

The **GSE** REPORT™

www.gsereport.com

Contents of GSE Report™

Major Events

- [FHFA places Fannie Mae and Freddie Mac into conservatorship \(p. 3\)](#)
 - [The winners and losers--and unintended consequences \(p. 8\)](#)
 - [World markets greet Treasury action with sigh of relief \(p. 11\)](#)
 - [Editorial boards address the GSE bailout \(p. 11\)](#)
 - [The truth hurts—particularly two months before an election \(p. 16\)](#)
 - [The presidential candidates address the future of Fannie and Freddie \(p. 19\)](#)
 - [After the GSEs' conservatorship, what will be the enterprises' future role? \(p. 21\)](#)

Fannie Mae and Freddie Mac

- [The new Federal Housing Finance Agency has its hands full \(p. 24\)](#)
- [Fannie and Freddie receive special treatment by the IRS and the NYSE \(p. 27\)](#)
- [The people responsible for the failure of Fannie Mae and Freddie Mac \(p. 27\)](#)
- [Subprime and beyond... \(p. 31\)](#)
- [The Housing and Recovery Act of 2008 may spur more bias probes \(p. 33\)](#)

Fannie Mae

- [Fannie's new CEO Allison has 30 years of Wall Street experience \(p. 34\)](#)
- [Fannie Mae completes a \\$7 billion debt sale \(p. 34\)](#)
- [Fannie Mae is allowed to pay its third quarter dividends \(p. 35\)](#)
- [Secretary Paulson urges Fannie Mae employees to "look forward" \(p. 35\)](#)

Freddie Mac

- [Freddie Mac's new CEO Moffett is a banker, who has been analyzing interest rate risk and credit risk all his career \(p. 36\)](#)
- [Treasury Secretary Paulson urges Freddie Mac's employees to stay and continue their important work \(p. 36\)](#)

Federal Home Loan Banks

- [The Federal Housing Finance Agency is poised to write new capital requirements for the FHLB System \(p. 37\)](#)

Ginnie Mae

- [Lawmakers make last ditch effort to derail FHA's ban of seller-assisted down payments \(p. 38\)](#)

Farm Credit System / Farmer Mac

- [Farmer Mac's stock prices falls 33.3% due to losses on Fannie Mae preferred stock \(p. 39\)](#)

Postal Service

- [APWU notifies Postal Service of errors made in their Voluntary Early Retirement Plan notices to employees \(p. 39\)](#)

TVA

- [Environmentalists seek to block work on TVA nuclear plant \(p. 39\)](#)
- [TVA dropped its contract for outside security guard service at three nuclear plants \(p. 40\)](#)
- [TVA named a top utility by *Site Selection Magazine* \(p. 40\)](#)

Major Events

FHFA places Fannie Mae and Freddie Mac into conservatorship

The winners and losers—and unintended consequences

World markets greet Treasury action with sigh of relief

Editorial boards address the GSE bailout

The truth hurts—particularly two months before an election

The presidential candidates address the future of Fannie and Freddie

After the GSEs' conservatorship, what will the enterprises' future role?

FHFA places Fannie Mae and Freddie Mac into conservatorship

- In a dramatic bid to restore faith in the GSEs and arrest a vicious cycle in the housing market, Treasury Secretary Henry Paulson and Federal Housing Finance Agency (FHFA) director James Lockhart, III announced that FHFA has placed Fannie Mae and Freddie Mac into conservatorship on September 7. Through agreements with FHFA and the conserved entities, the Treasury Department has committed up purchase up to \$100 billion of senior-preferred stock in each GSE. Purchases will be made, on an as needed basis, to ensure “positive net worth” in each firm. Fannie and Freddie have agreed to an up-front purchase by Treasury of \$1 billion in senior preferred stock with a 10% coupon. Treasury will also receive warrants for the purchase of common stock of each company, representing 79.9% of the common stock of each GSE on a fully diluted basis at a nominal price. While the shareholders have not been abrogated, common shareholders will be first in line to absorb losses, followed by preferred shareholders. FHFA has eliminated the companies' dividends for common and preferred shares, but is protecting the GSEs' interest and principal payments on their subordinated debt.
- As a part of the bailout, Treasury also is establishing the [new] Government Sponsored Enterprise Credit Facility (GSECF), which will provide short-term loans (generally for terms of one week to one month) to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs), to serve as an ultimate liquidity backstop. These loans will be collateralized by GSE-issued MBS or FHLB advances. In addition, Treasury is initiating a program to purchase new mortgage-backed securities issued by the GSEs, starting with \$5 billion in September, through December 2009. Treasury plans to hire independent asset managers to purchase and run the MBS portfolio. “There's no reason to expect taxpayer losses from this program—and it

could produce gains,” said Treasury. To address systemic risk, the plan calls for Fannie Mae and Freddie Mac to make modest additions to their retained mortgage portfolio through the end of 2009. Thereafter, Fannie Mae and Freddie Mac will be required to reduce their mortgage holdings by 10% annually, largely through mortgage run-offs, until they reach \$250 billion.

- The FHFA acts as the Conservator for Fannie Mae and Freddie Mac to preserve and conserve the companies’ assets and property and put them in a sound and solvent condition. As Conservator, FHFA has removed the chief executive officers of Fannie Mae, Daniel Mudd, and Freddie Mac, Richard Syron, who have both agreed to remain with the companies for a brief transition period. FHFA has hired Herbert Allison, 65, the former CEO of TIAA-Cref, to run Fannie Mae. The agency has also hired David Moffett, 65, the former US Bancorp vice chairman to run Freddie Mac. Under the conservatorship, Fannie Mae and Freddie Mac are banned from lobbying the government, putting an end to their ability to use their political machine on Capitol Hill. Also, FHFA will likely direct Fannie and Freddie to cut the fees they charge on mortgages which they guarantee. “[Fannie and Freddie] will no longer be managed with a strategy to maximize common shareholder returns, a strategy which historically has encouraged risk taking,” said Paulson.
- “Our economy will not recover until the bulk of this housing correction is behind us,” said Paulson. “Fannie Mae and Freddie Mac are critical to turning the corner in housing.” The over-riding goal of the GSE bailout is to keep Fannie Mae and Freddie Mac in operation through 2009, while leaving it to the next president and Congress to decide their long-term structure. “The new Congress and next administration must decide what role government in general and these entities in particular, should play in the housing market,” said Paulson. “There is a consensus today that these enterprises pose a systemic risk and they cannot continue in their current form.”
- Paulson said the bailout plan was structured to achieve three critical objectives of (i) providing stability to the financial markets; (ii) supporting the availability of mortgage finance; and (iii) protecting the taxpayers. Paulson’s stop-gap plan will give the next president and Congress the opportunity to engineer a long-term solution for Fannie Mae and Freddie Mac, which hopefully will remove the current ambiguity resulting from private ownership with public financial backing.
- Paulson’s actions, taken after consultation with Federal Reserve chairman Ben Bernanke, followed a review of Fannie Mae and Freddie Mac. A month ago, Paulson hired Morgan Stanley to conduct an independent review of the GSEs. According to unnamed sources, this review concluded that the accounting, while legal, enabled Freddie Mac—and to a lesser extent Fannie Mae—to overstate their reserves. The advisors estimated that as much as \$50 billion would be needed to offset the companies combined losses. Further complicating matters, Fannie and Freddie’s cost of borrowing was also growing expensive, as central banks in Asia and Russia began scaling back their purchases of agency debt. When a last ditch effort by Freddie Mac to raise capital failed, Paulson and his advisors concluded that the markets had lost

confidence in the GSEs and they couldn't survive in their present form, so Treasury had to act. Following extensive consultations with the FHFA, Federal Reserve, White House, members of Congress, Fannie and Freddie, and other stakeholders, Paulson concluded that conservatorship was the best choice of action, which would provide a government backing of the GSEs' debts, remove management, and keep the entities operating. "They called it 'sticking the companies in timeout,'" said one source with firsthand knowledge of Treasury officials' debate. "It protects the safety and soundness of the economy, but gives everyone breathing space."

- One unknown in the bailout plan is its cost to the taxpayers. An earlier estimate by CBO suggested \$25 billion as a rough estimate. However, a senior government official told the *New York Times* that even that estimate was optimistic. The White House budget office has decided not to incorporate Fannie Mae and Freddie Mac into the federal budget, citing the temporary nature of the Treasury Department's takeover and the "level of federal ownership" of the GSEs. This decision affects the way public expenditures will be incorporated into official budget projections. On September 9th, the Congressional Budget Office announced that the bailout bound the federal government so tightly to Fannie Mae and Freddie Mac, that their operations should be included in the government's balance sheets. OMB director Jim Nussle announced that he had decided differently, but may "reevaluate their budgetary status in the future, should conditions change." In the interim, Nussle said, "We will ensure the government's financial relationship with the [the firms] is transparent in the budget and Financial Statements of the U.S. Government, including details on the implementation of the current conservatorship and any federal assistance, the financial health of the entities involved, and the current and projected fiscal impact on government finances."
- Initial reaction to the bailout plan was positive in Washington. "Paulson has threaded the needle just right by taking necessary action to stabilize U.S. financial markets while minimizing the liability for taxpayers," said Senator Chuck Schumer (D-NY), who chairs the congressional Joint Economic Committee. "This plan will be met with broad acceptance in Congress because it doesn't prejudge the ultimate fate of Fannie Mae and Freddie Mac." During a September 8th interview on CNBC, Schumer added, "Our number one goal is the financial markets, and if people lose confidence, whether here or overseas in Fannie and Freddie and start selling them and not refinancing and not buying new ones, who knows what would happen. So Paulson had no choice and he's gotten broad support for his move."
- During a September 8th appearance on CBC's *Face the Nation*, Senator John McCain (R-AZ), the Republican nominee for president, said he supported Treasury's actions. "We've got to keep people in their homes," said McCain. "There's got to be restructuring, there's got to be reorganization, and there's got to be some confidence that we've stopped this downward spiral. ...It's an example of cronyism, special interest, lobbyists. [Fannie and Freddie need] more regulation, more oversight, more transparency, more of everything, and frankly, a dramatic reduction in what they do."

- Senator Barack Obama, the Democratic presidential nominee, said “some” intervention by Treasury was necessary to prevent a “larger and deeper crisis.” After the current crisis subsides, Obama said, “The plan must move toward clarifying the true public and private status of our housing policies.” He added, “Any action we take must be focused not on the whims of lobbyists and special interests worried about their bonuses and hourly fees.” On NBC’s *Meet the Press*, Senator Joseph R. Biden Jr. (D-DE), the Democratic nominee for vice president, said Treasury’s plan has a good chance of succeeding. “It’s not an official reorganization,” said Biden. “It will be left to the next administration and the Congress to make those judgments.”
- However, the majority of Democrats have already begun to push back on Treasury’s plan to restrict the size of the GSEs’ mortgage portfolios. “Good luck with that,” said House Financial Services chairman Barney Frank (D-MA), when asked about Treasury’s plan to start reducing the GSEs’ mortgage portfolio. Calling the plan “more of a sop to the right” than a real policy prescription, Frank said it wasn’t going to happen. Frank said he wasn’t certain that the takeover was necessary, but “it probably was.” He added, “Given that they decided to do it, I think they did it in as good a fashion as they can.” Further, it was “nonsense” that Paulson could have anticipated the takeover, he said. Frank also noted, “[Secretary Paulson] told me on Friday [September 5th] that he intends to stand by his commitment [to the GSEs’ affordable housing fund], and Mr. Lockhart was with him when he told me that.” Frank has scheduled a hearing entitled “Oversight Hearing to Examine Recent Treasury and FHFA Actions Regarding the Housing GSEs” for September 25th at noon.
- Representative Spencer Bachus (R-AL), minority leader of the House Financial Services Committee, said, “Regardless of one’s views on the wisdom of the legislation adopted in July ...we should all be able to agree that the time has come for our financial regulators and Congress to address the fundamental issue of the federal government’s proper relationship to the GSEs and their role in the mortgage finance system. Maintaining the failed status quo is simply no longer an option.”
- After the bailout was announced, Senate Banking Committee chairman Christopher Dodd (D-CT) said he will hold a September 16th hearing and ask Paulson why he elected to seize Fannie Mae and Freddie Mac less than two months after assuring Congress that no such action was necessary. “I’m not opposed to this necessarily,” said Dodd in a conference call with reporters. “I’m going to be more cautious. I need a lot more assurances that this is a step in the right direction. ...We certainly accepted him at his word that that was all that was going to be necessary.” Dodd also expressed concerns about the role ideology played in the bailout. “I’m hoping we’re not talking about eliminating [Fannie and Freddie] all together,” said Dodd, adding the U.S. is the “only country” where homeowners are able to get 30-year fixed-rate mortgages because of the GSEs. “This will be a real problem [if the takeover is ideologically driven].” Later, during a Bloomberg Television interview, Dodd asked why the Bush administration didn’t act sooner. “Why weren’t we doing more, why did we wait almost a year before there were any significant steps taken to try to deal

with this problem?” said Dodd. “I have a lot of questions about where was this administration over the past eight years.”

- In an interview on CNBC, former Federal Reserve chairman Alan Greenspan welcomed the federal government’s takeover of Fannie Mae and Freddie Mac. He reiterated his criticism that the structure of GSEs, which have private stockholders but have an implicit government guarantee, “socializes losses while privatizing gains.” This type of institution “should not exist in a competitive market environment,” he said.
- Investor Warren E. Buffett said, “Secretary Paulson has made exactly the right decision for the country. He is minimizing the problem of moral hazard and maximizing the benefits for the housing market and for the smooth functioning of financial markets.”
- “I thought this was a very elegant approach,” said attorney Thomas Stanton, author of two books on the GSEs and a lecturer at Johns Hopkins University. “[T]axpayers are going to be above preferred shareholders. The Treasury has really worried about protecting taxpayers.”
- Bill Gross, co-investment chief of PIMCO, said he believes “the bond market— certainly the agency mortgage market—will scream upwards in price and substantially lower in yield.” Part of the bailout might turn out to be a good investment for Treasury, since the government could get a good return on its preferred stock and will be buying mortgage securities at a relatively low price, said Gross. “I think the plan will likely make a profit of the taxpayer.” The plan certainly “profited” Gross’s Pimco Total Return Fund, which reaped a \$1.7 billion “payday” the day after the GSE bailout was announced on the bet the fund had made on mortgage bonds issued by Fannie and Freddie.
- “This is not a permanent solution—they’ve not saved Fannie and Freddie, what they’ve done is they’ve bought 15 months,” said Bill Ackman, founder of Pershing Square Capital Management. “It’s a band aid. They haven’t permanently recapitalized the companies.” (*Bloomberg News*, Dawn Kopecki, 09/09/08; *Wall Street Journal*, Deborah Solomon, Dudeep Reddy and Susanne Craig, 09/08/08; *Bureau of National Affairs*, Aaron Lorenzo, 09/09/08; *CNNMoney*, Jeanne Sahadi, 09/07/08; *Wall Street Journal’s Morning Brief*, 09/08/08; *New York Times*, Charles Duhigg, Stephen Duhigg, Stephen Labaton, and Andrew Ross Sorkin, 09/08/08; *Washington Post*, Neil Irwin and Zachary A. Goldfarb, 09/08/08; *Bloomberg News*, Rebecca Christie and John Brinsley, 09/08/09; *New York Times*, Stephen Labaton and Edmund L. Andrews, 09/08/09; *Treasury Secretary Paulson Press Release*, 09/07/08; *Washington Post*, Zachary A. Goldfarb and Neil Irwin, 09/09/08; *CQ Today*, Benton Ives, 09/10/08; *CQ Today*, Benton Ives, 09/08/08; *American Banker*, Steven Sloan, Stacy Kaper, and Cheyenne Hopkins, 09/10)

The winners and losers—and unintended consequences

- As a result of the bailout, the GSEs' common and preferred shareholders were substantially diluted, and have lost, at least temporarily their voting rights and dividends. Further, common shares are first in line to absorb losses, followed by preferred shares, which total \$36 billion on a combined basis. The bailout is “unambiguously bad” for preferred shareholders who, along with common shareholders, “will in all likelihood be wiped out,” said Kathleen Shanley, an analyst with Gimmie Credit LLC. “The government opted not to sweeten the till for bank holders of preferred stock [which is] likely to set a precedent for any future rescue transactions.” The prospects for the GSEs' preferred shares are especially problematic for commercial banks and thrifts which hold high concentrations of the shares. According to OTS, approximately 17 institutions hold concentrations of GSE common and preferred shares, which surpass 10% of their Tier 1 capital. Regulators issued a statement saying that they would work with the “limited number” of smaller institutions that have large exposures to Fannie and Freddie “to develop capital restoration plans,” if necessary. Community bankers, in particular, are frustrated by the federal regulators “underplaying” the impact of the government's seizure of Fannie and Freddie and its impact on the banking system. In a recent report by Keefe, Bruyette & Woods, analyst Samuel Caldwell found that banks and thrifts had roughly \$3 billion of exposure to GSE preferred stock. “That's just what was disclosed to us,” said Caldwell, who estimates the actual figure to be between \$5 billion and \$10 billion. “I don't think any of these exposures are so big that any one bank will fail just based on their GSE preferred shares exposure.”
- Holders of agency debt are winners in GSE bailout. China is the top holder of this debt (\$376 billion), followed by Japan, Russia, and the Cayman Islands. In addition, sovereign wealth funds hold an unknown chunk of this debt. “The U.S. government's actions will definitely contribute to restoring confidence in financial markets,” said Han Duck-Soo, former prime minister of South Korea. “Many people were worried, including central bankers and private foreign investors. The U.S. actions will eliminate all those worries.”
- One of the largest defaults in the history of the credit derivatives market has been triggered by the federal government's seizure of Fannie Mae and Freddie Mac. According to Lehman analysts, “There is likely to be a considerable amount of notational protection outstanding.” The recovery value of the Fannie and Freddie CDS is currently expected to be about \$0.95 on the dollar, leaving a 5% loss for insurance companies of banks who offered protection against a default. The International Swaps and Derivative Association said it would launch a protocol to facilitate settlement of credit derivative trades involving Fannie and Freddie and report the results at a later date. Creditsight analysts said they expect regulators to “use the bailout as another lever” to enhance the CDS market's efficiency and transparency.

- Ultimately, homeowners may benefit from the GSE bailout with the government positioned to exercise more control over the foreclosure process than private sector companies. Since the bailout was announced, mortgage rates dropped “substantially” —falling below 6% for the first time in months. MSNBC analyst, Jim Cramer said, “The government can cut the mortgage payments, and it can extend the terms, say to 45 years. It can take any hit to keep you in your home, and the paper is still insured.” However, homeowners are also taxpayers and eventually will end up footing the bill anyway.
- The federal takeover of the GSEs may eventually be a boon to Wall Street, if the bailout jumpstarts a faster rebound in mortgage securities issues and if the GSEs presence in the \$6 trillion securitization market gradually diminishes over time. “[The government plan could] bring liquidity back faster and remove uncertainty [in mortgage markets] now that market participants know what the future holds,” said Fox-Pitt, Kelton brokerage analyst David Trone. “If it would have taken three years for the mortgage market to get back to normal, now maybe it’s a year and a half.” A Wall Street mortgage executive said, “Longer term, the less stuff they originate and hold, the better for the Street.”
- Under the terms of their employment contracts, Fannie Mae’s former CEO Daniel Mudd and Freddie Mac’s former CEO Richard Syron could have received severance pay, retirement benefits, and deferred compensation totaling \$9.3 million and [at least] \$14.1 million, respectively. Mudd has already taken home \$12.4 million in compensation and stock options since becoming CEO in 2004, while Syron has received \$17.1 million in pay and stock option gains since 2003. The golden parachutes for Mudd and Syron have come under harsh criticism by lawmakers. In letters to FHFA director James A. Lockhart, lawmakers have asked for a review of the payment of these termination packages and urged that the payments be vastly curtailed. Presidential candidate Senator Barack Obama (D-IL) wrote, “Under no circumstances should the executives of these institutions earn a windfall at a time when the U.S. Treasury has taken unprecedented steps to rescue these companies with taxpayer resources. At a Fairfax, VA rally, presidential candidate Senator John McCain (R-AZ) said, “CEOs that led us into this mess are walking away with over \$20 million, and we’re not going to let that happen as president. They deserve nothing. They should be paying it back.” On September 14th, Lockhart notified Mudd and Syron that the “golden parachute” payments contemplated under their contracts would not be paid. In an agency press release, Lockhart stated, “The Agency, serving as conservator, determined that under applicable statute and regulations, the Enterprises should not make such payments to these individuals and directed the Enterprises, accordingly.” On September 12th, the FHFA also proposed a new rule which would seek to limit golden-parachute payments for departing executives, board members, contractors, outside lobbyists, business partners, and shareholders. Under the rule, GSE executives and board members would also need FHFA approval for the enterprises to have their legal costs covered by the standard directors and officers’ liability insurance coverage. The proposed rule, which would

cover Fannie Mae, Freddie Mac, and the FHLBs, will be open for public comment for 45 days.

- According to the *Wall Street Journal's Deal Journal Blog*, “The Bush administration gets kudos for avoiding the economic meltdown that likely would have resulted from further Fannie-Freddie troubles, at least for now. That could boost the candidacy of John McCain, or at least dull any Democratic attacks on things economic. Fannie and Freddie have long been generally supported by Congressional Democrats and generally loathed by Republicans, who wanted the two giants to shrink to a more-manageable level. In conservatorship, Fannie and Freddie are temporarily making ‘big government’ even bigger. But, as McCain economic adviser Doug Holtz-Eakin said..., ‘the long-term reforms are to scale down Fannie and Freddie so their size is no longer a threat. And then privatize them.’”
- Since the 1990 election cycle, Fannie Mae’s and Freddie Mac’s employees and PACs have given \$19.5 million to federal candidates and committees with Freddie ranking among the top 100 industry donors of all time. According to *OpenSecrets.org*, the top recipients of Fannie Mae and Freddie Mac campaign contributions from 1989 to 2008 include Senate Banking Committee chairman Christopher Dodd (D-CT), receiving \$133,000; Senator John Kerry (D-MA), receiving \$111,000; Senator Barack Obama (D-IL), receiving \$105,849; Senator Hillary Clinton (D-NY), receiving \$75,550, and Subcommittee chairman Paul Kanjorski (D-PA), receiving \$65,500. Between 1980 and 2007, the Fannie Mae Foundation gave \$608,000 to the Congressional Black Caucus Foundation and \$285,000 to the Congressional Hispanic Caucus Institute. Wall Street analyst and CNBC commentator, Jim Cramer wrote, “We are at this extreme because our policymakers have simply been lazy, wrong, intransigent and foolish. If this were the private sector, all of these people would be candidates to be fired.”
- The disbanding of the GSEs’ lobbying operation will create a big void on Capitol Hill and K Street. Over the past decade, Fannie Mae and Freddie Mac paid more than \$174 million—\$79.5 million and \$94.8 million, respectively—for lobbying services to fend off the attempts to tighten its regulatory oversight. During the first six months of 2008 alone, the companies spent a combined \$8 million on lobbying. Teams of lobbyists at Fannie and Freddie haven’t been fired yet, but have received emails from the companies telling them to cease all activities. “One of the most successful lobbying groups has basically been neutered,” said a Fannie Mae lobbyist, who asked not to be identified. Senator Jim Demint (R-SC) said, “For years, these two mortgage giants have used taxpayer guarantees to gain enormous profits and lobby Congress to look the other way, while they failed homeowners.”
- News of the federal takeover of Fannie Mae and Freddie Mac also sent a chill through the nonprofit world. Over the years, the GSEs have poured million of dollars into local charitable organizations, an activity that FHFA is currently reviewing. In the Washington DC metro area, the Freddie Mac Foundation has invested more than \$348 million in the local community since its inception. The Fannie Mae Foundation,

which was dissolved in 2007, invested more than \$1 billion into education, affordable housing, and economic development programs since 1979. “The possibility that they might disappear from the philanthropic scene is making people even more nervous,” said Lindsey Buss, president of the Washington, DC-based Martha’s Table, who has spoken with his usual contacts at the GSEs. “I don’t feel comfortable calling right now,” Buss said. “They’re probably wondering if they have jobs.” (*Washington Post*, Zachary A. Goldfarb and Neil Irwin, 09/09/08; *Washington Post*, Zachary A. Goldfarb and Kendra Marr, 09/08/08; *Financial Times*, Deborah Brewster, 09/09/08; *Wall Street Journal’s Deal Journal Blog*, 09/07/08; *New York Times*, Eric Dash, 09/08/08; *Wall Street Journal*, Randall Smith and Serena Ng, 09/08/08; *Wall Street Journal*, Daisy Maxey, 09/10/08; *Wall Street Journal*, David Reilly and Peter Eavis, 09/08/08; *Bloomberg News*, Dawn Kopecki, 09/08/09; *Bloomberg News*, Dawn Kopecki, 09/08/08; *Financial Services and Products Advisory*, Alton & Bird L.L.P., 09/08/08; *Financial Times*, Aline van Duyn, 09/08/08; *Washington Times*, David M. Dickson and David R. Sands, 09/09/08; *Roll Call*, Anna Palmer, 09/09/08; *Wall Street Journal*, Jessica Holzer and Damian Paletta, 09/10/08; *Politico*, Jeanne Cummings and Chris Frates, 09/09/08; *New York Times*, 09/11/08; *Los Angeles Times*, William Heisel, 09/09/08; *Wall Street Journal*, Kara Scannell and Phred Dvorak, 09/09/08; *Wall Street Journal*, 09/10/08; *New York Times*, Eric Dash, 09/08/08; *American Banker*, Rob Blackwell and Emily Flitter, 09/11/08; *American Banker*, Bonnie McGeer, 09/09/08; *Wall Street Journal*, James R. Hagerty, Ruth Simon, and Damian Paletta, 09/08/08; *Bloomberg News*, Hans Nichols and Nicholas Johnston, 09/11/08; *Wall Street Journal*, 09/12/08; *Los Angeles Times*, 09/12/08; *Los Angeles Times*, Dan Morain, 09/09/08; *Opensecrets.org*, Lindsay Renick Mayer, 07/16/08; *Federal Housing Finance Agency Press Release*, 09/14/08)

World markets greet Treasury action with sigh of relief

- Investors’ enthusiasm for the government’s bailout of Fannie Mae and Freddie Mac caused stock markets to rally in the U.S. and abroad and mortgage rates to fall. The day after the takeover was announced, U.S. stocks climbed the most in a month, as financial stocks led the rally and broad indexes surged. Treasuries fell, pushing the 10-year note yields up the most in a month, as the dollar advanced. “The market likes less uncertainty and this takes care of that,” said PNC Wealth Management’s chief strategist E. William Stone. “If this helps re-stabilize the housing situation, it’s got to be a positive.” Short-term indicators are that the Treasury plan may work as a stop-gap approach to ease market concerns and give the government time to rehabilitate the Fannie Mae and Freddie Mac. (*Wall Street Journal*, Deborah Solomon, Michael Corkery, and Liz Rappaport, 09/06/08; *Bloomberg News*, Elizabeth Stanton, 09/08/08)

Editorial boards address the GSE bailout

- In a September 9th editorial, the *Washington Post* wrote, “In placing troubled mortgage giants Fannie Mae and Freddie Mac under federal control, Treasury Secretary Henry M. Paulson Jr. did what he had to do, and he did it pretty well. ...

The next step is to restructure the companies so that something like this does not happen again. Mr. Paulson's plan doesn't say how to do that, but it does give the next Congress and president time to take on the job and incentives to do so by the end of 2009. If they don't, the firms will have to start shrinking their portfolios and paying the Treasury a fee for their taxpayer guarantee. In other words, Mr. Paulson has tried to prevent an actual collapse of Fannie and Freddie from dominating the rest of the election campaign—while putting both candidates on notice that permanent reform must be one of the next administration's first items of business. ... This bailout is a sad and expensive necessity for the U.S. economy. It must become an opportunity to rethink not only the future form and function of two failed companies but also U.S. housing policy as a whole." (*Washington Post*, 09/09/08)

- In a September 9th editorial, the *New York Times* wrote, "As an act of crisis management, the government takeover of Fannie Mae and Freddie Mac, ... was a reasonable and reassuring move. It ensures the flow of mortgage credit and is likely to reduce mortgage rates, which are important steps toward the eventual recovery of the ailing United States housing market. And it does so while putting taxpayers first for future dividends or money that may be earned when the firms are reprivatized, holding out hope that the bailout costs may someday be recouped..." (*New York Times*, 09/09/08)
- In a September 8th editorial, the *Wall Street Journal* wrote, "... Treasury Secretary Henry Paulson wants to prop up the walking dead [Fannie and Freddie] so the world keeps buying their mortgage-backed securities. His action may calm jittery credit markets, and it may get the companies through the current mortgage crisis—albeit at enormous cost to American taxpayers. The tragedy is that he and Congress didn't act 18 months ago—when the cost would have been far less—and that he still isn't killing the Fannie and Freddie business model that has done so much damage. These corpses could still return to haunt us again."
- "... By far the biggest risk here, however, is that the companies could still emerge with their business model intact. That model is the perverse mix of private profit and public risk, which gave them an incentive to make irresponsible mortgage bets with a taxpayer guarantee. Mr. Paulson could have ended that model immediately by putting the companies into "receivership." Both companies could have continued to securitize mortgages, even as their riskiest businesses were wound down. But Treasury says its lawyers at Wachtell Lipton advised that receivership might have triggered default claims and thus caused a run on Fannie and Freddie debt..."
- "... The Treasury chief has nonetheless decided to leave the hardest political choices to his successor, who will have to face down the usual phalanx of Fannie apologists: Democratic barons Barney Frank and Chuck Schumer, the homebuilders, various Wall Street sages and leftwing journalists. Both Barack Obama and John McCain are now saying sensible things about the need to change the companies. But who knows how the political mood will have shifted once the housing slump passes. It's easy to imagine the next Treasury Secretary concluding that he also thinks the fight for

permanent reform is too difficult. Then we are back to the same old stand.” (*Wall Street Journal*, 09/08/08)

- The *Wall Street Journal* wrote in a September 9th editorial, “Taxpayers are now on the hook for as much as \$200 billion to rescue Fannie Mae and Freddie Mac, and if you want to know why, look no further than the rapid response to this bailout from House baron Barney Frank [D-MA]. Asked about Treasury’s modest bailout condition that the companies reduce the size of their high-risk mortgage-backed securities (MBS) portfolios starting in 2010, Mr. Frank was quoted on Monday as saying, ‘Good luck on that,’ and that it would never happen. There you have the Fannie Mae problem in profile. Mr. Frank wants you to pick up the tab for its failures, while he still vows to block a reform that might prevent the same disaster from happening again. At least the Massachusetts Democrat is consistent. His record is close to perfect as a stalwart opponent of reforming the two companies, going back more than a decade. The first concerted push to rein in Fan and Fred in Congress came as far back as 1992, and Mr. Frank was right there, standing athwart. But things really picked up this decade, and Barney was there at every turn...”
- “...By early 2007, Mr. Frank was in charge of the House Financial Services Committee, arguing that he had long favored some kind of reform. ‘What blocked it [reform] last year,’ Mr. Frank said then, ‘was the insistence of some economic conservative fundamentalists in the Bush Administration who, to be honest, don’t think there should be a Fannie Mae or a Freddie Mac.’ What really blocked it was Mr. Frank’s insistence that any reform be watered down and not include any reduction in their MBS holdings. ...Mr. Frank also noted one reason he liked Fannie and Freddie so much: They were subject to his political direction. Contrasting Fan and Fred with private-sector mortgage financiers, he noted, ‘I can ask Fannie Mae and Freddie Mac to show forbearance’ in a housing crisis. That is to say, because Fannie and Freddie are political creatures, Mr. Frank believed they would do his bidding.”
- “And this is exactly what Mr. Frank attempted to prove when the housing market started to go south. He encouraged the companies to guarantee more ‘affordable’ mortgages, thus abetting their disastrous plunge into subprime and Alt-A loans. He also pushed for, and got, an increase in the conforming-loan limits to allow Fan and Fred to securitize and guarantee larger mortgages. And he pressured regulators to ease up on their capital requirements—which now means taxpayers will have to make up that capital shortfall.”
- “But the biggest payoff for Mr. Frank is the ‘affordable housing’ trust fund he managed to push through as one political price for the recent Fannie reform bill. This fund siphons off a portion of Fannie and Freddie profits—as much as \$500 million a year each—to a fund that politicians can then disburse to their favorite special interests. This is also why Mr. Frank won’t tolerate cutting the companies’ MBS portfolios. He knows those portfolios (bought with debt borrowed at taxpayer-subsidized rates) were a main source of Fannie’s profits before the housing crash, and

he figures that once this crisis passes they can do it again. And this time, his fund will get part of the loot.”

- “Mr. Frank has had many accomplices from both parties in his protection of Fan and Fred. But he was and is among the most vociferous and powerful. In any other area of American life, this track record would get a man run out of town. In Washington, he’s hailed as a sage whose history of willful error will be forgotten faster than taxpayers can write a check for \$200 billion.” (*Wall Street Journal*, 09/09/08)
- In a September 10th editorial, the *Dallas Morning News* wrote, “...There is perhaps no greater example of how and why Washington needs to change than this deadbeat couple, Fannie and Freddie. The candidate who can make the more plausible case for why he’s the one to bust the mortgage lobbyists’ grip on the Washington establishment will go a long way toward winning the confidence of taxpayers. Which is to say, voters.” (*Dallas Morning News*, 09/10/08)
- *The Nation* wrote in a September 10th editorial: “In this case the taxpayers are on the hook for some \$100 billion for each of the failing mortgage giants. The deal stinks because it doesn’t really solve anything. ...A real solution to this mess is not complicated: wipe out the corporations and nationalize them, buy out the shareholders for pennies on the dollar and restore Fannie Mae to its original status as a federal housing agency (maybe merged with Freddie). Its functions involve vital public services--supporting the flow of mortgage financing, encouraging broader homeownership and subsidizing construction of low-income housing. These public goods do not much interest private financiers unless they can harvest rip-and-run profits, which is exactly what they did, with their usurious lending in the subprime mortgage scandal...” (*The Nation*, 09/10/08)
- In a September 9th *WebMemo* published by The Heritage Foundation, Dr. J.D. Foster, David C. John and Stephen A. Keen wrote, “...The Treasury’s actions were unfortunate because the problems with Fannie and Freddie could have been avoided had previous Congresses heeded the many warnings about their systemic risk. The actions were necessary, however, because the collapse of either or both of Fannie and Freddie would have had devastating repercussions for the housing market, credit markets, and the economy generally. By acting as it did, Treasury chose the lesser of two evils.”
- “Going Forward: First, clean up the mess. Then, implement real reform. The Treasury Department was put in a tough spot, and Secretary Henry Paulson did what was necessary. Decades of policy mistakes creating and protecting Fannie and Freddie finally led the predicted system risk to become a dangerous financial reality. However, once the market is stabilized, free-market reform must be implemented to prevent a recurrence. The next President and Congress should allow Fannie and Freddie in their current form to wither to extinction. The private sector is ready, well-prepared, and subject to the proper incentives to continue to ensure a steady flow of

correctly priced capital to America's housing markets.” (*The Heritage Foundation's WebMemo*, J.D. Foster, Ph.D., David C. John and Stephen A. Keen, 09/09/08)

- In a September 9th *Wall Street Journal* editorial, AEI fellow Peter J. Wallison wrote, “Henry Paulson’s plan is a major disappointment... Instead of a conservatorship, the plan should have provided for a receivership. That system would get rid of the common stockholders while still monitoring the companies for an indefinite period in order to keep the mortgage market functioning smoothly. Thus, while Paulson’s plan was intended to provide some ‘breathing room’ for consideration of the companies’ future, what it will do in effect is restore them to health as government-sponsored enterprises, and, more critically, allow them and their newly empowered shareholders to bargain about the companies’ collective future from a position of strength.”
- “No wonder U.S. Sen. Charles Schumer of New York—probably the GSEs’ most ardent supporter in Congress—issued the following statement after Paulson addressed the press on Sunday: ‘This plan will be met with broad acceptance in Congress, because it doesn’t prejudge the ultimate fate of Fannie Mae and Freddie Mac.’ Translation: Prepare for a fight—because we intend to keep the GSEs alive.”
- “Republican presidential candidate John McCain has been campaigning against the culture of corruption in the federal government. Democratic presidential candidate Barack Obama has based his campaign on the idea of change in Washington. Fannie Mae and Freddie Mac are telling illustrations of corporate welfare—the profitable private exploitation of a cozy relationship with the government. And the Paulson plan will foster just what a cynic might expect: more of the same.” (*Wall Street Journal*, Peter Wallison, 09/09/08)
- On his blog, Robert Reich, who served as Secretary of Labor in the Clinton administration, wrote, “...Apologists will say that Fannie and Freddie exist to make housing loans to low-income Americans, so it was inevitable that the two giants would get caught in the quagmire of the housing burst. But the fact is, Fannie and Freddie -- and the executives who ran them and still run them -- have been out to maximize profits. Period. Just the same as every other mortgage and investment bank. High-risk sub-prime loans offered a higher rate of return, so Fannie and Freddie went into them big time. And because of the implicit government guarantee, Fannie and Freddie could take on even more risks and make even more money. Until now.”
- “It’s another case of socialized capitalism, folks. The largest, yet. Along with making lots of money for investors and their executives, Fannie and Freddie corrupted our political process. They blocked any attempt to rein in the risks. Their lobbyists were and are the most sophisticated and among the most ubiquitous in Washington. What to do now? Hope that, like the S&L fiasco, taxpayers can get back a fair portion of our dollars. But unlike the S&L fiasco, this time we should make sure we bury socialized capitalism for good.” (*Robert Reich’s Blog*, Robert Reich, 09/07/08)

- In a September 10th analysis, Joseph R. Mason wrote, “Treasury is very close to getting the incentive right in the Fannie and Freddie bailout. Despite Congress’ unwillingness to act, Treasury shut down GSE lobbying, took control, removed private shareholder dividends, and injected capital rather than debt. They did not however, extract a penalty rate on the Treasury senior preferred stock. Recall, recent recapitalizations have carried a stated 12%-14% rate of interest, and priced in the market to yield 20%-24%. While many might think that an inconsequential shortcoming, the rate in tandem with remaining shareholder votes provides the natural exit mechanism. Here, with a low rate and no shareholder vote, we are relying crucially on Congress to craft the exit. It is important to realize, however, that Paulson is right in maintaining that the exit needs Congress’ attention—a conscious decision and vote on nationalization or privatization. In the meantime, Treasury has set the stage for a de facto nationalized set of GSE’s, which, again, is probably the best he can do stabilize mortgage supply in the short term.”
- “The other policy shortcoming here is the conditions behind shrinking the portfolios. With the natural exit strategy outlined above, shrinkage happens organically, dictated by market conditions. Here, political battles will be fought in 2009-10 about the need or the GSE’s to continue to support mortgage supply. Furthermore, the requirement of shrinkage or a portfolio target of \$250 billion is specious in a world of ‘off-balance sheet’ accounting, securitization, and financial engineering. Hence, the short-term fix – while arguably necessary – will not restart mortgage markets. The plan merely replaces the market with a taxpayer-funded mortgage finance mechanism. That stopgap mechanism, however, leaves the system open to crony capitalism wherein the industry will continue to appeal to Congress for handouts.” (*Criterion Economics*, Joseph R. Mason, 09/10/08)

The truth hurts—particularly two months before an election

- White House Press Secretary Dana Perino said, “This is exactly the kind of event we warned about and tried to prevent over the years. Remember that we have highlighted the systemic risk posed by Fannie Mae and Freddie Mac because of the very large role they play in housing markets and because of their business practices... This [GSE bailout] is not action we wanted to take. President Bush initiated a call years ago to try to reform this [GSE] system because he did not want the status quo to continue. Unfortunately, Congress didn’t act on that.” Perino added, “[T]he systemic risk that was posed by Fannie Mae and Freddie Mac to our entire economy was one that the president felt it was more important to deal with now, and start to work on now, so that the next administration would be able to work with the Congress and figure out a way to make sure that this would not be allowed to happen again.” (*CQ Today*, Benton Ives, 09/08/08; *New York Times*, Stephen Labaton and Edmund L. Andrews, 09/09/08)
- Senator Richard Shelby (R-AL), the chairman of the Senate Banking Committee from 2003 to 2007, said, “Had we acted earlier, we could have avoided our current

situation. Now that the old structure has failed, and the Treasury Department has intervened to temporarily shore up the GSEs, we now need to begin a vigorous debate about the future of these entities and the role of government in our private housing market.” (*CQ Today Online News*, Benton Ives, 09/07/08)

- In response to the Republican’s criticisms, House Financial Services Committee chairman Barney Frank (D-MA) issued a statement on September 8th saying: “The truth is when President Bush took office, and the Republicans controlled both houses of Congress, he did not make any progress on comprehensive legislation to reform the regulation of the Government Sponsored Enterprises. It was not until 2005, when the House, on a bipartisan basis, and over the President’s objections finally passed a reform bill. It died in the Senate in part because the White House’s failure to make it a priority. In 2006, when the Democrats regained control of Congress, House Democrats made it one of our highest priorities, and passed a bill in May 2007. Finally, a full year later, as the financial crisis worsened, the Senate passed and the President signed GSE reform. It is unfortunate that ideologues in the White House who opposed common sense regulation did not join Congress early enough to help prevent the financial firestorm that now threatens the entire economy.” Senate Banking Committee chairman Chris Dodd (D-CT) called the White House “accusations incredible [and] laughable” (*House Financial Services Press Release*, 09/08/08; *New York Times*, Stephen Labaton and Edmund L. Andrews, 09/09/08)
- Public criticism of Congress and its failure to pass legislation creating a “world class” GSE regulator appears to be striking a nerve on—and off—Capitol Hill . According to the *Financial Times*, former Representative Michael Oxley (R-OH), who served as chairman of the House Financial Services Committee from 2001 to 2007, is fuming about criticism from his House colleagues. “All the handwringing and bedwetting is going on without remembering how the House stepped up on this,” said Oxley. “What did we get from the White House? We got a one-finger salute. ...We missed a golden opportunity that would have avoided a lot of the problems we’re facing now, if we hadn’t had such a firm ideological position at the White House and the Treasury and the Fed.” Oxley retired from Congress after the mid-term elections in 2006 and now serves as the vice chairman of Nasdaq. (*Financial Times*, Greg Farrell, 09/09/08)
- In a September 9th interview on NPR, Senator Christopher Dodd discussed his concerns about Treasury’s bailout plan [on the eve of the November election]. When asked specifically troubles him about the plan, Dodd responded, “Well, first of all, I want to know the motivations for it. We passed a major landmark piece of housing legislation about a month ago, in which was included newly sought authority by the secretary of the Treasury to possibly take equity positions within Fannie Mae and Freddie Mac, with a quick assurance by the secretary of the Treasury that that authority would never be used, but now getting a far more aggressive action taken by the Treasury. So I clearly have a question. What transpired? The second question I have is what effect does this have on home mortgages, on homeowners? Thirdly, what happens to taxpayers?”

- When asked how much this plan was going to cost taxpayers, Dodd responded, “Well, I’ll repeat to you what the secretary said. His intention is, of course, that there’ll be no exposure for the American taxpayer. But, you know, I was told a month ago that we’d never utilize the authority either. And so at this point I’m going to be a lot more cautious about adopting and supporting a proposal like this until I have some clear ideas on how this is all going to work.”
- “Well, I guess I’m part of that old school... When a secretary stands before a committee—he just didn’t say it to me, he said it to the whole country—and I think he said something like I want that gun under my raincoat, I want a real gun, not just a water pistol or something... Now I’m not suggesting that Hank Paulson wasn’t telling me the truth and that circumstances may radically have changed, I’d just like to know what’s happened, what’s caused this, and where are we going with all of this? There have been those for years who just want to get rid of these government-sponsored enterprises. I would just remind people, in your anxiousness to do that don’t ever forget how important these institutions have been for the average person in this country getting a 30-year, fixed-rate mortgage. No country in the world provides a 30-year, fixed-rate mortgage. If you get rid of that, you change fundamentally home ownership in this country. I think our economy can be dealt a severe blow.”
- In response to Senate Banking Committee chairman Christopher Dodd’s public comments about the Bush administration’s failure to prevent the demise of Fannie and Freddie, Al Hubbard, the former director of the National Economic Council and assistant to the president [2005-2007] and, Noam Neusner, the administration’s speechwriter and communications director [2002-2005], published a rebuttal to the chairman’s comments in the September 12th edition of the *Wall Street Journal*. Hubbard and Neusner wrote, “...Senator Christopher Dodd, the Democratic chairman of the Senate Banking Committee, has the gall to ask in a Bloomberg Television interview: ‘I have a lot of questions about where was the administration over the last eight years.’ We will save the senator some trouble...” Hubbard and Neusner then provide a first-hand account of the administration’s efforts to press Congress to pass meaningful reforms for Fannie Mae and Freddie Mac, starting in 2002. They conclude, “...The real question is: Where was he [Dodd]?” The full article is available at: <http://www.washingtonpost.com/wp-dyn/content/article/2008/09/11/AR2008091102841.html?sub=AR>. (*Wall Street Journal*, Al Hubbard and Noam Neusner, 09/12/08)
- Senator John Cornyn (R-TX), the vice chair of the Senate Republican Conference, has asked the Department of Justice to investigate possible “accounting fraud and other corrupt practices perpetuated by top executives [at Fannie Mae and Freddie Mac.]” In a letter to U.S. Attorney General Michael Mukasey, Cornyn wrote, “The public deserves a full understanding of the events surrounding the failure of Fannie Mae and Freddie Mac and, furthermore, corporate executives must be held accountable to the American people. He referred to “culture of corruption that plagued these institutions” and raised questions about previous Justice Department

investigations of Fannie and Freddie over the last five years in the wake of accounting scandals at both firms. “Moreover, the efficacy of prior investigations by (the firms’ regulator) and Justice are further called into questions in light of evidence of disturbing allegations of active interference on the part of Fannie Mae lobbyists,” wrote Cornyn. (*Wall Street Journal’s Washington Wire Blog*, Michael R. Crittenden, 09/10/08)

The presidential candidates address the future of Fannie and Freddie

- In a September 9th *Wall Street Journal* editorial, Senator John McCain and Alaska Governor Sarah Palin, wrote, “The bailout of Fannie Mae and Freddie Mac is another outrageous, but sadly necessary, step for these two institutions. Given the long-term mismanagement and flawed structure of these two companies, this was the only short-term alternative for ensuring that hard-working Americans have access to affordable mortgages during this difficult economic period. We are strong advocates for the permanent reform of Fannie and Freddie. For years, Congress failed to act and it is deeply troubling that what we are now seeing is an exercise in crisis management rather than sound planning, and at great cost to taxpayers.”
- “We promise the American people that our administration will be different. ...In our administration, every agency and department will undergo rigorous oversight and review. We will require the highest standards of accounting, reporting and transparency ever demanded in government. Enduring reform of Fannie and Freddie is a key first step. We will make sure that they are permanently restructured and downsized, and no longer use taxpayer backing to serve lobbyists, management, boards and shareholders.”
- “...Along with the commitment of taxpayers’ dollars [to Fannie and Freddie], we should make market reforms to help ensure that we do not face this problem again. We will make sure the marketplace understands its obligations. Homeowners must be able to understand the terms and obligations of their mortgages. In return, they have an obligation to provide truthful financial information, and should be subject to penalty if they do not. Policies must be in place to ensure that homeowners provide a responsible down payment of equity in the initial purchase of a loan. In the future, Fannie, Freddie or any government organization should never insure a loan when the homeowner doesn’t have enough of his or her own capital in the investment.”
- “Lenders who initiate loans will be held accountable for the quality and performance of those loans, and strict standards must be required in the lending process. Every lender must be required to meet the highest standards of ethical behavior, with recourse if they do not perform. Reforms are necessary now to make mortgage lending and banking organizations more transparent. We will require greater disclosure, so that complex derivative instruments and excessive leverage can’t put the marketplace, and the financial security of your home, at risk.”

- “We will push the nation’s top mortgage lenders to provide maximum support to help cash-strapped, but credit-worthy customers. Lenders should do everything possible to keep families in their homes and business growing.”
- “Fixing Fannie and Freddie, and reforming our mortgage and financial markets, is critical to getting the housing market and the entire economy moving again. A great deal of the savings and wealth of American families is wrapped up in the value of their homes. A house has traditionally been the wealth-building course to retirement. The housing industry employs millions of Americans. One of us, John McCain, said over two years ago, ‘If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose.’ Fannie and Freddie’s lobbyists succeeded and Congress failed. Under our administration this will not happen again...” (*Wall Street Journal*, Senator John McCain and Alaska Governor Sarah Palin, 09/09/08)
- In a statement, Democratic presidential nominee Senator Barack Obama said, “Given the substantial role that Fannie Mae and Freddie Mac play in our housing system, I believe that some form of intervention is necessary to prevent a larger and deeper crisis throughout our entire economy.” Obama added that the plan for Fannie Mae and Freddie Mac needed to focus on strengthening the economy and helping struggling homeowners rather than focusing on “the whims of lobbyists and special interests.” Jason Furman, economic policy director for the Obama campaign, told *Financial Times*, “McCain has been out there with a hasty ‘privatize and shrink’ approach. It has been ideologically driven and not sufficiently mindful of some of the public functions that Fannie and Freddie currently perform. The trick is how to disentangle their private and public functions and how to manage the complex task of the transition.” Furman argued that the Obama administration would privatized those elements of Fannie and Freddie which are better carried out by the private sector and retain a smaller government-chartered institution to support low-income, affordable housing. Obama’s position is increasingly different from many of his colleagues on Capitol Hill—particularly Representative Barney Frank, chairman of the House Financial Services Committee, who has yet to endorse privatizing *any* elements of the GSEs. One economist said, “Many Democrats believe we can simply go back to the status quo ante which is not realistic. The Obama campaign has at least recognized that a portion of the two institutions should be sold off.” (*Reuters*, Jason Szep, Deborah Charles and Randall Mikkelsen, 09/08/08; *Financial Times*, Edward Luce, 09/09/08)
- “[Senator Obama’s presidential campaign has] a huge problem with the mortgage and housing market story, and everyone is missing it,” said a Republican political media consultant with ties to the Obama campaign due to the bipartisan nature of the firm he does work with. “You look at Obama’s economic advisers, the guys he has counted on from day one and who have raised him a ton—and I mean a ton—of money: Franklin Raines and Jim Johnson, both of them are waisted to neck deep in the mortgage debacle.” A Democrat House member who supported Sen. Hillary Rodham Clinton, asks, “How can Obama go out with a straight face and say it was

Republicans who made this mess, when it is his key advisers who ran the agencies that made the big mess what it is? It's his people who are responsible for what may well be the single largest government bailout in history. And every single one of them made millions off the collapse that are lining Obama's campaign coffers. If the McCain campaign lets this one go, they deserve to lose." According to the Center for Responsive Politics, Senator Obama has received \$105,849 from donors tied to Fannie and Freddie since he ran for Senate four years ago, making him the third largest recipient in Congress of GSE political donations. In contrast, McCain has received \$19,000 in campaign contributions from the two companies over the past ten years. Anne Canfield, executive director of the Consumer Mortgage Coalition, said "There were quite a few lobbyists retained by Fannie and Freddie who tried to influence Senator McCain, but they never were able to get their hooks into him." The Obama campaign, however, is critical of McCain's ties to Fannie and Freddie, pointing to members of his campaign, fund raisers, and contributors, who previously lobbied on behalf of the GSEs.

- A House Republican added, "We ought to be able to—rightly—hang the Fannie and Freddie scandal around the neck of Obama, if they can get out in front. Middle-class folks' mortgages are probably safe, but the American taxpayer will also be paying for this scandal for years to come." (*American Spectator*, 09/08/08; *Wall Street Journal*, Nick Timiraos, 09/08/08; *New York Times*, Jackie Calmes, 09/10/08; *CNNMoney*, Allan Chernoff, 09/09/08)

After the GSEs' conservatorship, what will be the enterprises' future role?

- In structuring the GSE bailout, Treasury Secretary Henry Paulson placed Fannie Mae and Freddie Mac in "time out" [conservatorship] to give the companies' time to restructure and get their financial affairs in order and to provide Congress an opportunity to address the GSE business model. Paulson said, "I recognize that there are strong differences of opinion over the role of government in supporting housing, but under any course policymakers choose, there are ways to structure these entities in order to address market stability in the transition and limit systemic risk and conflict of purposes for the long-term. We will make a grave error if we don't use this time out to permanently address the structural issues presented by the GSEs."
- House Financial Services chairman Barney Frank (D-MA) said, "The tension between the public mission and the private structure [of Fannie Mae and Freddie Mac] got submerged when things were going good. The water recedes and the tension's there. ...There's always been a tension between public and private, but I am very skeptical that total privatization is the answer. We will have a serious discussion next year about what the structure will be." Frank added that the GSEs' affordable housing would be done in an [off-budget] "private format." He said, "Whatever kind of entity we have, I think it would be a mistake to say you should have nothing in your portfolio. It's very important to me to have the affordable housing trust fund, and you can't do that with a fully privatized entity." Douglas

Elmendorf, senior fellow at the Brookings Institution and advisor to Senator Barack Obama's campaign, said, "It's a huge issue. It's the government's role in housing, and it's the government's role in our financial system. The consequences are very large."

- Congress has three options for the long-term structure of Fannie and Freddie: (1) a continuation of the public ownership/ public mission hybrid; (2) a complete public ownership model; or (3) a privatization model. Some experts believe that the hybrid model is necessary in setting national mortgage standards and ensuring a stock of affordable housing for the country. Within Treasury, there is increasing interest among officials to structure Fannie and Freddie like public utilities, say sources familiar with the agency's thinking. Under a utility model, Fannie and Freddie would be able to raise private money by issuing stock, but regulators would cap shareholder returns and restrict the size of the enterprises—if not eliminating the GSEs' mortgage portfolios altogether. Under this structure, Fannie and Freddie also could maintain their public mission of supporting the mortgage markets without using public funding.
- Congress could nationalize Fannie Mae and Freddie Mac and make them government agencies. In a structure similar to Ginnie Mae, the enterprises would rely on public funding, rather than selling stock to the investors, and would not invest in mortgage-backed securities in their own portfolio. The downside to this option, some argue, is that the two agencies would have trouble attracting strong executives and the potential for political interference within the agencies would be "worse."
- Others argue—including Presidential candidate Senator John McCain (D-AZ)—that Congress should privatize or liquidate the GSEs, by breaking them up into smaller pieces and selling them off. Several large banks have said that they are eager to compete in the business of buying and securitizing loans from mortgage originators. In this scenario, HUD's Federal Housing Administration loan program could fulfill Fannie's and Freddie's mandate to provide money for affordable-housing loans. "There is no validity in taking a for-profit private company and forcing a nonprofit social mission on it," said Representative Jeb Hensarling (R-TX). "We already have the HUD that has 90 programs with either a housing or urban-development mission." Senate Banking Committee chairman Chris Dodd (D-CT) says anyone who tries to apply hardened political ideology to the massive mortgage market is misinformed and insists that only a hybrid GSE model can create the type of liquidity that's needed. "If this is an ideological thrust to make these institutions cease to exist, then we'll see further deterioration [in the housing market], said Dodd. "The idea that we're going to abandon this ...and replace it with what?"
- "The alternative argument to keeping Fannie and Freddie is that the private markets have grown up," said Professor Dwight Jaffee, professor of banking, finance and real estate at the University of California at Berkeley. "The argument goes that Fannie and Freddie were the training wheels that [were] needed. But we've learned how to ride our bikes fine and so we don't need a government subsidized program to make

the markets work. If we didn't have the subprime crisis, that might have been an easier statement to make. The truthful answer is we want to keep Fannie and Freddie in some sort of a government sponsored role. In view of the subprime crisis, we simply can't forget about them." Jaffee and others argue that the most attractive solution may be to reduce the size and influence of Fannie and Freddie, which would reduce the risk of future bailouts and eliminate the conflicts posed by the dual mission of serving both the housing markets and shareholders. "We need to move to a future where the secondary mortgage market operates privately without having the whole middle of the market taken over by a huge subsidized presence," said Professor Richard S. Carnell, a Treasury official in the Clinton administration, who now teaches at Fordham Law School. "Having huge firms like this owned by the government is not the way we normally do things and we have to get away from it."

- When the next president and Congress debate the future role of Fannie Mae and Freddie Mac, policymakers must also address the overriding issue of home ownership. "This is something the next administration will have to deal with: Are they going to be pushing people into homeownership?" said Dean Baker, co-director of the Center for Economic and Policy Research. (*Wall Street Journal*, Ruth Simon and Michael Corkery, 09/10/08; *New York Times*, Stephen Labaton and Edmund L. Andrews, 09/09/08; *CQ Today Online News*, Benton Ives, 09/07/08; www.politico.com, Matin Kady, II, 09/08/08; *Business Week*, Jane Sasseen, 09/11/08; *Washington Post*, 09/08/08; *Wall Street Journal*, Damian Paletta, 09/09/08; *CQ Today*, Benton Ives, 09/08/09; *Wall Street Journal*, Nick Timiraos, 09/12/08; *American Banker*, Steven Sloan, 09/10/08; *New York Times*, Stephen Labaton, 09/14/08)

Fannie Mae and Freddie Mac

The new Federal Housing Finance Agency has its hands full

- Just weeks after its creation by Congress, the Federal Housing Finance Agency (FHFA) finds itself in direct control of Fannie Mae and Freddie Mac and the \$5.4 trillion of mortgages that the enterprises own or guarantee. The new agency with its 400 employees already was a substantial transition agency, which included the tasks of combining the tasks of its predecessor agencies—OFHEO, Federal Housing Finance Board, and certain oversight duties of HUD—along with the task of writing a multitude of regulations governing the GSEs, including minimum capital standards, prudent safety and soundness standards, and portfolio limits, as mandated by the Housing and Recovery Act of 2008. Now, FHFA is also responsible for restoring Fannie Mae and Freddie Mac to financial health. Lockhart said FHFA’s main priority should be “to make sure the companies operate in a conservative manner and minimize risk taking. Because now, it is the taxpayers on the hook for losses.”
- Lockhart also said that Fannie Mae’s and Freddie Mac’s first priority is to support the battered mortgage market, which might include loosening the GSEs’ mortgage standards. “They may look at targeted changes that might allow more people to get mortgages,” said Lockhart. “[If the GSEs’ losses mount,] we know the U.S. government will be there [to cover them].” Richard S. Carnell, a law professor at Fordham University and a former senior Treasury official, said a “tension” exists between FHFA’s goals of providing a boost to the mortgage markets and maintaining the companies’ health. “[Fannie and Freddie] got into problems by guaranteeing mortgages where the credit quality of the loans was too weak,” said Carnell. “The more careful they are [in expanding lending], the more it constrains the macroeconomic and housing market goals.”
- Under the conservatorship announced on September 7th, FHFA has total control over the financial operations of Fannie Mae and Freddie Mac and the companies’ 10,000 employees. The agency has assumed the power of the companies’ board of directors, management and shareholders. FHFA spokesman Stephanie Mullen said the agency has at least 60 examiners in place at each enterprise and it is receiving oversight assistance from Treasury. In a letter to employees of both GSEs, Lockhart said that his staff “are not there to do your jobs, but rather to facilitate the conservatorship and ensure business is proceeding.” Lockhart’s main message to the GSEs’ employees was that the routine operation of Fannie and Freddie—that of purchasing and securitizing mortgages—must continue without interruption. FHFA is responsible for appointing senior staff and setting new compensation policies. The agency has hired a human resources consulting firm to assist them with personnel issues at both companies and plans to put into place a retention program, which is expected to include bonuses, to encourage employees to stay with the GSEs. Lockhart said, “I want to make sure that there is an incentive for the people [at Fannie and Freddie] to

stay.” FHFA and the GSEs’ new management will likely look to reduce costs in the firms political and public relations operations, said Lockhart.

- Lockhart faces a number of sensitive issues, including whether to write off tens of billions of troubled assets on the GSEs’ books and potentially increasing the short-term cost of the bailout, or whether to defer the day of reckoning. Loan modifications by Fannie and Freddie are another thorny issue. In a letter to Lockhart, Senators Charles Schumer (D-NY), Robert Menendez (D-NJ), Bob Casey (D-PA), and Sherrod Brown (D-OH) demanded that FHFA immediately put a 90-day moratorium on foreclosures by Fannie Mae and Freddie Mac and conduct an immediate investigation of those loans. The Senators also called on the GSEs to “revisit their policies and practices governing mortgage-backed securities issued by the respective agencies.” Lockhart said his agency is “looking into the loan modification programs of the two companies” and will discuss them with the GSEs’ management. “We have been discussing loan modifications over the last nine months with the companies, and we have prodded them to be creative and aggressive,” said Lockhart. Critics say Treasury has long advocated voluntary mortgage workouts and now has the opportunity to follow its own advice. “There will be no excuses now,” said Bruce Marks, president of Neighborhood Assistance Corp. of America. Supporters of wide-scale loan modifications argue that a government-driven workout plan through the GSEs’ mortgage portfolios would solve a critical loan servicing challenge that has hampered modification efforts. Marks suggested that Treasury and FHFA follow Shelia Bair’s lead on wide-scale loan modifications that she has implemented at IndyMac. “Look what Sheila Bair’s doing — she’s walking the walk, as well as talking the talk,” said Marks. “Now we need Secretary Paulson to walk the walk, as well as talk the talk.”
- Others are more sanguine over how much impact the GSEs can have on loan modifications, since the enterprises do not service mortgage loans and the mortgages they own are mostly part of mortgage-backed securities. “Once you start modifying the underlying object, it’s a free-for-all over what those securities are worth,” said David Gibbons, a former deputy comptroller and chief credit officer at the Office of the Comptroller of the Currency. “You could impact pricing and liquidity in these securities, which are on many banks’ balance sheets.” Lawrence Kaplan, an attorney at Paul, Hastings, Janofsky & Walker LLP, cautioned, “If they were to make a quick knee-jerk reaction, it could be more disruptive to the mortgage market. What they should be doing is seeing how the dust settles before they start making wholesale changes.” Bob Caruso, the former head of Bank of America Corp.’s home loan division, added, “To do [loan modifications] en masse without some level of controls and thought will probably extend the semi-recession or the property depreciation event, because more customers over time are going to be looking for more workouts.”
- On September 13th, Lockhart released a press release stating that it will be “business as usual” at the enterprises during the conservatorship. According to the press release, “[T]his applies to both their single-family and multifamily business. ...As conservator, FHFA expects each Enterprise to continue underwriting and financing

sound multifamily business. We do not expect either company to liquidate its' portfolio of [low income housing tax credits] or mortgage-revenue bonds. ...FHFA will only intervene when there is a question of unsafe and unsound business practice..." Over the short term, however, John H. Vogel, Jr., an adjunct professor at the Tuck School of Business at Dartmouth, said that the GSEs' social goals may take a back seat to the need for the enterprises' need to strengthen their finances. For example, Fannie and Freddie, who were the largest purchasers of tax credits used to fund low-income housing, withdrew from the this market [prior to going into conservatorship] because the companies' mounting losses meant they didn't have the profits to offset the LIHTCs. Thus, the GSEs' future presence in the LIGHTC market is also in doubt.

- Consumer advocates also expressed concern that Fannie Mae's and Freddie Mac's affordable housing mission—and the AH programs that the GSEs fund—will become casualties of the government's conservatorship. Advocates worry that affordable housing will be seen by FHFA and lawmakers as an expendable luxury, as the federal government absorbs losses from Fannie and Freddie. "Our concern is that the rhetoric has been about preserving the global financial system," said Mike Shea, executive director of Acorn Housing. "There has not been a whole lot of rhetoric about preserving homeownership." Lockhart said, "We will be working with the companies to establish a plan to ensure that they fulfill their affordable-housing mission." The details on how the GSEs will meet these goals and how the enterprises will balance these goals against the need to shore up their finances have not yet been worked out. Lockhart also indicated that his agency will review the GSEs' charitable contributions. Many activist groups have received vital funding and grants from Fannie Mae and Freddie Mac, which also may be in peril. For example, the Neighborhood Assistance Corp. of America received \$3 million from Fannie Mae and \$500,000 from Freddie Mac. These issues are of particular concern in Washington, DC, where the GSEs have long focused its affordable housing efforts in the District. "We do not have many sources to make up for what Fannie Mae has done here," said Representative Eleanor Holmes Norton (D-D.C.). "We are not a corporate headquarters city, to say the very least."
- Representatives of the financial services industry want FHFA to re-address the appraisal pact, entered into March by Fannie Mae and Freddie Mac with the New York Attorney General and OFHEO. Industry representatives, who have opposed the new standards, said the GSEs no longer legally have to follow the agreement. Under conservatorship, Lockhart has the power to void the agreement, which is scheduled to go into effect on January 1st. "The bottom line is the status of the GSEs and the landscape is different, and therefore issues such as this are very much back in play," argued Steve O'Connor, the Mortgage Bankers Association's SVP of government affairs. However, it's not clear that Lockhart is willing to reverse course and abrogate the agreement. "Regardless of what the legal parameters are on the contract issues, FHFA has agreed with the attorney general that the agreement will go on as planned," said a source said close to the parties. "There is no change. This is part of the business as usual that agreements are being honored." Others argue that Lockhart

could withdraw from the agreement, arguing that conditions have changed and the agreement is too burdensome for the GSEs to implement. “This is a legitimate ... [argument] that the conservator could make, especially since it didn’t go into effect,” said Gil Schwartz, a partner at Schwartz & Ballen LLP and a former Fed lawyer. (*Bureau of National Affairs*, Mike Ferullo, 09/12/08; *Washington Post*, David S. Hilzenrath, Zachary A. Goldfarb, 09/11/08; *Washington Post*, David S. Hilzenrath and Zachary A. Goldfarb, 09/11/08; *American Banker*, Joe Adler and Emily Flitter, 09/10/08; *HousingWire*, Paul Jackson, 09/10/08; *American Banker*, Stacy Kaper, 09/12/08; *American Banker*, Cheyenne Hopkins, 09/12/08; *Federal Housing Finance Agency Press Release*, 09/12/08; *Wall Street Journal*, Ruth Simon and Michael Corkery, 09/10/08)

Fannie and Freddie receive special treatment by the IRS and the NYSE
--

- On September 9th, the IRS issued Notice 2008-76, which in essence allows Fannie Mae and Freddie Mac to retain all of their net-operating loss carry forwards, despite the change of ownership that occurred with the GSEs being placed into conservatorship. As a result of the action, Fannie and Freddie will not have to pay any taxes to the federal government, as a result of Treasury becoming their controlling investor. The action was “very effectively done” by eliminating the “testing dates” that normally would have applied to the GSEs in the event to a takeover, said tax expert Robert Willens. “I’m not saying that this IRS ruling is a good thing, or a bad thing, it is just unusual,” added Willens. “Then again, this is a very unusual situation.” (*CFO.com*, Marie Leone, 09/08/08)
- The NYSE allowed the shares of Fannie Mae and Freddie Mac to remain on the floor until Thursday [September 11th], despite the fact that the companies’ shares had dipped below \$1 following the government’s seizure which exchange’s rule that penny stock should trade only in all-electronic markets. Why the exception? The NYSE said it believed “the market will substantially benefit from having the most available liquidity and the greatest number of venues in which investors can trade the securities of Fannie Mae and Freddie Mac, and would further benefit from the efforts of the NYSE specialists in those securities to stabilize the markets as public investors react to the news.” On September 10th, trading in Fannie topped 331 million shares, while Freddie’s volume was 215 million shares. On September 10th, Fannie Mae and Freddie Mac were also removed from the S&P Index after the close of trading. (*LA Times Money & Company Blog*, 09/10/08; *Wall Street Journal*, 09/10/08)

The people responsible for the failure of Fannie Mae and Freddie Mac
--

- In a September 10th *Motley Fool* article, Bill Mann, Seth Jayson, Nate Weisshaar and Keith Beverly wrote, “It was a wise man who noted that the only corporate structure more insidious than a government-sponsored monopoly is a government-sponsored and investor-owned monopoly. In the end, as Fannie Mae and Freddie Mac have now

so painfully proved, trying to serve the master of public policy while generating returns for investors will lead to disaster.”

- “Fannie and Freddie collapsed because they were part and parcel of the widespread gross financial misconduct that has taken place in the United States over the past decade. It’s easy to miss this fact, but the reality is that too many people were making too much money pumping up the housing market. In 2005, the Office of Federal Housing Enterprise Oversight ...attempted to limit their use of off-balance sheet entities to groom earnings. In the end, it didn’t, because, as one reform-minded politician admitted, Congress was afraid of undermining the housing boom. Some are more culpable than others.”
- “As part of the conservatorship, the Department of the Treasury has demanded that Daniel Mudd and Richard Syron, the CEOs of Fannie and Freddie, respectively, step down. Certainly, at the time of a corporate collapse, those in charge have to bear some responsibility. But Mudd and Syron came into their roles when the great pillaging was well in process. At some point not too long from now, the nation’s attention is going to turn from the immediate players to those who benefitted the most, shouted down the skeptics, and/or stood by as Fannie and Freddie deviated from their core business in the name of growth and/or mission. These people are keeping a low profile right now, until the taxpaying public starts paying attention to something else. As taxpayers, we don’t particularly enjoy our role in this relationship, and we’re hopeful over the longer term that the following folks cease to enjoy theirs.”
- **“Franklin Raines:** Fannie Mae was always a political beast, but it reached its elbow-swinging heights during the time when former Clinton administration budget director Franklin Raines sat in the CEO chair. Under Raines’ leadership, Fannie overstated earnings by a stunning \$10.6 billion, all the while paying Raines and his senior management team massive bonuses. It was under Raines’ management that Fannie morphed from being a company in a sleepy business—issuing debt to buy mortgages from lenders—into a far more risky and exciting one: buying up mortgages and holding them, thus capturing the spread between its borrowing costs (which were lower than anyone’s other than the federal government’s) and the interest rate received. It was a great business, except that it had nothing to do with Fannie’s charter. According to a May 2006 report from OFHEO, Raines became obsessed with keeping earnings per share as high as possible and motivated management to achieve that goal by setting up a bonus system that rewarded increasing earnings per share...”
- “The thing is: Any company can hit an EPS number if it doesn’t worry about little things like accounting rules, debt levels, and risk factors. All told, Raines pulled in some \$90 million between 1998 and 2003, the majority from bonuses. And when OFHEO began to ask uncomfortable questions, Raines actively lobbied Congress to cut its funding. In April, Raines agreed to disburse \$24 million for his role in the accounting ‘errors.’”

- **“Timothy Howard:** Former Fannie Mae CFO Timothy Howard is another major player who is probably cowering in a corner somewhere. For all of the expletives and derogatory names thrown at former Enron CFO Andrew Fastow, he at least stayed around to take his punishment. Inmate No. 14343-179 pleaded guilty to fraud and is serving a six-year prison term. Howard, on the other hand, saw the writing on the wall –largely because he was the author—and got out of Dodge. As Fannie’s CFO from 1990 to 2005, Howard signed off on the financials that overstated the company’s earnings by \$10.6 billion from 1998 to 2004. His reward? A cool \$14 million in salary and \$16.8 million in bonuses during the period -- bonuses based on the earnings plan that Raines set up. While Howard was not the only person at Fannie guilty of constructing fraudulent financial statements quarter after quarter, as CFO he is most responsible for the integrity of said statements. Whether he left early enough to avoid culpability remains to be seen. However, we’ve heard through the low-security-prison grapevine that Fastow is lonely these days and wouldn’t mind talking shop with a fellow former CFO.”
- **“[House Financial Services chairman] Barney Frank:** The House Financial Services Committee chairman and Democratic congressman from Massachusetts has long been a proponent of both Fannie and Freddie, assuring the public that their mission to encourage home ownership outweighed the distortive risks they brought to the market, and that the federal government was not, in fact, on the hook for their liabilities. In fact, it seems clear now that Frank had no idea of just how poor a grasp Fannie and Freddie had on their lines of business. As recently as Aug. 25 he told *Money Magazine*, “ Fannie and Freddie are better off than the market thinks. ... Part of the problem is rumor-mongering by short-sellers.”
- “What’s more, though Frank will blame past political opponents for failing to further regulate the mortgage market by banning products such as subprime loans, the fact of the matter is that the very presence of Fannie and Freddie incentivized brokers to overstate the creditworthiness of borrowers and then pass on that risk to the federal government, all while being cheered for helping more people ‘realize the American Dream.’ While we can all agree (I hope) that mortgage markets only function when – as Frank told *Money*, banks ‘do not lend money to people who can’t pay it back’— Frank’s ideology in this case blinded him for decades to the realities of the marketplace and the operations at these companies, leading him to stonewall realistic reform efforts that might have helped us avoid the current calamity.”
- **“Angelo Mozilo:** There’s good reason for Angelo Mozilo to hide under a desk these days. Few, if any, extracted more personal profit from the credit bubble than the CEO and founder of Countrywide Financial. Mozilo’s talking points always borrowed heavily from the propaganda of our government-sponsored enterprises (GSEs). Countrywide liked to pretend that it was performing some kind of public service—‘breaking down barriers’—by making homes more “‘affordable’ to the average (or sub-average) wage earner. Unfortunately, as speculation drove home prices to ridiculous levels across the U.S., ‘affordability’ came to be the code word

for gimmicky, high-interest subprime loans lavished on the riskiest of borrowers in order to get them into a mortgage that would soon be bundled and shipped off to the suckers on Wall Street. Unfortunately for borrowers and investors in Countrywide's mortgage paper, the American Dream of home ownership quickly morphed into a nightmare. Default rates surged, followed by the inevitable foreclosures, and mortgage paper backed by Countrywide loans became as valuable as post-bubble, dot-com stock options. Countrywide was only spared the ignominy of bankruptcy when its longtime sugar daddy, Bank of America, stepped in to take it out."

- "As captain of this sinking ship, CEO and founder Mozilo was, for a time, very vocal in defending his company's legacy. But like so many others in America's great housing bubble, talk was one thing, and actions were another. As the housing bubble began peaking in 2003 and 2004, through the period when Countrywide's risky lending fell apart, Mozilo engaged in one of history's greatest stock dumps, selling more than \$480 million worth of shares, according to the tally of insider filings on secform4.com."
- "[**Former Federal Reserve Chairman**] Alan Greenspan: If not the boldest of the group, then at least the most public, Greenspan, the man many are now blaming for the housing bubble (there were a brave few that piped up years ago), has refused to go quietly into his well-padded retirement. The man charged with providing the country with a financial voice of reason fell far short, so much so that it might be comical if it weren't so tragic. Greenspan's denial of the possibility of a housing bubble has been widely derided in the past year, but a single statement could be excused as human error. However, a quick scan shows that this wasn't a single event. He also promoted the adoption and expansion of adjustable-rate mortgage (ARM) products in early 2004, when short-term rates were at or near historic lows. That same year he claimed, 'securitization by Fannie and Freddie allows mortgage originators to separate themselves from almost all aspects of risk associated with mortgage lending.' And separate themselves they did, ceasing to perform any kind of due diligence as to the ability of borrowers to pay for the homes they were buying."
- "Now retired from his role as the nation's monetary conscience, Greenspan continues to espouse his, er, theories on the financial crisis through editorials in which he denies any culpability for the events of the past three years. He is also applying his experience and insight as an advisor for Paulson & Company, a hedge fund which cashed in on billions of dollars by calling the collapse of the subprime mortgage market that Greenspan helped create."
- "An ignominious list. To be sure, there were many more complicit in this mess, including consumers who bought more house than they could afford. And though we have to move forward now, let's hope no one forgets what's happened here." (*The Motley Fool*, Bill Mann, Seth Jayson, Nate Weisshaar and Keith Beverly, 09/10/08)
- In the public comments on this article, a "former bank examiner" wrote, "Forced to work within Congress' Community Reinvestment Act requirements, bank regulators

had their hands tied in controlling the poor underwriting. In fact, regulators were forced to persuade banks to find innovative ways to approve mortgage loans to low and moderate income borrowers. Statistics were kept to show how well banks were doing. ‘Second look’ committees were recommended to find ways to make loans that didn’t meet the banks normal underwriting standards. No credit history, bring in some rents checks or electric bills to show what a good credit risk you were. No down payment, no problem and we will roll the closing cost into the loan. Congress decided everyone had the right to own a home regardless of their financial circumstances and they got their wish.” (<http://www.fool.com/investing/dividends-income/2008/09/10/the-people-responsible-for-fannie-mae-and-freddie-.aspx>, 09/11/08)

Subprime and beyond...

- Mark Zandi, chief economist for *Moody’s Economy.com* and economic adviser to the McCain presidential campaign, told the National Economists Club that the housing downturn is “the worst crash since the Great Depression” and still has a ways to run. On June 30th, there were 9.86 million homeowners with negative equity, resulting from housing prices off more than 18% since their peak in 2006, said Zandi. Housing starts have dropped more than 50% and “there’s a very good chance” they will set a record low, surpassing the one set in 1981, he added. Zandi projects home prices to decline another 5% to 10%, before stabilizing around June 2009. In some markets, such as Boston, Chicago, Denver, and “even” Orange County, CA, “affordability has been restored,” said Zandi, which is a prerequisite to stability. He expects home sales to stop declining in the fourth quarter of 2008, followed by housing starts bottoming out in the first quarter of 2009. Under this scenario which assumes no increases in interest rates by the Federal Reserve, financial markets will stabilize in the second quarter [of 2009], foreclosures peak in the third quarter, and a self-sustaining expansion begins at the end of 2009. “I think our prospects are good,” said Zandi. “I think it will be about 12 months.” Zandi said he assumes that Treasury’s takeover of Freddie Mac and Fannie Mae was “a necessary event” to avert insolvency. “I do think it’s very helpful ...because it will bring down mortgage rates.” A consensus seems to have emerged among housing experts that housing prices will stabilize in the summer of 2009. These experts include Zandi, Goldman Sachs economist Charlie Himmelberg, S&P managing director David Blitzer, and S&P senior economist Beth Ann Bovino. (*Bureau of National Affairs*, Diana I. Gregg, 09/12/08; *CNNMoney*, Les Christie, 09/11/08)
- U.S. foreclosures rose to a record 303,879 in August, or one in 416 U.S. households, received a default notice, were warned of a pending auction or foreclosed during the month. Filings increased 27% from a year earlier, reported RealtyTrac Inc. Defaults rose 10% and auctions rose 7% from August 2007. According to the National Association of Homebuilders, there are 3.9 million unsold existing single-family homes, which represents an 11.1 month supply, based upon the current sales pace. (*Bloomberg News*, Dan Levy, 09/12/08)

- CBO reports the federal deficit is expected to hit \$407 billion for FY2008, ending September 30th, and projected to be \$438 billion in FY2009. According to the *Wall Street Journal*, “The real runaway train is what CBO calls a ‘substantial increase in spending’ that is ‘on an unsustainable path.’ That’s for sure. ...This year alone, federal agencies have lifted their spending by 8.1%, with another 7% raise expected for 2009. There’s certainly no recession in Washington. The CBO says that, merely in the two years that Democrats have run Congress, federal expenditures are up \$429 billion—to \$3.158 trillion. The fiscal blowouts have included a record farm bill, notwithstanding record farm income; an aid bill for distressed homeowners, extended unemployment benefits, and more generous veterans benefits. Next up: votes on \$50 billion for Detroit auto firms, an \$80 billion energy bill, as much as \$50 billion for spending masked as a ‘second stimulus,’ plus \$100 billion or more for the Fannie and Freddie rescue. Rather than sort through priorities, Congress is spending more on just about everything. Meanwhile, remember that ‘pay as you go’ spending promise that Speaker Nancy Pelosi made in 2006? ...Senator Judd Gregg (R- NH) has tallied up at least \$398 billion in ‘paygo’ violations so far. Earmarks were also supposed to be cut in half by this Congress. In 2008 there were some 11,000 at a cost of \$17 billion, the second most ever, and far more than half the peak of 14,000 in 2006.” (*Wall Street Journal*, 09/10/08)
- According to a study by Navigant Consulting, Inc., the number of subprime-related cases filed in federal courts through the second quarter has topped the 559 lawsuits filed during the failure of the savings and loan industry during the late 1980s. Counties, such as Prince George’s County Maryland, are hiring prosecutors and investigators to work solely on mortgage fraud, to meet the growing number of mortgage fraud cases and real estate foreclosures. Topping the list of recent large fraud cases is Olympia Mortgage Corp, owned by Leib Pinter, which was accused to defrauding Fannie Mae of \$44 million between 1994 and 2004. In a plea deal, Pinter pled guilty to conspiracy to commit wire fraud and admitted that he pocketed the payoff proceeds for 257 mortgages his company serviced for Fannie Mae. He faces a sentence of 10 years for his crime. (*HousingWire*, Paul Jackson, 09/10/08; *Washington Post*, Ovetta Wiggins, 09/10/08; *New York Post*, Stefanie Cohen, 09/12/08)
- The Association of Community Organizations for Reform Now—or ACORN—has also been rocked by a recent embezzlement scandal. Its founder, Wade Rathke, resigned after it became public this summer that his brother, Dale Rathke had embezzled nearly \$1 million from ACORN eight years ago. In 2000, the embezzlement of \$948,607.50 was discovered, but was concealed by senior executives and not reported to the board, until a whistle-blower told a foundation leader about the theft in May. Now, two board members are seeking a court order, forcing the organization to hand over financial documents for the non-profit and are claiming that Rathke continues to direct the organization’s staff and expenditures. The suit is filed on behalf of the entire 51-member board—although ACORN executives and some board members say that the individuals who filed the suit had no

authority to file the complaint or to claim to represent the board and are demanding that the petition be withdrawn. The Rathke family has pledged to repay ACORN for the funds embezzled. The organization has also been accused of voter fraud in more than a dozen states. ACORN employees were convicted of voter fraud and/or perjury in Colorado (2004 election) and King County, Washington (2007). ACORN receives approximately 40% of its funding from government sources. (*New York Times*, Stephanie Strom, 09/10/08; *Consumer Rights League Press Release*, 07/31/08)

The Housing and Recovery Act of 2008 may spur more bias probes
--

- Under the provisions of the Housing and Recovery Act of 2008, financial institutions which sell loans to Fannie Mae and Freddie Mac may be exposed to claims of discriminatory loan pricing, even if the claims rest only on a preliminary finding, according to a legal memo prepared by K&L Gates, a law firm. According to Paul Hancock, a K&L Gates partner who spent more than two decades at the Department of Justice, directing fair lending and fair housing enforcement in the civil rights division, the new law's procedures allow bias probes to ramp up quickly, if FHFA finds a pattern of disparities on the part of a lender. The agency director is required to refer the preliminary finding to the appropriate regulator or enforcement authority, rather than allow for fuller investigation. "Unlike ECOA, the referral requirement is imposed upon 'preliminary findings' even if the inquiry has not been completed," said Hancock. "The expected congressional pressure on the regulator to explain its failure to act upon referrals from the [FHFA] director may lead to an increase in enforcement action." (*Bureau of National Affairs*, R. Christian Bruce, 09/11/08)

Fannie Mae

Fannie's new CEO Allison has 30 years of Wall Street experience

- The Federal Housing Finance Agency has named Herbert M. Allison, Jr., 65, to serve as the chief executive officer of Fannie Mae. Allison has almost three decades of experience on Wall Street and has deep ties in Washington. He worked for nearly 30 years for Merrill Lynch & Co., where he served as head of human resources, treasurer and chief financial officer. In 1993, Allison became head of investment banking, added capital markets oversight to his portfolio in 1995, and was named president in 1997. In July 1999, Allison left Merrill, after being told he would not be named to the firm's top position. He then ran the finance committee for Senator John McCain's 2000 presidential campaign and later was named chairman of TIAA-CREF, a retirement fund manager for college employees. Allison declined to comment on his new role at Fannie, except to say: "It is going to be a 24/7 thing for me from here on in."
- "As CEO of TIAA-CREF, if you lined up Herb with 100 other CEOs, he would come up as number one on corporate governance," said Steve Bartlett, president of the Financial Services Roundtable. "Accountability, transparency, good governance. He is the guru on that stuff." (*Washington Post*, Thomas Heath and Dina ElBoghdady, 09/08/08; *Wall Street Journal*, Randall Smith, Robin Sidel, and JoAnn S. Lublin, 09/08/08)

Fannie Mae completes a \$7 billion debt sale

- On September 10th, Fannie Mae completed the sale of \$7 billion of two-year benchmark notes at a yield of 2.896% or 70 basis points over Treasuries, marking the lowest spread since June. The deal received more than \$9 billion of orders, which helped to reduce the notes' financing costs. "The deal is a spectacular success," said Rajiv Setia, an agency strategist with Barclays Capital. "It got an overwhelming response." The success of the issue encouraged the Federal Home Loan Bank System to announce a \$3 billion offering of five-year notes later that day, said William O'Donnell, head of U.S. interest-rate strategy and research with UBS AG.
- Asian and European investors bought 12% and 8%, respectively, of the issue, down from 39% and 17% in the July sale. Central banks bought 27%, down from 57% in July. The spread on Fannie Mae's outstanding two-year notes below interest rate swaps was about 35 basis points, the lowest since 2004. (*Bloomberg News*, Jody Shenn, 09/11/08; *Wall Street Journal*, Anusha Shrivastava, 09/11/08)

Fannie Mae is allowed to pay its third quarter dividends

- Fannie Mae has received consent from the FHFA to pay its third quarter dividends on all of its outstanding preferred stock series on September 30th, as scheduled. Fannie had declared these dividends prior to being placed into conservatorship and was deemed to be an outstanding obligation, which must be honored. The record date, as previously announced, is September 15th. Treasury's consent is limited solely to the payment of this previously declared, but unpaid preferred stock dividend. Thereafter, all future common and preferred stock dividends are suspended. (*Fannie Mae Press Release*, 09/10/08)

Secretary Paulson urges Fannie Mae employees to "look forward"

- *Investment Dealers Digest* reports that on September 10th, Treasury Secretary Henry Paulson met with Fannie Mae's employees and urged them to "look forward" and take a positive attitude about the government's takeover. During the 25 minute meeting, Paulson took questions from the audience for about 15 minutes following his remarks to the group. According to a witness, employees were respectful of Paulson. The Treasury Secretary told the audience the Fannie's conservatorship was not a problem or fault of its employees, but rather the result of an ambiguous charter which frightened the market. When employees asked about their stock holdings which have lost value, Paulson responded, "The market has voted." A chief concern among the employees was the whether their company would still sponsor the Help for Homeless Walkathon, an annual event scheduled for November 22nd. Fannie Mae's new CEO, Herbert M. Allison assured the employees that the event would go ahead as planned and he would attend. "I may have to get someone to send me my sneakers," Allison added. (*Investment Dealers Digest*, Aleksandrs Rozens, 09/11/08; *Bloomberg News*, Dawn Kopecki and Bryan Keogh, 09/10/08)
- On December 31, 2006 [the latest data available], Fannie Mae had 6,400 active participants in its employee-stock-ownership plan with \$116 million in assets, of which 90%--or \$104 million—was Fannie Mae stock. In addition, the company has 6,400 participants in its 401(K) retirement plan with assets of \$667 million at the end of 2006. Fannie's stock *was not* among the investment options offered for this plan. (*Wall Street Journal*, James R. Hagerty, Joann S. Lublin, and Kristen McNamara, 09/10/08)

Freddie Mac

Freddie Mac's new CEO Moffett is a banker,
who has been analyzing interest rate risk and credit risk all his career

- The FHFA has named David M. Moffett, 56, to serve as the chief executive officer of Freddie Mac. Moffett brings a deep knowledge of the banking industry and strong relationships with Wall Street from his career as a chief financial officer at a series of banks. Over the past 14 years, Moffett helped transform U.S. Bancorp from a small Ohio bank into the nation's sixth biggest lender with assets of \$247 billion, where he oversaw the bank's reporting, treasury operations and real estate functions. In 2007, he left the bank when he was passed over for the top position and joined the Carlyle Group, a private equity firm. Moffitt has also served on high profile boards, including eBay, E.W. Scripps, and MBIA.
- "If I personally had a question about anything regarding financial standards, I would call David Moffett first," said Steve Bartlett, president of the Financial Services Roundtable. "His reputation is above reproach." Richard Davis, chairman and chief executive of U.S. Bancorp, who worked closely with Moffett for 15 years, added, "David is understated, not a self-promoting guy. He doesn't say a lot at meetings, and then when he says a lot, people are all ears." Longtime banker Edward J. Kelly, III, said, "This job is all about interest rate risk and credit risk, and he has been analyzing that all his life."
- Both Moffett and Fannie Mae's new CEO, Herbert Allison, were on a short list of financial services executives who were untarnished by recent credit-market troubles. The government's selection of Moffitt and Allison reflects its emphasis strong operating experience, rather than high-profile leaders.
- According to an email to company employees from former CEO Richard Syron, Moffett "will be joined by an equally strong non-executive Chairman, John Koskinen." (*Washington Post*, Thomas Heath and Dina ElBoghdady, 09/08/08; *New York Times*, Eric Dash, 09/08/08; *Washington Post's Washbizblog*, Dan Beyers and Terri Rugar, 09/12/08)

Treasury Secretary Paulson urges Freddie Mac's employees
to stay and continue their important work

- On September 10th, Treasury Secretary Henry Paulson met with Freddie Mac's employees to remind them how important their company is to the markets and getting through the housing correction—and urged them to continue their important work. (*Bloomberg News*, Dawn Kopecki and Bryan Keogh, 09/10/08)

- On December 31, 2006, Freddie Mac has \$812 million in its 401(K) plan for its employees, of which about \$64 million (or 7.9%) was invested in company stock. (*Wall Street Journal*, James R. Hagerty, Joann S. Lublin, and Kristen McNamara, 09/10/08)

Federal Home Loan Banks

The Federal Housing Finance Agency is poised to write new capital requirements for the FHLB System

- The Housing and Recovery Act of 2008 requires the FHFA, the FHLB System's new regulator, to write new capital requirements for the Banks. According to sources, the FHFA is eyeing a plan to force the FHLBs to increase their capital base, by retaining more of their earnings. While no final decision has been made, the proposal under consideration could require some FHLBs to retain as much as three times the amount of retained earnings they currently hold. When asked to comment on this matter, the agency's spokeswoman said, "Director Lockhart said that he has received no proposals or even alternatives on this subject." Sources confirmed that the proposal has not yet reached Lockhart's desk and his views are unknown. The agency's predecessor, the Federal Housing Finance Board, attempted to boost the FHLB System's capital in 2006, only to be struck down by 1,066 angry letters from bankers and criticism from lawmakers on Capitol Hill. Today, the issue becomes part of a larger discussion over capital for the housing GSEs and an internal debate over the best time for regulators to boost capital requirements.
- Former OFHEO director Armando Falcon warned, "The agency has to be careful not to get too aggressive with trying to overhaul the regulation of the Federal Home Loan Bank System at a time when they are dealing with Fannie and Freddie." According to a recent report, the FHLBs have less exposure to subprime and other riskier types of mortgage loans that have caused the losses for Fannie Mae, Freddie Mac and private mortgage lenders. Moreover, the FHLB System has been profitable, reporting aggregate net income of \$718 million for the second quarter, up 14% from a year earlier. However, the FHLB System is similar to Fannie and Freddie in at least one crucial respect—size. The System is "enormous" and growing. Over the past year, the Banks' balance sheets have ballooned by 30%. Today, the 12 FHLBs, owned by more than 8,000 financial institutions, have combined assets of \$1.34 trillion. Like Fannie and Freddie, the FHLBs have borrowed large amounts of money in the debt markets, totaling \$1.3 trillion.

- John von Seggern, president of the Council of Federal Home Loan Banks, said the FHLBs “are doing what we were chartered to do in a safe and sound manner.” However, Professor Lawrence White, an economics professor at New York University, countered that the goal should be to cut the links between the government and the FHLBS. Although they perform a useful function, “they’ve got to be doing it on their own nickel and not any government’s implicit guarantee,” said White. (*Bureau of National Affairs*, Mike Ferullo, 09/12/08; *New York Times*, Eric Dash, 09/10/08; *Wall Street Journal*, 09/09/08; *American Banker*, Steven Sloan, 09/05/08)

Ginnie Mae

Lawmakers make last ditch effort to derail FHA’s ban of seller-assisted down payments

- With just weeks before the October 1st deadline in which FHA’s ban on seller-assisted down payments (SADP) goes into effect, member of Congress are proposing a bill which would limit the use of SADP to borrowers with higher credit scores. In exchange, HUD would be able to institute risk-based pricing for FHA-insured mortgages. Specifically, borrowers with credit scores above 680 would be able to use the program, but those with scores ranging from 620 to 680 might face higher insurance premiums. Borrowers with scores below 620 would be able to use the programs until mid-2009, when the HUD secretary would have the discretion to extend the program to less-creditworthy borrowers. House Financial Services Committee chairman Barney Frank (D-MA) said HUD officials appear to be receptive to the proposal. However, a HUD spokesman said the agency has “deep reservations about the legislation in its current form.”
- Homebuilders have aggressively marketed the seller assistance programs, which have been used by nearly 20% of first-time homebuyers. Howard Glaser, a former HUD official in the Clinton administration, said, “If one of the few financing mechanisms that allows for an accelerated sales rate for builders is taken off the table, it has some impact. On the other hand, you don’t want to create more problems with a loan product that’s doomed to fail, and that’s also been the case.” (*Wall Street Journal*, Nick Timiraos, 09/11/08)

Farm Credit System / Farmer Mac

Farmer Mac's stock prices falls 33.3% due to losses on Fannie Mae preferred stock

- A week after the U.S. Treasury announced its GSE bailout, Farmer Mac saw its stock plunge 33.3%, or \$8.25, to \$16.51, after the agency filed a disclosure with the SEC, saying it would book losses on Fannie Mae preferred stock holdings. On June 30th, Farmer Mac owned \$47.2 million of Fannie's preferred shares, of which about \$44.0 million of value has written off. (*Forbes*, Lisa LaMotta, 09/12/08)

Postal Service

APWU notifies Postal Service of errors made
in their Voluntary Early Retirement Plan notices to employees

- According to an American Postal Workers Union's Web News article, "APWU President William Burrus has notified the Postal Service of significant errors in information the USPS provided to employees eligible for Voluntary Early Retirement (VER), and has requested management's 'immediate attention to these matters' so that employees do not suffer irrevocable harm as a result. The letters offering eligible employees early retirement notified them that VER applications must be received no later than 8:30 p.m. Eastern Time (ET) on Sept. 30, and said their retirement would become effective Dec. 31, 2008. However, employees were incorrectly informed that the decision to retire also would become irrevocable at 8:30 p.m. ET on Sept. 30, Burrus said. 'An agency must permit an employee to withdraw his or her retirement application before the effective date of retirement,' he wrote. 'In this VER, the effective retirement date is Dec. 31, 2008; therefore, eligible employees have the right to withdraw their retirement application no later than Dec. 31, 2008.'" (*APWU Web News Article #81-08*, William Burrus, 09/10/08)

TVA

Environmentalists seek to block work on TVA nuclear plant

- The Blue Ridge Environmental Defense League, the Bellefonte Efficiency and Sustainability Team and the Southern Alliance for Clean Energy asked the Nuclear Regulatory Commission to suspend TVA's request to renew its construction permits to complete construction on two nuclear plants at Bellefonte, AL. The groups argue that TVA has not addressed the possible environmental impact that work on the plant,

might have on the nearby Tennessee River. The utility had no immediate response to the groups' claims. (*Associated Press*, 09/12/08)

TVA dropped its contract for outside security guard service at three nuclear plants

- In an “organizational alignment,” TVA plans to drop its contract with Pinkerton Government Services for private security guard service for its Browns Ferry, Sequoyah and Watts bar nuclear stations in favor of an in-house force. TVA paid Pinkerton \$159 million over six years for a security force of approximately 500 employees. The return of the all-TVA force should occur over the next fiscal year. TVA Chief Nuclear Officer Bill Campbell said the utility made this decision to improve “management controls and lines of communications with the security force.” NRC spokesman Roger Hannah said there have been “some security issues” at TVA plants in recent years, but nothing so severe that the regulator requested that changes be made.
- TVA made these plans, as *The Tennessean* [Knoxville, TN] was preparing a report claiming lax security at nuclear plants from the former employees. According to the paper, two women working for Pinkerton and one TVA nuclear security officer said they suffered a pattern of intimidation and eventually lost their jobs, after bringing up safety breaches. These breaches included napping on the job, inadequate training, and malfunctioning radioactivity monitors. Neither TVA’s inspector general nor NRC officials offered much relief, the women claimed. TVA spokesman Gil Francis said privacy laws prevented the utility from discussing any cases, but added “intimidation and harassment are not tolerated—period.” (*The Tennessean*, Anne Paine, 09/03/08; *Associated Press*, Duncan Mandfield, 09/02/08)

TVA named a top utility by *Site Selection Magazine*

- Site Selection Magazine has named TVA has one of the 2008 Top Utilities of the Year by Site. The selection is based upon the utility’s economic development achievements in 2007, which helped attract or retain more than 45,000 jobs and \$5.6 billion in capital investment in TVA’s seven state service area. (*Memphis Business Journal*, 09/11/08)

Canfield & Associates, Inc.
101 Constitution Avenue, N.W.
9th Floor West
Washington, DC 20001
Phone: (202) 742-4366
Fax: (202) 403-3926
www.canfieldassoc.com