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The GSE REPORT ™

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Major Events

Fannie Mae and Freddie Mac report staggering third quarter losses:

Fannie Mae reports $29 billion loss for third quarter
and requests equity injection from Treasury

Freddie Mac posts third quarter loss of $25.3 billion
and receives $13.8 billion cash injection from Treasury

The short-term financial outlook for Fannie Mae and Freddie Mac appears bleak

What future role should Fannie and Freddie play in the housing market?

Fannie Mae reports $29 billion loss for third quarter and requests equity injection from Treasury

- Fannie Mae reported a third quarter loss of $29 billion compared with a $2.3 billion loss in the year-ago period. The majority of Fannie's loss was attributable to a $21.4 billion write-off of deferred tax credits and a $9.2 billion charge for credit expenses. The company's seriously delinquent loans (90 days or more) jumped to 1.72%, up 94 basis points from a year earlier, while its level of nonperforming assets, which includes foreclosures, swelled by 37% to $71 billion, or 2.2% of its total guaranty book of business. On September 30th, Fannie Mae had 67,519 single-family foreclosed properties, up 24.6% from June 30th. The company's $298.9 billion Alt-A portfolio, which accounts for 11.1% of Fannie's single-family conventional mortgage credit book of business drove 47.6% of its third quarter credit losses. Fannie estimates that 19% of its Alt-A borrowers are now "underwater" and 9.1% of its entire book has negative equity.

- On September 30th, Fannie reported capital of $9.3 billion, after write-downs, down 79% from its $44.1 billion on December 31, 2007. Fannie also reported a significant decrease in the non-GAAP estimated fair value of its net assets from a positive $35.8 billion on December 31, 2007 to a negative $46.4 billion on September 30, 2008. The main drivers in the severe deterioration in the company's asset values over the nine month period included (i) a non-cash charge of $21.4 billion related to the deferred tax write-off; (ii) a decrease of approximately $36 billion, net of tax, in the fair value of the company's net guaranty assets; and (iii) a decrease in the fair value of the net portfolio for the firm's Capital Markets business.

- Fannie said it has "limited ability to issue debt securities with maturities greater than one year" and that its greater reliance on short term funding has exposed the company to greater interest rate risk. The cost of using derivatives to manage those risks has also increased, Fannie added. The company's financing agreement with Treasury constrains its ability to issue debt, capping the total outstanding amount at 110% of the balance as of June 30—or $892 billion. On October 31st, Fannie had $880 billion in total debt outstanding.

- Through the third quarter, home prices have fallen 9.7% from their peak during the second quarter of 2006 and are projected to fall a total of 19% before hitting bottom, said Fannie Mae. Given the stark drop in home prices coupled with the GSEs' rising delinquencies, Fannie is likely to suffer steep losses in the coming months, which will require the government injecting significant capital into the company that is likely to exceed Treasury's $100 billion equity commitment for each GSE. Fannie warned that its mission to revive the mortgage market could be compromised unless Treasury provides the company additional assistance. "[Treasury's] commitment [of $100 billion] may not be sufficient to keep us in solvent condition or from being placed into receivership," if there are additional "substantial" losses or if the company is unable to sell unsecured debt, said Fannie Mae in its 10Q filing. Fannie Mae CEO Allison has approached Treasury about providing help, but Treasury Secretary Paulson has demurred, according three sources familiar with the discussions.

- Fannie Mae has received a notice from the New York Stock Exchange that it may lose its listing on the New York Stock Exchange because its share price has been under $1 for more than 30 days. Fannie said it must "notify the NYSE by November 26, 2008, of our intent to cure this deficiency by bringing the common share price and average share price for 30 consecutive trading days above $1" or risk a delisting of their common and preferred shares. The company is working with FHFA "to explore options relating to this deficiency and has yet determined its response or any specific action that it will take as a result of the exchange's notice." Fannie's common stock price plummeted from $69 in June 2007 to less than $1, following the company's losses of $38.4 billion over the past five quarters and its placement in receivership by federal regulators. According to *Bloomberg*, Fannie's common stock price has averaged $0.83 a share over the past 30 days. (*Bloomberg News*, Dawn Kopecki, 11/18/08; *CNNMoney*, Chris Isidore, 11/10/08; *Bloomberg News*, Dawn Kopecki, 11/10/08; *Wall Street Journal Online*, Kerry E. Grace, 11/10/08; *Bloomberg News*, Dawn Kopecki, 11/10/08; *HousingWire*, Paul Jackson, 11/10/08; *Fannie Mae Press Release*, 11/10/08; *Form 10Q*, Fannie Mae, 11/10/08)

Freddie Mac posts third quarter loss of $25.3 billion and receives $13.8 billion cash injection from Treasury

- Freddie Mac announced a $25.3 billion loss for the third quarter, bringing the company's net worth to a deficit of ($13.8) billion and triggering an equity injection from Treasury of $13.8 billion. The company's net loss widened to $25.3 billion, after the company wrote down of $14.3 billion of tax assets and provided $9.1 billion of security impairments in the company's mortgage-backed securities portfolio and $6.0 billion in credit-related expenses. On September 30th, Freddie Mac had a net deferred tax asset of $11.9 billion, which represented the tax effect of unrealized losses on available-for-sale securities, which management believes is more likely than not of being realized because of the company's intent to hold these securities until the unrealized losses are recovered. The company's provision for credit losses increased due to continued credit deterioration of Freddie's single-family credit guarantee portfolio related to further increased in delinquency rates and higher severity of loses on a per property basis.

- Freddie Mac cited the general economic malaise rather than the credit crisis as the key driver in the company's quarterly loss. In a press statement, Freddie said that "declining home prices, increasing unemployment, a significant decline in consumer spending and a considerable tightening of both consumer and business credit" were the underlying causes of its third quarter loss. Freddie noted that unemployment rates "worsened significantly" during the third quarter, with California, Arizona and Nevada seeing a quarterly rise in unemployment that ranged from 14% to 27%. Beyond economic conditions, Freddie saw credit conditions in its mortgage book of business deteriorate, with severe delinquencies rising 29 basis points to 1.22% in the third quarter, non-performing assets increasing almost 30% during the quarter to $35.5 billion, and its REO inventory soaring 27.5% to more than 28,000 units. Losses on REO properties increased as well, with the company's average loss severity reaching 29.3% during the third quarter, versus 25.2% in the second quarter. The company's losses are concentrated in its Alt-A portfolio, which comprised 10% of Freddie's mortgage portfolio but accounted for approximately 50% of its credit losses. Freddie Mac estimated that 9% of its single-family mortgage portfolio consists of borrowers who owe more on their mortgage than their property is worth, while 17% of its portfolio has a current loan-to-value ratio of 90% or greater.

- On September 30, 2008, Freddie Mac's fair value of net assets was negative ($42.2) billion, compared to $12.6 billion at year-end 2007. During the nine months ended September 30, the company's fair value of net assets decreased by $54.1 billion, before capital injections and payment of dividends. [The partial write-off of $19.4 billion of tax assets is included in the reduction of fair value of net assets.]

- The New York Stock Exchange has notified Freddie Mac that it had failed to satisfy one of the NYSE's standards for continued listing of its common stock— specifically so-called "$1 dollar rule" now that company's common stock has traded below $1.00 per share for more than 30 days, which prompted the warning. The company's common and preferred stock may be suspended and delisted unless Freddie provides the SEC a plan outlining a means of restoring the stock's daily trading price by December 2. Freddie Mac said it is "currently working with its conservator, the Federal Housing Finance Agency, to explore options relating to this deficiency and has not yet determined its response or any specific action that it will take as a result of the exchange's notice." (*Freddie Mac Press Release*, 10/14/08; *Form 10Q*, Freddie Mac, 10/14/08; *Washington Post*, Zachary A. Goldfarb, 11/14/08; *HousingWire*, Paul Jackson, 11/14/08; *Bloomberg News*, Dawn Kopecki, 11/14/08; *Bloomberg News*, Dawn Kopecki, 11/17/08; *HousingWire*, Paul Jackson, 11/21/08)

The short-term financial outlook for Fannie Mae and Freddie Mac appears bleak

- Some analysts believe that Treasury's $200 billion backstop for Fannie and Freddie [$100 billion for each GSE] won't be adequate to offset the GSEs' future losses. Joshua Rosner, an analyst with Graham Fisher, Fannie's and Freddie's losses to date have yet to rivaled those experienced during the most recent bad real estate slump in the late 1980s. "If we saw loss rates at those levels, we would quickly eat through the $200 billion," said Rosner. "This is a once-in-a-century flood." "Fannie Mae and Freddie Mac are completely exposed to the housing market," said Fox-Pitt Shelton analyst Howard Shapiro. "Until home values stabilize and delinquency trends stabilize, we're going to continue to have this discussion: What are these losses are going to be?" "You could very well get losses north of $100 billion on both of these companies [Fannie and Freddie],'" said FBR Capital Markets' analyst Paul Miller. Through the end of the year, Freddie Mac may need an additional $30 billion to $50 billion in financing from the Treasury to offset fourth quarter losses, added Miller. (*Washington Post*, Zachary A. Goldfarb, 11/14/08; *Wall Street Journal*, James R. Hagerty, 11/18/08; *Bloomberg News*, Dawn Kopecki, 11/14/08; *Bloomberg News*, Dawn Kopecki, 11/17/08)

What future role should Fannie and Freddie play in the housing market?

- In November 12th speech, Treasury Secretary Paulson said, "When we [placed the GSEs into conservatorship] in September, I said that we would be entering a 'time out—a period where the new President and Congress must decide what role government in general, and the GSEs in particular, should play in the housing market. In my view, government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. And policymakers must address the issue of systemic risk. In the weeks ahead, I will share some thoughts outlining my views on long term reform." During a question and answer session with reporters, Paulson added that Congressional action is needed to reduce the risk that Fannie Mae and Freddie Mac pose to the broader economy and "to resolve the conflict between [the GSEs'] public and private purposes." (*Treasury Department Press Release*, 11/13/08; *Bloomberg News*, Dawn Kopecki, 11/12/08)

- In a November 14th *Forbes* article, Susan Lee wrote, "… [T]here are tons of reasons why Fan and Fred should evanesce. Their business model--publicly subsidized but privately profited firms—yields massively leveraged portfolios, incompetent but grossly compensated management, a huge lobbying establishment and political pork galore. Of course there was no rejoicing from one of Fan and Fred's chief cheer-leaders—Congressman Barney Frank. When asked about the shrinkage of Fan and Fred's portfolios, he responded: 'Good luck on that.' And then went on to characterize such an idea as a 'sop' to the right, not a policy possibility. Simply put: It ain't going to happen on his watch."

- "Frank's words were, apparently, not lost on the chairman of the Federal Reserve, Ben Bernanke. Next thing you know, Bernanke was proposing taking many steps back and none forward. His main point? Even if Fan and Fred were privatized, some sort of 'government backstop' would be necessary in "times of turmoil" … [which] would, alarmingly, draw taxpayers deeper and deeper into backstopping not only Fan and Fred, but a great portion of the country's financial system. He suggested the creation of government bond insurance for both mortgage-debt and mortgage-backed securities. This government insurance, rather like the Federal Deposit Insurance Corp., would be available to both Fan and Fred and private banks."

- "The country and, for sure, taxpayers, need an exit strategy for Fan and Fred, not a resurrection plan. Given the incentives embedded in any model that depends on government backstopping, the absence of an effective exit strategy will mean it'll really be déjà vu all over again in a decade or two." (*Forbes*, Susan Lee, 11/14/08)

- In a November 18th speech in Detroit, Bank of America president Ken Lewis called for scrapping the GSEs' current business model. Lewis said, "Over the longer-term, I think we should consider a few principles, none of which includes Fannie or Freddie in their current business model. Lower income borrowers should continue to be served by FHA lending, and such government guaranteed lending can be expanded to cover a greater share of the market. In place of Fannie and Freddie…while I don't have a specific model or structure in mind… I think we should move in the direction of a system that relies more on private sector institutions… without government guarantees… to intermediate between originators of mortgages and investors in the secondary market… with some limited role for the government to ensure liquidity." (*Remarks to the Detroit Economic Club*, Kenneth D. Lewis, 11/18/08)

- Jerry Howard, CEO of the National Association of Homebuilders, said that Fannie and Freddie are "teetering on the brink" as their losses and borrowing costs rise and called on the government to explicitly guarantee the GSEs. He also urged Congress to quickly develop a new structure and better defined role for Fannie Mae and Freddie Mac in the mortgage market. Howard opposes the concept of nationalizing the GSEs, arguing that government wouldn't be nimble enough to keep up with the market's needs. Instead, he argued that it might make sense to operate Fannie and Freddie as tightly-regulated quasi-public entitles, like public utility companies, or as cooperatives, owned by mortgage lenders. (*Wall Street Journal*, James R. Hagerty, 11/18/08)

- In a November 19th editorial, the *Los Angeles Times* wrote, "Fannie Mae and Freddie Mac thrived for nearly four decades as companies that were private in name only. The bonds and mortgage-backed securities they sold to Wall Street had a unique advantage over their competitors': an unstated guarantee that the federal government would prevent defaults. And sure enough, when the housing bubble burst and the companies' bets went bad, regulators promised to supply up to $200 billion to cover any losses. The two companies are due to remain in a federal conservatorship until the end of 2009."

- "The obvious problem with the arrangement is that the companies' executives and shareholders collected all the gains during the go-go years, but the taxpayers got stuck with the losses when the market crashed. This month, the Treasury Department is expected to pump $13.8 billion into Freddie Mac to cover shortfalls. And Fannie Mae, which recently reported a $29 billion quarterly loss, warned that it may be pushed into insolvency too."

- "Nevertheless, Congress hasn't changed Fannie's and Freddie's status. They remain privately held companies, albeit with stocks that sell for less than $1 a share, and are barred from paying dividends while federal regulators are in charge. When the conservatorship ends, Fannie and Freddie will be under private control once more, and their operations will be aided again by the expectation of a federal rescue. After all, if the feds bailed them out once, won't they do it again? The main difference is that the two companies' mortgage-related holdings will be significantly larger—as much as $1.7 trillion more than when the feds stepped in. That's because the Treasury has pushed Fannie and Freddie to increase their shares of the housing finance market to offset cutbacks by private sources."

- "The credit crisis makes it difficult today, yet lawmakers and the incoming administration need to start working soon on a whole new approach to Fannie and Freddie. In particular, they should explore ways to phase out both companies, allowing truly private firms to take over the secondary market for mortgages that Fannie helped create decades ago. As for Fannie's and Freddie's mission to promote affordable housing, there are much more efficient and transparent ways for the government to achieve such goals—for example, by providing subsidies directly through federal agencies instead of siphoning dollars from Fannie and Freddie. The collapse of Fannie and Freddie calls into question the government's role in the American dream of home ownership. Washington needs to start looking for answers now, before taxpayers relive the Fannie-Freddie nightmare." (*Los Angeles Times*, 11/19/08)

Fannie Mae and Freddie Mac introduce a systemized loan modification program and announce a year-end foreclosure "holiday"

FDIC introduces a loan modification program to help approximately 2.2 million at-risk homeowners

It's time for Congress to restructure the loan servicing mechanism to help troubled borrowers, says Chairman Frank

Fannie Mae and Freddie Mac introduce a systemized loan modification program and announce a year-end foreclosure "holiday"

- On November 11th, FHFA announced the Streamlined Modification Program (SMP) with uniform requirements to help at-risk homeowners avoid foreclosure. The program, designed by the Treasury, FHFA, Fannie Mae, Freddie Mac, FHA, and the HOPE NOW Coalition, targets highest risk borrowers, who have missed three mortgage payments or more, owns and occupies the collateral property as his primary residence, and has not filed bankruptcy. Borrowers will not be eligible for the program, if the current value of their home exceeds their mortgage balance by more than 10%. While the SMP applies only to mortgages which are owned or guaranteed by Fannie Mae or Freddie Mac, major lenders, including Bank of America, Wells Fargo and Citigroup, have agreed to adopt the program as an industry standard for the loans that they service. The program, which begins on December 15th, will create a fast track method to help borrower reduce his mortgage payment to 38% of his household's income, using a combination of lower interest rates, extending the life of the loan, or deferring payment on part of the principal. To encourage participation, servicers will receive a payment of $800 for each loan modified through this program. Officials hope the new program could help more than 400,000 troubled borrowers.

- FHFA director James Lockhart told reporters, "I have talked to servicers in the last couple of days. They are telling me that it is important that this standard was set because it gives them a lot more cover and they are going to be more aggressive in modifying loans. … [N]ow that Fannie and Freddie have put something forward, they are the standard in the marketplace and that gives them a lot of leeway. …[T]hey are very pleased."

- In a written statement, FDIC chairwoman Sheila Bair said, "This is a step in the right direction, but falls short of what is needed to achieve wide-scale modifications of distressed mortgages, particularly those held in private securitization trusts. As we lend and invest hundreds of billions of dollars to help institutions suffering leveraged losses from defaulting mortgages, we must also devote some of that money to fixing the front end problem: too many unaffordable home loans."

- Senate Banking Committee Chairman Christopher Dodd (D-CT) said the program was "a constructive step forward," but more needed to be done. Dodd added, "This should not be considered a replacement for the guarantee program authorized by the recently-enacted financial rescue law which the FDIC has agreed to operate." Senator Charles E. Schumer (D-NY) questioned if the program would be of much help, since "these voluntary plans sound nice, but they don't do the job." Schumer added, "A program like this will only scratch the surface of the mortgage crisis." Members argued that voluntary loan modifications are insufficient to help trouble borrowers and legislation must be passed to allow bankruptcy judges to restructure mortgages in bankruptcy to reduce foreclosures. "We're not going to successfully deal with the foreclosure issue until we enact this [bankruptcy legislation]," said Senate Majority Whip Richard Durbin (D-IL).

- On November 17th, Durbin introduce a mortgage bankruptcy modification bill, similar to the bill that passed the Senate Judiciary Committee last April. The bill would require all federal banking regulators to restructure all loans which they now own or have controlling interest in; require loan servicers to restructure all loans that qualify for the Hope for Homeowners program; and allow bankruptcy judges to modify the terms of mortgage loans secured by primary residences. The bill would also limit the rights of banks to declare dividends, if they have received capital injections from Treasury's TARP. The measure, while unlikely to pass this year, has a good chance of enactment in the next Congress, given that the Democrats will have wider majorities in both the House and Senate and President-elect Barack Obama has said he supports the bill's basic concept. According to a *HousingWire* source, "This [bill] is a priority for the Barack Obama administration." (*Financial Times,* James Politi, 11/12/08; *CQ Today Online*, Benton Ives, 05/11/08; *New York Times*, Edmund L. Andrews, 11/12/08; *Reuters*, Patrick Rucker, 11/13/08; *Washington Post*, Renae Merle, 11/12/08; *CNNMoney*, Les Christie, 11/14/08; *Bureau of National Affairs,* 11/14/08; *Bloomberg News,* Rebecca Christie and Robert Schmidt, 11/10/08; *Federal Housing Finance Agency Press Release*, 11/11/08; *American Banker,* Stacy Kaper, 11/20/08; *Bureau of National Affairs*, 11/20/08; *American Banker,* Stacy Kaper, 11/18/08; *HousingWire,* Kelly Curran, 11/18/08)

- Separately, Fannie Mae and Freddie Mac announced a temporary suspension of foreclosures and evictions on owner-occupied homes from November 26, 2008 to January 9, 2008. The GSEs said the suspension was part of an effort to work with servicers to implement the company's recently announced streamlined modification program that goes into effect December 15th. "Until the streamlined modification program is fully implemented, we felt it was in the best interest of both borrowers and Fannie Mae to take this extra step to ensure that homeowners with the desire and ability to prevent a foreclosure have an opportunity to stay in their homes," said Fannie Mae CEO Herb Allison. The suspension of foreclosure sales and eviction lockouts for the six-week period will affect roughly 16,000 borrowers. The suspension does not affect foreclosures on vacant properties or proceedings in bankruptcy cases. "It's a giant time out," said Paul Miller, an analyst at FBR Capital Markets in a *Bloomberg Television* interview. "I wouldn't be surprised to see this across the board." (*HousingWire*, Paul Jackson, 11/21/08; *Bloomberg News,* Dawn Kopecki, 11/20/08; *Washington Post,* Zachary A. Goldfarb, 11/21/08)

FDIC introduces a loan modification program to help approximately 2.2 million at-risk homeowners

- On November 14, FDIC introduced a proposal for affordable mortgage modifications that could be applied to approximately 2.2 million troubled mortgage loans that are not owned by Fannie Mae or Freddie Mac. Under the proposal, borrowers who are behind at least two payments on their mortgages could refinance their loans into sustainable, long-term, low interest rates mortgages that would average about 31% of household income. In restructuring loans under this program, interest rates would be as low as 3% for five years, before increasing 1% a year until reaching the market rate, with a term of up to 40 years. The program would pay loan servicers $1,000 for modifying trouble mortgages through the program and FDIC would share 50% of the losses on a modified loan, if it subsequently failed. FDIC estimates that the program would cost approximately $24.4 billion, assuming a default rate of 33% for modified mortgages. FDIC chairwoman Shelia Bair said the funding for this program should come from the $700 billion bailout program approved by Congress last month. The program is modeled after the loan modification program being implemented at IndyMac, in which approximately 20,000 modification offers have been made to a pool of roughly 46,000 troubled mortgages. To date, 5,000 loans have been modified at IndyMac and several thousand more are in the pipeline. FDIC is offering mortgage servicers a tool kit for streamlining loan modifications, called the “mod in a box.” Bair said, “I would encourage all industry participants to adopt the FDIC Loan Modification Program as the standard approach for dealing with the grave problems facing us with continued mounting foreclosures.”

- During a *Wall Street Journal* interview, FDIC chairwoman Shelia Bair argued that the government must step up its efforts to avoid foreclosures, saying: “People say we should punish all these people because they got these mortgages they couldn’t afford. Why? Who is that going to help? It’s just going to put more empty houses on the market, and more houses where the lawn maybe isn’t going to get mowed, and the windows may be broken, or the owner isn’t there, so they aren’t paying taxes.”

- Treasury Secretary Henry Paulson rejected FDIC’s modification proposal, arguing that it is a spending program and an inappropriate use of TARP funds. “We have a TARP, which is investment, not spending,” said Paulson. Michael Krimminger, a special policy advisor to FDIC, responded, “The juxtaposition that some have drawn between investing and spending is a false dichotomy, because we are investing in trying to solve the mortgage problem and investing in the mortgages that need to be restructured. We’ve supported the actions that Treasury has taken, but I think now we actually need to deal with the underlying problem, too.”

- “[The FDIC plan is] effectively telling servicers in order to modify loans, you may have to breach your servicing contracts, and no servicer is going to agree up front to that,” said Laurence Platt, a partner with K&L Gates LLP. Joe Belew, the chief executive of the Consumer Bankers Association, argued that the plan may be too aggressive because it would commit a massive amount of resources to restructuring loans without a firm idea of how many modifications would succeed. "If you simply modify wholesale all [of] the portfolio or all of the segment of a portfolio, you still don't know how many people will make it, so it's a real unknown for a lender," said Belew. Modifications on a case-by-case basis—something that FDIC argues slows down the modification process—may still be more attractive to the industry, he added.

- Members of the Senate Banking Committee expressed support for the FDIC modification plan and anger at Paulson's opposition to the program. Committee chairman Christopher Dodd (D-CT) said, "It is confounding to me why the Secretary of the Treasury and others refuse to understand that this is the heart of the problem. Until we solve the foreclosure problem, we will not have any hope of solving the larger problem." During a Senate Judiciary Committee hearing, Senators Patrick Leahy (D-VT) and Arlen Specter (R-PA) also criticized Paulson for rejecting the FDIC's $24 billion relief program to assist troubled borrowers. Specter argued that the Treasury Secretary is wrong, when he argued that the $700 bailout package approved by Congress in October was not intended to help the housing problem.

- Mortgage industry officials are concerned that new modification programs, like the FDIC's proposal, would encourage people to stop making their mortgage payments. "Loan modification discussions are increasing the odds that moral hazard becomes an enormous risk factor for mortgages in 2009 and 2010," said Chris Flanagan, head of global structured finance research for JPMorgan. Ken Lewis, CEO of Bank of America, said, "Foreclosure mitigation programs have to be structured so as not to attract homeowners who don't need them. Unfortunately, this is happening too often, as people who are underwater on their loans but who are able to make their payments, seek the same benefits they're seeing their neighbors get." An economist told *HousingWire*: "Bair and the FDIC are walking a fine line there. Her program needs to succeed, but not so much so that everyone decided they ought to get a 3 percent mortgage." These misgivings are likely behind the Bush administration's refusal to support the FDIC proposal. The unintended consequences of such a program would likely be higher default levels, higher interest rates, and, ultimately, a lower number of people who can afford mortgage loans.

- "The longer-term issues may be greater than the short-term gain," said Bank of America executive Anne Finucane in testimony before the Senate Banking Committee. While this line of reasoning has held sway with Congress for many years, Dodd said that he has seen a change of thinking in the Senate recently. "I think we're getting to the tipping point with some of my colleagues that they will accept the gravity of this situation," said Dodd. (*American Banker*, Joe Adler, 11/14/08; *Bureau of National Affairs*, Thecla Fabian, 11/17/08; *CNNMoney*, Tami Luhby, 11/14/08; *American Banker*, Joe Adler, 11/08/08; *Washington Post*, Binyamin Appelbaum, 11/14/08; *HousingWire*, Paul Jackson, 11/18/08; *American Banker*, Stacy Kaper, 22/21/08; *CongressDaily*, Andrew Noyes, 11/19/08; *Financial Times*, 11/19/08; *American Banker*, Allison Bisbey Colter, 11/13/08)

It's time for Congress to restructure the loan servicing mechanism to help troubled borrowers, says Chairman Frank

- During a November 12th hearing of the House Financial Services Committee, Chairman Barney Frank (D-MA) said legislation is needed to make it easier for lenders to modify loans for homeowners to help them avoid foreclosure. "We have not seen servicers participate in a significant way," said Frank. "I believe it's now a situation that requires legislation. This committee has to act by restructuring the servicing mechanism. Someone had to have the authority to make a decision. We face a situation now where that isn't the case." Frank did not discuss any details about possible legislation.

- Michael Gross, managing director of Bank of America's loan administration loss mitigation, told the panel that investor rules and underlying servicing contracts with respect to the modifications aren't uniform and may prevent servicers from making modifications that are beneficial to both investors and borrowers. Molly Sheehan, SVP for home lending with JPMorgan, added, "It's not the servicer's role to impose conditions on investors; instead, our role is to fulfill our contractual obligations by working to achieve the best possible results for our investors while creating affordable payments for borrowers." Representative Spencer Bachus (R-AL) pointed out, "[The] fear of being sued is a powerful disincentive for mortgage servicers considering whether to modify a troubled borrower's mortgage." (*Bloomberg News*, Dawn Kopecki, 11/12/08; *Bureau of National Affairs*, Yin Wilczek and Mike Ferullo, 11/13/08; *CQ Today Online News*, Benton Ives and Phil Mattingly, 11/12/08; *CongressDaily*, Bill Swindell, 11/12/08)

- During the hearing, Frank said while reducing the number of foreclosures will play a key role in stabilizing the financial crisis, the government should avoid giving a "free ride" to a borrower who couldn't afford the mortgage to begin with. "There is, in my judgment, zero likelihood that taxpayer dollars will go to those who never should have had loans in the first place," said Frank. (*HousingWire*, Diana Golobay, 11/13/08

The Federal Housing Finance Agency sets conforming loan limits at $417,000 for 2009

- For 2009, the conforming loan limit will remain unchanged at $417,000 for single-family homes and $533,850, $645,300, and $801,950 for two-, three-, and four-unit properties, respectively in most areas in the United States, said the Federal Housing Finance Agency. These loan limits do not apply for certain high-cost areas in California, Colorado, New York, New Jersey, Massachusetts, and District of Columbia, where the limits can exceed the standard limits by up to 150%. FHFA set the loans limits based upon changes to the agency's monthly and quarterly house price index, which declined 5.9% over the past 12 months. Under the Housing and Recovery Act of 2008, FHFA was prohibited from lowering the conforming loan limits. (*Bureau of National Affairs*, Mike Ferullo, 11/10/08)

TARP

Federal government provides Citigroup $20 billion of new capital
and guarantees $306 billion of toxic assets

- On November 23rd, Citigroup received a U.S. government financial rescue package, which provides $20 billion of new capital and a package of liquidity and loan guarantees on $306 billion of the Bank's toxic assets. Treasury's $20 billion equity injection comes on top of a $25 billion infusion the Bank received in October under the Troubled Asset Relief Program (TARP).

- Under the agreement, Treasury and the FDIC will guarantee a pool of up $306 billion assets, consisting of loans and securities collateralized by residential and commercial real estate, the assets' associated hedges, and "other such assets" that the government has agreed to guarantee. Citigroup will absorb up to $29 billion of losses on these assets, above pre-existing reserves, and share 10% of any additional losses. The federal government will share 90% of the losses with $5 billion of funding from TARP and $10 billion of funding from the FDIC. If necessary, the Federal Reserve Bank will finance the remaining pool of assets, subject to Citigroup's 10% loss sharing. The Federal Reserve's non-recourse loan will have a floating rate of OIS plus 400 basis points with interest payments having recourse.

- Under the agreement, TARP will invest $20 billion of preferred stock in Citigroup, which pays an 8% dividend to the Treasury and provides warrants with an aggregate exercise value of $2.7 billion. Citigroup is prohibited from paying common stock dividends in excess of $0.01 a share for the next three years.

- Citigroup has also agreed to comply with "enhanced" executive compensation restrictions and implement the FDIC's mortgage modification program. Unlike the bailouts of AIG, Fannie Mae, and Freddie Mac, the federal government is not requiring the Bank to make any management changes and CEO Vikram S. Pandit will keep his job, said government officials.

- "With these transactions, the U.S. government is taking the actions necessary to strengthen the financial system and protect U.S. taxpayers," said the federal agencies in the press release for the rescue plan. The sweeping bailout of Citigroup underscores the federal government's concern about letting the Bank's financial condition continue to deteriorate. The previous week, Citi's stock price tumbled 60% to $3.77—a 16-year low—on concerns about the Bank's viability. "It really was a must-do thing," said Nader Naeimi, a strategist at AMP Capital Investors. "If they'd let Citigroup go, that would've been disastrous."

- Analysts with CreditSights Inc. wrote, "[The rescue was] structured in a way that existing debt holders are not impaired and equity investors are not overly diluted. All in all, these actions should settle market jitters surrounding the company for now and provide a boost for bondholders."

- Peter Kovalski, a portfolio manager at Alpine Woods Capital Investors LLC, said "[The rescue plan] gives them a little bit of breathing room, but longer term, things may deteriorate and losses increase," said Kovalski. "The Achilles heel with Citi is their exposure to emerging markets and what's going to happen when emerging markets turn down, as they're doing now." (*Bloomberg News*, 11/24/08; *Reuters*, Dan Wilchins and Jonathan Stempel, 11/24/08; *Wall Street Journal*, David Enrich, Carrick Mollenkamp, Matthias Rieker, Damian Paletta, John Hilsenrath, 11/24/08)

Paulson decides not to use TARP funds to purchase illiquid mortgage assets

- Treasury Secretary Henry Paulson announced that his agency will use funds in the Troubled Asset Relief Program (TARP) to aid consumer credit and capital needs of non-banks and abandoning its plans to purchase of illiquid mortgage assets. "Our assessment at this time is that this is not the most effective way to use TARP funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources, in helping to strengthen our financial system and support lending," said Paulson. The major strategies that Treasury will pursue going forward will include using TARP funds to augment capital in bank and non-banks and increase the support for securitizing credit outside the banking system to stimulate the flow of credit. Specifically, TARP funds will be used to shore up the market for credit-card receivables, auto loans and student loans. "This market, which is vital for lending and growth, has for all practical purposes ground to a halt. With the Federal Reserve, we are exploring the development for a potential liquidity facility for highly-rated AAA asset-backed securities," said Paulson. The Treasury Secretary said TARP funds should not be used to help ailing automakers in Detroit or homeowners facing foreclosure, because such a use of funds would violate the intent of the TARP initiative. "I know automakers are important to the United States [and] we care about the automobile industry," said Paulson. "[But] my focus is on the financial sector—getting credit going, getting lending going." The Secretary's moves underscored the severe challenges that the administration faces in trying to quickly design a successful comprehensive bailout program aimed at stabilizing the U.S. financial system in the midst of a rapidly deteriorating economy and severe financial crisis.

- In testimony before Congress, Paulson said he is unlikely to use the remaining $410 billion of TARP funds to launch any new substantial programs in order to preserve flexibility and resources for the incoming administration. "I'm going to do what we need to do to keep the system strong but I'm not going to be looking to start up new things unless they're necessary, unless they make great sense," said Paulson. "I want to preserve the firepower, the flexibility we have now and those that come after us will have." The Treasury Secretary also indicated that he would not seek additional TARP funds in addition to the $350 billion, which Treasury has been authorized to invest through EESA. To date, Treasury has allocated about $315 billion of TARP funds, including $125 billion to the nation's nine largest banks, $125 billion to regional banks, $25 billion in additional capital and loan guarantees to Citigroup, and $40 billion to expand the existing bailout of AIG.

- Lawmakers voiced concerns about Paulson's redefining the goals of the TARP in midstream. Senators Robert Casey, Jr. (D-PA) and Mel Martinez (R-FL), who serve on the Senate Banking Committee, said lawmakers are frustrated "on a number of levels" because Treasury wasn't clear about its intent with TARP and hadn't used its authority to help reduce the level of foreclosures. Senators Tom Coburn (R-OK), Richard Burr (R-NC) and David Vitter (R-LA) wrote a letter to Paulson, saying that the Secretary's "rapid reversal" raised questions about Treasury's future plans for the bailout funds.

- A number of lawmakers said they would encourage President-elect Obama to offer the FDIC loan modification program, when he takes office in January. "I disagree with one of the major decisions, from my standpoint, which is not to use any of the TARP [funds] for mortgage foreclosure reduction," said House Financial Services Committee Chairman Barney Frank (D-MA). Frank also said he was disappointed that Treasury has abandoned plans to buy mortgage assets directly, which would have given the government more leeway to engage in loan modifications. "I think he's wrong not to use it that way because the point was, we would buy these assets from lenders at less than 100 cents on the dollar …and then in turn modify the mortgage downward," Frank said. Senate Banking Committee chairman Christopher Dodd (D-CT) said, "I'm concerned that we may have to wait until the next administration before we have the real change in economic policy that our nation needs." (*New York Times*, Edmund L. Andrews, 11/13/08; *Washington Post*, Peter Whoriskey, David Cho, and Binyamin Appelbaum, 11/13/08; *American Banker*, Cheyenne Hopkins, 11/13/08; *Wall Street Journal*, Michael R. Crittenden, 11/14/08; *Bureau of National Affairs*, Stephen Joyce and Aaron Lorenzo, 11/13/08; *Wall Street Journal*, Deborah Solomon, 11/17/08; *HousingWire*, Diana Golobay and Paul Jackson, 11/12/08; *MarketWatch*, Greg Robb, 11/12/08;)

- In a November 10th editorial, the *Washington Post* wrote, "The Treasury Department's Troubled Assets Relief Program …is barely underway. But the second-guessing from Congress has already begun. … TARP is an improvised approach to a financial panic. It is best conceived of as general, temporary support for the financial sector—not the first phase of long-term, detailed government involvement in banking business decisions. The experience of many countries has shown that the more government gets into banking, the more politics controls the allocation of capital, upon which all economic activity depends. Efficiency suffers, corruption flourishes and the economy stagnates. As Congress exercises its legitimate and necessary oversight powers with respect to TARP, it must remain aware of those dangers." (*Washington Post*, 11/10/08)

- In a November 19th editorial, the *Washington Post* wrote, "Some six weeks after its enactment, the Treasury Department's Troubled Assets Relief Program is itself, well, troubled. Treasury Secretary Henry M. Paulson Jr. has shifted the $700 billion plan's focus from the purchase of distressed securities to the direct injection of public capital into banks and other financial institutions—which Treasury then expanded to include providers of auto loans and, possibly, credit card and student loans. These midcourse corrections were pragmatic and probably wise. But they put a crimp in Mr. Paulson's credibility. … History will judge whether Mr. Paulson's course demonstrated a healthy flexibility, as his supporters say, or a debilitating rudderlessness, as his critics contend."

- "We do think, however, that almost anyone else in his position would have struggled to manage the conflicting pressures. Government had to act to prevent a financial meltdown. But once the government stepped in, it could not recapitalize the banking sector and jump-start lending all at once. Bank capital will not grow if financial institutions take government money with one hand and immediately lend it all out with the other. One objective has to take priority over the other."

- "TARP has arrested a downward spiral in the financial system. As Federal Reserve Chairman Ben S. Bernanke told Congress yesterday, the cost of interbank short-term funding has dropped since mid-October, and corporate bond issuance is up a bit. But banks remain highly indebted and extremely fragile; it is unrealistic to expect a gusher of new loans, especially when demand for credit is weakening because of recession. As Mr. Paulson noted yesterday, TARP 'was not intended to be an economic stimulus or an economic recovery package; it was intended to shore up the foundation of our economy by stabilizing the financial system.' The financial authorities should be encouraging banks to raise capital, not only through government aid but through the sale of stock. Restoring financial institutions' long-term solvency and, hence, their long-term ability to carry on normal lending should be the program's top goal -- both in what is left of this administration and at the outset of the next." (*Washington Post*, 11/19/08)

- In a November 20th editorial, the *Financial Times* wrote, "…The mechanism by which the Tarp would work was never clear. The objective of the Tarp, however, was. Although the Treasury secretary, Hank Paulson, has suffered regular Damascene conversions on what exactly he wanted to do with his $700bn, it was always intended to hold the financial sector together in order to support the real economy and prevent a downturn becoming a depression."

- "So far, TARP has stuck with that purpose. The $250 [billion] set aside for recapitalizing US banks, combined with federal guarantees on funding, have eased the panic which gripped the financial system in September. There was no alternative to putting $40bn more from Tarp funds into AIG—the insurance giant was simply too important to fail. This focus on fighting the credit squeeze must remain in the forefront of policymakers' minds. Confidence is low, the commercial paper market has dried up and Libor spreads are still high. This financial crisis is far from over."

- "The Treasury must focus the money on financial businesses that are both systemically significant and vulnerable to failure, in present circumstances. The aim is to avoid any more Lehman-like collapses. One was enough. The regulatory categories into which these companies currently fit—be they insurers or consumer finance groups—is unimportant. But they should also be subjected to federal oversight as the price of receiving federal money. The Tarp must also backstop the Federal Reserve, enabling it to expand its lending practices and enter the commercial paper markets without the central bank taking on credit risks directly."

- "A plan to help stem foreclosures seems a political necessity. And the carmakers may well get support from the government; they are large employers with the support of the new president-elect. But both plans must seek their own money from Congress transparently and democratically, rather than abusing the Tarp's lack of legislative guidance and supervision. The Tarp must remain the firewall against financial collapse. It must not become pork-barrel investor of first resort." (*Financial Times*, 11/20/08)

Treasury Secretary Paulson's guiding principals for handling the financial crisis

- In a November 20th speech at the Reagan Library, Treasury Secretary Hank Paulson outlined his guiding principles for the past few months. Paulson said:

  - "…**One**, never forget our awesome responsibility to the American people who depend on the financial system to save for college and retirement, for financing homes, cars and companies. If the financial system were allowed to collapse, it is the American people who would pay the price. This has never been just about the banks; it has always been about continued prosperity and opportunity for all Americans."

  - "**Two**, run to problems—the cost of preventing a systemic event is less than the cost of addressing its catastrophic consequences;"

  - "**Three**, bring people together to work on solutions. Although it is always desirable, in times like these it is essential for government leaders of both parties and for financial leaders from around the world to work together;"

  - "**Four,** define my portfolio expansively – look beyond how authorities have been used in the past, and motivate the private sector, Administration colleagues and regulators to do what is needed;"

  - "**Five**, guard against systemic risk while maintaining market discipline and protecting the taxpayer; and,"

  - "**Six**, be pragmatic enough to change plans when facts and conditions change." (*U.S. Treasury Department Press Release*, 10/20/08)

The number of companies seeking TARP capital injections grows

- On November 17, the Treasury Department rolled out the second phase of its Capital Purchase Program, which extends the program to non-publicly traded financial institutions under terms which are economically the equivalent to the terms for publicly-traded institutions. This phase of the CCP applies to bank holding companies, thrift holding companies and banks and thrifts which are not publicly-traded, but does not apply to Subchapter S firms and mutual holding companies or institutions that are controlled by foreign banks or other companies. The application process is open to qualifying institutions that have applications pending to change their charters, so long as their applications are filed by December 8th. (Bureau *of National Affairs*, R. Christian Bruce, 11/18/08)

- As the economy deteriorated in the third quarter, the number of companies expressing interest in TARP funds grew exponentially, as the number of bank and thrift charter applications mushroomed. Two life insurance groups—Hartford Financial Services, the Dutch insurer Aegon—are taking the extraordinary steps of buying savings and loan associations as a means of participating TARP. Lincoln Financial Group, the Phoenix Cos., and Genworth Financial are among the insurers, who have applied to become savings and loan holding companies in order to gain access to government funds. [Additionally, Rock Holdings Inc., which owns the online lender Quicken Loans, and PHH Corp., a mortgage originator and servicer, have filed "placeholder" applications with OTS to meet Treasury's deadline, but have not completed the details on their thrift acquisitions.] Principal Financial Group, which already owns a bank, is applying for TARP funds. American Express and GMAC Financial Services, the financial arm of General Motors Corp, have applied to become a banking holding company to access capital through TARP. Citi Group, the century old corporate lender, and American Express are also applying to become a banking holding company and TARP participants. (*MarketWatch*, Christopher Hinton, 11/20/08; *Washington Post*, 11/21/08; *Dow Jones Newswires*, 11/19/08; *Reuters*, 11/18/08; *New York Times Dealbook Blog*, 11/13/08)

- The National Credit Union Administration has asked congressional leaders to support the agency's request that Treasury establish a TARP for credit unions. The proposed initiative would create a hybrid bailout/loan modification program specific to credit unions, which would receive low cost funds from Treasury and pass the lower rate funds along to troubled homeowners in the form of temporarily lowered month mortgage payments. The plan, called the Credit Union Homeowners Affordability

Relief Program [CU HARP], would increase home ownership affordability, keep borrowers in their homes, and reduce the likelihood of borrower defaults. "My principal reason for advancing CU HARP is simple: The consumer must not be left out of the broader government efforts to mitigate the housing and credit market dislocations," said NCUA chairman Michael Fryzel. *(Bureau of National Affairs*, Thecla Fabian, 11/21/08; *HousingWire*, Diana Golobay, 11/19/08)

- To date, administration officials and Congressional Republicans have rejected Democrats calls for $25 billion loan from TARP for the U.S. auto industry, as proposed in a bill sponsored by Representative Barney Frank (D-MA). Instead, Republicans have proposed that the rules be loosened on the $25 billion loan to automakers for retro-fitting plants to meet new fuel efficiency requirements. Instead, the White House would redirect those funds into a bridge loan, providing short-term debt relief for the manufacturers to keep them from filing for bankruptcy. Democrats have conceded that the Republicans' opposition to a bailout of the automakers is insurmountable during the lame duck session and hold out hopes for a short session in December to revisit the matter.

- On November 20th, Democratic leadership announced that Congress may return the week of December 8th to work on legislation to help the nation's ailing auto manufacturers, if the auto industry submits a "viable" plan by December 2nd which can be "vetted" and found to pass the scrutiny of lawmakers. Majority Leader Harry Reid (D-NV) said, "It's all about accountability and about reliability… Until they show us the plan, we cannot show them the money." He added, "The sad reality is no one has come up with a plan that can pass the House and Senate and be signed by the president." (*Bloomberg News*, Dawn Kopecki and John Hughes, 11/12/08; *CongressDaily*, Daren Goode, 11/18/08; *The Hill*, Jared Allen and J. Taylor Rushing, 11/20/08; *CongressDaily*, Darren Goode, Christian Bourge, and Bill Swindell, 11/20/08; *Bureau of National Affairs*, Nancy Ognanovich, 11/21/08)

- Requests for emergency federal funds are also piling up from cash-strapped cities, which are seeking to shore up budgets constrained by sinking revenues, pension-plan losses, and difficulties in obtaining financing in the credit crisis. The mayors of Philadelphia, Atlanta, and Phoenix have asked Treasury to set aside $50 billion of TARP funds to spur infrastructure investments and create local jobs. The mayors are also requesting loans to cover short-term borrowing needs and meet payrolls. (*Wall Street Journal*, Kris Maher and Paulo Prada, 11/15/08)

- In an opinion editorial, former New York City Mayor Edward I Koch wrote, "…Everyone is lining up to get their federal handout. AIG has come back for more and is to receive a total of $150 billion. The three American car companies, General Motors, Chrysler and Ford, have received $25 billion and want another $25 billion of taxpayers' money. Why not let them be bought by others in bankruptcy? There are those who say we are bailing out companies in order to prevent massive layoffs. In my view, those layoffs will come sooner or later anyhow because those companies are run by incompetents and no longer able to compete, while foreign companies like

Toyota, manufacturing their cars in the U.S., are selling them and not seeking to be bailed out. They make cars Americans want to buy."

- "In the meanwhile, the vast majority of Americans have lost upwards of 50 percent of their savings including in the stock market and their 401(k)s. Particularly heartbreaking are the financial futures of those already in retirement who are dependent on their now lost or greatly reduced savings, as well as the millions more who hoped to retire soon. Plans should be made to bring to Washington hundreds of thousands, if not millions, of Americans? We should carry pitchforks to scare the hell out of government, particularly the newly-elected members of Congress as well as all of those re-elected recently, for failing us so miserably." (*Newsmax*, the Honorable Edward I. Koch, 11/12/08)

Treasury's Capital Purchase Plan needs tweaking

- In a November 12th article in the *American Banker*, former FDIC chairman William M. Isaac wrote, "…Bankers should focus on Section 5.3 of the Standard Terms of the Treasury Purchase Agreement, which states that the Treasury 'may unilaterally amend any provision of this agreement to the extent required to comply with any … changes … in applicable federal statutes.' This provision appears to allow Congress to do virtually anything it wants to banks that participate in the program. For example, dividends on the preferred stock the Treasury buys could be increased, and/or a higher level of warrants could be required. Limitations on salaries and bonuses could be imposed. Increases in lending could be mandated, including loans to certain economic sectors or demographic groups, and foreclosures could be halted. These are not far-out hypothetical examples. Each has been the subject of debate from the day the program was announced."

- "Section 5.3 is unconscionable. If bankers included a similar clause in loan agreements, several things would likely happen. First, no borrower, except for the most desperate, would sign up for a loan. Second, the courts would rule the provision is not enforceable. Third, Congress would enact legislation prohibiting the practice. I suspect that many boards would not allow their banks to enter into a contract of this sort. Moreover, the idea behind the program is to get banks to go to the private capital markets as quickly as possible. Private firms might well be reluctant to invest in banks that are exposed to the political winds under Section 5.3. I believe the Treasury should delete Section 5.3. At the very least, the contract ought to provide that if the Treasury made changes to the deal terms, banks would have the right to void the deal and return the money within a reasonable period."

- "Another important change should be made. The Treasury acknowledges that it is picking winners and losers, which I believe is a highly inappropriate role for the government. National City had its CPP application denied and promptly entered a deal to sell itself to PNC (which got Nat City's capital allocation under the program). I would be fine with that outcome if it resulted from a voluntary decision by both companies, but I have a lot of problems with a shotgun marriage. The Treasury has not been forthcoming on the tests being applied to the applications, but it appears that banks are not being approved unless they can demonstrate their viability in the absence of the capital infusion. That standard is too high and will likely force a lot of companies out of business needlessly. I believe an applicant should be approved if it can demonstrate its viability after the capital infusion. Our nation needs a system of healthy community and regional banks, and the heavy hand of government should not be used to promote the destruction of that system. The CPP should try to save banks when possible and should be neutral on consolidations except when necessary to avoid failures."

- "Finally, there is the issue of lending. The major premise of the program, which I support, is that adding $250 billion of capital to banks will increase lending capacity by $2 trillion or more. Though we should not expect bankers to lend the entire amount in the face of a weak and uncertain economy, we have a right to expect a significant increase in lending by banks that participate in the program. I believe the Treasury should consider requiring that participating banks increase loans by a reasonable multiple of their capital infusion within one year, unless the bank is directed by its regulator not to do so."

- The CPP is a much better use of taxpayer money than the purchase of bad loans contemplated in the original bailout bill. With some important changes, it could prove to be a very successful program at no cost to taxpayers. (*American Banker,* William M. Isaac, 11/12/08)

- During a November 14 hearing, Senate Banking Committee chairman Christopher Dodd (D-CT) said financial institutions that benefit from taxpayer funds will have to use those funds in a way that benefits the public at large. "The acceptance of public funding carries with it a public obligation, in my view," said Dodd. "One cannot benefit from taxpayer support in all of its many forms and assume that one has no duty to serve that same taxpayer." The chairman endorsed the use of taxpayer-funded capital injections for acquisitions of failing institutions, calling the transactions "a proper utilization" of TARP funds. Other uses of the funding, including purchases of healthy institutions, or payment of dividends, are inconsistent with the purpose of the EESA, and should instead be deployed to make loans and prevent foreclosures, said Dodd. "Let me say as clearly as I can this morning, hoarding capital and acquiring healthy banks are not, I repeat not, reasons why Congress authorized $700 billion in emergency funding." **(***Bureau of National Affairs*, R. Christian Bruce, 11/14/08)

Treasury Inspector General to investigate the "creation process" of the Notice on Bank Losses

- At the request of Senator Charles Grassley (R-IA), Treasury Inspector General Eric Thorson is opening an investigation into the agency's issuance of Notice 2008-83, which lifts the limits on losses banks can use in following years. In a November 18th interview with *Bureau of National Affairs*, IG counsel Richard Delmar said, "The OIG will look into the Notice's creation process, to determine if it comported with the Department's standard procedures for issuing tax guidance." When asked if the scope of the inquiry would be similar to what Grassley requested, Delmar responded, "Until we begin our work, we can't determine what our scope will be." Grassley has asked Thorson to specifically review the Wachovia sale and "obtain and review" all documents and communications related to the issuance of the notice, including those between Treasury officials and representatives of Wells Fargo and Wachovia. Senate Finance Committee chairman Max Baucus (D-MT) said the new special inspector general for TARP should also review the controversial banking notices. (*Bureau of National Affairs*, Alison Bennett, 11/19/08)

- Representative Lloyd Doggett (D-TX), who sits on the House Ways and Means Committee, has introduced a bill that would override the Treasury Department's guidance allowing banks to claim deductions for losses on any financial institutions they require (Notice 2008-83). Doggett said, "The Treasury Department clearly exceeded its authority in its effort to subsidize bank mergers—and at the expense of taxpayers. We should not allow the 'Paulson Panic' to undo 20 years of sound tax policy. We should not reopen a previously closed tax loophole, and banks already 'too large to fail' should not enjoy the added incentive of tax avoidance to get even larger." The bill would not affect the mergers of PNC/National City Corp. or Wells Fargo/Wachovia, which relied upon the tax savings provided by Notice 2008-83 to offset losses in the troubled institutions that were acquired. (*Bureau of National Affairs*, Brett Ferguson, 11/21/08)

Oversight of TARP is a "mess"

President Bush nominates Neil Barofsky to serve as Special Inspector General for TARP

Senate hold placed on Barofsky nomination

Legislation introduced to expand Special Inspector General's powers

Oversight of TARP is a "mess"

- A November 13th article in the *Washington Post* highlighted the lack of formal action to fill the independent oversight posts established by Congress, six weeks after passage of Treasury's $700 bailout of the financial services industry. *WaPo* quoted Eric M. Thorson, Treasury's inspector general, as saying: "It's a mess. I don't think anyone understand right now how we're going to do proper oversight of this thing." Treasury Secretary Henry Paulson has asked Thorson to serve as the interim IG for TARP, until a nominee for the position can be approved by Congress. Thorson has a few dozen staff members working on the program, but no one is devoting full time to the oversight of the program. He said at least 100 people should staff the new special inspector general's office to provide proper oversight of the TARP. (*Washington Post*, Amit R. Paley, 11/13/08)

President Bush nominates Neil Barofsky to serve as Special Inspector General for TARP

- On November 14th, the President George W. Bush nominated Neil Barofsky to serve as Special Inspector General for TARP. Barofsky, 38, is currently an assistant United States attorney for the Southern District of New York and chief of the mortgage fraud group. Previously, he was a lead prosecutor in the district's securities fraud unit. If confirmed, Barofsky will report on the value of any assets acquired by the government and justify why the assets were purchased. (*Associated Press*, Deb Riechmann, 11/14/08

- During his November 19th confirmation hearing, Barofsky vowed a vigorous enforcement of conflict-of-interest rules for the $700 billion TARP and assured lawmakers that he would have the power to monitor all aspects of the financial rescue plan. Barofsky assured lawmakers that conflicts of interests investigations would be a "top priority" for him. (*CongressDaily*, Terry Kivlan, 11/19/08)

Senate hold placed on Barofsky nomination

- The Senate's plan to move quickly on the nomination of Neil Barofsky to serve as Special Inspector General for the Troubled Asset Relief Program has been delayed because of objections from one or more Republican senators, said Senate Banking Committee Chairman Christopher Dodd (D-CT). On November 21, Dodd issued a statement saying that all Democratic senators are on board to support the nomination of Barofsky, but one or more Republicans had placed a hold on the nomination. "It is my sincere hope that those who are blocking this nomination will reconsider their actions and confirm Mr. Barofsky at the earliest opportunity," said Dodd said. (*Bureau of National Affairs*, 11/24/08)

Legislation introduced to expand Special Inspector General's powers

- Senators Claire McCaskill (D-MO) and Charles E. Grassley (R-IA) have introduced legislation that would give the Special Inspector General for TARP temporary expedited hiring authority and bypass normal civil service procedures. The bill also would give the IG broader power to address concerns about mortgage foreclosures. Under the current language of EESA, the Special IG authority over only two sections of the TARP. This bill would expand the IG's authority to cover any and all action taken under the TARP. McCaskill said, "We voted on this measure thinking there would be responsible oversight of how the tax dollars are being spent. Instead, almost half the money has been doled out but no one is watching to make sure that the government is spending it wisely. We need to fix this before another cent is spent unsupervised." (*CQ Today*, Benton Ives, 11/19/08; *Bureau of National Affairs*, R. Christian Bruce, 11/21/08)

Members of Congressional oversight panel for TARP are named

- The members of the Congressional oversight panel for the Troubled Asset Relief Program and Troubled Asset Insurance Finance Fund have been named by Democratic and Republican leadership. The three appointed Democratic members of the panel include Richard Neiman, the New York State's Superintendent of Banks; Elizabeth Warren, a professor of law at Harvard University; and Damon Silvers, Associate General Counsel at the AFL-CIO. The Republican panel members include Senator Judd Gregg (R-NY) and Representative Jeb Hensarling (R-TX). The oversight panel will have the dual role of making monthly reports on TARP's effectiveness and presenting a plan for remaking the regulatory system for financial institutions by January 20th.

- The GAO's 20-person oversight team will release its first oversight report on TARP on December 2. "There's a lot going on, said Tom McCool, director of GAO's Center for Economics. "We're trying to keep up." McCool said his oversight team is trying to determine how best to measure the success of Treasury's direct investments in financial companies and has been talking to bank regulators about their handing of banks' applications for TARP funds. (*American Banker*, Emily Flitter, 11/18/08; *CQ Today*, Benton Ives, 11/19/08)

Treasury doesn't intend to issue additional compensation restrictions under EESA

- During a November 18th speech, Helen Morrison, acting deputy benefits tax counsel in Treasury's Office of Benefits Tax Counsel, said the agency does not intend to issue additional restrictions on executive compensation under the EESA, despite demands from some lawmakers that the department beef up the regulations issued on October 15th. "The politics around executive compensation is very thick," warned Morrison. "…[W]e have no intention of going beyond the statute and our statutory authority in terms of providing guidance in the executive compensation area. It may be, however, in the coming year with the change in administration that we may see additional legislation in the executive compensation area. This is not a topic that we've seen the last of." Treasury has no intention of taking on executive compensation issues that exceed the four corners of the EESA, she added. There are several proposals that may gain momentum in the new Congress, including further limitations on nonqualified deferred compensation and a proposal to cap nonqualified deferred compensation at $1 million. "In our current environment and in an environment in which revenue is king," Morrison said, "I think executive compensation is likely a topic Congress will revisit." Treasury is working on a compliance proposal applicable to financial institutions participating in the EESA's Capital Purchase Program, said Morrison. (*Bureau of National Affairs*, Michael Bologna, 11/19/08)

- In a November 19th letter to Treasury Secretary Paulson, nine members of the Senate Finance Committee sought assurances from the Secretary that he intended to keep companies from offering golden parachutes to their executives for firms participating in the TARP. The lawmakers wrote, “We want to convey our concern that the executive compensation provisions continue to be a priority in the implementation of [the Emergency Economic Stabilization Act]. We expect that the Treasury, in implementing EESA, will carry out both the letter and the spirit of the law and the accompanying guidance. We also expect continued transparency throughout the process—on behalf of both Treasury and the companies involved in the rescue program.” The signatories included committee chairman Max Baucus (D-MT), seven Democratic members of the committee, and Republican member, Olympia Snowe (R-ME). (*Bureau of National Affairs*, Brett Ferguson, 11/20/08)

Treasury hires to firms provide legal assistance with the Capital Purchase Program

- The Treasury Department has awarded contracts with Hughes Hubbard & Reed, LLP and Squire Sanders & Dempsey to provide the agency legal assistance with the implementation of the Capital Purchase Program. The firms will review investment agreements, work with participating financial institutions, and close CCP transactions. The contracts, which are effective until April 28, 2009, are not expected to exceed approximately $5.5 million for each firm, said Treasury. (*Bureau of National Affairs*, 11/04/08)

Fannie Mae and Freddie Mac

The housing GSEs—Fannie, Freddie, and the FHLBs—had $6.8 trillion of debt outstanding on September 30, 2008

- According to the Federal Housing Finance Agency's Performance and Accountability Report for 2008, Fannie Mae, Freddie Mac and the 12 FHLBs had a combined $6.8 trillion of debt outstanding on September 30, 2008—exceeding the U.S.'s publicly-held debt by $1.0 trillion. The housing GSEs have purchased or guaranteed nearly 87% of the new mortgages made during the second quarter of 2008, according to the report.

- The FHFA has successfully integrated OFHEO, the Federal Housing Finance Board, and staff from the HUD into the agency, less than 90 days after passage of the Federal Housing and Economic Recovery Act in July, which called for the creation of the single housing regulator.

- "The year 2008 was the most challenging in the history of OFHEO and the FHFB, as the decline in the housing markets not only threatened Fannie Mae and Freddie Mac, but also financial markets worldwide," said FHFA director James Lockhart. "Working together with Congress and the Administration, we can restore confidence in the Enterprises and build a stronger and safer future for the mortgage markets, homeowners and renters in America." (*FHFA Press Release*, 11/17/08)

- FHFA's seizure of Fannie Mae and Freddie Mac by FHFA caused the agency to exceed its FY2008 budget by 14.2% to $75.4 million—$9.4 million more than the $66 million budget appropriated by Congress for the agency. FHFA set aside $5.5 million for attorneys, who consulted with the agency about the GSEs' conservatorship. In addition, the regulator spent $13.6 million for outside legal assistance, litigation, and expert witnesses for FY2008. (*Bloomberg News*, Dawn Kopecki, 11/17/08)

- The White House has nominated Justice Department criminal fraud attorney Steve Linick to serve as the new inspector general, overseeing the Financial Housing Finance Agency. Linick currently heads Justice's National Procurement Fraud Initiative and Task Force. Previously, he served as the acting deputy chief of the financial fraud unit at the Justice Department (*Bloomberg News*, Dawn Koepcki, 11/14/08)

Expensive lessons learned with the “too big to fail” GSEs

- In a November 22nd article in the *Wall Street Journal,* American Enterprise Institute fellow Peter Wallison wrote, “…[P]redicting the true sources of systemic risk in advance of their actual failure is probably impossible. But even if it could be done, should we want to? The answer is no. An institution designated as systemically significant, or ‘crucial,’ would be marked as too big to fail. After all, that’s what such a designation means—that the institution’s failure must be avoided because of its potential impact on the economy or financial system. But once we designate a financial institution as too big to fail, and regulate it as such, a lot of unpleasant things follow.”

- “First, we will have created ‘moral hazard’ and impaired market discipline. The markets will understand that a loan to a systemically significant institution will carry less risk than a loan to an institution that does not have this status. Accordingly, systemically significant institutions will have an easier time raising funds than others, will pay lower rates and grow larger than others, and it will be able to take more risks because of the absence of market discipline.”

- “This in a nutshell is the story of Fannie Mae and Freddie Mac. The two companies were implicitly backed by the U.S. government, which in practical terms meant that they would not be allowed to fail. As a result, they were able to borrow as much as they wanted and take risks with those funds that they couldn’t have taken unless the markets believed—correctly as it turned out—that Uncle Sam would stand behind them.”

- “Second, systemically significant institutions would suddenly have an unfair competitive edge that would warp the market. Why? Because their lower funding costs would make them more profitable than others, and enable them—as it enabled Fannie and Freddie—to drive competitors from any markets they enter.”

- “The effect of designating certain companies as systemically significant would cause a consolidation of the industries in which they are located, with the systemically significant companies gobbling up those that couldn’t survive, and others seeking mergers simply to claim designation as systemically significant or too big to fail.”

- “Finally, the support voiced in Washington for the idea of regulating systemically significant financial institutions is based on the fundamental misperception that regulation can prevent them from taking the huge risks their protected status would permit. This New Deal notion should be discarded.”

- “Exhibit A is the banking system, now mired in the worst financial crisis since the Great Depression—even though it has always been the most heavily regulated. Exhibit B is the S&L debacle less than 20 years ago. Thousands of S&Ls and more than 1,500 commercial banks collapsed in another memorable regulatory failure.”

- "It is completely inexplicable—after the blindingly obvious failure of bank regulation—that Washington (and European Union) policy makers would now want to spread regulation beyond banking and into other financial institutions, including hedge funds, brokerage houses and others that the government designates as systemically significant. This would give the government the opportunity to pick winners in each financial industry—ultimately creating Fannies and Freddies everywhere. Among bad ideas, this one stands out." (*Wall Street Journal*, Peter Wallison, 11/21/08)

Hearing on collapse of Fannie Mae and Freddie Mac scheduled for December 9th

- On December 9th, the House Committee on Oversight and Government Reform will hold a hearing on the collapse of Fannie Mae and Freddie Mac. The former executives of both companies have been invited to testify at the hearing. (www.oversight.house.gov/schedule)

FHFA suspends the GSEs' housing fund requirement

- On November 13, the Federal Housing Finance Agency suspended the GSEs' requirement to allocate funds equal to 4.2 basis points of new mortgage purchases for a Housing Trust Fund and Capital, according to an SEC disclosure by Fannie Mae. The company said it should not allocate money to the funds "until further notice" by FHFA. (*Reuters*, 11/18/08)

A new wave of mortgage putbacks coming from Fannie and Freddie

- Mortgage originators are facing a new wave of forced loan repurchases—this time from Fannie Mae and Freddie Mac, who have stepped up reviews for underwriting problems. While rising mortgage delinquencies have triggered these reviews, servicers say that the loans being sent back are often several years old, and not all of them are delinquent. Some lenders argue that the GSEs are going too far, pushing back loans for minor oversights that aren't relevant to credit performance. The GSEs' more vigorous putbacks also have led to more careful underwriting, which has caused counterparties to toughen standards on one another. "If you're a mortgage banker, and you sell a loan to a GSE-sponsored company … the number one thing you have to be worried about is that at some point, that loan is going to have to be repurchased due to a fraud claim by the GSE," said Scott Stern, the chief executive of Lenders One.

- According to a Fannie Mae spokeswoman, the company's increase in repurchase requests is the result of "the increase in defaults, not any change in policy. We are committed to working with our servicers and try to be balanced in our reviews. In addition, we have a process in place for servicers who have questions or want to provide additional information." In August, Fannie was it was expanding its "loan reviews where the company incurred a loss or could incur a loss due to fraud or improper lending practices." The company said it planned to more than quadruple its reviews of foreclosed mortgages 4,000 a month by year-end and to double its antifraud investigations. Fannie also said it was expanding "quality control reviews for targeted products and practices."

- In August, Freddie Mac disclosed that in the first half its putbacks rose 130% compared with the first half of 2007, to $737 million. (*American Banker*, Harry Terris, 11/12/08)

Congress will focus on restructuring financial regulatory system in the 111th Congress

- During the 111th Congress, Chairman Barney Frank (D-MA) plans for his committee to tackle a complete overhaul of financial regulation on the scale of the New Deal, which is expected to include tighter capital standards for banks, more oversight for the lightly regulated hedge fund industry and new standards for credit default swaps. President-elect Obama is expected to help Democrats accomplish some of their goals, including tougher home lending standards and requirements for more transparency from financial companies. (*CQ Today*, 11/21/08)

- In a speech at a conference sponsored by the Securities Industry and Financial Markets Association, Senator Charles Schumer (D-NY), chairman of the Joint Economic Committee and member of the Senate Banking Committee, said, "The restructuring of financial regulation will be a major priority of the new Congress [that] some think we're going to work on immediately." Schumer outlined six elements that he believes must by part of any financial services regulatory reform effort undertaken by the next Congress. A chief tenet of the reform program would be to consider adopting a single regulator for the financial services industry, a concept opposed by many state insurance and banking regulators. "We need to look closely at unifying and simplifying our regulatory structure, perhaps moving toward a single regulator," said Schumer. "In this era of global markets and global actors, we cannot return to the older model of separate businesses with separate regulators. We must consider whether a more unified financial regulatory system could provide more efficient regulation. Other elements in his plan include: (i) focusing on controlling systemic risk and ensuring financial stability; (ii) extending regulatory reach to parts of the financial services industry that are currently not regulated but have the ability to put U.S. financial markets at risk; (iii) increasing transparency; (iv) ending the concept that no regulation of the financial services industry is an appropriate governmental perspective; and (v) recognizing that today's modern financial environment requires global solutions to regulatory challenges.

- The financial regulatory system in the United States is "outdated and overmatched" and based on old assumptions that a financial services firm seamlessly aligns with one regulator—even though the company may engage in myriad businesses offering various financial services, said Schumer. "Today these firms don't operate in the same old ways, but our regulatory system still imagines they do. (*Bureau of National Affairs*, Stephen Joyce, 11/12/08)

Obama team has ties with Fannie Mae and Freddie Mac

- President-elect Barack Obama's chief of staff, Representative Rahm Emanuel (D-IL), will be working on overhauling the financial services' regulatory regime, an industry in which he earned more than $16 million during a two-year stint working for the investment banking firm Wasserstein Perella & Co. Emanuel also has close ties to Freddie Mac, where he was appointed by President Bill Clinton to serve on the board of directors. During his 18 months on Freddie's board, Emanuel received fees of $262,715. During his board tenure, the company was plagued with scandals involving campaign contributions and accounting irregularities. OFHEO later accused the board of having "failed in its duty to follow up on matters brought to its attention." Emanuel resigned from the board in 2001 to run for Congress. (*ABC News*, Brian Ross and Rhonda Schwartz, 11/07/08; (http://en.wikipedia.org/wiki/Rahm_Emanuel\)

- Two members of Obama's transition team at the State Department also have close ties to Fannie Mae. Tom Donilon, who was a top lobbyist for Fannie Mae from 1999 to 2005, oversaw an aggressive, backdoor lobbying campaign by the GSE to undermine the credibility of a probe into the company's accounting irregularities, according to a 2006 examination report by OFHEO. Donilon's efforts, which reportedly included attacks on the funding for the oversight agency, was ultimately unsuccessful.

- Obama's other State Department team transition leader, Wendy Sherman, served as president and CEO of the Fannie Mae Foundation from 1996 to 1997. Neither Donilon nor Sherman have worked for Fannie Mae during the last year, and neither will be advising the transition team on housing issues. (*Politico.com*, 11/12/08; *ABC News*, Emma Schwartz and Justin Rood, 11/17/08; *Wall Street Journal*, Brody Mullins and Siobhan Hughes, 11/08/08)

Federal banking regulators publish appraisal guidelines for residential and commercial real estate

- On November 13, the federal banking regulators issued for comment revised guidelines and supervisory expectations for real estate appraisals for residential and commercial properties. The new guidance provides an expanded discussion of portfolio management techniques and circumstances under which a financial institution should update or replace collateral valuations for an existing real estate transaction. The guideline's proposed revisions address (i) expanding the agencies' expectations for an independent appraisal and evaluation function; (ii) requiring greater explanation of the agencies' minimum appraisal standards, including clarification of requirements for appraisals of residential tract developments; (iii) revising the Uniform Standards of Professional Appraisal Practice, which are incorporated by reference in the agencies' appraisal regulations; (iv) requiring a risk-focused appraisal and evaluation reviews separate and apart from an institution's compliance function; and (v) adding three appendices—Appendix A to provide further clarification on real estate transactions that are exempt from the agencies' appraisal regulations; Appendix B to address acceptable evaluation alternatives and use of automated valuation models; and Appendix C to provide a new glossary of terms. (*Bureau of National Affairs*, Thecla Fabian, 11/14/08)

HUD issues a final rule updating the requirements for RESPA

- HUD has issued a final rule amending Regulation X, which updates the requirements of the Real Estate Settlement Procedures Act (RESPA). The new rule's provisions include: (i) the establishment of new Good Faith Estimate and HUD-1/HUD-1A settlement statement forms; (ii) limitations on the charge that may be imposed on consumers for delivery of the GFE; (iii) a requirement that yield spread premiums to be included in the "origination charge" disclosed on the GFE, and treats lender payments to mortgage brokers as a credit towards settlement charges; (iv) an expansion of the definition of "mortgage broker" to include exclusive agents of a lender who provide origination services and serve as an intermediary between the lender and the borrower; (v) an amendment of the "required use" definition to include incentives for using a particular service provider (e.g., builder discounts for using an affiliated lender); (vi) a clarification of escrow account requirements and mortgage servicing transfer provisions; and (vii) a provision that all RESPA disclosures may be provided to consumers in electronic form, as long as the consumer consents to receive the disclosures electronically and the other requirements of the Electronic Signatures in Global and National Commerce Act are satisfied. Under the final rule, compliance with the new GFE and settlement statement goes into effect on January 1, 2010, while certain provisions, including the required use provision, will go into effect on January 16, 2009. HUD dropped a provision that would have required a lengthy "script" be read to borrowers during the loan closing, which would have set out the terms of the loan. Lenders complained that the script would have raised costs by taking up too much time during the loan closing. The final rule is available at this web address: http://www.goodwinprocter.com/~/media/58CB1355A959446D82F1BFB2FAE73E02.ashx (*Consumer Financial Services Alert*, Goodwin Procter, 11/18/08; *Wall Street Journal Online*, James R. Hagerty, 11/12/08)

- How *did* this "perfect storm" occur in the financial services industry? In a November 18th speech, Bank of America chairman and CEO Ken Lewis describes the cataclysmic events which reeked havoc in the financial markets: "This was a 'perfect financial storm.' …[T]here's a long list of factors that brought us to our current state: All kinds of government subsidies for the housing industry. Excessively low interest rates. Appraisers and ratings agencies that based their analytical models on recent historical data drawn from inside the growing bubble. A global savings glut that created massive liquidity, and global investors chasing higher yields. Complex securitizations that were not always well-understood by those investing in them. Investment banks, freed from leverage limits, piling on debt. Lightly regulated mortgage companies, thrifts and brokers, feeding investors' growing appetite by underwriting all kinds of crazy mortgage products… low-doc, no-doc, no money down, negative amortizing loans. All of which combined to form a society-wide consensus that house prices would rise forever."

- Lewis continued, "The combination of these factors… all of which reinforced one another…produced a few key effects. First, real estate speculation…that is, purchases for investment, not for shelter…increased from an historical average of 3-4% of the total residential market to a high in 2006 of 28%. Second, median house prices, adjusted for inflation, which took 40 years to double between 1960 and 2000… almost doubled again between 2000 and 2007. And third, homeownership rates spiked to an all-time high. We all know what happened next. The market peaked… defaults rose… prices began to fall… greed turned to fear… and the party came to an abrupt end." (*Remarks to the Detroit Economic Club*, Kenneth D. Lewis, 11/18/08)

- John Thain, chairman and CEO of Merrill Lynch, warned that the global economy is entering a slowdown of epic proportions—comparable to the period after the 1929 crash. "Right now, the US economy is contracting very rapidly," said Thain. "We are looking at a period of global slowdown. This is not like 1987 or 1998 or 2001. The contraction going on is bigger than that. We will in fact look back to the 1929 period to see the kind of slow-down we are seeing now." The economic problems afflicting the US, where housing prices and other asset values were falling, will wreak havoc across the world, he added. "There is no such thing as decoupling. All equity markets are linked. Each individual economy will be more or less affected, depending on reliance on global trade and commerce." (*Financial Times*, Greg Farrell, 11/12/08)

- The U.S. may need to spend another $1.2 trillion to recapitalize the eight largest financial institutions and stabilize the markets because private investors won't take the risk, said FBR Capital Markets analyst Paul Miller in a research note. "The sheer size of the capital deficiency, coupled with the opaque nature of credit risk, will keep private capital sidelined," wrote Miller. Only injections of true tangible common equity will solve the current crisis. …Eventually, capital levels will be strengthened by both private capital raises and internal capital generation, but the federal government will have to be the primary first responder to the crisis." Miller estimates that the U.S. needs to inject between $1 trillion to $1.2 trillion of common equity into the eight largest banks to restore investor confidence and help the institutions weather the losses from financial crisis. He believes it will take three to five years for the financial system to fully recover. (*Bloomberg News*, Dawn Kopecki, 11/20/08)

- In 2008, FDIC has taken over 19 failed banks at an estimated cost of $16.0 to $16.2 billion to the bank insurance fund. On November 21st, Downey Savings and Loan, New Port Beach, CA ($12.8 billion in assets), PFF Bank & Trust, Pomona, CA ($3.7 billion), and Community Bank, Loganville, GA ($681 million) were the latest institutions to fail and be placed into receivership by FDIC. (*Wall Street Journal*, Damian Paletta, 11/22/08)

- In October, the U.S. unemployment rate reached 6.5% with 1.2 million jobs being lost since the first of the year and over half of those losses occurring in the last three months. In October, month-over-month unemployment rates increased in 38 states and the District of Columbia, while unemployment rates held steady in seven states and fell in five. Many economists forecast the national unemployment rate to top 8% in the next few months. (*Wall Street Journal*, Connor Dougherty, 11/22/08; *Frontline Weekly Newsletter*, John Mauldin, 11/07/08)

- In October, consumer prices dropped a record 1%, the largest single month decline on record (dating back to 1947). Energy prices fell a record 8.6%, while food prices rose 0.3%, the smallest gain since May. (*MarketWatch*, 11/19/08; *Associated Press*, 11/19/08)

- Construction of new homes and apartments fell 4.5% in October to an annual rate of 791,000, marking the slowest construction pace on records going back to 1959. (*Associated Press*, 11/19/08)

- Home prices plummeted during the third quarter by a record 9% year-over-year, caused by the sale of foreclosed properties which accounted for 35% to 40% of home sales during the period. The median price of a single-family home fell in four out of five states, according to the National Association of Realtors. Three California markets recorded the steepest year-over-year declines in median prices—Riverside San Bernandino, east of Los Angeles, down 39.4% to $227,200; Sacramento, down 36.8% to $212,000 and San Diego, down 36% to $337,300. The national median price of a home was $200,500, down 2.9% from the second quarter of 2008. (*CNNMoney*, Les Christie, 11/18/08; *HousingWire*, Paul Jackson, 11/19/08)

- Approximately 84,900 homes were lost to foreclosure during October, marking the 34th consecutive month in which U.S. foreclosure activity increased compared to the prior year. A total of 936,439 homes have been lost to foreclosure since the housing crisis began in August 2007. In October, 279,561 at-risk borrowers received foreclosure filings, including default notices, notices of auction sales, and bank repossessions, an increase of 5% from September and up 25% from October 2007. (*CNNMoney*, Catherine Clifford, 11/13/08)

- The market for commercial real estate is expected to weaken further over the next six to nine months, as the availability of credit tightens, according to the National Association of Realtors. RBS Greenwich Capital Markets warn that commercial real estate borrowers are running out of options as asset-backed markets dry up and alternative financing, such as regional banks and insurance companies, have stopped lending. Sales of bonds backed by commercial mortgages have fallen to $12.2 billion in 2008, versus a record $237 billion last year, according to JPMorgan Chase. The dearth of financing options will make it challenging for borrowers with loans coming due in 2009 in which approximately $88 billion in commercial real estate loans will mature next year, according to RBS Greenwich Capital. (*Bloomberg News*, 11/21/08; *Washington Post*, Heather Landy and Dana Hedgpeth, 11/21/08; *Bloomberg News*, 11/10/08)

Fannie Mae

Fannie Mae completes its first long-term note sales since September

- On November 17th, Fannie Mae raised $2 billion in its first long term debt sale in two months, paying record yields over benchmark rates to complete the offerings. The sale was split evenly between a reopening of a five-year benchmark notes priced to yield 1.32% above similarly priced Treasuries and three-year notes that paid an average spread of 1.45%. Fannie had to offer spreads that were roughly double what it paid in September to attract investors. “This is the testing of the waters,” said Ira Jersey, an interest rate strategist for Credit Suisse. “My guess is that there will be some people continuing to question exactly what the future of Fannie and Freddie will be.” (*Bloomberg News*, Jody Shenn, 11/17/08)

- In a November 21st *New York Times* article, Rob Cox and Dwight Cass wrote, “…Fannie Mae and Freddie Mac bonds should be ideal for investors seeking high returns on low risk debt. But they’re staying away in droves, reflecting skepticism over whether the United States will make good on its guarantees. Fannie Mae’s 10-year bonds now yield 1.81 percentage points more than equivalent Treasuries, three times as big a spread as when the government put it and Freddie Mac into conservatorship in September.”

- “Big investors, including China, are leaving money on the table by favoring Treasury bonds over the debt of the government-sponsored enterprises, despite the fact they now have explicit government support that runs to a full guarantee. Why? The bond traders who would normally buy G.S.E. debt and sell Treasury bonds when their yields diverged are unable to obtain the debt to finance their activities. More importantly, Treasury yields have plumbed record lows as investors scrambled for safe havens."

- "Yet [GSE] debt has not been snapped up by those seeking to shed risk, despite the government's backing. It didn't help that Treasury Secretary Henry M. Paulson Jr. waffled about the extent of the government's backing for the G.S.E.'s at a news conference last week. And both Fannie Mae and Freddie Mac just reported record losses."

- "If investors thought Washington's backing was bulletproof, that wouldn't matter. But United States coffers are increasingly stretched. The latest flare-up in the financial crisis, troubles in Detroit and the deterioration of the economy may require more cash. Uncle Sam's resources may be vast, but investors shunning G.S.E. debt are probably right to bet they're not unlimited." (*New York Times*, Rob Cox and Dwight Cass, 11/21/08)

Fannie Mae spends $6,000 on golf outing

- Television station KTVT in Dallas-Fort Worth reported that Fannie Mae paid for a 20 golfers to attend a $6,000 golf excursion in Texas on September 29th—22 days after the government take over. According to documents reviewed by CBS11, the tab included more than $4,000 for the golf outing with "mango towel service," $1,700 worth of buffet food, a $555 bar tab.

- "I am outraged by this," said Representative Jeb Hensarling (R-TX), who serves on the House Financial Services Committee. "They have $200 billion …of taxpayer money from the school teacher in Mesquite, the factory worker in Garland, the policeman in Dallas, and they're running around golfing, getting mango towel service. I'm not even sure what mango towel service is, but I know the taxpayers of Dallas County and America shouldn't have to be paying for it." Leslie Paige with the non-partisan watchdog group Citizens Against Government Waste said, "Do they have any idea how bad this looks? They can take care of client relations with teleconferencing. They don't need to go around having very extravagant golf outings and that may be only one. We don't know, but I guarantee you if there's one, there's probably more."

- Fannie Mae, which did not dispute the report, called the outing a customer meeting which is held semi-annually. "We do regret that the activities surrounding the customer meetings in Dallas may be perceived as excessive," said company spokesman Brian Faith. "We have ceased all similar activities as those associated with this event, and we regret having not done so in this case." Fannie's golf outing snafu follows revelations in September that AIG spent $440,000 on a posh California retreat for its executives after the company received an $85 billion loan from the government to stave off bankruptcy. (*Associated Press*, 11/07/08; *CBS 11 News,* Doug Dunbar, 11/03/08)

Freddie Mac

Freddie Mac names a new treasurer

- Timothy Bitsberger, a former Treasury official who joined Freddie Mac to serve as treasurer in 2005, has left the company. Bitsberger's successor is Peter Federico, who has been senior vice president of assets and liabilities. (Bloomberg News, Dawn Kopecki, 11/18/08; *Wall Street Journal*, James R. Hagerty, 11/19/08)

Freddie Mac and JPMorgan in dispute over bad mortgages sold by WaMu

- Freddie Mac and JPMorgan Chase are in embroiled in a dispute over Washington Mutual's repurchase obligations, which could impact millions of dollars of JPMorgan's fees. When it purchased certain assets and liabilities of WaMu from the FDIC in September 2008, JPMorgan asserted that it would not be responsible for WaMu's obligations to repurchase mortgages which were found to be inconsistent with representations and warranties made at the time of sale. In turn, Freddie Mac has notified JPMorgan Chase that it is unwilling to consent to the Bank being the successor servicer for Washington Mutual, unless JPMorgan assumes WaMu's repurchase obligations. During the first nine months of 2008, WaMu and JPMorgan Chase accounted for 7% and 9%, respectively, of Freddie Mac's single-family mortgage purchase volume.

- "Next year will bring more of these sorts of disputes to light as the stakes get larger and patterns of bad originations standards in 2006-2007 become clearer," said Jim Vogel, head of agency debt research at FTN Financial Group. (*Form 10Q*, Freddie Mac, 11/14/08; *Bloomberg News*, Jody Shenn, 11/14/08)

Freddie Mac funds major Southern California rental property

- Freddie Mac has purchased a $73.7 million loan from Wells Fargo Bank, which enabled Loma Palisades, a California general partnership, to refinance the 546-unit Loma Palisades Apartments. The 68 building complex in San Diego, CA was built in 1959. A portion of the proceeds will be used to complete the rehabilitation of the units' interiors. "The deal was rate-locked and funded in 45 days in an extremely volatile rate environment," said Tom Szydlowski, head of production for Wells Fargo Multifamily Capital. "The client was impressed with the pricing, execution, and client-focused approach that the team took in underwriting the credit, which helped deepen an important bank relationship." (*Freddie Mac Press Release*, 11/13/08)

Federal Home Loan Banks

FHLB System assets increase 12.3% to $1.272 trillion
during the first nine months of 2008

- On September 30th, the FHLB System reported total assets of $1.429 trillion, an increase of 12.3% from $1.272 trillion at yearend 2007. The System's advances increased 15.6% to $1.012 trillion and represented 70.8% of total assets. Investments rose 6.4% to $316 billion, while member mortgage assets, which totaled $88 billion, were down 4.0% from year-end 2007. The System's consolidated obligations outstanding totaled $1.323 trillion at September 30, 2008, an increase of 12.2% from year-end 2007. On September 30, the System reported total capital of $57.1 billion, a 6.5% increase from December 31, 2007.

- The FHLB System reported combined net income for the third quarter of $506 million, a 30.9% decrease from the same period last year. The System's combined net income for the nine months ended September 30, 2008 totaled $1.921 billion, a 3.0% decrease from same period in the previous year. The System's net income was adversely impacted by write-offs/reserves on receivables due from Lehman Brothers Special Financing and other than temporary impairment charges on certain private label mortgage-backed securities.

- At least 11 FHLBs reported that the value of their private-label MBSs dropped during the third quarter, while the FHLB-Seattle delayed its earnings report for the period, as it tried to value its securities. Some industry observers fear that rising losses on the FHLBs' portfolios could force one of more of the banks to run through its retained earnings and be forced to lower the value of their par-value stock. "Declines in market value relative to book values could conceivably get to where the financial strength of the [FHLB] would appear to be so impaired that its viability would be suspect," said a source close to the FHLBs. "If you're the regulator, and that occurs, you become increasingly concerned." (*FHLBanks Office of Finance Press Release*, 11/19/08; *American Banker*, Steven Sloan, 11/19/08)

- The FHLB-Atlanta reported a third quarter loss of $46.1 million, due in part to a credit loss on money owed the Bank by a unit of the now bankrupt Lehman Brothers and an $87.2 million write-down on mortgage-backed securities. The FHLB-Pittsburgh and FHLB-New York also recorded provisions of $41.5 million and $64.5 million, respectively, related to exposures to Lehman during the third quarter. (*Wall Street Journal*, 11/17/08)

FHA /Ginnie Mae

FHA sets aside $12.2 billion to cover mortgage losses in FY2008

- The FHA booked $12.2 billion of additional reserves to cover expected losses on its single-family mortgage portfolio. During FY2008, the FHA-insured mortgage portfolio grew 36% to $479.6 billion, while the agency's reserves surged 163% to $19.7 billion. The agency attributed its sharp rise in "loan guarantee liability" to high default rates on FHA-insured loans with down payment assistance and to house price declines. The agency's capital ratio for its single-family insurance fund fell 3.4% to 3% during FY2008, still above the fund's 2% capital ratio requirement. (*National Mortgage News*, 11/19/08)

HUD eases the requirements for the Hope for Homeowners program

- On HUD Secretary Steve Preston today announced that the HOPE for Homeowners (H4H) Board of Directors had approved changes to the program to help more distressed borrowers refinance into affordable, government-backed mortgages. Under these changes, the H4H program's loan to value ratio is increased to 96.5% for some H4H loans and the loan terms can be extended from 30 to 40 years. Also, the program is simplifying the process to remove subordinate liens by permitting upfront payments to lien holders. During a speech at the National Press Club, HUD Secretary Steve Preston said that since second lien holders "have low expectations already," HUD will likely pay "pennies on the dollar" for these seconds." FHA Commissioner Brian D. Montgomery said, "These changes will further encourage lenders to take a hard look at this program before heading down the path to foreclosure and will provide families with another resource to refinance into a loan they can afford. HOPE for Homeowners will continue to serve as another loss mitigation tool that can be used to help families keep their homes."

- Initially, the H4H program had required lenders to write down a mortgage loan to 13% below the market value of the collateral property. To date, few lenders have applied to participate in the H4H program. "This hasn't been a gangbuster success," said Robert Davis, the ABA's executive vice president for government relations. "It's ramping up. … Nothing's been approved. You have 50 or so loans in the queue; that's not going to change the landscape of America…" (*American Banker*, Stacy Kaper, 11/04/08; *HUD Press Release*, 11/19/08; *National Mortgage News,* 11/21/08)

Chairman Frank urges Treasury to use TARP funds to reduce FHA's insurance premiums and fees on Hope for Homeowners loans

- In a November 20th letter to Treasury Secretary Henry Paulson, House Financial Services Committee chairman Frank Barney(D-MA) argues that the agency should use TARP funds to reduce the reduce the "high level" of upfront and annual fees on the "Hope for Homeowners" program. The FHA is required to charge a 3% upfront and a 1.50% annual premium in the H4H program, as compared to the upfront premium is 1.75% and annual premium is 55 basis points for "regular" FHA loans. "These high fees are depressing program usage, and using TARP funds to pay them down could significantly increase the number of foreclosures averted," wrote Frank. The chairman also urged Paulson to begin purchasing whole loans on a "large scale" to facilitate for loan modifications and help keep borrowers in their homes. (*National Mortgage News*, 11/21/08)

Seven trade groups urge HUD to extend the *FHASecure* program

- In a November 19th letter to HUD Secretary Steve Preston and OMB Director Jim Nussle, seven trade groups expressed their full and united support in the continuation of the *FHASecure* program, which is scheduled to sunset on December 31, 2008. The groups wrote, "The FHASecure program has proven to be an effective and critically important tool to assist distressed homeowners. …We urge the extension of FHASecure so it can continue, without disruption, through at least 2009." The letter was signed by the American Bankers Association, the American Financial Services Association, the Center for Responsible Lending, the Consumer Bankers Association, the Consumer Mortgage Coalition, the Housing Policy Council and the Mortgage Bankers Association. (*Correspondence to The Honorable Steve Preston and The Honorable Jim Nussle*, American Bankers Association, American Financial Services Association, Center for Responsible Lending, Consumer Bankers Association, Consumer Mortgage Coalition, Housing Policy Council and Mortgage Bankers Association, 11/19/08)

FHA: The New Fannie Mae?

- In a November 19th *Business Week* article, Chad Terhune and Robert Berner wrote, " Thousands of subprime mortgage lenders and brokers—many of them the very sorts of firms that helped create the current financial crisis—are going strong. Their new strategy: taking advantage of a long-standing federal program designed to encourage homeownership by insuring mortgages for buyers of modest means. You read that correctly. Some of the same people who propelled us toward the housing market calamity are now seeking to profit by exploiting billions in federally insured mortgages. Washington, meanwhile, has vastly expanded the availability of such taxpayer-backed loans as part of the emergency campaign to rescue the country's swooning economy."

- "For generations, these loans, backed by the Federal Housing Administration, have offered working-class families a legitimate means to purchase their own homes. But now there's a severe danger that aggressive lenders and brokers schooled in the rash ways of the subprime industry will overwhelm the FHA with loans for people unlikely to make their payments. Exacerbating matters, FHA officials seem oblivious to what's happening—or incapable of stopping it. They're giving mortgage firms licenses to dole out 100%-insured loans despite lender records blotted by state sanctions, bankruptcy filings, civil lawsuits, and even criminal convictions."

- "As a result, the nation could soon suffer a fresh wave of defaults and foreclosures, with Washington obliged to respond with yet another gargantuan bailout. *Inside Mortgage Finance* …estimates that over the next five years fresh loans backed by the FHA that go sour will cost taxpayers $100 billion or more. That's on top of the $700 billion financial-system rescue Congress has already approved. Gary E. Lacefield, a former federal mortgage investigator who now runs Risk Mitigation Group, a consultancy in Arlington, Tex., predicts: 'Within the next 12 to 18 months, there is going to be FHA-insurance Armageddon.'"

- "…Some current and former federal housing officials say the agency isn't anywhere close to being equipped to deal with the onslaught of lenders seeking to cash in. Thirty-six thousand lenders now have FHA licenses, up from 16,000 in mid-2007. FHA 'faces a tsunami' in the form of ex-subprime lenders who favor aggressive sales tactics and sometimes engage in outright fraud, says Kenneth M. Donohue Sr., the inspector general for HUD. 'I am very concerned that the same players who brought us problems in the subprime area are now reconstituting themselves and bringing loans into the FHA portfolio,' he adds. FHA staffing has remained roughly level over the past five years, at just under 1,000 employees, even as that tsunami has been building, Donohue points out. The FHA unit that approves new lenders, recertifies existing ones, and oversees quality assurance has only five slots; two of those were vacant this fall, according to HUD's Web site. Former housing officials say lender evaluations sometimes amount to little more than a brief phone call, which helps explain why questionable ex-subprime operations can re-invent themselves and gain approval. 'They are absolutely understaffed,' says Donohue, 'and they need a much better IT system in place. That is one of their great vulnerabilities.'" (*Business Week*, Chad Terhune and Robert Berner, 11/19/08)

Ginnie Mae modifies its policies for handling delinquent mortgages

- Effective January 1st, Ginnie Mae will be tightening its requirements for accepting loans with a history of delinquency as collateral in pools eligible for the "to-be-announced market"—Ginnie Mae I X SF, Ginnie Mae II M SF, and Ginnie Mae II M JM pools—unless the borrowers have fully caught up on payments by the time the new securities are issued. The current rules, which allow delinquent loans repurchased from Ginnie pools to be securitized again if the borrowers are no more than 60 days behind on payments by the new issue date, will remain in effect for all for all other types of Ginnie pools.

- Ginnie also clarified its policy for removing delinquent mortgages from pools. Loans delinquent 90 days or more can be repurchased without written permission from the agency. This policy will provide servicers more flexibility to pursue workouts, since lenders are unable modify the terms of loans still in Ginnie pools. The agency also reiterated that certain types of workouts are allowed by the FHA, including “special forbearance” and “partial claim” plans which do not alter the terms of a loan and can be accomplished without removing the loan from a pool. (*American Banker*, Allison Bisbey Colter, 11/13/08)

International Markets

The G20 adopts a Summit Declaration that addresses strengthening the transparency and accountability of accounting standards

- On November 15th, the G20 leaders outlined the foundation for reforms to reshape the international financial system and worldwide regulatory and accounting rules. The 20 nations agreed on five over-riding principles: (i) strengthening transparency and accountability; (ii) enhancing sound regulation; (iii) promoting integrity in financial markets; (iv) reinforcing international cooperation; and (v) reforming international financial institutions. The G20 leaders adopted the Declaration on Financial Markets and the World Economy (Declaration), which identifies approximately 50 different areas for action, ranging from the regulation of hedge funds to the coordination of national tax incentive measures. The summit’s 12-page final conclusions focus on improving international cooperation through the creation of “supervisory colleges”—or bodies comprising representatives of regulatory authorities—in order to “strengthen supervision” for all major cross-border financial institutions, which would encompass the world’s 30 biggest banks. Other priority areas include strengthening the credit derivatives market, reviewing financial sector pay schemes, and improving the guidance for valuation of illiquid securities. However, the statement did not include the “reinvention of the international financial system,” as envisaged by French President Nicolas Sarkozy and the European Union.

- With regard to the need for transparency and accountability for accounting standards, the Declaration said: “The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress. Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles. Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants."

- "With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities. Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies."

- The only concrete result of the summit was Japan's announcement of a $100 billion to the IMF to help developing countries that are struggling because of the global crisis. Welcoming Japan's "leadership [and] commitment towards multilateralism", IMF Managing Director Dominique Strauss-Khan said he hoped that other countries would now support the work of the IMF.

- "It was a productive and successful summit," said President George Bush, who welcomed the G20's position that capitalism and free trade, together with some regulation, were the best means of ensuring growth, employment and poverty reduction. The G20 leaders stressed that the Washington summit was a first step and instructed their ministers to draw up detailed proposals in the 50 areas for action by March 31, before a possible second summit in April 2008.

- The November meeting marked the first time that the G20, formed in 1999, gathered at the level of heads of state and government. The event emphasized not only the seriousness of the current crisis but also the growing importance of emerging economies such as China, India or Brazil and confirmed the advent of the European Union as a full partner in the international community.

- World Bank president Robert Zoellick, warned that the integration of emerging countries should not come at the expense of the poorest countries. "This is a positive step to see the leaders of developed countries meeting those of emerging economic powers, but the poorest developing countries should not be ignored," said Zoellick. "[However,] the current crisis is not resolved and long-term solutions will not be implemented by accepting a world that runs at two speeds". (*White House Press Release*, 10/15/08; *Financial Times*, Krishna Guha, 11/17/08; *Washington Post*, Glenn Kessler and Anthony Faiola, 11/16/08)

G20 meeting may be "the one bright light in the gathering darkness"

- In a November 16th editorial, the *Financial Times* wrote, "Nothing is harder than to determine the historic significance of events when they are happening. Yet the meeting of the heads of governments of the Group of 20 in Washington …looks as historic as the crisis it responds to. It might even prove the one bright light in the gathering darkness. While the G20 contains countries of small significance, it does include all important advanced and emerging countries. The fact that this group could meet and commit itself to a substantial agenda and another meeting in April 2009 shows belated recognition of the shift in the balance of economic power."

- "As important is the consensus on the roots of the crisis and what needs to be done. On the former, the communiqué [recognizes] not just the failures of the financial system itself, but also the underlying mistakes in macroeconomic policies. On the latter, it stresses two imperatives: strong and co-operative action to stimulate the world economy and maintenance of the open economy on which all depend."

- "If we have learnt anything from the catastrophe of the 1930s it is the importance of avoiding beggar-thy-[neighbor] policies, particularly protectionism. Fortunately, at the rhetorical level, the leaders seem to understand that they must hang together or hang separately. The commitment to completion of the Doha round may even be real. More important will be strong action to reduce external imbalances, particularly by large countries with huge current account surpluses."

- "Furthermore, the leaders have set their finance ministers a set of tough objectives, to be carried out by the end of March 2009. These include: mitigating against pro-cyclicality in regulatory policy; reviewing global accounting standards; strengthening derivatives markets; reviewing compensation practices in financial institutions; and reviewing the mandates, governance and resource requirements of international financial institutions. Moreover, the leaders also agreed to broaden the membership of the financial stability forum."

- "The agenda is ambitious, as it has to be. The world confronts huge dangers. It must now [minimize] the scale of the slowdown and create a more robust economic and financial regime. It can only achieve these objectives if all significant countries co-operate. It is a point the incoming Obama administration, attracted by the lures of protectionism, must note. If the world works together, it can yet emerge healthy from this crisis. If it does not, no government, however powerful, will be able to deliver on its promises. It is as simple—and brutal—as that." (*Financial Times*, 11/17/08)

EU members resist legislative proposals that would establish cross-border supervision in the insurance and banking industries within the EU

- Less than a week after the G-20 summit, EU member states defeated a pending legislative proposal that would have allowed for more EU-wide supervision in the $8 trillion European insurance industry. In addition, the EU member states expressed opposition to a European Commission legislative plan calling for a “college of supervisors” to oversee the activities of the 44 cross-border banking institutions in the EU.

- Last year, the EC proposed legislation to revamp the EU insurance regulatory regime, containing a key provision to allow for a “home country supervisor” for companies with cross-border businesses. This provision would have allowed the government of a member state where a multinational company is based to have the lead role in regulating the activities of all the company’s operations. Under current EU laws, each EU member state government has strict regulatory control over the insurance businesses operating within their borders, regardless of where else they do business or are based. Following six months of intense negotiations, EU member states agreed on November 19 to eliminate the cross-border supervisory component of the legislation. The move triggered intense criticism from the EC, which threatened to withdraw the proposal. “The Commission cannot accept the changes suggested by the member states,” said Commission spokesman Oliver Drewes. “Streamlining supervision is central to moving away from national supervision only. Removing that would mean that we are not moving sufficiently to more European supervision in this area, which is highly needed.”

- The EU’s failure to make progress on setting up European supervision for the banking and insurance industries has triggered criticism from independent experts, who say the failure will undermine efforts in the G-20 process. “The European Union has to get its own house in order before it can continue to lead in the G-20 forum,” said Karel Lanoo, executive director of the Center for European Policy Studies. (*Bureau of National Affairs Daily Report for Executives,* Joe Kirwin, 11/24/08)

The Japanese and EU economies have fallen into a recession

- Japan’s GDP contracted at an annual rate of 0.4% during the third quarter, marking the second consecutive quarter of negative growth—the technical definition of a recession. Japan’s last recession occurred in 2001, following the collapse of the dot.com bubble in the U.S. Kaoru Yosano, Japans economy minister, said that the collapsing sale of Japanese goods in the U.S. and Europe in the midst of the global downturn threatens to make the country’s export-dependent economy even weaker in coming months. “Downside risks to the economy are growing further, and Japan is in a very serious situation,” warned Yosano. Over the past two months, the Japanese stock market has plunged to lows not seen in 26 years, as the profits of some of the world’s best-known and most respected companies, including Toyota, Honda and Canon, have been slashed by as much as 70%. In an analyst report, Masamichi Adachi, senior economist at J.P. Morgan Securities in Tokyo, wrote, “We are now looking for a severe recession, similar to that during Japan’s own financial market crisis in 1997 to 1998, and to the current U.S. recession, in terms of depth of real GDP contraction." (*Washington Post*, Blaine Harden, 11/17/08)

- During the third quarter, the euro zone and European Union economies slipped into a recession, as the financial crisis continued to depress manufacturing activity and consumer demand. In the euro zone, GDP growth is projected to drop from 1.2% in 2008 to only 0.1% in 2009, before recovering to 1.1% in 2010. Similarly, the 27-country EU's GDP is expected to grow 1.4% in 2008, 0.2% in 2009 and then recover to 1.1% in 2010. According to the forecast, the euro zone and the EU currently are suffering recession. In the euro zone, the contraction is projected to last three quarters, from the second quarter to the fourth quarter this year, while the EU would record a 0.1 percent drop in both the third and fourth quarters.

- According to the European Commission's forecasts, 13 EU countries will experience technical recessions, including Germany, France, Britain, Italy, and Spain. The tiny Baltic states of Latvia and Lithuania will suffer the longest downturns with eight consecutive quarters, followed by Ireland with seven and Britain with five quarters From 2009 to 2010, only 0.5 million jobs are forecast to be created in the euro area, compared to 4 million in 2007-2008. In the EU, only 0.25 million jobs are expected to be created during the two-year period compared to 6 million in the previous period. As a result, unemployment is projected to rise from 7.0% in 2008 to 7.8 percent

- "The economic horizon of this forecast is dark. Recession is a real risk for some countries, as for the euro zone and the European Union," said EU Economics Commissioner Joaquin Almunia. "The EU economy is hit by the financial crisis that deepened during the autumn and is taking a toll on business and consumer confidence. We need a coordinated action at the EU level to support the economy similar to what we have done for the financial sector." (*Bureau of National Affairs*, Bengt Ljung, 11/04/08; *New York Times*, Matthew Saltmarsh, 11/15/08)

- Olivier Blanchard, the chief economist for the International Money Fund, warned that the global financial crisis will worsen next year and the situation will not begin to improve until 2010, before returning to "normal" in 2011. "The worst is yet to come," said Blanchard, adding "a lot of time is needed before the situation becomes normal."

- On November 21st, the IMF promised to help Latvia deal with its economic crisis after providing assistance to Iceland, Hungary, Ukraine, Serbia and Pakistan. Blanchard said the IMF was not able to solve all financial issues, in particular problems of liquidity. Withdrawals of capital leading which create liquidity problems that "can be so significant that the IMF alone cannot counter them," he said. Massive withdrawals of investments from emerging countries could represent "hundreds of billions of dollars," Blanchard added. "We do not have this money. We never had it." During the last two weeks, the IMF has spent a fifth of its $250 billion dollar fund.

- Blanchard also urged central banks around the world to cut interest rates. The central banks “should lower interest rates to as close to zero as possible,” he said. (*AFP*, 11/22/08)

Farm Credit System / Farmer Mac

Farmland values move higher in the third quarter

- According to the Federal Reserve Bank of Kansas City, cropland values in the district [Kansas, Missouri, Nebraska, Oklahoma and the mountain states] were up more than 20% in the third quarter from a year ago, which ranchland values have posted 15% gains. These gains are on top of last year’s 8.8% increase in U.S. farmland values, which included a 14.8% in the Corn Belt and 18.8% in the Northern Great Plains.

- Farm credit conditions remained healthy in the third quarter, but are expected to weaken in the coming months, according to the Bank’s survey of agriculture credit conditions in the tenth district. Participants in the survey expect additional tightening in credit standards and farm loan demand to rise, which will further reduce available funds to the agriculture sector.

- But has the farm boom reached its peak? In a regional analysis, Jason Henderson, vice president and Omaha Branch Executive for the Federal Reserve Bank of St. Louis, wrote, “Despite record crop prices, rising input costs associated with fertilizer, fuel, seed, and chemicals have trimmed farm income expectations below spring highs. Surging production costs have boosted the capital needs for farmers and raised operating loan demand. The sustainability of the farm boom will depend on future production costs and crop prices. While higher crop prices could sustain record profits, the combination of high input costs and weaker crop prices are a risk to the booming farm economy.” The economic outlook for the agricultural sector is further impacted by the falling price of oil and its impact on ethanol demand, coupled with falling commodity prices. (*Survey of Tenth District Agricultural Credit Conditions*, Jason Henderson and Maria Akers, Third Quarter 2008; *The Main Street Economist*, Jason Henderson, 2008 Volume III, Issue V)

FCA adopts a market emergency standby resolution

- The Farm Credit Administration’s board of directors adopted a Market Emergency Standby Resolution, which authorizes a waiver of the liquidity reserve requirement in the event of a serious market disruption. Under the Resolution, FCS institutions would be allowed to fund their assets with short-term discount notes, even if doing so would cause the liquidity reserve of one or more of the FCS banks to drop below the minimum regulatory requirement. The FCS members would be granted a temporary waiver of their liquidity requirement for no more than 14 days under the Resolution. "We believe that this resolution will give System banks the flexibility they need in an emergency to continue to provide the funding that farmers, ranchers, cooperatives, and other eligible borrowers rely on while at the same time ensuring that System banks address any resulting shortfalls in their liquidity reserve," said Chairman Leland A. Strom. (*FCA Press Release*, 11/13/08)

Postal Service

USPS posts a $2.8 billion loss for FY2008

- The Postal Service posted a $2.8 billion loss for FY2008, due in part to a 9.5 billion decline in mail volume which was triggered by the faltering economy. Overall, the USPS reported total revenue of $74.9 billion, operating expenses of $72.1 billion, and a health benefit fund payment of $5.6 billion. In FY2008, the Postal Service handled 202.7 billion of pieces, down 4.5% from the previous year. First class mail volume was down 4.8% to $91.7 billion letters and cards, followed by standard mail (4.3% to $99.1 billion items) and periodicals (2.2% to 8.6 billion).

- Postmaster General John Potter said the agency is making sharp reductions in hours and overtime, but has made no plans for layoffs at this time. The agency recently offered early retirement to its work force, which has been accepted by 3,865 workers to date. The Postal Service plans to ask Congress to restructure the way it handles payments for retiree health care, said Potter. A 2006 law required the Postal Service to create a fund to cover retiree health care costs and contribute $2 billion annually to the fund over a ten year period. Potter said the USPS would like to eliminate the need to make the extra $2 billion contribution. "The board will work with members of Congress to ease some of the financial pressure we are currently facing from the Postal Act," said Board of Governors Chairman Alan Kessler. "Legislative relief is only part of the solution to the problems facing the Postal Service. The board and management will actively pursue the actions necessary to further reduce costs and grow revenue."

- Shipping costs for packages are slated to increase in January, followed by an increase in the cost of letter mails to occur in May. The USPS Board of Governors approved FY2009 rate increase of 5.7% for Express Mail, 3.9% for Priority Mail, 5.9% for parcel select, 5.3% for parcel return service, and 8.5% for international shipping. New prices for first class mail will be announced in February and take effect in May.

- "We expect the new fiscal year to be another difficult one for the Postal Service and the entire mailing industry, as economic factors will continue to reduce mail volume and increase expenses," Potter said. "As we continue to reduce work hours and other costs, our top priority remains providing excellent service to our customers. The combination of excellent service and affordable prices makes Postal products a great value." (*Associated Press*, Randolph E. Schmid, 11/13/08; *Bureau of National Affairs*, Adam Snider, 11/14/08)

Postmaster General Potter is under investigation for receiving a VIP mortgage from Countrywide

- Postmaster General John E. Potter is under formal investigation by the Postal Service for receiving a VIP loan from Countrywide Financial. An outside investigator is reviewing Potter's mortgage, in which all fees were waived and a point was shaved on the $322,700 mortgage loan. We're taking it seriously enough that we wanted it reviewed and we didn't want it done internally," said Alan Kessler, chairman of the USPS Board of Governors. The Postal Service has hired Abbe Lowell, a Washington defense attorney to handle the agency's investigation. (*Associated Press*, 11/17/08

TVA

TVA to trim rates by 6% to reflect lower fuel costs

- On January 1st, TVA will lower its electrical rates by 6% to reflect the utility's lower fuel costs. The change represents a 25% reduction in the energy surcharge, which is adjusted quarterly. (*WBKO-Fox* [Bowling Green, KY], 11/14/08)

TVA's economic development growth exceeds $5.5 billion and creates more than 40,000 jobs

- During FY2008, TVA's economic development efforts generated more than $5.5 billion of investments in new and expanded businesses and created more than 40,000 jobs in its seven state service area. Volkswagen's decision to build a $1 billion auto assembly plant in Chattanooga, TN was a significant factor in boosting the area's economic growth this year. TVA vice president John Bradley cautioned that business prospects slowed dramatically this fall and "there is a tougher year ahead" because of the economic downturn. (*Associated Press*, 11/11/08)

TVA plans to move ahead with the completion of a second nuclear reactor despite falling power consumption

- TVA president Tom Kilgore said the utility's power sales are expected to remain flat in FY2009 due to rising power rates and declining economic activity. "I think we're very likely to continue to see less growth in the next few years," said Kilgore. "We do hear talk from some of our customers about cutting back or laying off people, and everybody is being more conservative in their use of electricity."

- Despite falling demand for power, Kilgore argues that TVA still needs to build additional nuclear plants to help the utility reduce its purchase of power from other, more expensive producers. In 2008, the restart of TVA's oldest nuclear reactor at the Browns Ferry Nuclear Plant helped the utility save approximately $800 million, said TVA chairman Bill Sansom. The $1.8 billion cost of restarting the unit, originally forecast to pay for itself within eight years, should now end up paying for itself in 2.5 because of the unexpected jump in the costs for other power generation. "Nuclear power is still very cost-effective," said Sansom.

- The TVA also plans to finish a second reactor at its Watts Bar Nuclear Plant by 2013 for a projected cost of $2.5 billion. The utility projects that new unit will generate power for less than the continued costs of buying power from other generators or building new coal- or gas-fired plants. "We need Watts Bar so we will keep working on that, but with the prospect of a slowdown in our sales, everything else in our capital budget will get 'scrubbed' to make sure we still need it," said Kilgore. (*Chattanooga Times Free Press*, 11/04/08)

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