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The GSE REPORT ™

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Federal Reserve Chairman Ben Bernanke discusses the future for the GSEs

- In an October 31st speech at the UC Berkley/UCLA Symposium, Federal Reserve Chairman Ben Bernanke discussed the future role that Fannie Mae and Freddie Mac might play in the mortgage market, after emerging from conservatorship. Bernanke said, "Looking beyond the immediate concerns, …the conservatorships of Fannie Mae and Freddie Mac can usefully be viewed as a 'time out'—one that will give everyone involved, especially the Congress, the opportunity to reconsider the appropriate roles of Fannie and Freddie in the U.S. mortgage market. Key objectives of that reconsideration include both minimizing systemic risk and putting in place the most efficient mechanism possible for providing the mortgage credit necessary to sustain homeownership and a healthy housing sector. To address these issues, we must consider both the part played by securitization in the mortgage market and the role of the government and government-sponsored entities in facilitating securitization."

- "The ability of financial intermediaries to sell the mortgages they originate into the broader capital market by means of the securitization process serves two important purposes: First, it provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits; second, it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks associated with holding mortgages to maturity, thereby reducing the overall costs of providing mortgage credit."

- "Developing an effective securitization model is not easy—according to one economic historian, mortgage securitization schemes were tried and abandoned at least six times between 1870 and 1940. Eventually, experience provided three principles for successful mortgage securitization. First, for the ultimate investors to be willing to acquire and trade mortgage-backed securities, they must be persuaded that the credit quality of the underlying mortgages is high and that the origination-to-distribution process is managed so that originators, such as mortgage brokers and bankers, have an incentive to undertake careful underwriting. Second, because the pools of assets underlying mortgage-backed securities have highly correlated risks, including interest rate, prepayment, and credit risks, the institutions and other investors that hold these securities must have the capacity to manage their risks carefully. Finally, because mortgage-backed securities are complex amalgamations of underlying mortgages that may themselves be complex to price, transparency about both the underlying assets and the mortgage-backed security itself is essential."

- "During the early phases of the development of the subprime mortgage market, most lenders and investors followed these principles. Investors readily understood the simple senior/subordinated structure, and substantial useful information was provided about the subprime pools. However, during the credit boom period in the United States, worldwide demand for assets of perceived high quality became intense. Incentives to properly underwrite and evaluate new mortgage credit weakened, and many investors became over-reliant on credit ratings. To meet investor demand for customized products, the securities became increasingly complex. Although highly sophisticated methods for sharing risk were developed, not enough attention was paid to the risk that housing markets might turn down sharply across a range of geographical areas. The rapid rise in early payment defaults in the fall of 2006 signaled that something had gone wrong. As investors lost confidence, significant flaws in the securitization process, including inadequate risk management and disclosure as well as excessive complexity, became apparent."

- "Perhaps the recent mortgage cycle will be remembered as just another failed episode of financial innovation. But one feature that makes it different from previous episodes was the relative success of government-sponsored securitization. Fannie Mae and Freddie Mac continued to produce and sell significant quantities of mortgage-backed securities to secondary-market investors throughout the period of turmoil. Their ability to continue to securitize when private firms could not did not appear to result from superior business models or management. Instead, investors remained willing to accept GSE mortgage-backed securities because they continued to believe that the government stood behind them. That experience suggests that, at least under the most stressed conditions, some form of government backstop may be necessary to ensure continued securitization of mortgages. However, as I will discuss, that government support can take many forms."

- "How can we ensure that, in the future, mortgage securitization will be feasible even during highly stressed financial conditions? …One approach would be to try to return Fannie and Freddie to their pre-conservatorship status. In considering this possibility, we should remind ourselves of the problems that have surfaced with the traditional GSE structure. First, the existing GSE model involves an inherent conflict between the objectives of the companies' private shareholders and the objectives of public policy. For example, the GSEs were reluctant earlier this year to raise capital and to expand their operations, even though this would have helped financial and macroeconomic stability at a time of much-reduced mortgage availability. The GSEs' disinclination to support the mortgage market was motivated by the fact that raising additional capital would have diluted the values of the holdings of the existing private shareholders. Second, during the past 15 years or so, the GSEs have operated with high leverage compared with other large financial institutions. This relative lack of capital ultimately proved their downfall. Of course, to the extent that the debt of the GSEs is perceived to be guaranteed by the government, it is in the shareholders' interest for the companies to increase leverage whenever possible. Third, it is also in the shareholders' interest for the GSEs to maximize the size of their portfolios to take advantage of the differential between the returns to mortgage-backed securities and the low GSE funding costs arising from the perceived guarantee. However, as the Federal Reserve has argued for many years, the enormous GSE portfolios pose risks to financial stability."

- "As a result of the concerns I just outlined, the Federal Reserve Board in the past has advocated a three-part approach to GSE oversight: a strong regulator, capital standards adequate for the risks the GSEs assume, and an explicit and measurable public purpose for the GSEs' portfolios. Progress has been made in meeting some of these conditions. The Housing and Economic Recovery Act of 2008 established a strong regulator with the power to establish more-robust capital standards and with some authority over the size of GSE portfolios. In particular, the law directs the new regulator to establish criteria to ensure that the portfolios are consistent with the mission and safe and sound operations of the enterprises. However, the public purpose of the GSE portfolios, at least during times when financial conditions are relatively normal, has not been fully clarified, and systemic risks will remain as long as the portfolios remain large. Moreover, the recent legislation does not fully resolve the fundamental conflict between private shareholders and public purpose that is the source of many concerns about the GSEs. Considering some alternative forms for the GSEs (or for mortgage securitization generally) during this 'time out' thus seems worthwhile. Needless to say, however, even if alternative organizational structures are considered for the future, the U.S. government's strong and effective guarantee of the obligations issued under the current GSE structure must be maintained."

- "How might the GSEs be reorganized in the future to address the problems that have been revealed with their traditional structure? Are there approaches that do not rely on GSEs to create a robust mortgage securitization market that will function in bad times as well as good?"

- "Privatization. One option that has been discussed is to privatize the GSEs and let them compete in the market as private mortgage insurers and securitizers. To eliminate the presumption of government support and to stimulate competition, some proposals advocating privatization call for breaking up the companies into smaller units before privatizing them. Privatization would solve several problems associated with the current GSE model. It would eliminate the conflict between private shareholders and public policy and likely diminish the systemic risks as well. Other benefits are that private entities presumably would be more innovative and efficient than a government agency, and that they could operate with less interference from political interests."

- "However, whether the GSE model is viable without at least implicit government support is an open question. From a public policy perspective, a greater concern with fully privatized GSEs is whether mortgage securitization would continue under highly stressed financial conditions. As I have noted, almost no mortgage securitization is occurring today in the absence of a government guarantee. So, if the GSEs were privatized, it would seem advisable to retain some means of providing government support to the mortgage securitization process during times of turmoil. One possible approach, suggested by Federal Reserve Board economists Diana Hancock and Wayne Passmore, is to create a government bond insurer, analogous to the Federal Deposit Insurance Corporation (FDIC). This new agency would offer, for a premium, government-backed insurance for any form of bond financing used to provide funding to mortgage markets. For example, debt and mortgage-backed securities issued by the (privatized) GSEs as well as mortgage-backed bonds issued by banks would be eligible for the guarantee. That approach would clearly limit the government's exposure while making the benefits of explicit government support available to the market."

- "GSE-type organizations are not essential to successful mortgage financing; indeed, many other industrial countries without GSEs have achieved homeownership rates comparable to that of the United States. One device that has been widely used is covered bonds. Covered bonds are debt obligations issued by financial institutions and secured by a pool of high-quality mortgages or other assets. Today, covered bonds are the primary source of mortgage funding for European banks, with about $3 trillion outstanding. … To date, not many covered bonds have been issued in the United States, for several reasons. First, the Federal Home Loan Banks (FHLB) can tap capital markets and provide cost-effective funding for mortgage assets. In addition, as a source of financing, covered bond issuance today is not generally competitive with FHLB advances. Second, Fannie Mae and Freddie Mac have traditionally securitized U.S. prime mortgage assets. The GSEs' implicit government backing and their scale of securitization operations have made it difficult for banks to use covered bonds to finance their own prime mortgages. Third, the United States does not have the extensive statutory and supervisory regulation designed to protect the interests of covered bond investors that exists in European countries. To this end, the recent introduction of the FDIC policy statement on covered bonds and the Treasury covered bond framework were constructive steps. Finally, the cost disadvantage of covered bonds relative to securitization through Fannie and Freddie is increased by the greater capital requirements associated with covered bond issuance. … [G]iven longstanding features of the U.S. system such as the prominent role of the Federal Home Loan Banks, covered bonds may remain an unattractive option to U.S. banks."

- "A third approach, besides privatization and covered bonds, is to tie the government-sponsored enterprises even more closely to the government. In doing so, the choice must be made whether to continue to allow an element of private ownership in these organizations. A public utility model offers one possibility for incorporating private ownership. In such a model, the GSE remains a corporation with shareholders but is overseen by a public board. Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return to shareholders. Public utility regulation itself, of course, has numerous challenges and drawbacks, such as reduced incentives to control costs. Nor does this model completely eliminate the private-public conflict of the current GSE structure. But a public utility model might allow the enterprise to retain some of the flexibility and innovation associated with private-sector enterprises in which management is accountable to its shareholders. And, although I have noted the problems associated with private-public conflict, that conflict is not always counterproductive; an entity with private shareholders may be better able to resist political influences, which, under some circumstances, may lead to better market outcomes."

- "If private shareholders are excluded, several possibilities worth exploring remain. One approach would be to structure a quasi-public corporation without shareholders that would engage in the provision of mortgage insurance generally. Here, perhaps, one might envision the consolidation of the GSEs and the FHA, with all securitization undertaken by a Ginnie Mae-type organization. Private mortgage insurers could still participate in this framework, though the role of the government in supporting mortgage insurance and securitization would become more explicit than it is today. Finally, one might consider cooperative ownership structures, where the originators of mortgages must hold the capital in the government-sponsored enterprises, analogous to the current structure of the Federal Home Loan Banks."

- "Regardless of the organizational form, we must strive to design a housing financing system that ensures the successful funding and securitization of mortgages during times of financial stress but that does not create institutions that pose systemic risks to our financial markets and the economy. Government likely has a role to play in supporting mortgage securitization, at least during periods of high financial stress. But once government guarantees are involved, the problems of systemic risks and contingent taxpayer involvement must be dealt with clearly and credibly. Achieving the appropriate balance among these design challenges will be difficult, but it nevertheless must be high on the policy agenda for financial reform." (*Speech at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy*, Federal Reserve Board Chairman Ben Bernanke, 10/31/08)

Treasury is urged to interpret EESA's insurance provisions "creatively and purposively"

- In an October 27th comment letter, Mortgage Guaranty Insurance Corporation chairman and CEO Curt Culver urged the Treasury Department to "interpret EESA's insurance provisions creatively but purposively." Specifically, Culver urged Treasury to take actions which make clear that the insurance provisions "were not an afterthought" to TARP. MGIC believes that this can be accomplished by the agency establishing a clear priority to pursue efforts which strengthen the existing insurance infrastructure in the U.S. financial system through separate insurance approaches for mortgage-backed securities and whole (residential) mortgage loans.

- Culver wrote, "MGIC believes the Treasury should emphasize support of the current financial infrastructure. In the case of private mortgage insurance, …[t]he Treasury should use its authority under EESA to consider transactions which would free up capital for private mortgage insurers to insure new business in support of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system. [While] this comment is presented at a conceptual level, [the] highlights include:"

- "Covered assets - EESA restricts the applicability of its insurance/guarantee provisions to troubled assets (residential mortgages in this case) originated or issued before March 14, 2008. Private mortgage insurers have insured nearly $1 trillion in eligible mortgages. As noted, the loans carrying private mortgage insurance generally are not 'toxic' by definition. Rather, it is the combination of dramatic house price declines and economic uncertainty which has created these unique circumstances."

- "Program structure - Private mortgage insurers classify insured loans by origination year, commonly referred to as a 'vintage.' MGIC's proposal envisions giving private mortgage insurers the opportunity to transfer to, or share with, the Treasury all or part of a vintage. The risk transfer generally might be in the form of a guaranty of the mortgage insurer's obligations and a transfer or sharing of its rights, which could include non-traditional transactions in addition to more conventional (re)insurance structures. In either case, risk exposure likely would be less than what has been assumed by the Government via the FHA. That is because private mortgage insurers typically offered 25% coverage versus the 100% variety offered by the FHA, and historically private mortgage insurers have attracted a higher credit quality borrower (Fannie Mae and Freddie Mac 'conforming' loans with private mortgage insurance typically were cheaper for the eligible consumer). The Treasury could choose to have the subject portfolio administered by the insurer in the transaction or transfer administration to another private mortgage insurer (practically, system constraints, portfolio familiarity and cost efficiency would minimize administrative transfers)."

- "Program process - EESA's insurance provisions require actuarial review to ensure a sufficient premium for the Treasury to accept the risk. Actuarial review protects against adverse selection because the premium rate needed to safeguard the US taxpayer against loss is related to the quality of the underlying loans insured. The actuarial review also would need to make assumptions regarding the Government's cost of capital, its accounting rules regarding insurance, the confidence level used in estimating losses, matters related to macroeconomic environment, individual loan losses and premium payments (periodic or lump sum). However, the underlying premise is that (1) the Government is better able to withstand the ongoing uncertainty as these loans 'season' (progress toward repayment); (2) could reserve more efficiently against eventual loss exposures; and (3) has a different return calculus as a public actor (minimizing societal effects of borrower defaults and avoiding a net loss to the taxpayer after premiums are collected/invested and losses are paid versus obtaining a return sufficient to attract continuing private capital investment). The reverse auction format used for troubled asset purchases could be employed to encourage competition between insurers seeking to transfer insurance risks, but we believe an actuarial approach provides a more appropriate means through which to determine a fair price for the credit risk transfer."

- "By assuming the private mortgage insurers' contract rights, the Treasury would obtain important participation rights in the administration of individual mortgage loans. …From a public policy perspective, obtaining these contract rights could be very helpful in terms of encouraging borrower relief measures. The Treasury is in a much better financial position to exercise MI policy rights flexibly (in a way different from a return-oriented, publicly trade company like MGIC)."

- Culver concluded, "The Treasury appears to have three related motives under EESA[:] (1) not to worsen existing conditions; (2) to use its authority to repair broken credit markets (by spurring new lending, in the case of residential mortgages); and (3) to use the allocated funds as efficiently as possible. <u>Working with private mortgage insurers on portfolio risk transfers, reinsurance or other innovative structures represents a practical but powerful use of EESA's insurance provisions, freeing up insurance capacity for new lending and also conveying important contract rights to the Government</u>. [Emphasis supplied.] (*Comment Letter to Lindsay Valdeon, Deputy Executive Secretary of the Department of the Treasury,* MGIC Chairman and CEO Curt Culver, 10/27/08)

- In an October 28th letter on Treasury's development of a guarantee program for troubled assets, Ambac's president and CEO David W. Wallis recommended that the government program be comprised of two sub-programs, a loss guaranty program and a program directly guarantying existing securities.

- Specifically, Treasury should establish a loss portfolio guarantee program for U.S. financial guarantors, whose credit ratings have been threatened and whose access to the capital market has been denied due to potential volatility in the performance of their portfolios.

- Wallis wrote, "An excess of loss guarantee would provide a guarantee on a specific amount of portfolio losses in excess of a threshold, or 'attachment point' in order to free up capital and permit additional generation of capital. The benefits of the excess of loss portfolio guarantee program include: (i) efficient utilitization of the limited capacity under the Act; (ii) rapid impact on financial market liquidity and stability; (iii) substantial financial and operational efficiencies; and (iv) reduced moral hazard and risk of adverse selection, as guaranteed assets continue to be managed by current holders who have significant knowledge of the assets and a significant interest in mitigating losses. Alignment of interests may be achieved by providing for risk sharing with the entity receiving the benefit of the guarantee. Such risk sharing could consist of one or more of the following three elements: (i) an attachment point structured to exceed expected losses on the portfolio; (ii) a parallel loss absorption structure, under which the guarantee program would cover a portion, but not all, of the losses experienced beyond the attachment point…; and (iii) a 'detachment point' beyond which all risk of loss would revert to the entity benefiting under the guarantee program. This structure would make the program efficient and attractive to users, with the relatively high attachment point providing a lower requirement for individual asset analysis, rendering administration of the program more cost effective."

- Ambac also proposes the creation of a guarantee program to directly guarantee existing securities to provide the buyer of the guarantee protection against further potential capital risk, arising from future rating downgrades or further deterioration of the underlying collateral. Wallis wrote, "The guarantee program could also assist in creating market liquidity for performing but otherwise illiquid securities…To be effective, the program should limit its risk exposure by guaranteeing only senior securities and should further limit participation in this program to entities whose participation will assist in meeting multiple objectives of the Act, e.g., better access for consumers to mortgage loans and/or freeing liquidity that will be used to generate additional lending or guarantees or other extensions of credit. The program should not guarantee securities if a holder has purchased a security or credit default swap (CDS) on the same security unless the holder unwinds the hedge and any benefits of the hedge contract are applied to reduce the government's risk. …[T]he guarantee program offers flexibility that the purchase program does not, including risk-sharing options. ..This approach has the benefits of reducing Treasury's risk, aligning the interests of two parties, keeping securities on balance sheet for the financial guarantor and allowing it to continue to manage the exposure. It also avoids moral hazard and adverse selection." (*Comment Letter to Lindsay Valdeon, Deputy Executive Secretary of the Department of the Treasury*, Ambac President and CEO David W. Wallis, 10/27/08)

- In an October 10th report to Congress, the Congressional Research Service cautioned that a plan for Treasury to insure mortgage-backed securities "will face significant practical challenges" and could expose the government to significant costs. "Providing guarantees for [mortgage-backed securities] has, in practice, proved a very risky and costly business [for the private sector] over the past year," wrote CRS analysts. "Most of the bond insurance companies ...have seen their stock prices collapse and their credit ratings downgraded as losses have mounted on guarantees for [mortgage-backed securities].... It is unclear if and how a federal insurance program would be able to incur fewer losses than private insurers."

- "In theory, such a program could have a significant impact by improving confidence in the financial markets. …If the federal government were to issue a 100 percent guarantee on a mortgage-backed security, even one backed by subprime loans with a high default rate, the market may treat it essentially as a U.S. Treasury security, which is widely considered to be the safest and most liquid security that can be held." However, establishing premiums to cover potential government losses would be extremely difficult, said CRS. "Setting optimal premiums for mortgage-backed securities would require an accurate estimate of what mortgage default rates will be around the country in the future and how these default rates will affect the payment streams on mortgage-related securities. The inability to make such accurate estimates is identified by many to be at the heart of the uncertainty bedeviling the financial system today." (*CQ Today Online News*, 10/29/08)

TARP

The President authorizes Treasury to expand TARP purchases up to $350 billion

- In an October 14th letter to the Speaker of the House of Representatives and the President of the Senate, President George W. Bush wrote, "Pursuant to section 115(a)(2) of the Emergency Economic Stabilization Act of 2008 (Public Law 110-343)(the "Act"), I hereby certify that it is necessary for the Secretary of the Treasury to exercise the authority granted under the Act to purchase, or commit to purchase, troubled assets up to the limit of $350 billion outstanding at any one time." (*White House Press Release*, 10/14/08)

Treasury and the federal banking regulators announce the impact of tax change on financial institutions' investment in GSE preferred stock

- On October 31st, the U.S. Treasury Department, the Federal Reserve Board, the FDIC, the OCC, and the OTS issued a joint press release to announce that the agencies were extending the applicability of their October 24, 2008 Interagency Statement on direct investments to certain indirect investments in Fannie Mae and Freddie Mac preferred stock. The agencies wrote, "The change, made in response to a newly issued federal tax revenue procedure, means that banks, bank holding companies, and thrifts (banking organizations) are permitted to adjust their September 30, 2008 regulatory capital calculations for the tax effects from losses on direct and indirect investments in Fannie Mae …and Freddie Mac …preferred stock."

- On October 29th, the Treasury Department and IRS issued Rev. Proc. 2008-64 to provide banking organizations the tax benefit of treating gains and losses on certain indirect investments in Fannie Mae and Freddie Mac preferred stock as ordinary rather than capital. Indirect investments in Fannie Mae and Freddie Mac preferred stock include certain adjustable rate preferred stock programs (such as auction pass-through certificates) and stock held by certain subsidiaries of financial institutions. (*Joint Release of the U.S. Treasury Department, the Federal Reserve Board, the FDIC, the OCC, and the OTS*, 10/31/08)

Treasury has committed to invest $163.3 billion in the preferred stock of 35 participating financial institutions as of October 31, 2008

- As of October 31st, 35 financial institutions had agreed to sell $163.33 billion of preferred shares to the Treasury Department's Capital Purchase Program (CPP). On October 13th, Treasury unveiled its $250 billion CPP in which nine financial organizations agreed sell $125 billion of preferred capital to the agency with the first round of participants starting to receive CPP funds on Tuesday, October 28th. The following table provides a list of the participating financial institutions. (*Wall Street Journal*, 10/31/08)

Date Announced	**Company**	**Headquarters**	**Capital, In millions**
10/13/2008	Wells Fargo & Co.	California	$25,000
10/13/2008	State Street Corp.	Massachusetts	$2,000
10/13/2008	Bank of America Corp.	North Carolina	$15,000
10/13/2008	Bank of New York Mellon Corp.	New York	$3,000
10/13/2008	Goldman Sachs Group Inc.	New York	$10,000
10/13/2008	Morgan Stanley	New York	$10,000
10/13/2008	Merrill Lynch & Co Inc.	New York	$10,000
10/13/2008	Citigroup Inc.	New York	$25,000
10/13/2008	JPMorgan Chase & Co.	New York	$25,000
10/24/2008	Regions Financial Corp	Alabama	$3,500
10/24/2008	PNC Financial Services Group	Pennsylvania	$7,700
10/24/2008	Valley National	New Jersey	$330
10/24/2008	First Horizon	Tennessee	$866
10/26/2008	Washington Federal	Washington	$200
10/27/2008	United Commercial	California	$298
10/27/2008	Northern Trust	Illinois	$1,500
10/27/2008	City National Corp.	California	$395
10/27/2008	First Niagara	New York	$186
10/27/2008	Provident Bankshares Corp	New York	$16
10/27/2008	Huntington Bancshares Inc.	Ohio	$1,400
10/27/2008	KeyCorp	Ohio	$2,500
10/27/2008	Fifth Third	Ohio	$3,400
10/27/2008	Comerica	Texas	$2,250
10/27/2008	SunTrust	Virginia	$3,500
10/27/2008	Capital One	Virginia	$3,550
10/27/2008	BB&T	North Carolina	$3,100
10/28/2008	Zions Bancorporation	Utah	$1,400
10/28/2008	Marshall & Ilsley	Wisconsin	$1,700
10/28/2008	Umpqua Holdings Corp.	Oregon	$214
10/28/2008	HF Financial	South Dakota	$25
10/28/2008	Saigon National	California	$1
10/28/2008	Old National Bancorp	Indiana	N/A
10/28/2008	Bank of Commerce Holdings	California	$17
10/28/2008	Bank of Florida Corp	Florida	N/A

Date Announced	**Company**	**Headquarters**	**Capital, In millions**
10/28/2008	Whitney Holding Corp	Louisiana	$282

Source: *Wall Street Journal*, 10/31/08

- The CPP is available to healthy financial institutions in an amount ranging from 1% to 3% of risk-based assets. Treasury officials emphasized that the $250 billion program is adequate to cover every eligible institution. Treasury Secretary Henry Paulson said he does not foresee the program costing the American taxpayers anything. "This is an investment, not an expenditure, and there is no reason to expect this program will cost the taxpayers anything." During testimony before the Senate Banking Committee, Neel Kashkari, interim assistant Treasury secretary for financial stability, told lawmakers that his agency's bank equity purchase program might be used to encourage acquisitions of failing financial institutions. "If you have a small, failing institution being acquired by a much healthier institution ...we think that is good use of taxpayer dollars because that community is well served by that combined, stronger institution," said Kashkari.

- Treasury is clearly picking the winners and losers, as it decides which financial institutions can receive equity injections. According to industry participants, Treasury has enlisted the primary regulator to make the first cut on selection of participants, using Camel ratings to sort the weak from the strong "Of course, nobody outside of the government knows the methodology for sure," said Mark Fitzgibbon, head of research at Sandler O'Neill & Partners LP. "But my assumption is, if you've got a weak rating and you can't show that you're working your way of the woods yet, you probably aren't going to get Tarp money."

- At an October 28th financial conference, American Banker Association CEO Edward L. Yingling said, "There is a great deal of confusion around the country about this capital plan and it's understandable. In fact each day there seems to be a new version of it…. If there is widespread confusion about the purpose of this program …there are potential [unintended] consequences" Yingling's chief concern is attendant "strings" attached to using the CCP, in addition to restrictions placed on executive compensation and dividend payments. Lawmakers have publicly asked if additional rules, such as banning recipients from lobbying Congress, should also be attached to the program. "We don't know what strings are going to be attached. That has to be a concern that after the fact Congress is going to say, 'Well, you took the money so therefore this, or therefore that.' Hopefully that won't be the case but that is a concern of ours."

- In a meeting the Treasury Secretary Henry Paulson, Yingling said bankers need more time to opt into the CPP, arguing that financial institutions are being pressured into participating in the program without a clear idea of what comes next. "These bankers believe they are being asked—in some cases pressured—to participate in a program they did not seek and do not need," he told Paulson. "In many cases they see the value in the program to the economy and their communities, but they should not be required to make this critical decision that could affect the very future of their banks in such a tight timeframe and with so many uncertainties." A host of factors are still unclear for bankers—particularly for institutions that are not publicly traded. Yingling asked Paulson to extend the Nov. 14 deadline and to spell out more clearly what participating banks can expect in terms of new obligations and mandates. "It is completely unfair to ask thousands of banks across the country—and they are being explicitly asked by their regulators—to participate in a program when the impact of the program on those banks is unknown," Yingling added.

- Some 2,500 banks, which are structured as S corporations, and 550 mutual thrifts cannot issue preferred shares and are ineligible to participate in the CPP, as originally structured. Treasury officials said they are working to include privately-held banks in the CPP and will post forms for the institutions to complete on the department's web site in the near future. Treasury will set a later deadline for privately-held institutions to submit their CPP applications.

- The Treasury bailout plan also is fueling fears among small banks that the big banks receiving the rescue money will be encouraged to buy smaller healthy rivals, which are too small to fight back. "It will be a battle royal from day one in Congress" next year, said Camden Fine, chief executive of the 5,000-member Independent Community Bankers of America. "The one part of this system that has functioned well has been the community banking system...We're going to be screaming every step of the way." (*American Banker*, Bonnie McGeer, 10/20/08; *Wall Street Journal*, Elizabeth Williamson, 10/27/08; *American Banker*, Bonnie McGeer, 10/22/08; *American Banker*, Kevin Dobbs, 10/28/08; *American Banker*, Cheyenne Hopkins, 10/27/08; *Bureau of National Affairs*, Stephen Joyce, 10/30/08; *Bureau of National Affairs*, 10/31/08)

Lawmakers want more strings attached to TARP

- Lawmakers are considering taking steps to alter the terms of Treasury's financial rescue plan, by forcing banks to lend the funds that they've received and impose additional limits on executive compensation at participating financial institutions. Representative Dennis Kucinich (D-OH) and other critics hope that their concerns about the Treasury plan can be addressed during a lame-duck session of Congress. During an interview with the *Wall Street Journal*, Kucinich said, "We have to force these issues out into the open."

- In recent weeks, members of Congress have pressured Treasury Secretary Henry Paulson to put pressure on participating banks to fulfill the program's goal of increasing the banks' lending volumes. To date, Treasury officials have balked at adding additional criteria to the program, concerned that added requirements would diminish the banks' participation. Currently, the program has few restrictions on how the funds can be used by the banks. Ed Lazear, chairman of President George W. Bush's Council of Economic Advisers, defended the implementation of the rescue plan and pointed out that there is little hard evidence that banks are not appropriately using federal funds. "We have to make sure that banks have the appropriate flexibility to do those things that will get credit markets going," said Lazear.

- Democratic lawmakers acknowledge that making major changes to the rescue plan during a lame-duck session would be difficult. "There's not much we can do other than jawbone," said Senator Charles Schumer (D-NY). Senator Christopher Dodd (D-CT) said he is considering crafting a federal statute based upon New York state law, which would allow the government to reclaim money from firms that accept federal funds but don't fulfill their commitments. Specifically, Dodd wants to expand the government's right to address his concerns that financial institutions may be using government funds to pay executives. "We've got to make sure we deal with this," said Dodd, who added that he's tried lecturing firms "and it's not working." Senator Bernie Sanders (I-VT) plans to plans to introduce legislation during the lame duck session that would put caps on executive compensation at firms participating in the Treasury program. Sanders has expressed frustration that the rescue legislation, which was originally supposed to be used to purchase illiquid assets, has morphed into a vehicle for direct capital injections that healthy banks may be using to acquire weaker rivals. "The goal seems to be changing every single day," said Sanders. "Are we comfortable that a handful of bankers are literally alone in a room deciding which banks get what?"

- On October 29th, House Speaker Nancy Pelosi (D-CA) and Senate Majority Leader Harry Reid (D-NV) sent a letter to Paulson, raising concerns about lucrative "golden parachutes" at financial firms enrolled in the Treasury program. Pelosi and Reid wrote that while Treasury's current restrictions on executive compensation for companies participating in TARP are commendable—but they are insufficient. The lawmakers specifically called for tighter limitations on golden parachute payments and substantial severance packages as part of a company's merger or acquisition. Despite Paulson's promise for tighter executive compensation rules at banks participating in CPP, six major financial institutions have plans to pay their executives "billions" according to news reports, said Pelosi and Reid. Thus, Paulson's promise has not alleviated public concerns and constituents continue to express outrage at the compensation levels, said the lawmakers. Pelosi and Reid asked Paulson to consider stronger restrictions on golden parachute payments, but requested no specific actions or responses to their concerns.

- During an October 29th hearing, Housing Oversight and Reform Committee chairman Henry Waxman asked nine banks, which are participating in the TARP program, for details on their executives' compensation and bonus plans. Separately, New York Attorney General Andrew Cuomo (D) has asked the nine financial institutions to provide him a "detailed accounting regarding your expected payments to top management in the upcoming bonus season." Cuomo warned that payments worth more than services provided by the companies' executives might violate New York law. In addition to executives' compensation and other contract provisions, lawmakers are also focusing on the companies other outstanding obligations to senior management, including deferred compensation and pension obligations. According to an October 31st *Wall Street Journal* analysis, the financial "giants," which were receiving federal taxpayer funds, owed their executives more than $40 billion for deferred compensation and pensions at year-end 2007.

- In an October 29th letter to Paulson, House Minority Leader John Boehner (R-OH) complained that banks are using TARP funds not only for employee compensation, but also for acquisitions of other banks. Boehner pointed to the October 24th announcement that PNC Financial Services would sell $7.7 billion of preferred stock to Treasury through the CPP and use much of that equity injection to purchase National City Corp. Senator Sherrod Brown (D-OH) also wrote Paulson to express his concern about Treasury's bailout fund being used to encourage mergers rather than to jump-start lending. "I urge you to insist that participants in the capital purchase program not use taxpayer dollars to buy healthy banks."

- In a letter to Treasury Secretary Paulson and Commissioner of the IRS Douglas H. Shulman, Senator Charles E. Schumer (D-NY) asked the officials to justify their joint September 30th notice that changed tax regulations, making bank mergers easier for banks and more expensive to U.S. taxpayers. Through a one-sentence ruling, the Treasury effectively lifted a restriction on the amount of losses that companies are permitted to carry-over for tax benefits, if the company being bought is a bank and the losses are attributable to a portfolio of loans. The new tax treatment applies to already-completed bank mergers completed over the past three years and possibly even longer, said Treasury. Schumer wrote, "I am concerned that the Notice, which was never debated by Congress, could end up costing taxpayers tens of billions of more dollars on top of the hundreds of billions of dollars already approved by Congress in the financial rescue plan." Schumer noted that three banks—Wells Fargo, which is acquiring Wachovia; PNC, which is taking over National City; and Banco Santander, which is acquiring Sovereign Bancorp—stand to reap significant tax benefits from their pending bank acquisitions.

- Schumer has also criticized the Treasury program for allowing participants to continue paying dividends to shareholders, so long as dividend payments on the CPP preferred shares are being made to the federal government. "The whole purpose of the program is to increase lending and inject capital into Main Street. If the money is used for dividends, it defeats the purpose of the program," said Schumer, who has called for Treasury to suspend dividend payments by all participants in the program.

- During the lame-duck session, Senator Dianne Feinstein (D-CA) plans to introduce legislation that will prohibit financial institutions participating in the Treasury's $700 billion TARP program from lobbying with that money. Feinstein's proposal would likely require participating institutions to submit detailed descriptions of how they plan to use the rescue funds and to demonstrate that it's not being spent on lobbying. "Federal dollars were not intended to be used for lobbying, and it would be unconscionable for these companies to misuse taxpayer dollars in this way," said Feinstein.

- Lawmakers are also stepping up public pressure on the Bush administration through a series of hearings on Treasury's TARP. In a statement, House Financial Service Committee Chairman Barney Frank (D-MA) said: "I am deeply disappointed that a number of financial institutions are distorting the legislation that Congress passed at the President's request to respond to the credit crisis by making funds available for increased lending. Any use of the these funds for any purpose other than lending—for bonuses, for severance pay, for dividends, for acquisitions of other institutions, etc.-- is a violation of the terms of the Act. I appreciate the fact that the Secretary of the Treasury has reemphasized that increased lending activity is the only legitimate purpose for taxpayer funding of these institutions. He must make it absolutely clear to any participating entity that the federal government will insist on compliance." Frank, who plans to hold TARP oversight hearings on November 12th and November 18th, has said he's open to imposing limitations on the program. Likewise, Dodd said he wants to hold a series of hearings. "The intent here certainly wasn't for healthy banks to buy healthy banks—it's infuriating." Dodd added, "I can tell you that we are going to have the bankers up here, probably in another couple of weeks and we are going to have a very blunt conversation. If it turns out that they are hoarding, you'll have a revolution on your hands. People will be so livid and furious that their tax money is going to line their pockets instead of doing the right thing. There will be hell to pay."

- New York Governor David Peterson (D) has called on congressional leaders to include state representatives on one of two panels overseeing Treasury's TARP. "Given the importance that financial institutions have to state economies, and the devastating impact that foreclosures are having on communities, state representation in the overview process would provide a unique perspective and valuable input," wrote Peterson in a letter to House and Senate leaders. The governor also argued that state officials could provide needed expertise in foreclosure mitigation and future reforms of the regulatory system for financial institutions. (*Wall Street Journal*, Michael R. Crittenden, 10/31/08; *Washington Post*, Binyamin Appelbaum, 10/30/08; *Washington Post*, Amit R. Paley, 10/31/08; *Bureau of National Affairs*, Malini Manickavasagam, 10/30/08; *New York Times*, Ben White and Jonathan D. Glater, 10/30/08; *Wall Street Journal*, Ellen E. Schultz, 10/31/08; *Wall Street Journal*, Jesse Drucker, 10/18/08; *New York Times*, Joe Nocera, 10/25/08; *Wall Street Journal*, Elizabeth Williamson, 10/21/08; *Bureau of National Affairs*, Kenneth P. Doyle, 10/22/08; *American Banker*, Joe Adler, 10/28/08)

- In an October 29th editorial, the *New York Times* wrote, "The problem is that the Treasury has refused to put conditions on the banks' use of the bailout funds, allowing them, in effect, to make purchases of banks that are not on the verge of failure. That could help to maximize the banks' profits — a worthy goal when the capital they are using is from private investors. However, when they're using taxpayer-provided capital, as they are now, Congress and the public have every right to require that the money be used to benefit the public directly, even if doing so crimps the banks' profits. If Treasury won't impose conditions, Congress must, including a requirement that banks accepting bailout money increase their loans to creditworthy borrowers and limit their acquisitions to failing banks, such as those listed as troubled by the Federal Deposit Insurance Corporation." (*New York Times*, 10/29/08)

- In response to the *New York Times* editorial, Keith Hennessey, the Assistant to the U.S. President for Economic Policy and Director of the U.S. National Economic Council, said, "This is a stunning suggestion. Part of the reason we're in this financial mess is that the government pushed lenders to make loans that didn't make financial sense. There is a philosophical difference here. Our approach is to create incentives for banks to strengthen themselves and the economy by relying on a profit motive. The *New York Times*' approach is to try to have government mandate certain outcomes by force, and tell banks, 'If you take this investment, you must do X, Y, and Z with the money, and you must not do A, B, or C.' The law already requires: limits on incentive compensation for senior executives; clawback of compensation for senior executives if financial statements are later proven to be materially inaccurate; prohibition of 'golden parachutes;' a new limit on tax deductibility of executive compensation; and for those firms that take an equity investment, restrictions on dividends and share repurchases. The *Times* forgets that this program is voluntary. If the government tries to mandate a use for the funds that a bank would not otherwise choose to do, that bank just won't take the funds. Make the requirements and restrictions onerous enough, and you'll end up right where we started—with a dangerously undercapitalized banking system." (*White House OPD Economics Note #2008-039*, Keith Hennessey, 10/30/08)

- In an October 25th editorial, the *Wall Street Journal* wrote, "You might think lawmakers would have had enough of politically directed credit after the $200 billion fiasco of Fannie Mae and Freddie Mac. But you'd be wrong. On [October 22nd], Senators Chuck Schumer (D., Fannie), Jack Reed (D., Freddie) and Robert Menendez (D., N.J.) called on the Treasury to set 'lending goals' for banks receiving capital injections under Treasury Secretary Hank Paulson's rescue plan. …Now that Treasury is buying bank stakes, the danger is that every politician in the Beltway will want a special dividend payable to him. …The Senators' letter is another reminder, if one were needed, that the sooner the feds get out of the banking business, the better for the banks, the economy and the country." (*Wall Street Journal*, 10/25/08)

The $700 billion down payment?

- Now that Treasury has allocated $250 billion of the TARP program to recapitalizing healthy banks, the remaining $450 billion balance will be used to buy troubled assets, develop an insurance program for mortgage-backed assets, and fulfill a congressionally mandated program to improve loan modifications for homeowners facing foreclosure. Some believe that Treasury will come back to Congress soon, asking for more money. "We've been jumping from program to program, and if there is an infinite number of things we can do with money, there is a need for an infinite amount of money," said Ellen Seidman, director of the New America Foundation's Financial Services and Education Project. "If you keep expanding the scope of what it is you are going to do with the money, you keep expanding your need for money." Many agree that $700 billion is just the tip of the iceberg. "People were skeptical about the first $700 billion being enough, so I don't know how $450 can be enough" for the asset purchase program, said Scott Valentin, Friedman, Billings, Ramsey & Co.'s managing director of equity research. "The $700 billion starts running thin if you start helping all the industries they are talking about."

- Since Congress enacted the massive rescue bill on October 3rd, Treasury has been rapidly expanding the goals of the TARP. On October 14th, the agency announced that $250 billion of the program would be dedicated to shoring up healthy banks' capital. In a recent CNBC interview, David Nason, Assistant Treasury Secretary for Financial Institutions, hinted that his agency may make equity investments in insurance companies as well. "It's something we have to consider," said Nason. "What I'm saying is we started with the banks because that's targeted to providing credit to the economy, but there are a lot of industries that are coming in saying they need federal assistance, so we're willing to listen." He said the Treasury remains committed to the asset program, but offered no new details on how the agency plans to proceed with asset purchases.

- According to sources, Treasury is considering expanding the program to include insurance companies. Under current guidelines, only banks, thrifts, and banking holding companies can participate in the program. On October 24th, the Financial Services Roundtable sent a letter to Treasury requesting that broker-dealers, insurance companies, and automobile companies be included in CPP.

- Industries through the country—everything from insurance firms and auto makers to state and local and local governments and transit systems—are clamoring for a piece of the government's $700 billion financial rescue program. GMAC Financial Services, which serves as the financial arm of General Motors Corp., is in talks with federal regulators about forming a bank holding company to facilitate its participation in TARP and allow the entity to get direct loans from the Federal Reserve and obtain debt guarantees from the FDIC. Michigan's congressional delegation is also urging Treasury to allocate part of the TARP program to help restore liquidity in the automotive sector through the purchase of car loans and home equity loans [used to buy autos] from a motor vehicle finance company. The Regional Bond Dealers Association is urging Treasury to identify municipal debt securities for purchase as part of the agency's troubled asset purchase program. New York State Insurance Superintendent Eric Dinallo said as much as $20 billion of the TARP should be put aside for bond insurers, to dislodge the "logjam" in the credit default swaps market. Shoring up Ambac and MBIA through a direct equity injection would be one of the "cheapest, quick ways to unlock the municipal bond market." Two of the country's largest, publicly-traded life insurers—MetLife Inc. and Prudential Financial Inc.—

are reportedly interested in selling an equity stake in their companies to Treasury, according to sources familiar with the discussions.

- According to media reports, Treasury is "reportedly" ready to use up to $50 billion from TARP for an anti-foreclosure program, in which the agency would guarantee loans that have been modified so borrowers remain in their homes. However, critics say such an action may not be "enough." At a Senate Banking Committee hearing, FDIC chairwoman Shelia Bair told lawmakers that "the FDIC is working closely and creatively with Treasury" on a new initiative to help troubled homeowners. Neel Kashkari, interim assistant Treasury secretary for financial stability, told the panel that his agency "is looking very hard" at implementing a large-scale guarantee program for troubled mortgages, which is authorized under Section 109 of EESA. Pursuant to Section 109, the Treasury secretary has the discretion to "use loan guarantees and credit enhancement to facilitate loan modifications to avoid foreclosures."

- In an October 26th editorial, The *Washington Post* wrote, "…Sheila C. Bair, chairwoman of the [FDIC] …[has] suggested …that the government set out a standardized loan modification package for loan servicers to follow, enabling them to do workouts faster. In return for their picking up the pace, the government would guarantee some or all of the newly modified loans. By offering a strong material incentive to lenders, Ms. Bair's concept addresses one of the weaknesses of previous proposals. It is not yet clear, however, how it would shield servicers from potential lawsuits by disgruntled investors who own loans via securities. To be acceptable at all, the proposal must limit relief to a particular set of troubled, low- or moderate-income borrowers who have had their loans for some time. It would be dangerous to extend it to recent or future borrowers. But if there was a simple and fair way to get relief to homeowners, it probably would have turned up by now." (*Washington Post*, 10/26/08)

- In an October 29th letter to Paulson, Senate Banking Committee chairman Christopher Dodd (D-CT) and eight Democratic lawmakers on the panel urged the Secretary to "act decisively, aggressively, and swiftly to reduce foreclosures." The lawmakers added, "Given the FDIC's demonstrated commitment to the goal of foreclosure prevention, and its proven track record in achieving results, the FDIC is clearly the federal agency best suited to implementing this program quickly and efficiently." (*Congressional Daily*, Bill Swindell, 10/31/08; *American Banker*, Cheyenne Hopkins, 10/28/08; *Wall Street Journal*, Deborah Solomon and Leslie Scism, 10/25/08; *Bureau of National Affairs*, Steven D. Cook, 10/24/08; *New York Times*, Nick Bunkley, 10/23/08; *CNBC*, 10/20/08; *Bureau of National Affairs*, Stephen Joyce, 10/31/08; *Bloomberg News*, 10/31/08; *Bureau of National Affairs*, Nora Macaluso, 10/31/08; *CQ Today Online News*, Phil Mattingly, 10/30/08; *Wall Street Journal*, John D. McKinnon and Jessica Holzer, 10/24/08; *Bureau of National Affairs*, 10/31/08; *Bureau of National Affairs*, Mike Ferullo, 10/24/08)

Treasury is drafting a rescue guide for systemic risks

- The Treasury Department is working on a formal rescue program designed to allow it to rescue systemically important institutions, which would "potentially provide direct assistance to certain failing firms on terms negotiated on a case-by-case basis," according to an agency announcing restrictions on executive compensation. Observers said that the program may be an effort to standardize the actions previously taken by the government in the cases of Bear Stearns, AIG, and may provide Treasury a means of taking over a role that had fallen to the Federal Reserve. "There were certainly people who felt that the Fed is at the broad edge of its statutory powers with some of the steps it has been taking," said Douglas Landy, a former lawyer for the Federal Reserve Bank of New York and now banking partner at Allen & Overy LLP. "On a longer-term basis, this just isn't going to work in such a haphazard function."

- Kip Weissman, a partner at Luse Gorman Pomerenk & Schick PC, said a more formal statement on when the government will bail out companies could be helpful in deflecting some of the criticism and may also help clarify circumstances under which the government would not step in and allow a company to fail. "If you go down the road for more customization, which I think you need to do in larger cases, you still want to have a statement of principles out there to avoid a perception of sweetheart deals, especially in this political environment," said Weissman. (*American Banker*, Joe Adler, 10/20/08)

Staffing of TARP continues, as Secretary Paulson prepares a transition plan for the next administration

- The Treasury Department has named James H. Lambright to serve as the interim CFO for the TARP under EESA. Before joining Treasury, Lambright served as the head of Export-Import Bank since July 2005, where he managed 400 employees and a $60 billion credit portfolio with $100 billion in financing capability. (*Treasury Press Release*, 10/22/08)

- The Treasury Department has hired Pricewaterhouse Coopers LLP and Ernst & Young to assist the agency in the implementation of TARP. Pricewaterhouse Coopers will help Treasury establish a sound internal control posture, while Ernst & Young will provide general accounting support and expert accounting advice. (*Treasury Press Release*, 10/21/08)

- Neel Kashkari, interim Treasury assistant secretary for financial stability, said his agency is reviewing more than 100 bids which have been submitted from firms interested in serving as asset managers. According to sources close to the process, several hurdles have arisen in the hiring process, including concern over the fees that government would pay the asset managers as well as a lack of manpower at Treasury. Managers' fees are expected to range form 0.15% to 0.20% of assets managed, compared to the typical management fee for institutional stock assets of 0.35%. The *Wall Street Journal* reports that Pacific Investment Management (Pimco) has received indications it will likely be accepted to manage assets for the Treasury. After Treasury gets its asset managers in place, the agency is expected to begin buying troubled assets within a matter of weeks. (*Wall Street Journal*, Deborah Solomon, 10/28/08; *Bloomberg News*, Robert Schmidt, 10/24/08)

- According to Federal Housing Finance Director James B. Lockhart, Fannie Mae and Freddie Mac have bid to manage the mortgage-backed securities purchased by Treasury for inclusion in the TARP. Lockhart said, "[Fannie and Freddie] have some skills in this area. Whether it is contacts with banks that hold these loans. Whether it is servicing or whatever," said Lockhart. "I don't think [this] is expanding their mission. I think it's just about using their current facilities." Several *HousingWire* sources expressed anger that Treasury would take contracts away from private market participants and award them to the GSEs. An unnamed hedge fund manager said, "Paulson has already proven his penchant for saying one thing and doing another when it comes to the GSEs. If they're actually going to award anything out of TARP to Fannie and Freddie, it makes no sense for them to ever have asked other firms to put in bids. Just give all of it to the government." (*HousingWire*, Paul Jackson, 10/20/08)

- Secretary Paulson is laying the groundwork to allow the incoming administration a role in making crucial decisions concerning the $700 billion TARP before Inauguration Day. Paulson plans to consult with the new administration on key TARP decisions, said an agency official. Office space with telephone and Internet equipment has been set aside for the new administration's transition team and briefing books are being prepared. Treasury's transition efforts are being coordinated by Jim Wilkinson, Paulson's chief of staff, Kenneth Carfine, Treasury's fiscal assistant secretary, and Peter McCarthy, assistant secretary for management. (*Wall Street Journal*, Deborah Solomon, 10/31/08)

Fannie Mae and Freddie Mac

A select committee will likely craft the overhaul of the financial regulatory structure for the financial services industry

- House Financial Services Chairman Barney Frank (D-MA) said House leaders will form a select committee to explore a rewriting of the financial regulatory structure governing the financial services industry. The hope is that a single committee, comprised of senior lawmakers from both the House and Senate, could avoid the turf wars which typically accompany the legislative process for overhauling the regulatory framework for an industry. "I think that's probably going to happen," said Frank. "The one thing I'm determined to do is not fight about turf," he added. Frank sees a "silver lining" in the financial crisis: "No one is doing any good things or bad things right now, so that the notion that we have to rush has been alleviated by the fact that not much is happening. And that gives us time to do this right. It is as important a set of economic decision[s] that we will be making since the [Great] Depression."

- House Financial Services Capital Markets Subcommittee Chairman Paul Kanjorski (D-PA) said "We have reached a crossroads. Because our current regulatory regime has failed, we now must design a robust, effective supervisory system for the future. In devising this plan, we each must accept that regulation is needed to prevent systemic collapse. Deregulation—along with the twin notions that markets solve everything while government solves nothing—should be viewed as ideological relics of a bygone era." The new regulatory system should ensure that regulators have adequate resources, recognize the interconnectedness of markets across borders, maintain current firewalls and close loopholes, and consolidate regulatory agencies, he said. It also should ramp up the number of regulators, prioritize consumer and investor protections, and safeguard Americans' savings, homes, rights, and financial security, Kanjorski added.

- In testimony at October 21st House Financial Services Committee's hearing on the future of financial services regulation, economists, academics and industry representatives agreed that the key to reform is "smarter" regulation, which improves enforcement of current rules and fills in the gaps in the current regulatory landscape. While Treasury Secretary Henry Paulson's "blueprint" for financial reform is a good start, it is incomplete, said the panelists. Nobel Prize winning economist Joseph Stiglitz, recommended that as new regulatory structure include the formation of a Financial Products Safety Commission to assess the risks of particular products and determine their suitability for particular users. Joel Seligman, the president of the University of Rochester and a securities law expert, suggested that Congress create a select committee [similar to the 9/11 Commission] to decide how to proceed. "The most difficult issues in discussing appropriate reform of our regulatory system become far more difficult when multiple congressional committees with conflicting jurisdictions address overlapping issues," said Seligman. "It is important that all appropriate alternatives be considered, including consolidating regulatory agencies, creating new regulatory agencies and transferring jurisdiction. This type of review is far more likely to succeed before a single Select Committee."

- T. Timothy Ryan Jr., president and CEO of the Securities Industry and Financial Markets Association, proposed a sweeping blueprint for change, calling for a financial markets "stability" regulator whose purview should include financial institutions, broker dealers, insurance companies, hedge funds, private equity funds, and other systemically important financial entities. Ryan proposed the stability regulator be empowered to use the information it gathers to identify which institutions actually are "systemically important" and be given broad regulatory authority over these institutions. Ryan urged Congress to provide the stability regulator the ability to set consolidated capital requirements at the parent company level and to recommend capital requirements at any subsidiary level; to examine both the parent company and its subsidiaries; and to be empowered to bring enforcement actions and require prompt corrective actions. Ryan said the stability regulator's new powers "could correspond to those that the Federal Reserve currently has as the umbrella supervisor of bank holding companies, but we believe it would not be appropriate to include the authority to impose the kind of activity restrictions that apply to bank holding companies." Congress also should consider providing the stability regulator the power to put a systemically significant institution of any type into conservatorship or receivership, and to create bridge institutions to facilitate orderly disposition of a failed institution's assets and liabilities, said Ryan.

- Ryan also called for a global approach to financial regulatory reform for today's worldwide financial markets. An international effort is required to develop a regulatory system with common principles that "limit regulatory arbitrage between and among countries." This new regulatory regime should minimize systemic risk to the world financial system; promote the safety and soundness of each regulated financial institution; contain business conduct rules to promote fair dealing and investor protection; and be consistent from country to country. Effective financial regulation will require common regulatory standards applied consistently across international markets, said Ryan. In crafting U.S. regulatory reform, Congress should be mindful of "the importance of regulatory and legislative solutions that work on a global, cross-border basis," he added.

- Michael Washburn, Independent Community Bankers of America's vice chairman of the association's policy development committee, urged Congress to stem excessive concentration and promote diversity in the financial sector and to beef up regulation of unregulated or lightly regulated players, such as mortgage brokers. Former Representative Steve Bartlett (R-TX), who serves as president and CEO of the Financial Services Roundtable, said the Federal Reserve Board should be given clear authority to supervise significant financial institutions that seek access to the discount window and other financial facilities. The Fed's supervisory powers should include appropriate reporting requirements, the authority to examine such firms, and the authority to set capital and liquidity requirements, he added. Bartlett also called for strengthening federal oversight over the insurance industry through an optional federal charter.

- During a break in the hearing, Frank said he wants to see a list of the consequences of mark-to-market accounting to see if the rules can be made more flexible in an effort to help struggling companies. While signaling he doesn't intend to scrap mark-to-market accounting, Frank said he supports "flexibility" of application. "That will be part of our agenda next year," he said. Later, Frank told reporters he is compiling a list of the consequences of tweaking fair value accounting rules. "You could have some relaxation on your need to build up capital [for companies adversely impacted by mark-to-market accounting]. Secondly, there are rules that some governmental bodies have that say people can only buy the paper from entities that meet a certain level. Well, if they've lost that because of mark-to-market, I don't want to make that happen." He pointed that that some of these changes wouldn't require legislation. "We could just urge the regulators to do it," said Frank. "You might have to do some legislation to give them some flexibility."

- Industry representatives welcomed Frank's comments. "What the chairman said makes a lot of sense," said American Bankers Association president Ed Yingling. "Disclose it, but don't let it hurt the institutions' ability to function." (*Wall Street Journal*, Brody Mullins and Elizabeth Williamson, 10/27/08; *Bureau of National Affairs*, Malini Manickavasagam and Thebain, 10/22/08; *CongressDaily*, Humberto Sanchez, 10/21/08; *American Banker*, Stacy Kaper and Emily Flitter, 10/22/08)

The age of prosperity is over…

- In an October 27th commentary in the *Wall Street Journal*, Arthur B. Laffer wrote, "…Financial panics, if left alone, rarely cause much damage to the real economy, output, employment or production. Asset values fall sharply and wipe out those who borrowed and lent too much, thereby redistributing wealth from the foolish to the prudent. … When markets are free, asset values are supposed to go up and down, and competition opens up opportunities for profits and losses. Profits and stock appreciation are not rights, but rewards for insight mixed with a willingness to take risk. People who buy homes and the banks who give them mortgages are no different, in principle, than investors in the stock market, commodity speculators or shop owners. Good decisions should be rewarded and bad decisions should be punished. The market does just that with its profits and losses."

- "No one likes to see people lose their homes when housing prices fall and they can't afford to pay their mortgages; nor does any one of us enjoy watching banks go belly-up for making subprime loans without enough equity. But the taxpayers had nothing to do with either side of the mortgage transaction. If the house's value had appreciated, believe you me the overleveraged homeowner and the overly aggressive bank would never have shared their gain with taxpayers. Housing price declines and their consequences are signals to the market to stop building so many houses, pure and simple."

- "But here's the rub. Now enter the government and the prospects of a kinder and gentler economy. To alleviate the obvious hardships to both homeowners and banks, the government commits to buy mortgages and inject capital into banks, which on the face of it seems like a very nice thing to do. But unfortunately in this world there is no tooth fairy. And the government doesn't create anything; it just redistributes [wealth]. Whenever the government bails someone out of trouble, they always put someone into trouble, plus of course a toll for the troll. Every $100 billion in bailout requires at least $130 billion in taxes, where the $30 billion extra is the cost of getting government involved. **If you don't believe me, *just watch how Congress and Barney Frank run the banks*. If you thought they did a bad job running the post office, Amtrak, Fannie Mae, Freddie Mac and the military, just wait till you see what they'll do with Wall Street."** [Emphasis added.] (*Wall Street Journal*, Arthur B. Laffer, 10/27/08)

House GOP wants a special counsel appointed to investigate
the failure of Fannie Mae and Freddie Mac

- Citing "fraud and mismanagement at Fannie Mae and Freddie Mac," House Minority Leader John Boehner (R-OH) and 27 Republican colleagues asked Attorney General Mukasey to appoint a special counsel to investigate alleged accounting and executive compensation fraud at the GSEs. "Because of the depth, sophistication and far-reaching impact of potential wrongdoing, we ask that you seriously consider the formation of an Enron-like task force or the appointment of a special counsel to spearhead the investigation," wrote the lawmakers. Boehner said, "Today's financial crisis was triggered by a Washington culture that allowed executives at Fannie Mae, Freddie Mac, and elsewhere to run amok."

- In response to the Republicans request for a special counsel to investigate the GSEs, House Financial Services Committee chairman Barney Frank released a statement saying, "In an unusual event, even by this year's standards, House Republicans appear to be demanding a criminal investigation of their failure to legislate. In the letter to Attorney General Mukasey, House Republicans cite among other things the fact that no legislation was adopted 'for years' to reform the GSEs. The record is very clear: the Republicans controlled Congress from 1995 – 2006, and that is the period in which the absence of regulation into which they want a criminal investigation occurred. …The Republican demand that their legislative record of non-action be investigated appears to be the political equivalent of the note left to the police by serial offenders: stop me before I do not legislate again."

- During an October 23rd hearing of the House Committee on Government Oversight, chairman Henry Waxman (D-CA) admitted that Fannie Mae and Freddie Mac played a role in the current financial crisis. Previously, Democrats and liberal academicians defended the enterprises with House Financial Services Committee chairman Frank going so far as to call the criticism of the GSEs as being "racist." Waxman has scheduled a hearing on November 20—a date "safely after the election"—to examine the failure of Fannie Mae and Freddie Mac "and their roles in the on-going financial crisis." The Committee has invited former Fannie Mae CEOs Franklin Raines and Daniel Mudd to testify, along with former Freddie Mac CEOs Leland Brendsel and Richard Syron. (*The Poltico*, Daniel W. Reilly, 10/21/08; *Wall Street Journal Political Diary*, John Fund, 10/21/08; *The Bulletin*, Michael P. Tremoglie, 10/28/08; *Bureau of National Affairs*, Mike Ferullo, 10/22/08; *House Financial Services Press Release*, 10/21/08)

Let's use the GSEs to clean up the mess the GSEs made

- In an October 25th commentary in the *Wall Street Journal*, American Enterprises Institute fellow Peter J. Wallison and mortgage finance consultant Edward Pinto wrote, "Earlier this week, James Lockhart, the director of the [FHFA] and the government conservator of Fannie Mae and Freddie Mac, said that the two companies need to begin writing down the principal on mortgages they hold or acquire. This could be an important step in slowing the housing slump. It also suggests that while Fannie and Freddie are largely responsible for the current financial crisis, they might offer a way out. The Treasury's use of the Troubled Assets Relief Program (TARP) to recapitalize banks will fail if foreclosures on subprime and other junk mortgages continue to default at their current rates. Bank capital will further decline, eating into the new capital the taxpayers provide. And if foreclosures spread significantly into the prime mortgage market because of the recession, bank solvency will be further undermined. In other words, to solve the financial crisis, we must address the problem of falling housing values and mortgage defaults. It is imperative to get ahead of this destructive curve."

- "The outstanding, institutionally financed single-family mortgage debt in the U.S. is about $10 trillion (subprime and Alt-A loans comprise about $3 trillion [or 30%]). Through its backing of Fannie, Freddie, Ginnie Mae, the Federal Home Loan Banks and the FDIC, the U.S. Treasury is already directly or indirectly responsible for perhaps $8 trillion [80%] of this debt. Up to now, all programs that have been advanced to address the problem of mortgage defaults have relied on renegotiation of mortgage loans, using the depleted value of the home as the measure of the lender's loss. The objective has been to convert the mortgage into a longer-term loan with a lower fixed interest rate. With millions of mortgages needing this relief, the renegotiation process will be painfully slow. We cannot wait for snail-paced remedial efforts to have their effect."

- "The problem can only be addressed with a standardized plan that must work both for whole mortgages held by banks, and mortgages that collateralize mortgage-backed securities (MBS). It must also address several obstacles and challenges: the refinancing agency must have the necessary legal authority now (there is no time to establish a new agency); funding for mortgage purchases must be immediately available; and the plan must be voluntary, so the rights of lenders and the holders of MBS are protected. The plan must also target the right group of homeowners--those already delinquent or in danger of default because of impending interest-rate resets or other factors, but who are otherwise willing and able to carry a fixed-rate, reasonably priced mortgage."

- "The legal authority and the funding for such a standardized plan are already in place. Fannie Mae and Freddie Mac, as government sponsored enterprises (GSEs), have the authority to renegotiate any mortgage they own or purchase from others. They also have the necessary funding, either from the sums they can themselves raise in the market or through borrowing by the Treasury, which is authorized under the Housing and Economic Recovery Act of 2008 to lend virtually unlimited amounts to both GSEs."

- "The banks that own whole mortgages will want to keep those that they assess as performing now and likely to perform in the future. They also know that if they have to foreclose on a mortgage, they will incur substantial costs. Accordingly, Fannie and Freddie should make a blanket offer to all banks or other mortgage lenders to buy any existing mortgage at a fixed discount--say, 20%--from the principal amount then due on the mortgage. This will induce the banks to sell their weaker mortgages (including those not now delinquent). This in itself will improve their financial condition. Fannie and Freddie would similarly identify the weaker loans in their own portfolios and write them down 20%."

- "The GSEs should then offer to modify or refinance these weak and defaulted loans under the following terms: The unpaid principal amount of the mortgage will be reduced 20%. If the loan has a fixed rate, the rate will be reduced by 2% (but not below 5%), and if it is an adjustable, it will be recast at a 5% fixed rate, over 20 years. The purpose of a 20-year (rather than a 30-year) amortization is to build up equity in the home more quickly and help protect taxpayers against loss, and to help stabilize home values. Monthly payments will end up being reduced about 20%, ultra-high loan-to-value (LTV) ratios will be eliminated, and the downward slide in housing markets will be mitigated."

- "Loans that are in pools of mortgage-backed securities present a more complex, but manageable, problem. Fannie and Freddie are authorized to modify the terms of defaulted mortgage loans in MBS pools, and they could offer to refinance loans that servicers of MBS pools deemed likely to fail. Banks that hold these MBSs are likely to accept an offer for these securities by the GSEs for the same reasons that they will sell whole mortgages that are troubled or in default."

- "There are two additional conditions that must be added to these new mortgages, to make them less of a windfall for borrowers. The house could not be further encumbered by a home-equity loan until the government mortgage is fully paid off; and the mortgage-holder would be fully liable for the loan, unlike almost all other mortgages, which are backed only by the house itself. Requiring the new mortgages to be 'full recourse' loans will tend to screen out of the plan those homeowners who can currently make their mortgage payments, and will attract those homeowners who are willing to assume personal liability in preference to foreclosure."

- "This plan requires banks that are holders of MBS to accept a 20% 'haircut' on the weak mortgages they hold. It also requires greater responsibility and risk for the homeowners who choose a modified GSE mortgage. True, if many of these mortgages ultimately go into default, the taxpayers will suffer losses--but this is a risk that was always implicit in the TARP, and the risk will only be greater if we fail to act and losses further weaken the banks."

- "It is in our national interest to clean up the mortgage mess as promptly as possible, return the banks to financial health, and arrest the rise in mortgage defaults. This plan has a chance to accomplish these objectives—quickly enough to slow the slide into recession." (*Wall Street Journal*, Peter J. Wallison and Edward Pinto, 10/25/08)

FHFA director Lockhart's congressional testimony about the government's "explicit" guarantee of the GSEs' debt stirs market confusion

- In written testimony before Congress, FHFA director James B. Lockhart stated "the conservatorship and the access to credit from the U.S. Treasury provide an explicit guarantee to existing and future debt holders of Fannie Mae and Freddie Mac." After the hearing, Lockhart clarified his testimony, saying: "What we did say is [that there's] an effective guarantee because there's $100 billion backing their equity provided by the U.S. Treasury. That does give them effectively a guarantee of the U.S. government." The director's comments briefly caused a stir in the debt markets, sending the GSEs' yields over benchmark rates lower before erasing the *majority of those gains. (Wall Street Journal*, James R. Hagerty, 10/21/08*; Bloomberg News*, Dawn Kopecki, 10/23/08*; FHFA Press Release*, 10/23/08)

- GSE debt costs have risen, amid signs that foreign investors continue to abandon agency debt. Foreign central banks trimmed their agency debt and MBS holdings by $8.78 billion during the week ended October 29th to $909.1 billion, down 7.8% [$76.9 billion] from a peak of $986 billion three months ago. According to *HousingWire* sources, the flight out of agency issues is not driven by credit concerns about the GSEs, but instead by a liquidity crisis which has now expanded well beyond the U.S. borders. Foreign central banks are amassing liquidity to ensure that they can bailout their own banks, if necessary, say sources. In an interview with *Bloomberg News*, Jamie Jackson with RiverSource Investments said, "Countries, really just like banks, need to hold liquidity to prop up their own financial well-being and they're not going to lend that out to other people."

- According to *Asian Investor* [magazine], Taiwan's financial regulators have "reportedly" ordered the nation's insurance companies to pare back their holdings of agency debt and mortgage-backed securities. "Exposures to U.S. agency MBS have created massive holes in Taiwanese insurers' balance sheets," wrote the *Asian Investor*, which has resulted in the FSC easing requirements for MBS to be marked-to-market. A sell-off by Taiwanese insurers could be another blow the reeling U.S. mortgage market, since Taiwan owns approximately $55 billion of U.S. agencies [on June 30, 2007].

- Investors' confidence in the GSEs affects their borrowing costs and determines how aggressively the enterprises can purchase mortgages and MBS—which, in turn, has a big impact on the rates that lenders charge borrowers. Despite the government's efforts to help Fannie Mae and Freddie Mac by placing the firms in conservatorship, the borrowing cost for both enterprises have been rising, not falling, which has pushed mortgage rates up. On October 29th, the average rate for 30-year fixed-rate mortgages was 6.64%, up 30 basis points from the average rate on September 5th (6.34%), before the GSEs were placed into conservatorship. (*Washington Post*, Zachary A. Goldfarb, 10/29/08; *Wall Street Journal*, James R. Hagerty, 10/30/08; Reuters, 10/24/08; *HousingWire*, Paul Jackson, 10/27/08; *Wall Street Journal*, James R. Hagerty, 10/21/08; *Baron's*, Randall W. Forsyth, 10/24/08; *Reuters*, 10/30/08)

Chairman Frank to push for higher conforming loan limits for the GSEs

- House Financial Services Committee chairman Barney Frank (D-MA) said he will likely push to keep the GSEs' "temporary" loan limit of $729,750 in high cost areas to help maintain the supply of affordable mortgages. The loan limit, which is scheduled to readjust to $625,500 for the 90 most expensive U.S. real estate markets on January 1st. "If we have the right political alignment, I will push for moving it back up again," said Frank. "I think it is helpful and not harmful." (*Bloomberg News*, Dawn Kopecki and Alixon Vekshin, 10/21/08)

- The Mortgage Bankers Association plans to ask the Federal Housing Finance Agency to increase the conforming loan limits for Fannie Mae and Freddie Mac for a 50% increase in the current $417,000 limit in most areas of the country. "[An increase] will be simulative," said Gary Cipponeri, SVP of Chase Home Finance. "This market needs liquidity." (*Bloomberg News*, Dan Levy, 10/21/08)

- Separately, the Federal Housing Finance Agency said it plans to announce the 2009 conforming loan limits on November 7th. (*FHFA Press Release*, 10/17/08)

Fannie's and Freddie's success rate in working out troubled mortgages falls

- Fannie Mae's and Freddie Mac's success in resolving mortgage delinquencies fell in the second quarter as the GSEs completed fewer loan modifications and workout plans relative to the first quarter. According to a FHFA report, the number of borrowers entering workout plans with the GSEs to bring their mortgages current dropped 10.4% [from the first quarter] to 10,740, while the success rate of loans in loss mitigation declined to 37.2% from 43.7% in the first quarter. On June 30th, Fannie's and Freddie's inventory of foreclosed homes jumped to 43% during the second quarter to 76,154.

- James B. Lockhart, director of the FHFA, said he's pushing Fannie and Freddie to work harder on modifying mortgages to curtail foreclosures. FHFA has taken on the role of a "federal property manager," working to implement a plan with the U.S. Treasury that "maximizes assistance for homeowners to minimize foreclosures, said Lockhart in his October 23rd testimony before the Senate Banking Committee. FHFA will encourage mortgage servicing companies to modify troubled loans, he added.

- At the Mortgage Bankers Association annual conference, Fannie Mae CEO Hank Allison and Freddie Mac CEO David Moffett said their companies are trying to do more to stop home foreclosures, but conceded it still might take years for real estate to recover in some markets. "I don't think there is any magic bullet in regards to overbuilt markets [like Miami and parts of California, Nevada and Arizona], said Moffett. "We are working hard to keep people in their homes and to keep people from giving up on housing," he added. Allison also advises the lenders that Fannie Mae is open to all ideas for tackling the myriad problems facing the industry. "Anything that is not necessary under the old traditions, we are going to discard," said Allison. The GSE executives conceded that it's not realistic to expect all delinquent borrowers to be saved from a foreclosure, in part, because so many home loans have been bundled into complex packages or securities that are now owned by institutional investors around the world. In some cases, the borrowers shouldn't be given a break because they were speculating on real estate as an investment, added Lockhart, who was a participant on the panel.

- Protestors rallied outside—on occasion inside—the conference, demanding that troubled borrowers be provided relief from foreclosure. Medea Benjamin, co-founder of the activist group Code Pink, "materialized" on stage with the GSE executives to argue that handling foreclosures on a case-by-case basis does not work. "Since the public bailed out your companies, the public should have a right to ask a question," Benjamin said. "We need a moratorium on foreclosures. Will you please call for that, sirs?" [Benjamin was quickly hustled off stage.] "In response to my sister's question, this is something we're working very, very hard on," said Allison, referring to Benjamin. "Measures we used in the past simply aren't adequate. On a case-by-case basis, we need to see if we can somehow recover a number of these loans and keep people in their homes. ... We need to provide incentives for lenders to get current again." Moffett acknowledged that foreclosure prevention is labor intensive. "Each customer will have a different situation," said Moffett. "We've embarked on a large program to identify different programs that fit different people." (*Bloomberg News*, Dawn Kopecki, 10/22/08; *San Francisco Chronicle*, Carolyn Said, 10/21/08; *Associated Press*, 10/20/08; *Bloomberg News*, Dawn Kopecki, 10/23/08)

- Separately, House Financial Services Committee chairman Barney Frank (D-MA), along with a group of influential House Democrats, wrote a stern letter to the hedge fund industry, warning them not to stand in the way of federal government efforts to curb foreclosures. The lawmakers wrote the letter in response to a *New York Times* article that stated Greenwich Financial Services and Braddock Financial Corporation are telling servicers of mortgages owned by the funds to avoid rewriting the loans' terms. In a letter to Braddock, the lawmakers wrote, "We were outraged to read in today's *New York Times* that you are actively opposing our efforts to achieve a diminution in foreclosures by voluntary efforts. Your decision is a serious threat to our efforts to respond to the current economic crisis, and we strongly urge you to reverse it." Frank will hold a committee hearing on November 12th to examine this issue. "We believe it is essential for our policymaking function for you to appear at such a hearing, and if this cannot be arranged on a voluntary basis, then we will pursue further steps," wrote the lawmakers. In a public statement, they added, "For hedge funds, which have been the beneficiary of a lack of regulations and a very permissive attitude, now to put obstacles in the way of this important national policy is intolerable." (*CQ Today Online News*, Benton Ives, 10/24/08)

Fannie and Freddie called on to jumpstart the tax-exempt housing bond market

- In a letter to lawmakers and the Bush administration, four trade groups called on Fannie Mae and Freddie Mac to resume their purchases of tax-exempt housing bonds in order to jump start a virtually dead market. In a letter to Treasury Secretary Henry Paulson, FHFA director James B. Lockhart, and Congressional leaders, the trade groups wrote, "Today ... there is virtually no market for tax-exempt housing bonds because of the current economic crisis." The letter's signatories included the National Association of Counties, the National Association of Local Housing Finance Agencies, the National Community Development Association, and the U.S. Conference of Mayors. The groups urged lawmakers and federal officials to direct Lockhart to bring Fannie and Freddie back as purchasers of tax-exempt single-family and multi-family housing bonds. (*Bond Buyer*, Lynne Funke, 10/29/08)

Six members of Congress urge FHFA to continue the GSEs' charitable donations

- In an October 22nd letter to FHFA director James B. Lockhart, six lawmakers urged the regulator to continue Fannie Mae's and Freddie Mac's important role in charitable giving. In a letter signed by signed by Representatives Donna Edwards (D-MD), Steny Hoyer (D-MD), Chris Van Hollen (D-MD), Tom Davis (R-VA), Jim Moran (D-VA) and Eleanor Holmes Norton (D-DC), the lawmakers wrote, "As you know, Fannie Mae and Freddie Mac are the top two charitable givers in the National Capital region. Their contributions have directly touched the lives of thousands of families.

A loss of these contributions, or a significant diminution, could have devastating consequences for thousands of families."

- To ramp up the political pressure on lawmakers, nonprofits that receive contributions from Fannie Mae and Freddie Mac recently organized a call-in day to their representatives. The effort was led by the Nonprofit Roundtable of Greater Washington and the Center for Nonprofit Advancement (CNA). Glen O'Vilvie, executive director of CNA, said the lawmakers' letter would "apply an extra layer of support and influence on …Lockhart." And, O'Vilvie expects the lawmakers to continue their push until a decision is made. "I know these reps are not just letter writers," he said. (*Washington Business Journal*, Jonathan O'Connell, 10/27/08)

FHFA announces staff appointments

- On October 27th, FHFA director James B. Lockhart announced the formal integration of OFHEO, the Federal Housing Finance Board, and departments within HUD into the Federal Housing Finance Agency, pursuant to the Housing and Economic Recovery Act. At an All Hands meeting with employees, Lockhart congratulated his staff of nearly 400 for completing the administrative work required to "stand up" the new Agency and officially transfer all employees in less than 90 days since HERA's enactment, much quicker than the one-year implementation time provided for in the legislation. "In view of the tremendous amount of supervisory activity taking place given market conditions, and the appointment of the two conservatorships last month, the accomplishment of this task in less than three months is especially noteworthy," said Lockhart. The new agency will have a budget of $120.8 million for FY2009, an increase of 15% from its FY2008 budget.

- The Director also announced the appointments of three OFHEO and FHFB veterans to the deputy director positions: Edward DeMarco as Senior Deputy Director, Chief Operating Officer and Deputy Director for Housing Mission and Goals; Stephen Cross as Deputy Director of the Division of Federal Home Loan Bank Regulation; Chris Dickerson as the Deputy Director of the Division of Enterprise Regulation; and David Lee, the Federal Housing Finance Board's Director of the Office of Management, as FHFA's Chief Administrative Officer.

- FHFA also announced the establishment of the new agency's web site: www.fhfa.gov. (*FHFA Press Release*, 10/27/08; *Bureau of National Affairs*, Mike Ferullo, 10/29/08)

Federal Reserve defines "higher-priced" mortgages under HMDA

- On October 21st, the Federal Reserve published a final rule amending the definition of a "higher priced mortgage" under the Home Mortgage Disclosure Act. Under the new definition, a higher-priced mortgage is one whose annual percentage rate spread is at least 1.5% for a first-lien mortgage loan or 3.5% for a subordinated-lien loan. (*American Banker*, Cheyenne Hopkins, 10/21/08)

HUD pushes ahead with RESPA reform

- At the Mortgage Bankers Association annual convention, HUD Secretary Steve Preston reiterated that his agency plans to issue a final rule this year, revising RESPA. The "unnecessary complexity" of mortgages had contributed to the housing crisis, said Preston. "We must make mortgages more understandable and the process more transparent." HUD has gone through a "lengthy period of public comment" and engaged many people in the industry, he said. "We are committed to striking a balance between the needs of the consumer and industry concerns." (*American Banker*, Kate Berry, 10/22/08)

Subprime and beyond…

- Fitch Inc. estimates home values have dropped 22% nationally and will fall an additional 10% before stabilizing. The remaining price decline will be absorbed over the next few quarters with prices stabilizing in 2010. "Should economic conditions become much worse than expected, home prices would decline more than Fitch's projection and price stabilization would be delayed," said Fitch managing director Huxley Somerville. (*National Mortgage News*, 10/22/08)

- The FHFA price index for conforming home loans was off 5.9% from year-ago levels during August. In contrast, the Standard &Poor's/Case-Shiller 20-city home price index, which includes non-conforming mortgage data, posted a 16.6% decline in August from a year ago. "The downturn in residential real estate prices continued, with very few bright spots in the data," said David Blitzer, chairman of S&P's index committee. Of the 20 metro areas covered by the index, nine markets recorded record annual declines, led by Phoenix (down 30.7%). The Los Angeles, San Francisco and San Diego markets all were down more than 25% from a year ago, while the Miami and Tampa, FL markets were down 28.1% and 18.1%, respectively. The Dallas, TX and Charlotte, NC markets have best weathered the downturn, reporting 2.7% and 2.8% declines, respectively, in local area home prices. (*Bureau of National Affairs*, Diana I. Gregg, 10/29/08; *HousingWire*, Paul Jackson, 10/24/08)

- The National Association of Realtors reported that the median home price in the U.S. dropped 9% in September from a year ago to $191,600—down 17% from the July 2006 peak. (*Associated Press*, 10/274/08)

- New home sales rose 2.7% to 464,000 in September, based on higher sales volumes in the West and South. August new home sales were revised downward to 452,000 from the previously announced 460,000—for a revised 12.6% decline for the month. In addition, the number of new homes available for sale fell 7.3% to 394,000, reducing the inventory supply to 10.4 months based upon the September sales rate. (*Bureau of National Affairs*, Diana I. Gregg, 10/28/08)

- According to Moody's Economy.com, 23% of homeowners owe more on their loans than their homes are worth. That figure is project to rise to 28% by this time next year, when real estate values are expected to stabilize. (*Associated Press*, 10/274/08)

- A study by the Center for Economic Policy and Research and the National Low Income Housing Coalition concluded that while home prices have collapsed in key markets, "prospects for accumulating equity still look grim for homeowners, as prices are far from reaching their historical norm." The study argues that many homeowners face the prospect of never finding themselves with equity in their homes over the next five years. The study projects that homeowners in New York City and Los Angeles will have an average negative equity in their homes of $101,964 and $168,069, respectively, by the year 2012. (*HousingWire*, Paul Jackson, 10/28/08)

- HOPE NOW helped 211,000 homeowners avoid foreclosure in September, bringing the number of foreclosures prevented to nearly 2.5 million. In September, the coalition assisted 98,000 in modifying their mortgages and initiated 113,000 repayment plans for borrowers. According to HOPE NOW's data, subprime foreclosures fell 3% during the third quarter, while prime foreclosures jumped more than 20% in the same time period. (*MortgageOrb.com*, 10/28/08; *HousingWire*, 10/27/08)

- On October 31st, NeighborWorks America released its interim report to Congress on the National Foreclosure Mitigation Counseling Program (NFMCP), created under the FY2008 Consolidated Appropriations Bill. As of September 15th, nearly $55 million in cash had been disbursed to NFMCP grantees and 105,071 homeowners in all fifty states were provided assistance to address their mortgage delinquency and foreclosure challenges. On average, $523.46 of grant funds were expended to assist each troubled borrower during the period. (*National Foreclosure Mitigation Counseling Program*, NeighborWorks America, 10/31/08)

- Lenders wrote off an estimated $21 billion in bad credit card loans during the first six months of 2008. As a result of a slowing economy and rising layoffs, analysts expect the credit card industry to lose at least an additional $55 billion over the next 18 months. Today, current credit card losses represent 5.5% of credit card debt outstanding and may surpass the 7.9%, a level reached during the dot.com implosion of 2001. (*New York Times*, Eric Dash, 10/29/08)

- Personal bankruptcies filed in federal court totaled 934,000 over the 12 months ended June 30, 2008, up more than 28% for the 12 months ended June 30, 2007 (727,167 petitions). (*CNNMoney.com*, Jessica Dickler, 10/27/08)

- The U.S. economy contracted at an annualized rate of 0.3% during the third quarter, as consumer spending declined 3.1%—the fastest pace in 28 years, according to Commerce Department estimates. [Analysts had expected a 0.5% contraction.] (*Marketwatch*, 10/31/08)

- McGraw Hill projects construction starts to fall 7% in 2009 to $515 billion, as a result of "turmoil on the financial markets" and a credit freeze. "The speed and scope of the events in September and October were startling," said Robert A. Murray, McGraw-Hill's Vice President of Economic Affairs. "Tighter lending standards are a major constraint for the construction industry." (*Bureau of National Affairs*, Amanda King, 10/24/08)

- FDIC has closed the Alpha Bank and Trust, Alpharetta, GA ($354.1 million in assets) and Freedom Bank, Bradenton, FL ($287 million), the 16th and 17th banks to fail in 2008. (*FDIC Press Release*, 10/31/08; *FDIC Press Release*, 10/31/08; *American Banker*, Joe Adler, 10/24/08)

- According to SNL Securities, the three largest U.S. banks control nearly 33% of the nation's retail deposit market share versus the banks' 23% market share a year ago. Bank of America Corp. held $719.8 billion of U.S. deposits (11.31% market share), followed by Wells Fargo & Co. at $711.5 billion (11.18%, after completing its Wachovia acquisition) and JPMorgan Chase & Co. at $649.3 billion (10.20%) . SNL said "The recent spate of bank acquisitions and failures has led to significant industry consolidation, increasing market share of the top banks." Over the past year, retail bank deposits rose 3.72% to $6.364 trillion, which compared favorably to last year's deposit growth of 2.54%. (*American Banker*, Matt Ackermann, 10/28/08)

- During an interview on *60 Minutes*, Bank of America president and CEO Ken Lewis said that his bank has a deposit or loan relationships with half of the households in America. "We bank every other American family, you know, in America," said Lewis. The largest bank in America is headquartered now 600 miles south of Wall Street in Charlotte, NC. In the bank's acquisition of Merrill, Lewis said "we've got $7 billion of cost savings to get [from the acquisition], and so, that means there will be jobs eliminated." In reaction to Lewis's $7 billion cost reduction goal, *60 Minutes* interviewer Leslie Stahl gasped, "…Oh my God." Lewis said that his bank's best guess is that the housing problems will show signs of bottoming or the actual bottoming at the end of the first half of next year. Consumer debt [automobile loans and credit card debt] defaults have already increased "substantially", said Lewis, driving down BofA's third quarter earnings nearly 70%. "A damn disaster," said Lewis. *American Banker* has named Ken Lewis the newspaper's 2008 Banker of the Year. (*Transcript of 60 Minutes*, 10/19/08; *American Banker*, 10/27/08)

- According to a Federal Reserve update, the government has incurred a $2.7 billion—loss (9%) on the $30 billion of mortgage assets acquired by the government in the Bear Stearns bailout, leaving the government with a book worth of $26.8 billion on October 23rd. (*HousingWire*, Paul Jackson, 10/24/08)

- The travails of the $1.7 trillion hedge fund industry has loomed large over Wall Street, as the sector incurred $180 billion of losses over the past three months. According to the Chicago-based Hedge Fund Research, investors withdrew $31 billion from hedge funds during the third quarter—triggering vast liquidations of investments in the stock market. Morningstar's vice president John Rekenthaler, said, "[Hedge funds] are moving from an aggressive stance to a conservative stance, selling securities and knocking down the prices of those securities. …[W]hen one hedge fund pulls money out of the market, it tends to be a big chunk. Their moves also tend to be made with dramatic flair. They're active traders compared to mutual funds. They can have a larger influence regardless of their size because they trade more aggressively." The following table provides a profile of the Dow Jones Industrial Average's daily trading range over the past four weeks. Adding all of those daily swings together over the past 20 trading sessions, the DJIA has moved over 13,312 points (with a daily average range of 666 points), 143% of the index close of 9,325 on Friday, October 31st. (*New York Times*, Louise Story, 10/23/08; *Washington Post*, Kevin Sullivan and Neil Irwin, 10/25/08; *Financial Times*, Chris Hughes, 10/24/08; *Washington Post*, Nancy Trejos, 10/25/08)

DJIA's Daily Trading Range

	Monday	Tuesday	Wednesday	Thursday	Friday	Week Total	Daily Average
Week of:							
October 6, 2008	797	687	433	869	1,019	3,805	761
October 13, 2008	966	709	779	816	563	3,833	767
October 20, 2008	507	451	616	664	566	2,804	561
October 27, 2008	554	959	604	418	335	2,870	574
Total for October						13,312	666

Source: *TradingMarkets.com*, Gary Kaltbaum, 10/20/08; *Marketwatch.com*

- After the November 4th election results come in, House Democratic leaders will decide whether to return for a lame-duck session. The Senate is tentatively scheduled to return on November 17th to work on a second stimulus measure. House Speaker Nancy Pelosi and the rest of the Democratic leadership has made it clear that they would like to approve a second stimulus package in the near term, but the details of the measure remain up in the air. The Home Builders Association is actively lobbying for tax benefits and mortgage subsidies to be incorporated in to a new stimulus package, as a means of jump-starting the ailing housing market. The American Benefits Counsel is also lobbying for Congress to enact a series of proposals to help companies that support defined pension benefits, following a stock market downturn which caused at least $2 trillion of losses over the past 15 months. And, the leaders of the National Governors Association have asked leaders to include money for state Medicaid costs and for infrastructure projects in the proposed economic stimulus package. In testimony before Congress on October 20th, Federal

Reserve Chairman Ben S. Bernanke said it "seems appropriate" for Congress to consider a new economic stimulus bill to bolster the struggling economy. He added, "I think it should be significant, but I can't give you a number [on how large the stimulus should be]." (*CQToday*, 10/20/08; *CongressDaily*, Christian Bourge and Ben Schneider, 10/21/08; *American Banker*, Allison Colter, 10/30/08; *CongressDaily*, Kasie Hunt, 10/22/08; *Bureau of National Affairs*, Jonathan Nicholson, 10/28/08)

Shades of 1873…

- In the October 17th edition of the *Chronicle Review*, Scott Reynolds Nelson wrote, "As a historian who works on the 19th century, I have been reading my newspaper with a considerable sense of dread. While many commentators on the recent mortgage and banking crisis have drawn parallels to the Great Depression of 1929, that comparison is not particularly apt. Two years ago, I began research on the Panic of 1873, an event of some interest to my colleagues in American business and labor history but probably unknown to everyone else. But as I turn the crank on the microfilm reader, I have been hearing weird echoes of recent events."

- "When commentators invoke 1929, I am dubious. According to most historians and economists, that depression had more to do with overlarge factory inventories, a stock-market crash, and Germany's inability to pay back war debts, which then led to continuing strain on British gold reserves. None of those factors is really an issue now. Contemporary industries have very sensitive controls for trimming production as consumption declines; our current stock-market dip followed bank problems that emerged more than a year ago; and there are no serious international problems with gold reserves, simply because banks no longer peg their lending to them."

- "In fact, the current economic woes look a lot like what my 96-year-old grandmother still calls 'the real Great Depression.' She pinched pennies in the 1930s, but she says that times were not nearly so bad as the depression her grandparents went through. That crash came in 1873 and lasted more than four years. It looks much more like our current crisis."

- "The problems had emerged around 1870, starting in Europe. In the Austro-Hungarian Empire, formed in 1867, in the states unified by Prussia into the German empire, and in France, the emperors supported a flowering of new lending institutions that issued mortgages for municipal and residential construction, especially in the capitals of Vienna, Berlin, and Paris. Mortgages were easier to obtain than before, and a building boom commenced. Land values seemed to climb and climb; borrowers ravenously assumed more and more credit, using unbuilt or half-built houses as collateral. The most marvelous spots for sightseers in the three cities today are the magisterial buildings erected in the so-called founder period."

- "But the economic fundamentals were shaky. Wheat exporters from Russia and Central Europe faced a new international competitor who drastically undersold them.

The 19th-century version of containers manufactured in China and bound for Wal-Mart consisted of produce from farmers in the American Midwest. They used grain elevators, conveyer belts, and massive steam ships to export trainloads of wheat to abroad. Britain, the biggest importer of wheat, shifted to the cheap stuff quite suddenly around 1871. By 1872 kerosene and manufactured food were rocketing out of America's heartland, undermining rapeseed, flour, and beef prices. The crash came in Central Europe in May 1873, as it became clear that the region's assumptions about continual economic growth were too optimistic. Europeans faced what they came to call the American Commercial Invasion. A new industrial superpower had arrived, one whose low costs threatened European trade and a European way of life."

- "As continental banks tumbled, British banks held back their capital, unsure of which institutions were most involved in the mortgage crisis. The cost to borrow money from another bank — the interbank lending rate — reached impossibly high rates. This banking crisis hit the United States in the fall of 1873. Railroad companies tumbled first. They had crafted complex financial instruments that promised a fixed return, though few understood the underlying object that was guaranteed to investors in case of default. (Answer: nothing). The bonds had sold well at first, but they had tumbled after 1871 as investors began to doubt their value, prices weakened, and many railroads took on short-term bank loans to continue laying track. Then, as short-term lending rates skyrocketed across the Atlantic in 1873, the railroads were in trouble. When the railroad financier Jay Cooke proved unable to pay off his debts, the stock market crashed in September, closing hundreds of banks over the next three years. The panic continued for more than four years in the United States and for nearly six years in Europe."

- The long-term effects of the Panic of 1873 were perverse. For the largest manufacturing companies in the United States — those with guaranteed contracts and the ability to make rebate deals with the railroads — the Panic years were golden. Andrew Carnegie, Cyrus McCormick, and John D. Rockefeller had enough capital reserves to finance their own continuing growth. For smaller industrial firms that relied on seasonal demand and outside capital, the situation was dire. As capital reserves dried up, so did their industries. Carnegie and Rockefeller bought out their competitors at fire-sale prices. The Gilded Age in the United States, as far as industrial concentration was concerned, had begun."

- "As the panic deepened, ordinary Americans suffered terribly. A cigar maker named Samuel Gompers who was young in 1873 later recalled that with the panic, 'economic organization crumbled with some primeval upheaval.' Between 1873 and 1877, as many smaller factories and workshops shuttered their doors, tens of thousands of workers — many former Civil War soldiers — became transients. The terms "tramp" and "bum," both indirect references to former soldiers, became commonplace American terms. Relief rolls exploded in major cities, with 25-percent unemployment (100,000 workers) in New York City alone. Unemployed workers demonstrated in Boston, Chicago, and New York in the winter of 1873-74 demanding public work. In New York's Tompkins Square in 1874, police entered the crowd with clubs and beat up thousands of men and women. The most violent strikes in American history followed the panic, including by the secret labor group known as the Molly Maguires in Pennsylvania's coal fields in 1875, when masked workmen exchanged gunfire with the 'Coal and Iron Police,' a private force commissioned by the state. A nationwide railroad strike followed in 1877, in which mobs destroyed railway hubs in Pittsburgh, Chicago, and Cumberland, Md."

- "In Central and Eastern Europe, times were even harder. Many political analysts blamed the crisis on a combination of foreign banks and Jews. Nationalistic political leaders (or agents of the Russian czar) embraced a new, sophisticated brand of anti-Semitism that proved appealing to thousands who had lost their livelihoods in the panic. Anti-Jewish pogroms followed in the 1880s, particularly in Russia and Ukraine. Heartland communities large and small had found a scapegoat: aliens in their own midst."

- "The echoes of the past in the current problems with residential mortgages trouble me. Loans after about 2001 were issued to first-time homebuyers who signed up for adjustable-rate mortgages they could likely never pay off, even in the best of times. Real-estate speculators, hoping to flip properties, overextended themselves, assuming that home prices would keep climbing. Those debts were wrapped in complex securities that mortgage companies and other entrepreneurial banks then sold to other banks; concerned about the stability of those securities, banks then bought a kind of insurance policy called a credit-derivative swap, which risk managers imagined would protect their investments. More than two million foreclosure filings—default notices, auction-sale notices, and bank repossessions—were reported in 2007. By then trillions of dollars were already invested in this credit-derivative market. Were those new financial instruments resilient enough to cover all the risk? (Answer: no.) As in 1873, a complex financial pyramid rested on a pinhead. Banks are hoarding cash. Banks that hoard cash do not make short-term loans. Businesses large and small now face a potential dearth of short-term credit to buy raw materials, ship their products, and keep goods on shelves."

- "If there are lessons from 1873, they are different from those of 1929. Most important, when banks [fail] on Wall Street, they stop all the traffic on Main Street — for a very long time. The protracted reconstruction of banks in the United States and Europe created widespread unemployment. Unions (previously illegal in much of the world) flourished but were then destroyed by corporate institutions that learned to operate on the edge of the law. In Europe, politicians found their scapegoats in Jews, on the fringes of the economy. (Americans, on the other hand, mostly blamed themselves; many began to embrace what would later be called fundamentalist religion.)"

- "The post-panic winners, even after the bailout, might be those firms—financial and otherwise—that have substantial cash reserves. A widespread consolidation of industries may be on the horizon, along with a nationalistic response of high tariff barriers, a decline in international trade, and scapegoating of immigrant competitors for scarce jobs. The failure in July of the World Trade Organization talks begun in Doha seven years ago suggests a new wave of protectionism may be on the way."

- "In the end, the Panic of 1873 demonstrated that the center of gravity for the world's credit had shifted west—from Central Europe toward the United States. The current panic suggests a further shift — from the United States to China and India. Beyond that I would not hazard a guess. I still have microfilm to read." (*The Chronicle Review*, Scott Reynolds Nelson, 10/17/08)

Fannie Mae

Fannie Mae's retained portfolio grows at an annualized rate of 2.3% in September

- In September, Fannie Mae's retained mortgage portfolio grew at an annualized rate of 2.3% to $761.4 billion. The company's net retained commitments increased to $9.0 billion in September, up from $4.0 billion in August. Fannie's MBS and other guarantees rose at an annualized rate of 8.9%, as the company's MBS issuances totaled $38.4 billion for the month of September. In August, Fannie Mae's single-family serious delinquency rate increased 12 basis points to 1.57%, while its multi-family serious delinquency rate rose three basis points to 0.16%. The company's effective duration gap averaged plus one month in September. (*Fannie Mae Monthly Summary*, September 2008)

- In a speech at the Mortgage Bankers Association's Annual Convention, Fannie Mae CEO Herb Allison said that his company sought to increase the flow of liquidity to the mortgage market in September. Allison said, "Altogether, in September, during the worst credit market in recent history, we helped finance 200,000 single-family homes, and 48,000 units of rental housing. And from August to September, we increased our financing for jumbo-conforming loans by nearly 40%, from $2.3 billion to $3.2 billion." Allison said that Fannie also has redoubled its efforts to protect borrowers from foreclosure, which has increased its foreclosure prevention workouts from 10,000 a month from January to August to 13,000 in September. Acknowledging that more needs to be done to help prevent foreclosures, Allison said that Fannie Mae has instituted the "Second Look" initiative, in which company personnel work with servicers and attorneys to review foreclosure referrals for owner-occupied homes to see if any help can be given the homeowner. Fannie also is working with IndyMac Federal Bank on a new program, in which loan rates and/or terms are modified for seriously delinquent loans to help struggling borrowers remain in their homes. (*Fannie Mae Press Release*, 10/20/08)

Fannie Mae may write down "substantially all" its $20.6 billion of deferred tax credits

- On October 30th, Fannie Mae said it has determined to take a valuation allowance against its deferred tax asset. The company said, "While the amount of the valuation allowance has not yet been determined, it is likely to be substantially all of the value of the deferred tax assets as of September 30, 2008." As of June 30, 2008, the company's deferred tax credits totaled $20.6 billion. Fannie's write-down may be an indication that the company sees little chance of returning to profitability in the near future.

- Moshe Orenbuch, an analyst with Credit Suisse, said, "Many companies have taken partial reserves against their deferred tax assets when they have profitability challenges and these guys did nothing. They recognized the entire tax asset, which was certainly on the aggressive side. …The issue of the deferred tax write-down has to do with whether you can reasonably expect to be consistently profitable. Both Fannie and Freddie have challenges to their profitability and the steps the government is taking to reducing their fees would actually limit their ability to be profitable."

- Orenbuch also said Fannie's decision increases the likelihood that Freddie will have to do the same. "Your ability to defend that position will go down with the fact that Fannie Mae's doing this," said Orenbuch. "The bigger question is Freddie because there the government will have to pony up some money." On June 30th, if Freddie had written off its deferred tax credits from its net worth ($12.9 billion), the company would have reported a negative book value of $6 billion. Similarly, if Fannie had written off its deferred tax credits, the company's net worth would have been cut in half on June 30th, said Orenbuch.

- In recent testimony before Congress, FHFA director James B. Lockhart told lawmakers that much of the GSEs' capital was based upon "intangible assets" which didn't amount to actual cash that could be used in the financial crisis. After examiners from the Federal Reserve examined the enterprises books this summer, Dallas Federal Reserve president Richard Fisher said in a speech last month, "When you look at temporary impairments and so on, we found that many of them might not be so temporary [at Fannie Mae and Freddie Mac]." (*Bloomberg News*, Dawn Kopecki and Jody Shenn, 10/29/08)

Fannie Mae shareholder suit vexes FHFA

- A class-action securities lawsuit alleging securities fraud by Fannie Mae places its regulator and conservator, FHFA, in an awkward position of trying to defend the company. The suit, filed by former Ohio Attorney General Jim Petro in the U.S. District Court in Washington, DC, potentially puts taxpayers on the hook for hundreds of millions of dollars in damages stemming from the lawsuit. The suit was filed on behalf of the Ohio Public Employees Retirement System, State Teachers Retirement System of Ohio and other investors who bought or sold Fannie shares from April 2001 through December 2004. [This period may be extended to FNM shares bought or sold to September 2005 or even February 2006.] The litigation based largely upon a highly critical report about Fannie Mae issued by the company's regulator, OFHEO [FHFA's predecessor]. A vigorous defense of Fannie Mae in this lawsuit would require FHFA to rebut its own 340-page report, that concluded Fannie's board and management were responsible for the company's corporate culture, which allowed managers to manipulate accounting and alter earnings to facilitate payment of millions of dollars in bonuses. "The regulator is between a rock and a hard place," said SEC lawyer Tom Ajamie, who is not involved with the litigation. "The report so strongly describes the misbehavior and supports the case," said Ajamie. "It's hard to get a better piece of evidence than this. A settlement would be the best resolution." (*Wall Street Journal*, Aparajita Saha-Bunba, 10/18/08)

Fannie Mae's loss mitigation policies are "major roadblock"
to restructuring troubled mortgages, says NACA

- In a letter to FHFA director Lockhart, Bruce Marks, CEO of the Neighborhood Assistance Corp. of America, said Fannie Mae's loss mitigation policies are a "major roadblock" to restructuring troubled mortgages. Fannie Mae won't reduce the interest rates below current market rates and will not reduce the principal amount to make the payments affordable, said Marks. He wrote, "We hope that you can make an immediate reversal of these policies." Fannie Mae is offering delinquent borrowers HomeSaver Advances and is considering other innovative loan modification actions, said Lockhart. Marks argues that Fannie's HomeSaver program is "deceptive" because the arrearage is placed in an unsecured loan while nothing is done to restructure the mortgage. "It is deceptive to have the loan appear current when the payments continue to be unaffordable," said Marks. (*National Mortgage News*, 10/29/08)

Just say *NO*!

- In an interview with the *Wall Street Journal*, former Fannie Mae CEO Daniel Mudd said, "I wish I'd said 'no' to more of the things the company was asked to do. We were asked—or required—to expand lending, to conserve capital while providing liquidity, to meet housing goals for the underserved, to serve shareholders and homeowners alike. In a crisis of these proportions, something had to give. I should have gone to the government and gotten a clear answer to the question: What do you want -- more capital or more lending?"

- He continued, "…Fannie Mae was chartered by Congress to provide stability—as well as affordability and liquidity—all the time, not just in troubled times. Balancing those objectives is tough in stable conditions, but in 2008 it became nearly impossible. This exposed the flaw in the business model. Fannie and Freddie are legally required to operate as monoline companies—only in, and always in, the U.S. mortgage market. When that market goes into a depression, the companies are going to fall in tandem."

- Mudd suggested that it may be time to abandon the GSE model, saying: "Maybe it is time to move beyond the model of government-sponsored enterprises, or GSEs. The mistake would be to leave the companies in no man's land—neither private nor public. Where to go from here is an issue that will be waiting for the next president. One option would be to privatize Fannie and Freddie. This would mean two things: eliminating their 'government sponsorship' and the requirement that they invest only in housing. Fannie and Freddie would diversify, and operate like other highly regulated financial institutions. Alternatively, the government could become the sole owner-operator by buying the outstanding stock of the companies and placing them under a full guarantee." (*Wall Street Journal*, James R. Hagerty, 10/30/08)

Fannie Mae reinstates homebuyer education and counseling

- On October 28th, Fannie Mae reinstated its requirements for homebuyer education and counseling for all first time homebuyers using the MyCommunity™ Mortgage loan or loans that relies on nontraditional credit to qualify for the loan. “High quality counseling provides the first-time homebuyer in particular with reliable information and the resources necessary to make the kind of informed decisions that ultimately lead to sustainable homeownership,” said Herb Allison, Fannie Mae’s president and CEO. “In this extraordinary market, we think it is critical to reinstate this requirement and to work with counseling agencies and our lender partners to help homeowners succeed.” (*Fannie Mae Press Release*, 10/28/08)

Centerline Capital Group closes $131 million loan package with Fannie Mae

- Centerline Capital Group, a subsidiary of Centerline Holding Company, announced it closed nine loans collateralized by nine multifamily properties in California, totaling $131 million, through Fannie’s DUS program. All nine properties carry the same loan terms, which consisted of a seven year fixed-rate and remaining year adjustable and pre-payable. (*BusinessWire*, 10/29/08)

Freddie Mac

Freddie Mac's retained portfolio shrank at an annualized rate of 37.9% in September

- In September, Freddie Mac's retained portfolio shrank at an annualized rate of 37.9% to $736.9 billion. Overall, market participants were surprised by the level of mortgages purchased by Freddie, which was smaller than expected. "We are a little surprised by the lack of mortgage purchases by Freddie Mac in their retained portfolio in September, as we expected the GSEs to be more robust in their mortgage purchases post conservatorship event," wrote Morgan Stanly analysts in an October 24th commentary. "The reduction in Freddie Mac's portfolio in August and September implies they have greater space to grow over the next 14 months, especially as they are no longer capital constrained." In a note to clients, Jim Vogel, the head of agency debt research at FTN Financial Group, wrote, "In its first month under conservatorship, Freddie Mac's retained portfolio didn't do anything much different than it would have otherwise, as best we can see from this morning's monthly summary." Vogel added, it's "improbable" that Freddie will substantially increase its purchases in October because its cost of borrowing has risen.

- Freddie's retained portfolio purchases totaled $17.4 billion, an increase from $4.4 billion in August. The company's retained portfolio sales totaled $33.4 billion in September, versus $32.5 billion in August. Freddie Mac's contracts to purchase mortgages rose by $2.5 billion in September, after declining by $15.4 billion in August.

- Freddie Mac's delinquencies on loans guaranteed by the company reached a record level of 1.22% of its book of business in September, up from 1.11% in August. The company reported a 0.01% delinquency rate on its multi-family portfolio in September, down form 0.02% in August. The company's duration gap averaged zero months in September. (*Reuters*, Julie Haviv, 10/24/08; *Bloomberg News*, 10/27/08)

Freddie Mac ends its purchase of stated income loans

- Effective February 2, 2009, Freddie Mac will tighten its loan underwriting standards, ending its purchase of stated income loans and toughening the requirements for Alt-A mortgages. The company will impose a maximum 45% debt-to-income rate for nearly all mortgages it purchases and introduce new minimum credit scores for substantially all of mortgages. Any borrower who has gone through foreclosure or used a "short sale" to retire a mortgage will also face tougher scrutiny under the new underwriting guidelines. Freddie Mac will continue to purchase mortgages financed by second mortgages—or "piggyback" loans—that allow the borrower to finance more than 80% of their home's value without private mortgage insurance. The company also introduced "refinements" of new upfront fees that it is charging lenders, which have been blamed for keeping mortgage rates "stubbornly" high despite Fannie's and Freddie's conservatorship. (*Dow Jones*, Jessica Holzer, 10/20/08)

Freddie Mac asks bankruptcy judge to investigate missing $1.2 billion that was borrowed by Lehman Brothers

- Freddie Mac has asked a bankruptcy judge to investigate the whereabouts of $1.2 billion of unpaid loans the GSE had made to Lehman Brothers (LBHI), which were due with interest on September 15th, the day Lehman filed for court protection. "Freddie Mac did not receive any portion of the required repayment before, on or after Sept. 15, 2008," wrote Freddie Mac's lawyers in court filings. "Moreover, Freddie Mac was not listed as being among LBHI's largest unsecured creditors." When the investment banker filed for Chapter 11, Lehman provided the court a list of its top 30 unsecured creditors that didn't include Freddie Mac. Lawyers argued that the GSEs' $1.2 billion in loans would have put Freddie Mac among Lehman's top five unsecured creditors. The GSE is not alone in seeking an investigation of money flows in the Lehman bankruptcy. Others who have asked for similar investigations include Bank of America, Wells Fargo Bank, the FHLB-Pittsburgh, and Fir ATree Value Mast Fund LP. (*Associated Press*, Vinnee Tong, 10/23/08)

Federal Home Loan Banks

FHFA names Steve Cross as deputy director in charge of the FHLBs

- Steve Cross, who ran the Federal Housing Finance Board's supervision department for six years, has been named the deputy director in charge of the FHLBs for FHFA. In 1984, Cross joined the OCC, where he took charge of compliance issues. He moved to FDIC in 1999, where he served as head of compliance and consumer affairs, before joining the Finance Board in 2002.

- During his tenure at the Finance Board, Cross managed an extensive policy portfolio related the FHLBs, including the agency's March 2006 proposal to slash the Banks dividends in half until retained earnings totaled $50 million plus 1% of non-advance assets. In an interview with *American Banker*, FHFA director James B. Lockhart sought to distance Cross from the capital proposal. Lockhart said, "The retained earnings policy was not his policy. It was the Finance Board's policy. And obviously, as the director of supervision in those days, he was very involved." Lockhart added that he hired Cross because "we felt that he had done and continues to do a good job."

- While Lockhart wouldn't comment on whether a retained earnings policy was imminent, he did emphasize the need for capital at FHLBs. "What I've told the [FHLB] presidents is I think capital is a significant issue for any financial institution at this point, especially given the marketplace we're in, and especially being in the mortgage market, it's important to have adequate capital. It probably makes sense at this point to think about building capital, and all of them are doing that."

- "There is certainly not a warm relationship between the [FHLBs] and Mr. Cross," said Bert Ely, an Alexandria, VA bank consultant. "The real question becomes what does this mean longer term in terms of the role for the Federal Home Loan banks vis-à-vis Fannie and Freddie and housing finance generally." A source close to the FHLBs acknowledged concerns about Cross. "He is a known quantity, but unfortunately, his background is a compliance background, which is somewhat rigid," said the source. "In this extraordinary crisis, where markets face this huge liquidity crisis, he might not have the right skill sets. He doesn't see the forest through the trees." (*American Banker*, Steven Sloan, 10/29/08)

Financial crisis poses different set of challenges for the FHLB System

- As the market turmoil has deepened, growing pressures on FHLB advances could make them less attractive to members. According to FHLB insiders, the System's debt that funds advances is becoming more expensive to sell, which will ultimately increase the cost of loans to members. In addition, the System faces unexpected competition form the Federal Reserve Board, which has dramatically eased access to the discount window over the past year. "This is the best of times and the worst of times," said Alfred DelliBovi, the president and CEO of the FHLB-New York. "The cooperative is performing very well and exactly as intended, and we're continuing to provide funds to Joe the plumber. But it is a tough environment, and the costs of our borrowing are going to go up. …This is the ultimate irony. We stuck to our knitting and performed well. [Fannie and Freddie] got into trouble and are in conservatorship, and investors say they're a better bet."

- Another complicating factor was the FDIC's announcement that it would temporarily guarantee all unsecured bank debt, making bank debt effectively one of the safest bets for investors, which helped drive up the costs of GSE debt. "What's made it worse is the FDIC guarantee," said Bert Ely, an Alexandria, VA bank consultant. "The FDIC program on the debt guarantee … has got to really whack the Federal Home Loan banks in terms of shorter-term advances."

- The extensive borrowing from the Federal Reserve is a blip which is unlikely to develop into a long-term trend, said DelliBovi. "This isn't going to continue. I don't think that most community bankers who are in this for the long term want to have a temporary partner. The Fed will go back to being what it always was: a lender of last resort." A Federal Housing Finance Agency spokeswoman also defended the value of advances by saying, "The Federal Home Loan banks remain a good source of longer-term funding." (*American Banker*, Steven Sloan, 10/20/08)

Ginnie Mae

Is the Hope for Homeowners program off to a slow start?

- On October 1st, the $300 billion Hope for Homeowners (H4H) program, which could help as many as 400,000 troubled homeowners, was officially launched. *CNN Money* reports that the program is off to a "slow" start because (i) the voluntary program requires lenders to take an economic loss before the borrowers to refinance their loan through this program; (ii) lenders lack the sheer manpower to handle borrowers' requests for the program; and (iii) not every borrower will qualify for the program. Bill Glavin, special assistant to the FHA commissioner, says it's too early to tell if the program is off to a rocky start. "I don't think you can say one way or the other," said Glavin. "We know the interest from the public is there, and the next question that can't be answered yet is are the lenders going to do this?" (*CNN Money*, Amanda Gengler, 10/22/08)

- Bi-weekly FHA operational data was released on October 31st for the October 1-15 reporting period showed just 42 mortgage applications were filed under the H4H program and none were endorsed. Over the same 15 day period, 203 mortgage applications were filed under the FHASecure program and 49 were endorsed. "Everyone in the mortgage market is waiting to see if this program is going to be as successful as legislators had hoped for," said one source, who spoke to *HousingWire*. The program's bottleneck appears to be with investors, who must agree to take a haircut on the mortgage balance, before the loan can be refinanced through H4H program. In an interview with *HousingWire*, Robert Paduano, managing director at Allegro Funding Corp, said, "The [H4H] program is a joke. It's not going to materialize into what we had hoped for because most lenders are unable or unwilling to write down the principle balance to 90 percent [of the collateral property's current appraised value] because their investors won't let them." (*HousingWire*, Paul Jackson, 10/30/08)

- At the Mortgage Bankers Association's annual convention, FHA Commissioner Brain Montgomery urged lenders to participate in the H4H program. "Explaining this to consumers, trying to explain the shared equity and appreciation, and training your staff is difficult," said Montgomery. "Please look into using this new product. The demand is not going to go away anytime soon." To date, 100 lenders have signed up for the program, he added. A number of attendees said that they were having trouble qualifying borrowers, largely because their FICO scores were below the typical 580 threshold needed for loan buyers to accept. Montgomery acknowledged that many homeowners will have to accept a significant reduction in their equity, while benefiting from only half of the home's appreciation when the housing market recovers. Montgomery said, "It potentially can become a very expensive program." FHA also is seeking an extension of the FHA Secure program, designed to help troubled borrowers, which is set to expire at year-end, he added. To date, the program has only helped a few thousand borrowers because of the stringent eligibility requirements.

- Montgomery said his agency plans to increase its minimum net worth requirements for FHA-approved lenders to $1 million from the current $250,000, and $73,500 for brokers from the current $66,000. He hopes the new net worth standards will be in place by January 20th, when the new administration takes office. Fannie Mae and Ginnie Mae recently announced similar changes. (*American Banker*, Kate Berry and Lew Sichelman, 10/21/08)

Farm Credit System / Farmer Mac

Financial crisis hits the farm belt

- The flight of investment funds out of the commodities markets, coupled with better-than-expected crop yields and the prospect of a global recession, have driven commodity prices sharply lower. Corn, soybean, and wheat prices have fallen approximately 50% from historic highs earlier this year, with wheat prices hitting a 16-month low. Some ethanol manufacturers, who bought corn at high prices, now predict big losses. The industry's profit outlook also has been adversely impacted by the falling price of crude oil, coupled with the strengthening U.S. dollar, which has curtailed foreign demand for ethanol. "The market was overleveraged," said Jim Bower, head of Bower Trading in Lafayette, IN. "You're seeing demand destruction taking place not only here, but all over the world."

- Farm bankers—including the Farm Credit System—are generally in better shape than other lenders, although the real test will evolve over coming months when growers apply for loans to plant next year's corps. Over the short-term, farmers will be forced to make business decisions based on a highly uncertain price outlook. On October 22nd, corn contracts for December delivery closed at $3.85 per bushel on the Chicago Board of Trade, down from $7.80 in June. "I don't think we've ever seen (corn prices) fall this much," said University of Illinois economist Gary Schnitkey. In 2009, it will cost corn famers in central Illinois about $4.02, on average, to produce a bushel of corn in 2009, said Schnitkey. (*USA Today*, Sue Kirchoff, 10/23/08)

- On August 28th, the U.S. Department of Agriculture projected net farm income to rise 10% to $95.7 billion in 2008. Last year, farm debt increased 7.7% to $211 billion, representing 9.6% of assets. According to the USDA, farm debt is projected to drop to 8.9% in 2008, the lowest level since at least 1960 [the earliest data available]. However, the value of the collateral farmers use to secure loans—crops and land—is diminishing, as lenders demand more equity for farm loans used to run operations or acquire land and equipment. "We need two to three times the amount of money we used to need with the same collateral,'' said Bo Stone, a seventh- generation farmer in Rowland, NC. "It means we have way more risk than we've ever had. This is a time where one bad crop year, with the amount of money and input tied up, could potentially cost you your equipment, land and livelihood.'' Illinois farmer Mark Kraft added, "This year is going to be the best year ever and now we are looking at the potential to give it all back in 2009 if prices don't rise above the expected cost of production. You have to hope that fertilizer, seed and land rents come down and the price of corn improves." (*Bloomberg News*, Carlos Caminada, Shruti Singh and Jeff Wilson, 10/27/08)

- Despite the credit crisis, money is still flowing into agriculture communities from lenders such as the Farm Credit System, which funds nearly 33% of all production loans. Farm Credit Council President and CEO Ken Auer, said, "We're not in the position to say there is concern for access to credit from the Farm Credit perspective." However, Auer advises producers that the best course of action is to err on the side of good business judgment saying that now is probably not the best time to ask for substantial new lines of credit to expand your business. "There is the potential for rates to come up a bit based on the need for all banking institutions to have sufficient capital to be able to lend going forward." (*Farm Journal*, Greg Vincent, 10/20/08)

- In the October *Farm Credit Watch*, Bert Ely wrote, "The financial crisis has greatly distorted funding costs for all GSEs, including the FCS. Although firm data are not yet available, anecdotal reports suggest that the FCS is facing a two-part problem—the cost of its short-term debt has risen while it is experiencing greater difficulty in selling longer-term debt. Consequently, it appears that FCS has lost some of its funding-cost advantage over banks at the short end of the yield curve, which should help banks compete against the FCS for non-real estate loans. Limited longer-term funding, coupled with capital constraints at some FCS associations, may restrain FCS real-estate lending for a period of time. FCS institutions paying high patronage dividends may be forced to cut those dividends, which will raise their borrowers' effective interest rate, further hurting FCS competitiveness." (*Farm Credit Watch*, Bert Ely, October 2008)

Farm Credit System reports a 12% increase in its third quarter earnings, relative to same period last year

- The Farm Credit System reported combined net income of $817 million and $2.370 billion for the three and nine months ended September 30, 2008, as compared with combined net income of $727 million and $2.021 billion for the same periods last year. Since year-end 2007, the System's assets grew 11.33% to 207.5 billion, while its loans, net of allowance for loan losses, grew 10.6% to 158.1 billion.

- The System's nonaccrual loans increased $423 million from December 31, 2007 to $935 million at September 30, 2008. The increase in nonaccrual loans is largely attributable to the deterioration in the credit quality of a limited number of loans to borrowers, some of which were adversely impacted by commodity price volatility and higher farm input costs in the current agricultural environment. On September 30th, 42% of nonaccrual loans were current as to principal and interest, as compared with 52% at December 31, 2007. Nonperforming loans, which consist of nonaccrual loans, accruing restructured loans, and accruing loans 90 days or more past due, totaled $1.029 billion at September 30, 2008 (representing 0.65% of outstanding loans), as compared with $621 million at December 31, 2007 (0.43% of the System's outstanding loans).

- "We are particularly pleased with the third quarter and year-to-date results given the weakening U.S. and global economy and the unprecedented instability in the global financial markets," remarked Jamie B. Stewart, Jr., president and CEO of the Federal Farm Credit Banks Funding Corporation. "The System has been able to meet its mission and continues to be a reliable source of debt capital for those businesses we serve. Despite the instability in the world financial markets, the System has, to date, maintained the ability to access the debt capital markets, although our cost of funding has increased, particularly for longer-term debt. System institutions are taking appropriate measures to address these issues, while remaining dependable lenders in their markets." (*BusinssWire*, 10/31/08)

A helpful "colloquy" for the Farm Credit System

- In the October *Farm Credit Watch*, Bert Ely wrote "…It is well-known that the Troubled Assets Relief Program (TARP) is a key element of the Emergency Economic Stabilization Act of 2008 (ESSA), but barely known is the near certainty that the FCS, and specifically CoBank, can sell troubled assets to the Treasury Department under TARP. That likelihood was established under a congressional practice known as a 'colloquy.' Colloquies are carefully orchestrated exchanges on the floor of the House or Senate where two or more members of that chamber clarify the intent of legislation under consideration at that time. Such a colloquy occurred on October 3 on the House floor between Representative Barney Frank (D-MA), Chairman of the House Financial Services Committee, and Representative Edwin

Perlmutter (D-CO), a committee member whose Denver-area district is near CoBank's headquarters."

- "In their colloquy, Mr. Perlmutter asked Chairman Frank if certain federal agencies, including the FCA, would 'be utilized to make sure that some of the funding or credit provided by [ESSA] will go directly to Main Street?' Chairman Frank answered, 'The bill fully authorizes the Secretary of the Treasury to do that, and I and others, including the gentleman from Colorado, will be working to make sure that he does, and I have every intention to believe that they intend to.' How the FCA will move troubled FCS assets from CoBank and other FCS institutions into the TARP is not clear, but no doubt a way can be found."

- "An October 17 *Wall Street Journal* article, headlined 'Debt Woes, Feed Costs Come Home to Roost at Pilgrim,' reported on the financial troubles at the Texas-based Pilgrim's Pride Corp., the world's largest chicken processor. Key to Pilgrim's travails is its 2006 acquisition of Gold Kist for $1.1 billion, plus the assumption of $144 million of debt, with much of the purchase funded with debt raised by Lehman Brothers and CoBank. According to the *Journal*, 'many industry analysts say Pilgrim's Pride paid the wrong price for Gold Kist at the wrong time.' It also reported that 'if the company can't raise money or extract concessions from its lenders, it could be forced to seek bankruptcy-court protection.' Over 20 FCS institutions have provided 60% of a $1.17 billion credit facility to Pilgrim's Pride. One wonders how much loss the FCS has reserved against this facility. Perhaps FCS will sell its toxic Pilgrim's Pride loan into the TARP, which could explain why the Frank-Perlmutter colloquy occurred." (*Farm Credit Watch*, Bert Ely, October 2008)

Farmer Mac was adequately capitalized on September 30th

- Farmer Mac has reported to the FCA's Office of Secondary Market Oversight that its capital surplus exceeded $29 million for the quarter ended September 30, 2008, following its successful issue of $65 million in preferred stock to build capital. Farmer Mac's capital raise was taken to address recently sustained losses from deterioration of certain investments, which were related to the broader deterioration in the financial marketplace. FCA chairman Leland A. Strom said, "I want to emphasize that Farmer Mac's agricultural mortgage program business remains strong. The Farm Credit Administration will continue to closely monitor the situation and take aggressive regulatory action as needed to address any capital or other regulatory or safety and soundness concerns. We will review the company's September 30 financial position in detail when it becomes available." (*Farm Credit Administration Press Release*, 10/01/08)

- In the October issue of *Farm Credit Watch*, Bert Ely wrote, "Last month, Farmer Mac had to raise $65 million of fresh equity capital, in the form of preferred stock, after reporting as much as $100 million in write-downs on investments in Fannie Mae preferred stock and Lehman Brothers debt. Had Farmer Mac not raised this capital, it would have fallen below its minimum statutory capital requirement, curbing its ability to make loans and extend new credit guarantees. The five FCS banks—CoBank, AgFirst FCB, AgriBank FCB, U.S. AgBank FCB, and the Farm Credit Bank of Texas—bought $60 million of the new preferred. These banks fund the 92 FCS associations." [Zions Bancorporation (Salt Lake City, UT), which has owned 20% of Farmer Mac's outstanding shares, purchased an additional $5 million of the cumulative perpetual preferred stock.]

- "This investment adds another element to the Farmer Mac-FCS relationship since as of June 30, 2008, Farmer Mac had guaranteed $1.97 billion of FCS loans under long-term standby purchase commitments, which essentially are credit-default guarantees. Additionally, the FCS had exchanged $1.65 billion of its loans for mortgage-backed securities issued by Farmer Mac. To monitor their interests, the FCS banks negotiated 'certain protective rights with respect to this investment and [the banks] will name three observers to the Farmer Mac Board of Directors.' As the ties between Farmer Mac and the FCS broaden, future Farmer Mac problems could negatively impact the FCS. If, for example, the guarantees Farmer Mac has extended to FCS institutions had to be unwound, that would boost the capitalization requirements for those institutions which had shifted credit risk to Farmer Mac. It will be interesting to see if FCS institutions, possibly under pressure from the Farm Credit Administration (FCA), begin to trim the amount of credit risk they have shifted to Farmer Mac." (*Farm Credit Watch*, Bert Ely, October 2008)

Deputy Agriculture Secretary Conner to serve as CEO
of the National Council of Farmer Cooperatives

- The National Council of Farmer Cooperatives has selected Deputy Agriculture Secretary Chuck Conner as its next chief executive officer, according to several sources close to the NCFC. Bill Davisson, who serves the council's chairman, confirmed that a search committee had selected a candidate, but declined to name him. According to a USDA spokesman, Conner said speculation about his next job "would be very premature." Before joining the Bush administration, Conner served as CEO of the Corn Refiners Association. (*Capital Press*, Jerry Hagstrom, 10/30/08)

Postal Service

Postmaster General John E. Potter addresses the future of the USPS

- In an interview with *Washington Post* reporter Joe Davidson, Postmaster General John E. Potter said, “I think our [Postal Service] network has served America well for over 200 years and we’ll continue to serve America well into the future. . . . I think the Postal Services is going to be around for at least another 100 years. We provide a vital service to all Americans. …As Americans’ need for mail changes or desire for new products occurs, we respond and react accordingly. The troubles the Postal Service has today, the challenges we face, are largely driven by what’s going on in the economy. As the economy recovers, I expect our business to grow.”

- With regard to the USPS’s current deficit, Potter said, “The Postal Service had positive net incomes until a [postal reform] law was passed in 2006. …It requires the Postal Service today to pay approximately 10 percent of every dollar we take in toward retiree health benefits. There are two facets of those retiree health benefits. We pay approximately $2.3 billion as the employer share of health benefits for those who are currently retired. In addition to that, we pay approximately $5.4 billion into a fund for future retirees’ health benefits. …Now without that obligation of $7.7 billion, the Postal Service would have a positive net income. …That is a burden that was recently placed on us, and it is something that we are right now in conversations with the folks on Capitol Hill, not to walk away from our obligation to retirees and their health benefits, because we want to certainly make sure we cover them, but looking at the pace at which we pay into the retiree health benefit fund. …If our payment schedule was revisited and spread out over a longer term, we again would be in the positive range when it comes to that income.”

- Addressing worker-work match concerns, Potter said, “We’re working very hard to match our use of resources, which is largely labor, to the lower volumes that we have. ...As an example, last Friday we signed an agreement with the National Association of Letter Carriers that will enable the Postal Service in an expeditious way to adjust routes to better reflect the lower workload that’s out there right now.”

- Davidson asked, “Does the Postal Service need all of the people it employs?” Potter responded, “We are reducing our use of overtime. We are reducing our use of non-career [part-time] employees. We are reducing the work hours that our flexible employees work, and we are restructuring the work to utilize less work hours. …I’m not planning on any [layoffs].

- With regard to future postage rates, Potter said, “If we raise rates above the rate of inflation, what it’s simply going to do is drive more volume away. …That exacerbates our problems for our customers, because they are dealing with tough economic times. They have alternatives for every class of mail we have. In advertising, you have opportunities in newspapers, radio, TV, as well as the Internet and Web-based advertising. If you're in the package business, obviously you have the opportunity to use ...competitors there. First-class mail [declines when] people can present bills online and pay online. So what we don't want to do is do something that would encourage our customers to move away from mail. …Right now, I'm convinced that [by] working with our unions, we can better match our use of resources to the workload we have. Working with Capitol Hill, we may be able to restructure our payments into our retirement health benefit fund, and working with our customers, we're going to look at ways to grow mail volume.

- Addressing the USPS's performance, Potter said, "Our postal service is the best in the world. …The United States Postal Service has 45 percent of the world's mail, and we certainly don't have 45 percent of the world's population in America. We have been one of the vital cogs in the economy of the United States, and we are serving America at higher levels than we've ever served in our history. Our on-time performance is second to none. (*Washington Post*, Joe Davidson, 10/30/08)

USPS is facing the most serious challenges in its 220-year history

- In an open letter to Postmaster General John Potter, APWU President William Burrus wrote, "…[H]alf-century of service qualifies me as a knowledgeable observer of our revered institution. Throughout these many years, I have never seen the level of uncertainty now confronting us. Without significant adjustment to its business strategies, the Postal Service will not survive as a government institution and a public service." (*The American Postal Worker Magazine*, William Burrus, November/December, 2008)

PRC chairman Blair expects a 5% increase in postal rates in 2009

- In an interview with *Multichannel Merchant*, Dan G. Blair, chairman of the Postal Regulatory Commission, said, "It appears that the average increase for each class of mail will be approximately 5%. The actual rate cap will depend upon the behavior of the monthly CPI between now and December. [The cap is based on an average over two consecutive 12-month periods.] The current value [as of Oct. 21] is 4.4%, and we've witnessed an upward trend over the past year. Given the current rate at which the Service is losing money, it is likely that the rate change in all classes will be close to the cap. [In addition,] there are small amounts of banked, or unused, rate authority available. The mailers should use their projection of the cap as a guide in developing their postage budgets."

- With regard to the USPS volume decline of 9 billion pieces in FY2008, Blair believes ways to stem this tide include improving service performance and keeping price increases to a minimum. "Faster, more reliable service will attract and keep volume," he says. And there will be a need to control cost growth to less than CPI "to ensure price (rate) changes will be less than the CPI-based cap." Mailers fear that significant mail volume decline numbers will result in inordinate rate increases in the future – despite the fact that Postmaster General Jack Potter keeps saying the Postal Service is not considering an exigent rate case [the "escape valve" mechanism which was included in Postal Reform legislation which would allow the USPS to increase rates over and above the CPI]. When asked if an exigent rate case is possible, given the current circumstances, Blair responded, "Anything is possible. However, the Postmaster General has repeatedly said he does not intend to seek an exigent rate increase, and I believe him." (*Multichannel Merchant*, Jim Tierney, 10/28/08)

USPS senior executives do not expect to receive pay raises because of the agency's deteriorating financial condition

- According to Mailers Council Executive Director Robert McLean, "Information has been leaked to several websites indicating that earlier this month USPS senior executives have been told they will not receive their pay raises this year because of the deteriorating postal financial situation and that USPS Labor Relations officials asked postal supervisors and managers to consider similar concessions. The Postmaster General is on record saying he would need the help of the employee organizations in working with the Congress as the Postal Service attempts to develop solutions to its fiscal problems. That support might never materialize from the management associations if the Postal Service pursues any change to the existing 'consultative' (meaning pay) agreement, as appears to have been the case this month. Postal officials asked the management associations to take the extraordinary step of reopening the existing consultative agreement, which was signed in 2007 and runs through FY 2010, with the intention of seeking new pay concessions. Such a move could generate a lawsuit from the management associations." (*Postcom.org*, 10/27/08)

Qualified leadership for USPS Board of Governors is needed

- In an October 20th letter to Senate Majority Leader Harry Reid (D-NV), Robert E. McLean, executive director of the Mailer's Council, wrote, "On behalf of the Mailers Council's membership that collectively represents more than 70% of all mail, I write regarding the need for exceptionally qualified individuals to be nominated to the United States Postal Service Board of Governors. …[I]t is imperative that the Senate consider and approve only candidates who meet the statutory criteria [set forth in the Postal Accountability and Enhancement Act in 2006] and who have experience managing large organizations. Soon the Postal Service is expected to announce a deficit for FY 2008 exceeding $3 billion so the need for qualified, talented, leadership has never been more pressing. As a result, we ask for the opportunity to discuss this situation personally. I will contact your staff to see if a meeting shortly after the election would be possible." McLean's letter is in response to mailers' concerns about the recent appointment of an elected property assessor from Washoe County, Nevada to a Democratic seat that is vacant on the Postal Service's Board of Governors. (*Correspondence to the Honorable Harry Reid*, Robert E. McLean, 10/20/08)

The business model for the USPS continues to deteriorate

- Video rental company Netflix Inc. and TiVo Inc. have joined forces to deliver more movies and old TV episodes to their mutual subscribers, consummating a relationship that will allow viewers to select from more than 12,000 movies and television shows starting in December. Online delivery of media content to viewers will allow Netflix to save the $0.84 postal service cost for a roundtrip delivery of a DVD rental. (*Washington Post*, Michael Liedtke, 10/30/08)

- After a century of continuous publication, *The Christian Science Monitor* will abandon its weekday print edition and appear online only in April, making *The Monitor* the first national newspaper to largely give up on print. John Yemma, the paper's editor, said, "Everybody's talking about new models. This is the new model." Yemma added, "We have the luxury—the opportunity—of making a leap that most newspapers will have to make in the next five years." According to the Association for Postal Commerce, *The Monitor* has relied largely on the Postal Service for its printed edition distribution in recent years. (*New York Times*, Stephanie Clifford, 10/29/08; *Postcom*, 10/30/08)

- As a result of the financial crisis, lenders have reduced the number of their direct mail offers to a trickle, which translates for the average American household into about 13 fewer pieces of credit card junk mail a year than its peak in 2005. According to the direct marketing research firm Mintel Comperemedia, mail offers to new and existing customers are on pace to drop below 8.4 billion pieces, the lowest level since 2004. (*New York Times*, Eric Dash, 10/29/08)

Mail does *not* have a major negative impact on the environment

- According to a new study by the Postal Service, the energy and CO2 emissions associated with mail is roughly equivalent to the annual household energy and CO2 emissions of an electric coffee pot. Based upon this study, the Association for Postal Commerce, concludes "…[M]ail is *NOT* the environmental dispoiler mail critics have recently sought out to make it be. Indeed, the data underlying the USPS study puts into starker contrast the recklessness regarding the integrity of the nation's universal mail delivery system associated with efforts to enact 'do not mail' provisions at the state and national levels by self-styled (but generally misinformed) 'environmental' advocates." (*Postcom*, 10/29/08)

TVA

TVA's board increases the CEO's salary 23%
and raises his maximum compensation to $3.25 million

- A month after implementing its biggest rate increase in three decades, TVA increased the salary of TVA president Tom Kilgore by more than 23% (or $200,000) to $850,000 and raised the maximum he could earn by nearly $500,000 to $3,275,000 for FY2009. The raise will make Kilgore one of the highest-paid federal employees in America, eligible to earn more than eight times the president's compensation. According to TVA's compensation consultants, the utility's new pay level for the CEO will be 45% below the compensation for other CEOs at comparable electric utilities.

- TVA Director Dennis Bottorff, chairman of TVA's finance, strategy and rates committee, insisted that Kilgore's compensation package adopted for FY2009 is "very conservative" compared with compensation packages for comparable executives at other utilities. "Compensation for TVA leadership is a very small but necessary portion of TVA's total budget," said Bottorff, who praised Kilgore's leadership. TVA chairman Bill Sansom said it was difficult to vote to raise Kilgore's pay less than a month after increasing TVA's electricity rates by 20%, but added "we need to remain competitive to keep good people."

- However, critics objected to TVA raising its executive pay. "We're in a period of belt-tightening for most Americans, except for CEOs and those that run our government agencies," said David Williams, vice president of policy for Citizens Against Government Waste. "This is why people are so frustrated with government and its leaders."

- Despite the increase in his own pay, Kilgore said most of the executives who report directly to him will get raises of about 3.5% in their base compensation in FY2009. They also will receive other compensation, based upon TVA meeting its performance goals for power reliability, economic development and plant performance, among other criteria. (*Chattanooga Times Free Press*, Dave Flessner, 10/31/08)

- In an October 31st letter to TVA chairman William Sansom, Representative John Duncan, Jr. (R-TN) wrote, "Each year an overwhelming majority of the people in this region become extremely upset about the millions of dollars in bonuses TVA gives to its top-level employees. Now I am hearing an even stronger reaction to the salary and bonus package, totaling $3,270,000, given to Mr. Kilgore. I have very great respect for you, Mr. Kilgore, and each member of the Board whom I know. However, this pay raise is excessive and very unnecessary. …I assume that the Board will not rescind this latest pay raise and will continue giving out huge bonuses, despite tremendous public opposition. But I hope, at the very least, you will consider delaying this pay raise and any bonuses until this Nation comes out of recession or until TVA rescinds its recent rate increase." *(Correspondence to TVA chairman William Sansom*, Representative John Duncan, Jr., 10/31/08)

- Representative Zach Wamp (R-TN) said raising TVA President Tom Kilgore's potential compensation package by $500,000 to $3.27 million is unfair when "many families in East Tennessee have been struggling to pay their bills during tough economic times. "It defies common sense that following TVA's biggest rate increase in three decades, the TVA board of directors would approve such a significant bonus package," he said. "This isn't fair to the many hard-working TVA customers who will have to tighten their belts even further to pay ever-higher electric bills."

- Senator Lamar Alexander (R-TN), who chairs of the TVA Congressional Caucus, said today he doesn't think Congress should try to micromanage TVA. "The TVA board should be sensitive to keeping its costs down, especially at a time when Tennesseans are hurting," said Alexander. "But TVA is the largest utility in the country and it's got to recruit competent people to run the agency, including its nuclear plants, and it need pay them a competitive wage in order to keep them." (*Chattanooga Times Free Press*, Dave Flessner, 10/31/08)

Consumers to receive modest reduction in TVA's power rates related to falling fuel costs

- In January, TVA will cut the price of electricity in response to falling natural gas and other power costs, said TVA president Tom Kilgore. TVA has not yet calculated how much of a price break it may provide under the utility's quarterly fuel cost adjustment, Kilgore added. (*Chattanooga Times Free Press*, Dave Flessner, 10/31/08)

TVA extends free energy audits for consumers, designed to help customers identify ways to conserve their use of power

- TVA is extending for another year their free energy audit program designed to help homeowners identify ways to conserve their power uses and minimize their power costs. The service, offered on-line and by mail, has been used by more than 41,000 TVA retail customers in the utility's seven-state service area. (*Associated Press*, 10/23/08)

- In a recent study, Memphis Light, Gas, and Water concluded that some inner-city homes use twice energy per square foot relative to homes in other parts of town, because of poor insulation and inefficient heating and air conditioning systems. MLGW is seeking $45 million from TVA for a five-year program to replace 90,000 inefficient window air conditioners in homes around Memphis. (*Associated Press*, 10/25/08)

- In Jackson, TN, officials from local nonprofit agencies are asking the Jackson Energy Authority [a TVA distributor] to begin a "round up" program to help those in need assistance in paying their utility bill. Under the program, customers' utility bills would be rounded up to the next highest dollar amount with the excess going into the aid program. Tentatively, residents would have the option of not participating in the program. (*Jackson Sun*, Ned Hunter, 10/28/08)

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