the housing finance system,” said Virginia Governor Timothy Kaine. “I appreciate the company’s commitment to solutions as a member of the Virginia Foreclosure Prevention Task Force and as a co-sponsor of these mortgage clinics around the Commonwealth.” (*Default Servicing News*, Kerri Panchuk, 06/02/08)

Freddie Mac adds New Vista Management Brokers to its national network of real estate professionals to help market its real estate owned homes

- On May 29th, Freddie Mac announced that it has added New Vista Management Brokers, a network of multicultural real estate brokers, to the company’s existing national network of real estate professionals to market HomeSteps’ inventory of real estate owned homes. [HomeSteps is the REO sales unit of Freddie Mac.] New Vista uses a diverse network of minority brokers, along with nonprofit counseling agencies, to create awareness among first-time and minority buyers of the availability of REO properties as a housing option. “New Vista is excited to work with HomeSteps. By matching our network of top multicultural real estate professionals with HomeSteps homes, we believe we can market and sell these homes to a diverse consumer base in a responsible way that will help reinvigorate neighborhoods affected by the recent real estate downturn,” said Jim Park, President and CEO of New Vista. (*PR Newswire*, 05/29/08)

The Freddie Mac Foundation and Enterprise Community Partners are pioneering “the development of adaptable, replicable resident services models” for AH projects

- In a May 15th speech at the 2008 Resident Services Symposium, Ralph F. Boyd, Jr., chairman of the Freddie Mac Foundation said, “...[F]ocused and calibrated investments in well-conceived and well-executed resident services programs can be very effective in helping transform the socio-economic fortunes of financially stressed and vulnerable families. This is good news; but the even better news is that the same thing is also true for depressed and financially underperforming properties as well, and for the communities where they’re located.”

- “So with this in mind, our challenge then is to secure adequate, sustainable funding for resident services – and it’s a challenge that’s more difficult in an environment where – as now – capital is constrained. And in order to meet that challenge, we really have to alter the thinking of property managers, affordable housing developers, investors, planners and policy makers about what’s achievable and how. This often will mean that we have to present new approaches, and a different vision of how to deploy resources to achieve human gain – human gain that brings with it the likelihood of improved financial performance of affordable developments. And of course, the more evidence-based these approaches and the resulting outcomes are, the better our chances are for attracting the community investment capital we need.”
- “...[T]he [Freddie Mac] Foundation has supported, with Enterprise [Community Partners], the development of an adaptable, replicable resident services model. And going forward, Freddie Mac and the Foundation are sharpening our mission-critical focus on eliminating homelessness, stabilizing families in crisis, and meeting the challenge of making safe, decent and affordable housing more achievable for those who need it most.”
- “Helping create effective, replicable (and ideally scaleable) resident services programs is an important part of this work. In fact, in an effort to improve the programs we support and be more responsive to residents’ needs, we recently partnered with several high performing non-profits to add a new health and wellness component to our resident services menu. We’re now piloting that health and wellness module at certain National Housing Partnership Foundation properties in New Orleans. And I should say that we’re very excited about the prospects for this module, and about the work Enterprise is doing with us to make it scaleable, replicable, and right-sized for developments with varying budgets and differing appetites for spending on resident services programs.”
- “And we’re also excited about a current partnership we have with NeighborWorks to pilot a comprehensive family asset-building program, which includes a new ‘coaching’ component for residents at affordable rental sites. Our first pilot is at the Arlington Housing Corporation development, across the river in Arlington. We’re fortunate that AHC also is a long-standing partner of our Foundation.”
- “...[O]ver the years we’ve seen how resident services investments in a variety of different settings help transform vulnerable families’ lives. ...[W]e will continue our commitment to supporting resident services – and we’ll encourage and incent governments and high performing nonprofits to continue to partner with us to provide effective, supportive services to affordable housing residents. *(Prepared remarks of Ralph F. Boyd, Jr., chairman of the Freddie Mac Foundation, 05/15/08)*

Federal Home Loan Banks

Slowing growth in FHLB advances in first quarter may signal an end of the credit crunch

- With FHLB advances growing only 4.3% in the first quarter, some say that the “heyday” for the System’s bank advances may be coming to an end with the easing of the credit crunch. “It appears to be stabilizing,” said Dave Fisher, the COO for FHLB-Topeka. “We’re seeing advances ... plateauing a bit.” During the first quarter, advances declined at three FHLBs and five Banks reported single-digit growth, while the Cincinnati, Des Moines, and Indianapolis FHLBs continued to report robust growth. While advance volumes may level off, Jim Vogel, the head of fixed-income research at FTN Financial Markets Corp., said demand for advances by the Banks’ larger members will remain strong. “We see the large banks still in sort of a scramble mode,” said Vogel. “They are not in a rebalancing mode just yet.” (*American Banker*, Steven Sloan, 05/27/08)

FHLB-Atlanta refines its system for assessing its members’ risk

- By the end of June, the FHLB-Atlanta plans to replace its existing system of assessing its members’ risk with a new analysis that incorporates a wider range of data, including more detail about the collateral that members have pledged for advances. Chris McEntee, the Bank’s spokesman, said the changes the Bank is making are unrelated to the mortgage market’s problems. “This is something that has been in the works for more than a year,” said McEntee. “It is not a reaction to the current environment. This particular change is in no way a reaction to the current credit environment or any particular borrower.”
- In a letter to members, Kirk Malmberg, the FHLB-Atlanta’s EVP and chief credit officer, and Wes McMullan, an executive vice president and the director of financial management, wrote, “The new system primarily focuses on an institution’s overall financial health, takes into account quality of assets, earnings, and capital position. This change ensures the Bank will continue to provide low-cost funding and competitive returns to member financial institutions while managing and measuring risk effectively.” Although the letter stresses that providing more information about collateral is optional, McEntee said such information will be used to help determine the credit score assigned to each member. (*American Banker*, Steven Sloan, 06/04/08)

FHLB-Des Moines modifies its Affordable Housing Program
to help address the housing crisis

- The FHLB-Des Moines has changed the scoring priorities for its Affordable Housing Program in an effort to help Bank members and community development organizations deal with vacant properties in their markets resulting from foreclosure. The Bank now is awarding additional points for AHP projects involving the resale of foreclosed properties in an effort to hopes of preventing a downward spiral of disinvestment in communities and neighborhoods. The Bank also has suspended its 2008 Urban First-time Homebuyer Fund program and is transferring the program's \$1 million of funding to the current AHP round. (*FHLB-Des Moines Press Release*, 05/20/08)

Protective Life Insurance joins the FHLB-Cincinnati

- The FHLB-Cincinnati has approved Protective Life Insurance as its 14th insurance company member and the 156th insurance company to join the FHLB System. Protective Life, headquartered in Birmingham, AL, has assets of \$26.2 billion. The insurer is eligible for membership in the Cincinnati Bank because of its Tennessee charter. (*American Banker*, Steven Sloan, 06/04/08; *FHLB-Cincinnati Press Release*, 06/03/08)

Ginnie Mae

Does FHA have the capacity to lead a national effort to rescue distressed borrowers?

- President Bush and Congress are all counting on FHA to lead the national effort to rescue troubled borrowers from the risk of foreclosure—but is this agency up the task it's being asked to tackle? Senator Patty Murray (D-WA) expresses confidence in FHA commissioner Brian D. Montgomery, but has reservations about the agency's capacity to handle the job. "[Montgomery] takes his job seriously and, to the best of my knowledge, he does not play politics," said Murray. "But I have some serious concerns about FHA and what it is likely to be asked to do in the future."
- In December, the agency launched the FHA Secure program, which is expected to help approximately 500,000 families refinance their homes—more than three times the number of mortgages financed by FHA in FY2007. Meanwhile, Congress is moving legislation forward that would allow an additional 500,000 homeowners to refinance their mortgages over the next five years. Critics warn that FHA lacks the physical capacity to handle such an extraordinary increase in its business. Agency officials say they need to fill 300 job vacancies by September 30th [the end of its

fiscal year] and may need even more staff to cope with the new caseload from FHA Secure. The legislation moving through Congress would allow FHA to borrow personnel from other agencies to help handle the increased workload. Moreover, FHA's computer systems are antiquated, having an average age of 18 years, with some of its computers being more than 28 years old. (*New York Times*, Rachel L. Swarns, 05/31/08)

- During a recent confirmation hearing, Joseph Murin, the president's nominee to head Ginnie Mae, cautioned the Senate Banking Committee that the agency has only 65 full-time employees and will face "issues" such as understaffing, as Ginnie's issuances increase. Murin, the former president of Mortgage Settlement Network, also said legislation "is needed" to expand the FHA and help more struggling homeowners and pledged that Ginnie Mae will "act diligently" to achieve the best execution of those securitizations. "If it is enacted, I think the investor community will embrace it, from what I am told and what I see," said Murin. (*National Mortgage News Daily Briefing*, 06/04/08)

Steve Ledbetter to serve as Ginnie Mae's SVP for MBS
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- *National Mortgage News* reports that Theodore Foster is leaving Ginnie Mae to join Wells Fargo Bank after 19 years with the agency, and Steve Ledbetter will assume Foster's position as the new senior vice president for mortgage-backed securities. Currently, Ledbetter is Ginnie Mae's director of securities policy and research. In May, Michael Frenz returned to his post as Ginnie Mae's executive vice president, after having been detailed by HUD to work in another section of the department. In recent months, Ginnie's mortgage-backed securities business has picked up issuance totaling \$15 billion in March and \$21.5 billion in May. (*National Mortgage News Daily Briefing*, 06/04/08)

International Mortgage Market

Home prices fall 2.5% in May in the UK, triggering fears of recession

- Home prices in the United Kingdom fell 2.5% in May, their sharpest fall since 1991, when such data began to be tracked. Home prices fell 4.4% from a year earlier, the biggest drop since December 1992, which marked the U.K.'s last recession. Neville Hill, an economist at Credit Suisse, said, "The circumstances we are in now really do raise the risk of recession, compared with two or three months ago." (*Wall Street Journal*, Alistair MacDonald, 05/30/08)

Proposed Government-Sponsored Entity

New GSE proposed to securitize SBA loans

- Can the Small Business Administration, an agency created during the Eisenhower administration, serve the needs of small businesses in the 21st century? In a recent survey by the National Federation of Independent Businesses, 85% of those surveyed said that SBA had no direct impact on their businesses over the last three years. “If the SBA were to go away tomorrow, would anybody really notice?” asks Susan Eckerly, vice president of federal public policy for the National Federation of Independent Business, the most powerful organization lobbying for small businesses in Washington.
- John Arensmeyer, a former Internet company CEO who now heads Small Business Majority, a Democratic-leaning advocacy organization, argues that SBA could be revitalized by creating a secondary market for small business loans. Arensmeyer advocates the establishment of Small Business Capital Corp., a government-sponsored entity similar to Fannie Mae and Freddie Mac, which would buy small business loans that meet certain loan underwriting standards and then pool and sell mortgage-backed securities securitized by these loans. Arensmeyer argues that the creation of a secondary market for small business loans would make these loans less expensive for borrowers and more profitable to lenders. (*The Business Review*, [Albany, NY], Kent Hoover, 06/02/08)

Farm Credit System / Farmer Mac

HORIZONS may be “dead,”
but the effort to expand the Farm Credit System’s reach continues

- In the May issue of Farm Credit Watch, Bert Ely wrote, “The credit provisions of the 2008 Farm Bill are now law, and are free of any HORIZONS provisions. The FCS has suffered a major political defeat as Congress clearly and explicitly refused to expand the FCS’s lending powers. This is a very important victory, not only for the banking industry, but for other tax-paying, private-sector lenders who believe that private capital best serves rural America. However, ...this ignoble defeat has not stopped the FCS and its ally and chief cheerleader, the Farm Credit Administration (FCA), from trying to stretch the Farm Credit Act as far as possible beyond

congressional intent despite Congress's reaffirmation of the FCS's existing statutory limitations.”

- “The FCA has issued for public comment a proposed rule authorizing FCS institutions to make ‘rural community investments.’ This rule would make permanent for all FCS banks and associations the authority to make a much broader range of ‘investments’ than they now can make. In fact, these ‘investments’ will merely be loans the FCS cannot make under the Farm Credit Act. The proposed rule flows from a ‘pilot program’ the FCA launched three years ago under which 37 FCS institutions made these types of investments. This rule, taken together with the processing and marketing rule the FCA recently finalized, as reported in the April FCW, greatly expand the FCS’s off-farm credit-granting powers in a manner Congress never intended.”
- “The proposed community investment rule would authorize FCS lenders to ‘invest’ in (1) ‘essential’ community facilities, (2) ‘basic’ transportation infrastructure, (3) rural communities recovering from disaster, (4) debt securities sponsored or guaranteed by government agencies, (5) debt securities that support the rural development activities of non-FCS financial institutions, (6) rural business investment companies, and (7) venture capital funds that invest in rural businesses that create jobs and economic growth under specific conditions. One wonders what investments would not qualify under this rule.”
- “The proposed rule has broad geographic reach as it would apply to ‘rural communities outside of urbanized areas,’ which the Census Bureau defines as communities having fewer than 50,000 residents. In some cases, the proposed rule would encompass the entire state. The rule also would permit rural investments up to 150% of an FCS institution’s surplus. Since surplus accounted for 81.3% of the equity capital in FCS institutions at the end of 2007, they potentially could bet more than their total equity capital on these investments. Interestingly, the FCA stated that at year-end 2007, the 150% limit equaled \$35.8 billion. That number, though, is more than 150% of the FCS’s surplus of \$21.481 billion on that date, which implies that the FCA definition of surplus exceeds by \$2.4 billion the surplus number the FCS reported at the end of 2007.”
- “By issuing the proposed rule, the FCA has ignored Congress’s clear rejection of any broadening of FCS lending powers—instead the FCA seeks to end-run Congress by regulatorily expanding the FCS’s investment powers. Regulations are merely interpretations of specific statutes and cannot reach beyond that which Congress has authorized. However, by citing numerous statutes to justify the proposed rule, the FCA is engaged in ‘gap-filling’—creating a statutory foundation for the proposed rule where no such foundation exists. Further, many of those statutes relate to FCS lending powers, a strong indication that the FCA is granting the FCS credit-creation powers in the guise of investments rather than loans the FCS clearly cannot make.”

- “The new types of ‘investments’ the FCA wants to authorize will transform the FCS into a government-backed investment bank. However, only Congress can redefine the mission of the FCS, and it has elected not to. More importantly, the FCS is trying to reinvent itself as its original rationale—to provide real-estate credit to farmers who could not obtain such credit elsewhere—has long since disappeared. Not only is it up to Congress to determine if the FCS should be transformed into a government-backed investment bank, but the jurisdiction over such a transformation must lie with the House Financial Services and Senate Banking Committees for they have the legislative jurisdiction over the primary credit-granting institutions in America, including depository institutions, securities firms, and the housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. If the FCS wants to become a government-backed investment bank, then it must prepare itself to be overseen by the Banking and Financial Services Committees. However, the FCS must first make the case that America needs a government-backed investment bank operating apart from an increasingly integrated financial system serving all of America -- rural, urban, and in between. That case cannot realistically be made.”
- “The end of bank-branching restrictions has lessened the distinction between urban and rural banks while electronic technology has erased geographical restrictions in delivering credit and other financial products to rural residents -- whether engaged in agriculture or not. There simply is no need for a specialized, tax- and credit-advantaged farm lender or a similarly advantaged, government-backed investment bank serving rural America, small towns, and cities under 50,000. Instead, the FCS should seek to privatize itself.” (*Bert Ely’s Farm Credit Watch*, Bert Ely, May 2008)

2008 Farm Bill gives Farmer Mac new authority to securitize rural utilities’ loans

- The 2008 Farm Bill includes a provision which allows Farmer Mac to purchase and guarantee securities backed by loans to rural utilities. Farmer Mac will now add loans for electric service and telecommunications to its portfolio of business, which are made by member of the National Rural Utilities Cooperative and the Farm Credit System. Farmer Mac President and Chief Executive Officer Henry D. Edelman said, “We are excited about this addition to Farmer Mac’s guarantee authorities and believe it offers important new business opportunities. While we cannot currently give any assurance as to what level of new business volume may result from it, this expansion of authorities significantly increases Farmer Mac’s potential for future growth. (*PRNewswire*, 05/27/08; *National Mortgage News*, 06/02/08)

Is speculative bubble in farm commodities “about to bust”—and damage the FCS?

- Price volatility in the commodities market is hitting the grain operators, who are trying to survive as margin calls are forcing them to pour much of their operating capital onto the trading floor. As a result, elevators have turned to their lenders to

increase their credit limits and lenders have turned to participations to help these elevators hold their positions.

- Over the past seven years, as much as \$200 billion has poured into commodity-linked index funds, according to the *Wall Street Journal*. Experts estimate that index funds already own all of this year's and next year's crop. Some worry that record commodity prices and the influx of investment dollars into the market aren't sustainable. "The problem is, all this money moves in and out of the commodities market without regard to traditional market forces, supply and demand," commented Bill Dankbar, a commodities broker with North Star Rail Intermodal. American Farm Bureau Federation president Bob Stallman contends that commodity index funds have hijacked the futures market, transforming them from a risk management tool into "an investment vehicle." The result is little market predictability and huge swings in the market that make it difficult for traditional players to compete. Dr. David Kohl, Professor Emeritus in the Department of Agricultural and Applied Economics at Virginia Tech, warned in early April that the speculative bubble is about to burst. "One must be extremely careful of developing long-term investment plans or borrowing based upon these price spikes," said Kohl, who predicted that a crash similar to that in housing market would occur.
- "Banks are nervous ... and they've got reason to be nervous," said Jerry Rowe, manager of Heritage Grain Cooperative. John Blanchfield, Senior Vice President of the American Bankers Association's Center for Agricultural and Rural Banking, concurred with Rowe's assessment. "If you've got loans to an elevator, you want to make sure that people will deliver on these contracts this year," said Blanchfield. "The need for producer education on price risk management has never been higher."
- Esther George, Senior Vice President, Supervision and Risk Management, Federal Reserve Bank of Kansas City, said that the Fed first noticed signs of trouble with elevators in January with wheat growing regions struggling the most. "Grain elevators asking for increased credit lines should expect increased scrutiny by lenders of their business operations, risk management practices, and financial statements," said George. **The Farm Credit System has two times the exposure of commercial banks in loans to grain elevators, she added.** [Emphasis added.]
- National Farmers Union President Tom Buis said, "The public is all too aware of the recent crisis on Wall Street. We don't want a lack of oversight and regulation to lead to a similar crisis in rural America." (*Northwestern Financial Review*, Jackie Hilgert, 05/15/08)
- Separately, the *New York Times* reported that huge investment funds are expanding their investment into agriculture by investing in farmland, fertilizer, grain elevators and shipping equipment. "It's going on big time," said Brad Cole, president of Cole Partners Asset Management, which manages a fund of hedge funds focused on natural resources. "There is considerable interest in what we call 'owning structure' — like United States farmland, Argentine farmland, English farmland — wherever

the profit picture is improving.” These investors are making big bets that their investments can bolster food production during this period of high demand. However, others worry that the newcomers’ focus on profits may have adverse consequences. “Farmland can be a bubble just like Florida real estate,” said Jeffrey Hainline, president of Advance Trading, a commodity brokerage firm. “The cycle of getting in and out would be very volatile and disruptive.” (*New York Times*, Diana B. Henriques, 06/05/08)

Fitch reaffirms the Farm Credit System’s ratings with stable outlook

- Fitch has reaffirmed the long-term Issuer Default Rating (IDR) and short-term IDR of the Farm Credit System at AAA and F1+, respectively. Fitch also affirmed the debt rating for the System’s debt issued by the Federal Farm Credit Banks at AAA with Stable Outlook. According to Fitch, “As of March 31, 2008, systemwide debt outstanding totaled \$165.1 billion, all of which is senior in ranking, and comprised of \$146 billion in bonds, \$1.5 billion in medium term notes and \$17.6 billion in discount notes.” Fitch concluded, “The Stable Outlook reflects Fitch’s view that the Farm Credit System is well positioned to sustain its current financial strength even in a scenario of significant stress.” (*BusinessWire*, 05/28/08)

Postal Service

The U.S. Senate approves USPS nominations

- The Senate has confirmed the nomination of Ellen C. Williams to the U.S. Postal Service’s Board of Governors and Nanci E. Langley to the Postal Regulatory Commission. Williams will be serving her second and final term on the Board of Governors, which will expire on December 8, 2014. She currently serves as a member of the Compensation and Management Resources Committee and the Governance and Strategic Planning Committee. Langley’s term on the PRC will end on November 22, 2012. (*Bureau of National Affairs*, 06/06/08)

Senator Chuck Schumer urges the USPS to “jump start negotiations” with Cappelli Enterprises on the sale of a post office building

- The *Journal News* reports that Senator Chuck Schumer (D-NY) called on the Postmaster General John Potter to expedite an agreement with Cappelli Enterprises on the sale of a post office building. The developer and the City of New Rochelle are working on LeCount Square, a \$500 million development which would include 1.2

million square feet of space for stores, offices, a hotel, and residential homes, which potentially would generate \$4.5 million in local taxes and \$6.6 million in sales taxes. In a letter to Potter, Schumer wrote, “The success of this project is dependent on relocating the existing carrier annex out of its current home to make room for LeCount Square and establishing independent retail space for postal patrons. That why it’s essential that all involved parties jumpstart these negotiations and figure out a quick and financially feasible way to get the job done.”

- The project would be built on the Postal Service’s North Avenue property and would require the demolition of the agency’s building. Since the city cannot use eminent domain for federal property, the parties must reach an agreement before the project can proceed. Joseph Apicella, EVP of Cappelli Enterprises, said the Postal Service’s requests for \$15 million for the building (and relocation and other costs) are too high. “To pay that kind of money for raw land and for a post office, really in this economy, would kill the deal,” said Apicella, who argues that the price should be closer to \$3 million to \$4 million. Craig King, the city’s commissioner of development, said, “The only major issue that is not fully resolved is the relocation of the post office. ... It is really appropriate for Sen. Schumer to get involved.” (*Journal News* [Westchester County, NY], Gerald McKinsry, 05/27/08)

Lots of major issues looming at the USPS
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- In the *Nonprofit Times*, Mark Hrywna wrote, “First Class mail is hemorrhaging cash for the United States Postal Service, Do Not Mail legislation is on the rise around the country, and universal and six-day delivery could look a lot different in a few years. There’s no shortage of issues for those in the mail industry to worry about, and they were all on the table at a conference sponsored recently by the Alliance of Nonprofit Mailers...“There are a lot of major issues looming for the postal system and they’re pretty much on us,” said Tony Conway, executive director of the alliance. “Can you continue to be everything to everybody the way you’ve always been? Can you afford to? Everyone would like to but is it self-sustaining?”
- “Those types of questions should be answered, at least to some degree, by a report from the Postal Regulatory Commission (PRC) on universal service and the postal monopoly [which is scheduled for completion on December 20th]. ...Requests For Proposals were issued last November to help gather information for the report and the PRC plans to solicit comments in the coming months. Congressman Danny Davis (D-IL), a member of the Subcommittee on the Federal Workforce, Postal Service and District of Columbia, said the Dec. 20 deadline for the PRC’s final report might be challenging, but stressed that ‘quality is more important than speed.’ The subcommittee, he promised, will look hard to maintain the Postal Service as a national service. ‘I believe in universal service. I believe in six-day delivery,’ Davis said. ‘But I also understand you can’t get blood from a turnip...but you need to provide good wages. If we’re going to have universal service, we’re going to have to pay for it.’”

- “William Young, president of the National Association of Letter Carriers (NALC), said the key to keeping universal service and six-day delivery is Standard A mail, which two years ago surpassed First Class mail volume for the first time. ‘First Class was the engine that drove growth the last hundred years,’ Young said, and accounting for two-thirds of the Postal Service’s fixed costs. After several years of 6- to 7-percent annual growth, Standard A (third class and bulk) now comprises more than 50 percent of all mail, he said. ‘If we lose Standard A mail, there’s no way we can keep universal service and six-day delivery.’”
- “First class single piece mail declined 4.5 percent last year, the ninth consecutive year it has dropped. Always the bread and butter of the Postal Service, First Class mail never declined from the Great Depression until 2000.”
- “Legislators around the nation have picked up on the same idea of the telemarketing industry’s Do Not Call registry and the number of bills to create Do Not Mail registries has tripled the last few years. Ben Cooper, a lobbyist with Williams & Jensen in Washington, D.C., is part of Mail Moves America, a coalition of about 50 associations and companies created in 2006 to combat Do Not Mail legislation. He said 15 states introduced bills last year, three times as many as just three years ago. It’s an easy message to push for organizations like GreenDimes and Forest Ethics, Cooper said, and they’ve been fairly effective. Legislation is patterned after telemarketing bills, exempting political speech, nonprofits, and prior business relationships from the Do Not Mail registry.”
- “The problem with the bills as Cooper described is that ‘advertising mail is not well defined, and there’s the question of whether mail is blocked to an individual or all mail to a particular address.’ Mailers would face fines of \$500 to \$5,000 per incident if they fail to recognize recipients who opt out, Cooper said, but whether that’s per incident or per mailing is undetermined as well...” Sponsors have withdrawn support of their own bills in New York and Tennessee after being approached, Cooper said, adding that people usually step back and realize what a big part of the economy mail is. “It’s a jobs issues, it’s an economic issue,” he said, encouraging nonprofits, along with “everyone in this postal food chain” to get involved.”
- “Catalog Choice, an effort started seven months ago by environmental organizations, has had close to 10 million opt out by choice, Cooper said. ‘It’s not that we’re pro-junk mail,’ he said, but rather, trying to stop the state regulation of mail. ‘At some point we have to accept advertising is part of what we do and how we pay for things.’
- “Cooper believes the worst of the state legislation is over and the coalition already is gearing up for 2009, but ‘all it takes is one state.’ He worries about states like Vermont—’because they do things like that’—and California. If a ballot petition had to be fought in California, Cooper estimates it would cost ‘tens of millions of dollars.

That's just what could happen; the dynamics in any state could change rapidly.”
(*The Nonprofit Times*, Mark Hrywna, 05/27/08)

Postal Service's study of its universal service obligation causes angst among stakeholders

- In testimony before a House subcommittee, APWU legislative directors Myke Reid expressed the union's concerns about the Postal Regulatory Commission, "which has undertaken, through private contractors, to study the Postal Service's universal service obligation." Reid warned lawmakers that the PRC has hired contractors who have expressed "hostility" to fundamental elements of universal service favor—the postal monopoly and uniform rates.
- Dan Blair, chairman of the PRC, told the panel, "Another critical undertaking this year by the Commission is our work on the Universal Service Obligation Study ... which I know is of interest to Members of this Subcommittee. The Commission's review will allow us to evaluate whether to recommend on any changes to universal service and the postal monopoly. ... The Commission selected the George Mason University School of Public Policy to support completion of the study due to the President and Congress by the end of the year." In a follow-up [May 9th] letter to the subcommittee, Blair added, "Contrary to what some imply, we have not 'contracted out' this responsibility [for an analysis of universal service]. We have hired a consultant to assist the Commission in researching the substantial information and background areas required by the law. However, any conclusions, findings, recommendations or policy determinations will be those of the Commission, not of a consultant. We will be receiving the consultant's work in drafts and components parts, not as a single document. That input will undoubtedly be edited, changed and reconsidered as the report progresses."
- In a rebuttal letter to the subcommittee, APWU President William Burrus reminded lawmakers that the individuals selected as contractors have voiced strenuous opposition to the postal monopoly. Burrus wrote, "We respectfully submit that any report to the Congress based on the work of these individuals must be viewed with the utmost skepticism." (*APWU Web News*, 06/02/08)

Magazines are transitioning from print to Internet distribution

- By 2020, magazines via "e-paper" will be a \$25 billion, as more publications transition to delivery via the Internet rather than a traditional print product delivered by the Postal Service. Through technology and hardware advancements, publishers are finding new ways to redistribute content and give the readers the media formats they're increasing using, such as iPhones, iPods, and PCs. Bo Sacks, publisher of Precision Media Group, said, "[Digital magazines] are a far superior reading experience in that the website is endless. There are billions of pages, where you can drift on tangents stemming from each story." Moreover, it's a cost-efficient ways to

give subscribers information, giving them the opportunity to read news when it happens rather than weeks later when a print magazine arrives in the mailbox.

- In the second half of 2007, paid circulation of consumer magazines fell 1.7% to \$277 million, marking the seventh year of decline after the industry's paid circulation peaked in 2000, according to Audit Bureau Circulation. Concurrently, the number of Internet users [world-wide] at home and work now tops 850 million, a 16.3% increase from 731 million users in late 2006.
- Digital magazines also are a cheaper product to produce. Since its 2005 launch of a digital edition of *Playboy* [magazine], some 1.7 million digital issues have been sold (versus *Playboy*'s annual magazine circulation of 2.6 million). Through its digital edition, *Playboy* has saved \$1.2 million from lower manufacturing, distribution, paper and postal costs. "We're saving publishers money and the forests trees," said Richard Maggiotto, CEO of Zino, which produces the digital edition of *Playboy*. "It can't get much better than that." (*USA Today*, Jon Swartz, 05/28/08)

USPS launches a "green" website

- The Postal Service has launched an "environmentally conscious website," which offers customers tips for recycling junk mail and links for removing their names from mailing lists, along with the opportunity to buy eco-friendly shipping products. The agency also provides advice for marketers looking to cut down on mail. The site includes facts about the USPS's efforts to "limit its environmental footprint." (*Postcom.org*, 06/02/08)

TVA

Senate confirms one of two pending appointments to TVA's board

- The Senate has confirmed Bishop William Graves' reappointment to the TVA's Valley Authority board of directors. Graves' nomination, along with that of Susan Williams of Knoxville, TN, had been held up by Senate Majority Leader Harry Reid (D-NV), over concerns that there were no Democrats on the TVA board. In May, the only Democratic board member retired after serving a 9-year term. Senators Lamar Alexander (R-TN) and Bob Corker (R-TN) retaliated against Reid's move, by placing a hold on the majority leader's nomination for the U.S. Institute of Peace. The Senate has yet to confirm Williams' nomination. (*Associated Press*, 06/05/08)

Senator Sessions (R-AL) urges push for nuclear power

- At the Tennessee Valley Corridor summit, Senator Jeff Sessions (R-AL) said, “Tim is a wastin’. I think we’re in a period where we need to have a renewal of new nuclear power in America.” Sessions praised TVA for restarting its oldest nuclear reactor at Browns Ferry Nuclear Plant, which he said should be a “cash register” for the utility. He also urged TVA to follow through on its plans to build two new nuclear reactors at the Bellefonte site and to finish the old reactors the utility scrapped two years ago. Sessions’ support for the development of more nuclear power was echoed by Senator Bob Corker (R-TN) and Representative Zach Wamp (R-TN). Wamp told the audience that TVA was uniquely positioned as a federal agency to work with the Department of Energy for a nuclear recycling facility in Oak Ridge. “We can be a leader in this Valley in not only producing nuclear power, but in recycling wastes,” said Wamp. (*Chattanooga Times Free Press*, Dave Flessner, 05/29/08)

Three Tennessee cities are among the nation’s top carbon dioxide emitters

- Nashville, Knoxville and Chattanooga rank 6th, 10th, and 13th, respectively, among the Brookings Institute’s ratings of the largest carbon footprints in the nation’s 100 largest metropolitan areas. “The highest emitters are mainly in Southeast,” said Marilyn Brown, a professor of energy policy at the Georgia Institute of Technology. “It has high growth, and its infrastructure is carbon intensive.” According to Brookings study, sprawl, limited public transportation, weather, cheap electricity and low conservation priorities have contributed to the Southeast’s large carbon footprint.
- Anda Ray, TVA’s vice president of environmental stewardship and policy, said the Brookings findings are not surprising. “We do have low-cost electricity and a dual (power-use) peak season [with Southern homes needing heat in the winter and air conditioning in the summer],” said Ray. “The good thing about this report is that it does raise awareness that individuals can do something about it.” (*Chattanooga Times-Free Press*, Pam Sohn, 05/29/08)

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