

The **GSE** REPORT™

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Major Events

CONGRESS PASSES THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

Bailout scorecard to date: \$1.8 trillion

Treasury moves on to the “nuts and bolts” of the rescue plan

Ways to quickly stabilize the financial system at a de minimis cost

Warren Buffett: U.S. mortgage market has triggered “an economic Pearl Harbor”

Congress passes the Emergency Stabilization Act of 2008

- On October 4th, the House of Representatives reversed course and approved by a vote of 263 to 171 the Emergency Stabilization Act of 2008, an unprecedented bailout plan for the financial system. The House’s wider bipartisan majority, with 91 Republicans joining 172 Democrats to vote for the bill, marked a remarkable turnaround from Monday’s vote, in which the chamber defeated an earlier version of the bill by 228 to 205. The change of course by the House was prompted by fears of a global meltdown along with “old-fashioned” political inducements added by the Senate—\$150 billion in popular tax provisions, such as credit for renewable energy and adjustment to the alternative minimum tax for middle-class families, along with an increase in FDIC’s and NCUA’s insurance of accounts limit from \$100,000 to \$250,000. Together, the Senate’s additional provisions increased the bill’s “price tag” by more than 20%. In the end, 33 Democrats and 24 Republicans in the House changed their votes, which assured passage of the legislation. Presidential contenders, Senators Barack Obama (D-IL) and John McCain, both supported the bill, which passed easily in the Senate by a vote of 74 to 25.
- Obama persuaded Representatives Elijah E. Cummings (D-MD) and Donna F. Edwards (D-MD) to vote for the bill, by assuring them that he would work to achieve passage of a change in the bankruptcy law to allow judges to modify first mortgages. In a speech in Abington, PA, Obama warned that passage of the legislation would “just be the beginning of a long-term rescue plan for our middle class...” McCain, speaking in Flagstaff, AZ, said, “It’s an outrage that it’s even necessary. But we must stop the damage done by corrupt and incompetent practices on Wall Street and in Washington...”
- Congressional Democrats cautioned that the legislation was only a first step and pledged to pass a sweeping overhaul of the nation’s regulatory system next year in the 111th Congress. To start this legislative process, the House’s Committee on

Oversight and Government Reform has scheduled hearings on the collapse of Lehman Brothers (October 8); the \$85 billion bailout of AIG (October 16); the role of hedge funds in the crisis (October 16); the actions of credit rating agencies (October 17), and role of federal regulators (October 23). House Financial Services Committee chairman Barney Frank said, “We will be back next year to do some serious surgery on the [U.S.] financial structure.” Frank added, “Our capacity to generate risk has outstripped our ability to control it effectively. It would be highly irresponsible, a betrayal of our oath, if were to stop here. ...It will be our job to enact—and I think it will be comparable to what Franklin Roosevelt and the Congress did in the New Deal—a set of regulations for all of the financial industry.”

- In an October 4th signing ceremony, President George W. Bush praised Congress for acting in two weeks to pass the legislation. “We have shown the world that the United States will stabilize our financial markets and maintain a leading role in the global economy,” said Bush.
- The 451-page Emergency Economic Stabilization Act (EESA), passed by Congress, gives Treasury Secretary Henry Paulson (the Secretary) wide latitude to purchase, manage, and sell up to \$700 billion of troubled assets from any firm—including banks, savings associations, credit unions, securities brokers and dealers, insurance companies, any institution regulated under U.S. law, and any U.S. branches of foreign-owned banks, but excluding foreign central banks and institutions owned by foreign countries—at any price, as a means of restoring liquidity and stability to the financial markets and to minimize foreclosures through a troubled asset relief program (TARP). The assets in TARP may include residential and commercial mortgages, securities, obligations or other instruments related to mortgages, and other illiquid assets, such as car and truck loans and student loans, if the Secretary deemed it was necessary for the stability of the financial markets. In managing TARP, the Secretary must consider a number of broad—and potentially conflicting—program “considerations” that include goals of (i) protecting the interests of taxpayers; (ii) minimizing the impact on the national debt; (iii) providing stability to financial markets; (iv) preserving homeownership; (v) protecting the needs of all financial institutions, regardless of size or “other” characteristics; (vi) protecting the needs of local communities; (vii) ensuring the stability of the United State’s public instruments; (viii) and protecting the retirement security of Americans.
- EESA authorized the Secretary’s request for a \$700 billion TARP, of which \$250 billion will be available immediately, \$100 billion will be available with Presidential certification, and the remaining \$350 billion will be available with a Presidential request and 15-day waiting period during which Congress may object by joint resolution. The TARP will be administered through a new Office of Financial Security (OFS), under the Assistant Secretary for Domestic Finance. The OFS will exercise its authority in consultation with the Federal Reserve Bank, the OCC, OTS, and HUD. Under EESA, TARP expires on December 31, 2009, but may be extended for no more than two years from enactment by the Secretary’s certification.

- Under the legislation, pricing is to be the “lowest price... consistent with the purposes” of the Act. The Secretary, who will determine the methods to price and value assets, must take steps to ensure the purchases are at “reasonable” prices and reflect the “underlying value of the asset.” The bill prohibits the resale of troubled assets to the Treasury at a higher price than the seller paid for the assets, except with respect to troubled assets acquired in a merger or from a financial institution in conservatorship, receivership or Chapter 11.
- The legislation empowers the Secretary to solicit and award contracts to asset managers, servicers, property managers, and other service providers or expert consultants through a streamlined process to be established by the Secretary. The bill directs the Secretary to publish program guidelines which (i) specify the procedures followed by Treasury to select asset managers; (ii) outline the mechanisms for purchasing troubled assets; (iii) describe the methods for pricing and valuing troubled assets; and (iv) outline the criteria to be used by Treasury to identify troubled assets for purchase. EESA also directs the Secretary to issue regulations or guidelines to address and manage conflicts of interest that may arise in administering TARP.
- EESA requires that any TARP transaction must include an equity sharing provision to minimize any long-term negative impact to taxpayers. Specifically, the bill requires that the Secretary receive from the financial institution selling troubled assets either (i) a warrant granting the Secretary the right to receive non-voting common stock or preferred stock for institutions registered and traded on a national exchange; or (ii) a senior debt instrument from the institution. In the event that (later) a financial institution is no longer listed or traded on a national exchange, the bill provides that Treasury’s warrant shall convert to senior debt.
- Treasury is required to establish a “de minimus” exception for financial institutions, based on the cumulative dollar amount of purchase of troubled assets, at not more than \$100 million. This exception applies to these specific equity ownership provisions of EESA only, meaning that even small participants may be subject to other TARP duties and burdens.
- The Treasury’s interests are non-voting, from a corporate law standpoint. It is not known whether Treasury would seek to assert any influence over corporate governance as a result of holding these interests, the extensive reporting requirements imposed on Treasury and other regulators under EESA as of the operation of the programs in effect will impose a new level of disclosure on financial institutions involved in EESA programs. (*Womble Carlyle Report*, 10/4/08)
- EESA requires the Secretary to establish the Troubled Asset Insurance Fund (TAIF), funded by any participating financial institution, to guarantee troubled assets under TARP. The TAIF premium will be set by the Secretary at a level sufficient to protect taxpayers, based upon the credit risks associated with the particular troubled asset that is being guaranteed. The Secretary must publish the methodology used by Treasury to set the TAIF premium. Any profits from the sale of TARP assets will be used to

pay down the national debt. EESA also requires the Secretary to establish risk-based premiums for Treasury's guarantees at a level sufficient to cover anticipated claims. Further, the legislation requires the Secretary to report to Congress on Treasury's establishment of guarantee programs.

- EESA requires any financial institution that sells troubled assets to Treasury to be subject to certain restrictions on executive compensation. If Treasury purchases assets directly without a bidding process of other available market price and receives a "meaningful" equity or debt position as a result of the transaction, the institution must (i) place limits on compensation to eliminate incentives which encourage executive officers to take unnecessary and excessive risks that threaten the value of institution while Treasury owns a equity or debt position in the company; (2) include a claw-back provision, allowing the company to recover any bonuses or incentive pay to senior executives based upon earnings statements, gains, or other criteria that later are proven to be factually inaccurate; and (3) prohibit the payment of golden parachute payments to the company's top five executives, while Treasury holds debt or equity positions in the institution [if the company is subject to the public disclosure requirement of the Securities and Exchange Act of 1934]. For institutions which sell more than \$300 million of troubled assets to Treasury, the Secretary must prohibit the company from entering into any new employment contracts with senior executive officers that provide a golden parachute provision that is triggered by an involuntary termination, bankruptcy filing, insolvency, or receivership.
- EESA seeks to maximize and coordinate efforts to modify mortgages for at-risk homeowners and requires the federal government to control all loan modifications related to TARP assets. Under the bill, the Secretary is required to take a systematic approach to maximizing assistance for homeowners and encourage loan servicers to take advantage of the Hope for Homeowners Program (HHP) or other programs available to minimize foreclosures. The legislation strengthens HHP by increasing the number of eligible homeowners and improving the tools to be used to prevent foreclosure. The bill authorizes the Secretary to use loan guarantees and credit enhancements to facilitate loan modifications to prevent "avoidable" foreclosures. The Secretary is also required by the legislation to request that loan servicers avoid preventable foreclosures of residential mortgages to the greatest extent possible. Under EESA, the Secretary has the discretion as an investor to prevent foreclosures under existing investment contracts. The bill directs the Secretary to consent, when appropriate, to "reasonable" requests for loss mitigation measures, such as term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a trust or other structure allowed to be modified, and/or the removal of other limitations or modifications.
- EESA establishes the Financial Stability Oversight Board (the Board)—comprised of the chairman of the Federal Reserve Board, the [Treasury] Secretary; the FHFA director; the SEC chairman, and the HUD Secretary—to review the actions of the Secretary and the Office of Financial Stability. The Board is charged with reviewing the policies implemented by the Secretary; the appointment of financial agents, the

designation of asset classes, the plans with for the structure of vehicles used to purchase troubled assets, and the effect of the Secretary's actions have on meeting EESA's defined TARP "considerations." The Board is directed to make recommendations to the Secretary regarding the use of his authority and to report publicly any cases of fraud, misrepresentations, and/or malfeasance. On a monthly basis, the Secretary must report to Congress a summary of his actions, which includes the actual obligation and expenditures of TARP funds, a detailed financial statement with respect to the Secretary's exercise of his authority; projected costs and liabilities; operating expenses; a description of the valuation methods used for each transaction; and a description of the vehicles established to exercise such authority. These reports shall be in accordance with GAAP and audited annually by GAO. In addition, EESA also requires the Secretary to provide Congress "Tranche Reports" for aggregate purchases of \$50 million in troubled assets. The Secretary must provide certain Congressional committees Tranche Reports detailing all transactions, which includes the pricing mechanisms used, a justification for the price paid and other financial terms, a description of the exercise of such authority on the financial system and the "challenges" which remain in the system, and an estimate of the additional action necessary. Before April 30, 2009, the Secretary also is required to report to Congress the state of the financial markets, the effectiveness of the current financial regulatory system of overseeing market participants, including the over-the-counter-swaps-market and GSEs, and outline his recommendations.

- EESA creates a Congressional Oversight Panel to conduct hearings, take testimony, receive evidence, and administer witnesses' oaths. The Oversight Panel is required to submit Regular Reports every 30 days, which monitor the TARP and Secretary's actions. By January 20, 2009, the EESA directs the Oversight Panel to submit an analysis of regulatory reform that assess the current regulatory system and provides recommendations for improving the regulatory apparatus for *all* financial market participants [including, specifically, those currently outside the regulatory system] and identify any gaps in existing consumer protections. Under the bill, the Oversight Panel is disbanded after the last monthly Regular Report is filed, following the sale of all TARP assets.
- EESA establishes the Office of the Special Inspector General for the Troubled Asset Relief Program, which will be responsible for conducting, supervising and coordinating audits and investigations of the purchase, management, and sale of assets in the TARP program. The Inspector General must submit quarterly written reports to Congress, providing a detailed statement of all purchases, obligations, expenditures, and revenues associated with any program established by the Secretary.
- In addition to the bill's provisions for problem asset resolution, EESA also provides tax provisions related to the Economic Stabilization Act, including (i) treating the write-down of the value of Fannie Mae and Freddie Mac preferred stock by financial institutions as ordinary income; (ii) creation of a tax penalty for executive compensation over \$500,000 and golden parachutes of employees participating in the

plan; and (3) an extension of current tax law forgiveness on the cancellation of mortgage debt qualified for principal residences until January 1, 2013.

- EESA also restates the SEC’s authority to suspend—by rule, regulation, or order—the application of FASB 157, if the agency determines that it is in the public interest and protects investors to take such action. The legislation also directs the SEC, in consultation with the Federal Reserve Board and Treasury, to conduct a study of marked-to-market standards under FASB 157. This study, which must evaluate the effects FASB 157 has on balance sheets and its impact on quality of financial information, must be submitted by the SEC to Congress within 90 days. The bill also directs the Controller General to assess the extent to which leveraging and sudden deleveraging by financial institutions has contributed to the current financial crisis and the ability of government agencies to monitor, regulate, and curtail the use of leverage by financial institutions. This study must be submitted to Congress by June 1, 2009.
- In the event there is a loss in TARP, the EESA requires the president to present Congress a proposal that after five years recoups from the “financial industry” any projected losses to the taxpayer. This provision ensures that the TARP does not add to the deficit or national debt. (*American Banker*, Stacy Kaper, 10/03/08; *New York Times*, David M. Herszenhorn, 10/04/08; *Washington Post*, Lori Montgomery and Paul Kane, 10/04/08; *The Emergency Economic Stabilization Act of 2008*, Patton Boggs Financial Institutions and Tax Policy Practice Group, 10/03/08; *Financial Services Alert*, Goodwin Procter, 10/03/08; *Associated Press*, 10/03/08)
- In an October 4th editorial, the *Washington Post* wrote, “...It is sadly ironic, however, that the Senate felt the need—or seized the opportunity—to add unnecessarily to the deficit. A moment of economic peril became powerful leverage for fiscal irresponsibility in the form of another \$100 billion-plus in deficit-financed tax cuts. We refer to the Senate’s move to tack on to the package an unrelated measure that had been the subject of congressional intramural football: the extension of expiring tax provisions that business eagerly sought and a temporary patch in the alternative minimum tax. The House and Senate agreed on the merits of the tax measure but differed about whether any of it should be paid for by closing tax loopholes. The House, prodded by the Democrats’ Blue Dogs, had been insisting on paying for everything but the AMT patch; the Senate balked. The take-it-or-leave-it, end-of-the-session Senate move to combine the rescue measure with the tax package was unnecessary—there were preferable legislative paths to a House majority—and put the House in a difficult position. House leaders made the wiser choice of poison later over poison now.”
- “Yesterday’s action by no means ensures that the problem has been solved. The bad economic news continued to mount, with a drop in orders for manufactured goods and a seven-year high in claims for unemployment benefits. The credit markets have become so dysfunctional that California Gov. Arnold Schwarzenegger (R) sent Mr. Paulson a letter warning that the state might need a \$7 billion loan because it has not

been able to borrow the money elsewhere. Meantime, the global nature of the metastasizing crisis adds to the nervousness. Maybe the only sure thing is that without the congressional action, prospects would be far bleaker..” (*Washington Post*, 10/04/08)

Bailout scorecard total: \$1.8 trillion

- According to *Reuters*, the estimated cost of the bailout is approximately \$1.8 trillion or roughly \$17,000 per household based up U.S. Census data. The bailout figures include the financial bailout package of up to or more than \$700 billion; Bear Stearns financing (\$29 billion); Fannie Mae and Freddie Mac nationalization (\$200 billion); AIG loan and nationalization (\$85 billion); FHA housing rescue bill (\$300 billion); community grants to purchase abandoned properties (\$4 billion); JPMorgan Chase repayments (\$87 billion); loans to banks via Fed’s Term Auction Facility (\$200 billion+); loans from Depression-era Exchange Stabilization Fund to shore up money market funds (\$50 billion); and purchases of Fannie Mae and Freddie Mac MBS (\$144 billion).
- This may be only the beginning of the bailout mania. On October 2nd, Governor Arnold Schwarzenegger said California may need a \$7 billion emergency loan from the Treasury, because the state is running out of cash and may be unable to access routine short-term loans because of the global credit crunch. Massachusetts treasurer Timothy Cahill already has asked the federal government and Federal Reserve Bank of Boston to loan the state money under the same favorable terms given to banks, because of the state’s inability to borrow from short-term debt markets. While Massachusetts has the cash its needs to cover expenses for coming weeks, Cahill said a low rate loan would ease a cash shortfall if credit problems persist. “That’s all we would ask them to do: Treat us like the investment banks,” he said. “It’s not just California,” said Scott Pattison, executive director of the National Association of State Budget Officers. “People will tell you publicly that they are doing okay, but state financial officers are very concerned. At the moment, there’s enough cash in the bank, but by November or December, if they still can’t get access to the markets to borrow money to meet payroll or other expenses, then you might have 10 to 12 states that may not be able to cover their costs.”
- Short-term credit trading for anyone other than the federal government has remained at a “virtually nonexistent level” said Mohamed A. el-Erian, co-chief executive of Pimco. “While constituting a necessary condition, the rescue package is not sufficient to radically counter the immediate disruptions.” (*CNet*, Declan McCullagh, 10/03/08; *Los Angeles Times*, March Lifsher and Evan Halper, 10/04/08; *Associated Press*, 10/04/08; *Washington Post*, Keith B. Richburg and Karl Vick, 10/04/08; *Washington Post*, David Cho, 10/04/08)

Treasury moves on to the “nuts and bolts” of the rescue plan

- In late September, Treasury Secretary Henry Paulson tapped Ed Forst, a Harvard University executive and former Goldman Sachs executive, to head Treasury’s transition team for TARP and to establish the agency’s new Office of Financial Stability. Paulson plans to outsource the management of TARP assets to as many as 10 asset management firms, who are paid on a percentage basis for the assets managed. Treasury will select the asset management firms through formal requests for services that they plan to publish on October 6th. BlackRock, Inc., Pacific Investment Management Co. and Legg Mason are interested in becoming managers for the program, say sources familiar with discussions.
- Within Treasury, Paulson plans to hire a bare-bones staff of about two dozen people with expertise in asset management, accounting and legal issues. According to sources, Paulson plans to tap Neel Kashkari, an assistant secretary of international affairs and former Goldman Sachs banker, to oversee the program and to report directly the Secretary.
- Despite the broad powers given to the Secretary under EESA, Paulson faces a morass of legal and financial issues in setting up the program. The agency is still working on a conflict-of-interest policy and compensation guidelines. In an interview, Paulson said the trick is coming up with the “right” price for the assets acquired. As the *New York Times* noted, “The bailout legislation itself highlights the contradictory goals that the Treasury will face when it goes on its buying spree. Among the goals it is supposed to consider are ‘protecting taxpayers,’ ‘preventing disruption to financial markets’ and ‘the need to help families keep their homes.’ Democratic lawmakers insisted that the Treasury use its authority to help restructure many subprime mortgages so that at least some troubled homeowners could avoid foreclosure. But the Treasury’s auction plan will make that difficult. More than 90 percent of all subprime mortgages are part of giant pools, or trusts, which sell mortgage-backed securities to investors around the world. Before the government would be able to modify any mortgage that was in a trust, securities experts said, it would have to acquire agreement from 100 percent of the bondholders. But a senior Treasury official said the government would probably want to buy no more than half of the securities tied to a trust, which would hamper winning agreement from all investors.”
- Despite working feverishly over the past two weeks, Treasury cautioned it will take approximately four weeks before TARP can begin acquiring distressed assets through a series of small pilot programs. The EESA also allows Treasury to “intervene very quickly if they want to,” said Vincent Reinhart, a resident scholar at AEI and former director of the Federal Reserve Board’s Division of Monetary Affairs. Reinhart expects that Treasury will “act in the markets first” possibly by working with the Fed. (*Washington Post*, David Cho, 10/04/08; *New York Times*, Mark Landler and Edmund

L. Andrews, 10/04/08; *Bloomberg News*, Rebecca Christie and Robert Schmidt, 10/04/08; *Associated Press*, 10/03/08; *Washington Post*, David Cho, 10/06/08)

- In an interview with *American Banker*, FDIC chairman Sheila Bair said that credit guarantee provisions in the bailout bill would allow the government to increase modifications and stabilize home prices at a much smaller cost than buying the loans themselves. “They can have so much bigger bang for their buck.” said Bair. “You don’t have an initial cash outlay, you can leave them in the private sector, you can do the servicing in the private sector, and you can condition them on some type of modification protocol, which would get the mortgages restructured faster. ...It will be another tool they have in their toolkit, and it will be cheaper. You can provide credit support to \$100 billion worth of mortgages with no up-front cash outlay.” (*American Banker*, Rob Blackwell, 10/03/08)

Ways to quickly stabilize the financial system at a de minimis cost

- In a September 19th *Wall Street Journal* commentary, William M. Isaac, the former chairman of the FDIC, outlined a straight forward plan to stabilize the U.S. financial system. Isaac wrote, “I am astounded and deeply saddened to witness the senseless destruction in the U.S. financial system, which has been the envy of the world. We have always gone through periods of correction, but today’s problems are so much worse than they needed to be. The [SEC] and bank regulators must act immediately to suspend the Fair Value Accounting rules, clamp down on abuses by short sellers, and withdraw the Basel II capital rules. These three actions will go a long way toward arresting the carnage in our financial system.”
- Isaac continued, “My interest is ...in trying to identify what is causing a situation, that should have been resolved easily, to develop into a crisis that is spreading like a cancer throughout the financial system. The biggest culprit is a change in our accounting rules that the Financial Accounting Standards Board and the SEC put into place over the past 15 years: Fair Value Accounting. Fair Value Accounting dictates that financial institutions holding financial instruments available for sale (such as mortgage-backed securities) must mark those assets to market. That sounds reasonable. But what do we do when the already thin market for those assets freezes up and only a handful of transactions occur at extremely depressed prices? The answer to date from the SEC, FASB, bank regulators and the Treasury has been (more or less) ‘mark the assets to market even though there is no meaningful market.’ The accounting profession, scarred by decades of costly litigation, just keeps marking down the assets as fast as it can.”
- “This is contrary to everything we know about bank regulation. When there are temporary impairments of asset values due to economic and marketplace events, regulators must give institutions an opportunity to survive the temporary impairment. Assets should not be marked to unrealistic fire-sale prices. Regulators must evaluate the assets on the basis of their true economic value (a discounted cash-flow analysis). ...If we do not halt the insanity of forcing financial firms to mark assets to a

nonexistent market rather than their realistic economic value, the cancer will keep spreading and will plunge the world into very difficult economic times for years to come. I argued against adopting Fair Value Accounting as it was being considered two decades ago. I believed we would come to regret its implementation when we hit the next big financial crisis, as it would deny regulators the ability to exercise judgment when circumstances called for restraint. That day has clearly arrived.”

- Specifically, Isaac recommends that the SEC immediately exercise its power to suspend fair-value accounting standards (FAS 157), as it applies mortgage-backed securities. Under the current FAS 157 accounting guidelines, financial institutions holding financial instruments available for sale—such as mortgage-backed securities—must mark those assets to market. In today’s market, there is NO meaningful market for mortgage backed securities, which forces the assets to be marked at unrealistic fire-sale prices. Regulators must evaluate these assets on the basis of their true economic value.
- In recent years, the SEC lifted restraints on short sellers of stock to allow “naked selling”—in which the investor shorts a stock without actually possessing it—and eliminated the requirement that short sellers could sell only on an uptick in the market. Recently, the SEC placed a temporary restriction on short-sales on financial stocks. Isaac recommends that, going forward, there should be no naked short sales. In addition, short sales should only take place when there are up ticks in the market.
- Isaac also believes that the banks’ new Basel II capital rules, which use historical data to project future losses to set capital levels, should be withdrawn. “When we go into a period like today where losses are enormous (on paper at least), the models require more capital when none is available, forcing banks to cut back lending,” wrote Isaac.
- Isaac also recommends that Congress provide FDIC the authority to issue “net worth certificates,” similar to the vehicle used in the 1980s which resolved the \$100 billion insolvency in thrift industry for a total cost of less than \$2 billion. The FDIC could issue net worth certificates for weak banks, which the agency determines is viable, to shore up the institution’s capital and to give them more time to resolve problems without any subsidy or cash outlay by the federal government. The FDIC should analyze each bank to determine if, by giving the bank a window of up to five years, it is reasonable to conclude the bank could pay back a note. If the answer is yes, the FDIC would issue a note to the institution. Banks entering the net worth certificate program should agree to strict supervision by the FDIC, which would include oversight of compensation of top executives and removal of poor management. Isaac added, that net worth certificates should be paid for by issuing FDIC senior notes to the banks resulting in NO cash outlay. Moreover, the interest rate on the net worth certificate and the FDIC notes should be identical so NO subsidy is necessary. Isaac also suggested that FDIC protect all general creditors in bank failures during the period of instability. (*Remarks by former FDIC Chairman William M. Isaac, 09/28/08; Wall Street Journal, William M. Isaac, 09/19/08*)

- In *MortgageDaily.com*, Anne C. Canfield wrote, "...[T]he mark-to-market accounting requirement is coming under significant criticism because it created an unnecessary crisis. This flawed accounting rule has failed miserably by creating unstable markets which have only benefitted short-sellers and vulture funds taking advantage of the volatility and artificially depressed asset prices. Essentially, bad mortgages were at the bottom of this debacle. But the rule took a bad situation and needlessly created a disaster out of it. Policymakers should first suspend the mark-to-market rule and, ideally, shelve it permanently." (*MortgageDaily.com*, Anne C. Canfield, 09/26/08)
- In a September 30th letter, a bipartisan group of 60 lawmakers urged SEC chairman Christopher Cox to suspend immediately fair value accounting as currently practiced. "We are writing to urge that the [SEC] immediately shore up the capital of the nation's banking system by suspending the use of fair value accounting, or 'mark to market,' and replace it with a form of mark to value that more accurately reflects the true value of the asset," wrote the lawmakers. "While the mark to market accounting method can raise important red flags, in an illiquid market it has become counterproductive and is simply making the situation worse." They urged the SEC to "expedite new guidance using a mark to value mechanism that better reflects the value of the asset."
- On September 30th, the SEC and FASB provided additional guidance aimed at providing some leeway for under-the-gun financial entities without suspending the fair value accounting standards. On October 1st, FASB also has agreed to quickly post additional guidance on how to assign fair values to financial assets in an inactive market. Many market participants viewed the September clarifications as anything but new. In an open letter issued October 1st, Consumer Mortgage Coalition Executive Director Anne Canfield said the joint FASB/SEC clarification "doesn't represent any change in fair value measurements." While the clarification was "perhaps well intended, [it] will have little positive impact," she added. An ABS/MBS analyst, who asked not to be named, said, "I'm still scratching my head how this is different from the guidance already available. It's just more sentences, plus the Treasury plan pretty much effectively means that all these illiquid assets are other than temporarily impaired anyway." Another source said, "If I were an audit firm I'd take those reverse auction prices as 'all it's worth for the foreseeable future' and whack everything like it in the portfolio I was signing off on." The statement likely signals that neither FASB nor the SEC intend to stand down and formally suspend fair-value accounting rules, as numerous financial institutions have pushed for in recent weeks. (*Bureau of National Affairs*, Steven Marcy, 10/02/08; *Housing Wire*, Paul Jackson, 10/01/08; *Bureau of National Affairs*, Steve Burkholder, 10/02/08)
- Global regulators and accounting rule makers came under renewed pressure on September 30th, when Nicolas Sarkozy, president of France, urged European leaders to support more flexibility in the accounting rules, which would allow banks "to smooth the effects" of market-to-market standards. David Cameron, leader of UK's

Conservative Party, said strict accounting rules had made the financial crisis worse and needed to be addressed. (*Financial Times*, Jennifer Hughes, Ben Hall, and Joanna Chung, 10/01/08)

Warren Buffett: U.S. mortgage market triggered “an economic Pearl Harbor”

- “It’s not like Pearl Harbor where you could look at what happened with your own eyes and decide you had to do something that day,” said Warren Buffett. “This is sort of an economic Pearl Harbor we’re going through.” Buffett words describe September 20th, the day credit many markets seized and Treasury Secretary Henry Paulson saw the “circulatory system” of the U.S. economy—the credit markets—starting to fail, which prompted Paulson to propose a \$700 billion taxpayer bailout of the U.S. financial system. Regulators watched in shock, as investors began fleeing money market mutual funds and sought the safety of government bonds [driving interest rates to zero], and the markets for short-term loans, long relied upon by banks to fund their day-to-day business, froze. It was only a question of time before consumers would panic.
- In a Senate Banking Committee hearing on the credit market turmoil, Senator Chuck Schumer (D-NY), noted, “Who would have thought that the lowly mortgage could bring our financial system to its knees? But that’s where we are [as a result of the subprime lending mess and falling residential real estate values].” The collapse of the house-of-cards was first apparent in August 2007, when a liquidity crisis struck the private secondary market for high yield debt. Over the past year, the dominos began to fall with the federal government’s bailout of Bear Stearns in March, the nationalization of Fannie Mae and Freddie Mac in July, and the bankruptcy of Lehman Brothers in August. Then Lehman’s failure triggered a sharp ratings cut for AIG’s debt, which forced the firm to the brink of bankruptcy, as its creditors demanded the insurer to come up with billions of dollars of collateral payments for its outstanding derivatives trades.
- According to a *New York Times* report, the nation’s regulators met at the Federal Reserve of New York to try and stave off disaster with AIG. The only Wall Street chief executive attending the meeting was Goldman Sachs’ chairman and CEO Lloyd C. Blankfein. According to six people close to AIG, Goldman Sachs was AIG’s largest trading partner. A potential collapse of the insurer threatened to trigger a loss of up to \$20 billion for Goldman, said the sources. Within days, federal officials structured an \$85 billion loan to AIG to stave off bankruptcy.
- As the crisis was peaking at AIG, FDIC placed the \$307 billion Washington Mutual Bank into conservatorship on September 25th, marking the 13th bank failure this year. Simultaneously, FDIC sold select assets, deposits and FHLB advances of WAMU to JP Morgan Chase. On September 29th, Citigroup, Inc. announced it had agreed to buy Wachovia’s banking operations in an FDIC-assisted transaction for \$1 a share. Under the agreement with FDIC, Citigroup will absorb up to \$42 billion of losses on Wachovia’s \$312 billion pool of loans with FDIC absorbing any additional losses on

the portfolio. In exchange for FDIC's risk-bearing, Citigroup has granted FDIC \$12 billion in preferred stock and warrants. However, on October 3rd, Wells Fargo announced that Wachovia had accepted its \$15 billion stock offer (approximating \$7 a share) with no assistance from FDIC. It appears that the courts will likely determine the acquirer of Wachovia.

- During the week of September 15th, Lehman's bankruptcy also triggered a run on money market funds, as hedge funds frantically pulled billions of dollars out of Goldman and Morgan Stanley in search for safe havens. By Wednesday, September 19th, institutional investors have withdrawn more than \$290 billion from money market funds in a "flight to safety." By that evening, there was a run on the \$12.3 billion Putnam Prime Money Market Fund.
- In a September 29th market commentary, Herman Moyses, Jr., wrote, "The FDIC should be proud this morning for, over the past week, resolving not one but two large institutions with little market effect. In both cases, the FDIC managed to arrange substantially whole-bank purchase and assumptions that avoided a straight deposit insurance payout. The FDIC's recent deals are important, since whole bank P&A's are the gold standard of FDIC resolution policy. Their success in these transactions should be applauded. While whole bank P&A's do not necessarily entail zero losses on behalf of the FDIC, they ensure a smooth transition of authority from the failed institution and virtually uninterrupted access to consumer deposits. This is the way the system is supposed to work... Don't get me wrong. Total resolution costs from this crisis will still exceed current reserves and the FDIC will most likely need to access additional credit (beyond its existing lines) at Treasury, but we will not need to invent any new procedures to do so and the FDIC will recover additional outlays from increased insurance premiums after the fact. Not a perfect system, but it will work and we will have time to improve it incrementally after the crisis – and it will cost substantially less than \$700 billion..."
- The past 13 months have marked the "demise of the shadow banking system, [consisting of broker-dealers, hedge funds, private equity groups, structured investment vehicles and conduits, money market funds, and non-bank mortgage lenders,] that has been created over the past 20 years," wrote economist Nouriel Roubini in the *Financial Times*. The shadow system's demise has evolved through four stages, to date, including (1) the collapse of the entire SIVs/conduit system; (2) runs at U.S. broker dealers (which resulted in failures at Bear Stearns and Lehman Brothers and the merger of Merrill Lynch); (3) the collapse of other leveraged institutions, including Fannie Mae, Freddie Mac, AIG, and more than 300 mortgage lenders, which were likely insolvent given their reckless lending; and (4) a panic in the money markets, which led the federal government to extend deposit insurance to the funds. Roubini wrote, "The next stage will be the run on thousands of highly leveraged hedge funds." In a September 25th article in *Forbes*, Roubini wrote, "Given the systemic importance of larger hedge funds, the time when the hedge fund industry will start to be directly regulated is coming closer. Indirect regulation...has not worked." In the *Financial Times*, Roubini concluded, "The real economic side of this

financial crisis will be a severe U.S. recession. Financial contagion, the strong Euro, falling U.S. imports, the bursting of European housing bubbles, high oil prices, and a hawkish European Central Bank; will lead to a recession in the eurozone, the UK and most advanced economies.”

- In the September 27th edition of *The Atlanta Journal-Constitution*, Jim Wooten wrote “...There are lessons to be learned here [in this financial crisis.]. One is don’t direct private companies [such as Fannie Mae and Freddie Mac] to be social service agencies. Build transparency and accountability into public-private relationships, which always should be kept at arm’s length. Government shouldn’t be in the business of picking industrial or financial winners, nor should it determine when executive compensation in the private sector is too much. People who made bad decisions should fail. That applies, of course, only to the private sector. Politicians are never held accountable for the regulatory and other decisions they make that invite ruin.” (*Atlanta Journal-Constitution*, Jim Wooten, 09/27/08; *Financial Times*, Nouriel Roubini, 09/22/08; *New York Post*, Bruce Bartlett, 09/27/08; *New York Times*, Gretchen Morgenstern, 09/28/08; *Transcript of the Senate Banking Committee hearing on Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions*; 09/23/08; <http://www.fdic.gov/bank/individual/failed/banklist.html>; *Wall Street Journal*, Deborah Solomon, Liz Rappaport, Damian Paletta, and Jon Hilsenrath, 09/20/08; www.fundmasteryblog.com/2008/09/19/; *Financial Times*, Aline van Duyn and Nicole Bullock, 09/22/08; *Bloomberg News*, Erik Holm, 09/24/08; *Forbes*, Nouriel Roubini, 09/25/08; *Special Market Commentary II*, Herman Moyse, Jr. on behalf of Joseph R. Mason, 09/29/08; *FDIC Press Release*, 09/29/08; *New York Times’ Deal Book Blog*, Andrew Ross Sorkin, 09/29/08; *New York Times*, Joe Nocera, 10/02/08)

<p>Why this financial crisis occurred...</p>

- In explaining why the financial crisis has occurred in the marketplace, Presidential candidate Senator Barack Obama (D-IL) recently told an audience: “When sub-prime-mortgage lending took a reckless and unsustainable turn, a patchwork of regulators systematically and deliberately eliminated the regulations protecting the American people.” But is that accurate? Dr. Stan Liebowitz, a professor of economics at the University of Texas at Dallas, said no—in fact this explanation is “*exactly backwards*.” In a September 24th *New York Post* article, Liebowitz wrote, “...Mortgage lending took that ‘reckless and unsustainable turn’ because of regulation—regulation driven by liberals and progressives, not free-market ‘deregulators.’ Pushed hard by politicians and community activists, the regulators systematically and deliberately altered financially sound lending practices.”
- “The mortgage market was humming along just fine when, in the late 1980s, progressives decided that it needed to be “fixed.” Their complaint: Some ethnic groups got approved for mortgages at lower rates than others. In reality, mortgage

lenders were simply being prudent—taking care to provide mortgages to those who could best afford to make the payments.”

- “The shift began in 1989, when Congress amended the Home Mortgage Disclosure Act to force banks to collect racial data on mortgage applicants. By 1991, critics were using that data to paint lenders as racist by showing that minority applicants were approved at far lower rates. Banks were “Shamed By Publicity,” as one 1993 *New York Times* headline put it. In fact, they found a racial disparity only by ignoring relevant data on applicants’ ability to make mortgage payments - such as their assets and credit history.”
- “But the political pressure was intense—with few in politics or media eager to speak the truth. And then, in 1992, came a study from four researchers at the Boston Fed, which seemed to bear out the critics’ contentions. [Note: In 1992, Richard Syron, the recently fired chairman and CEO of Freddie Mac, was the president of the Boston Fed.] That study was, in fact, based on quite flawed data—but the authors’ political, media and academic protectors stifled most serious criticism, smearing the reputation of one whistleblower and allowing the Boston authors to avoid answering serious academic challenges (mine included) to their work. Other studies with different conclusions were ignored. The very next year, the Boston Fed announced new requirements for banks—rules that have now turned out to be monumentally catastrophic: Adopt ‘relaxed lending standards’ or risk being labeled as racists, and face serious penalties under the federal Community Reinvestment Act. Gone (as ‘arbitrary’ and ‘outdated’) were traditional lending requirements such as requiring a down payment or limiting mortgage payments to 28 percent of income. (Of course, the loosened lending standards weren’t limited to poor and minority applicants—that would be discriminatory.)”
- “The new standards performed as intended: Home-ownership rates, stagnant for 25 years, began a rapid 10-year ascent in 1995, with many new homeowners being lower-income and/or minority families. The large rise in demand for houses, however, fed a run-up in prices starting in 1997—the infamous housing bubble. And rising prices hid the great vulnerability of these loans to defaults and foreclosures, because refinancing or selling at a profit was the easy alternative. Soon, these loans began to be sold in the secondary market. Fannie Mae and Freddie Mac were enthusiastic proponents of relaxed lending standards and purchased large swaths of these loans. Time after time, Fannie and Freddie trumped criticism by pointing to how they were helping broaden homeownership. Because of the subject’s racial overtones, they beat back calls for reform even after financial irregularities were found. Rating agencies such as Standard & Poor’s had no experience with such loans—and imprudently used the misleading bubble-induced performance to incorrectly judge the likely performance of financial instruments based on such loans.”
- “In 2002, the ‘reformers’ declared victory. In a Fannie report, four academic supporters of relaxed standards crowed how these changes were ‘fundamentally

altering the terms upon which mortgage credit had been offered in the United States from the 1960s through the 1980s. ...These changes in lending herald what we refer to as mortgage innovation.' Lucky us."

- "Now that the popped bubble has left us swimming in foreclosures, the supporters of loosened credit standards seem shy about taking credit for their 'mortgage innovations.' Instead, [consumer advocates] blame subprime lenders for becoming 'predatory'—when they were simply taking the Boston Fed rules to their logical conclusion while broadening the mortgage market. Investors holding mortgage-based assets now want out. Perhaps they deserve a \$700 billion refund—since they were sold a bill of goods by 'progressive' politicians, academics and government officials who, in the hope of remaking society, insisted that loans based on relaxed underwriting standards were sound." (*New York Post*, Dr. Stan Liebowitz, 09/24/08)
- In the September 28th edition of the *Wall Street Journal*, John Fund wrote, "We will look back on the failure of Congress to reform the government-sponsored enterprises at the heart of the mortgage meltdown as one of the most expensive derelictions of its duty ever. Fannie Mae and Freddie Mac used their lobbying clout, political contributions and even charitable largesse to charm or bully anyone demanding reform in their lending practices."
- "The Bush administration certainly didn't cover itself in glory either, for example issuing news releases in 2005 touting the introduction of 'zero down-payment' mortgages through federal housing programs designed to encourage home ownership. But the administration at least tried to warn Congress that the GSEs should be reined in. ...President Bush publicly called for GSE reform 17 times this year before Congress finally passed a bill increasing oversight of Fannie and Freddie—though by then it was too late."
- "Indeed, the White House's list calls for GSE reform is a long one, stretching as far back as April 2001. At that time, the administration's first budget declared that Fannie Mae and Freddie Mac's growing dominance of the mortgage market was 'a potential problem,' because 'financial trouble of a large GSE could cause strong repercussions in financial markets, affecting Federally insured entities and economic activity.' In 2003, after both Fannie and Freddie were found to have cooked their accounting books, then-Treasury Secretary John Snow urged Congress to 'create a new Federal agency to regulate and supervise the financial activities of our housing-related government sponsored enterprises' and set prudent and appropriate capital requirements. Two years later, Mr. Snow again called for GSE reform, noting that recent events 'reinforce concerns over the systemic risks posed by the GSEs and further highlight the need for real GSE reform.... Half-measures will only exacerbate the risks to our financial system.'"
- "The response? Rep. Barney Frank, who now vilifies Republican House members for questioning a policy of throwing another \$700 billion on the bonfire, insisted to the *New York Times* during the 2003 accounting scandal: "These two entities -- Fannie

Mae and Freddie Mac—are not facing any kind of financial crisis. The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing.”

- “The tale of lost opportunities and thwarted reform is a long one. As a reporter who covered the savings and loan meltdown of the late 1980s, I wish I had paid more attention to the next impending disaster. I knew Fannie Mae and Freddie Mac were bad-faith actors. I just didn’t realize how much their recklessness would spread to other players in the financial markets and create the conditions for the current meltdown. But make no mistake. When the history of this debacle is written, Washington’s failure to supervise and rein in Fannie and Freddie will be seen as the original sin.” (*Wall Street Journal*, John Fund, 09/28/08)
- In the late 1990s, economists were warning about dangers of Congress’s push the lowering mortgage underwriting standards. “We have created a tremendous amount of risk,” said Cynthia Latta, economist with DRI/McGraw-Hill in Boston, during an interview with *Insight in the News* in November 1999. “At some point, the economy is going to turn down. There will be large numbers of defaults that will trigger a lot of political heat.” David A. Levy of the Jerome Levy Economics Institute, said, “The real danger in this is we’re talking about an economy that has really been supercharged by the wealth effect from the stock market and the tremendous job market. A lot can happen when the stock-market bubble bursts, and that will happen sooner or later.” With personal bankruptcies and household debt are at record highs, “a time bomb” waiting to explode when the economy takes a downturn, said Levy. (*Insight in the News*, Patrice Hill, 11/08/99)
- On September 25th, *Good Morning America* co-host Chris Cuomo asked former President Bill Clinton: “Is it a little surprising to you to hear the Democrats say this [crisis] came out of no where? I mean—this was all the Republicans’ [fault]? Pelosi is saying it. ...They all sophisticated people. Is this playing politics in this situation?” Clinton responded, “The responsibility that the Democrats have may rest more in resisting any efforts by Republicans in Congress and me, when I was president, to put some standards and tighten up a little on Fannie Mae and Freddie Mac.” (*Good Morning America*, former President William Jefferson Clinton, 09/24/08)

The role of Fannie Mae and Freddie Mac in the mortgage crisis

- In a September 23rd commentary in the *Wall Street Journal*, Charles W. Calomiris, professor of finance and economics at Columbia Business School, and Peter W. Wallison, a fellow at American Enterprise Institute, argue that Fannie Mae’s and Freddie Mac’s aggressive purchasing of subprime and Alt-A mortgages [from 2004 to 2007] is “largely to blame for our current [financial] crisis.” During this period, the credit quality of the subprime and Alt-A mortgage declined, while the volume of these loan originations grew from 8% in 2003 to 20% in 2006. The authors argue that

Fannie and Freddie stepped up the purchases of these loans to curry support of lawmakers—particularly Democrats—in the wake of the Freddie Mac’s and Fannie Mae’s accounting scandal in 2003 and 2004, respectively. Representative Barney Frank (D-MA) described his “arrangement” with the companies in a 2003 hearing on GSE reform: “Fannie Mae and Freddie Mac have played a very useful role in helping make housing more affordable... a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing.” The authors wrote, “The hint to Fannie and Freddie was obvious: Concentrate on affordable housing, and, despite your problems, your congressional support is secure. ... If the Democrats had let the 2005 [GSE regulatory reform] legislation come to a vote, the huge growth in the subprime and Alt-A loan portfolios of Fannie and Freddie could not have occurred, and the scale of the financial meltdown would have been substantially less. The same politicians who today decry the lack of intervention to stop excess risk taking in 2005-2006 were the ones who blocked the only legislative effort that could have stopped it.” (*Wall Street Journal*, Charles W. Calomiris and Peter W. Wallison, 09/23/08)

- An October 5th *New York Times* article, Fannie Mae insiders confirmed that Fannie Mae’s management succumbed to pressure from Wall Street firms, Congress and company shareholders for the company to take additional risk in its mortgage portfolio, which pushed the company to the brink of failure. Between 2005 and 2008, Fannie purchased or guaranteed \$311 billion in loans to risky borrowers, more than fivefold the amount the company had made in *all* of its previous years. “We didn’t really know what we were buying,” said Marc Gott, a former director in Fannie’s loan servicing department. “This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears.”
- In an interview, former Fannie Mae CEO Daniel Mudd said he responded as best he could to the company’s challenges and worked to balance Fannie’s risks prudently. “Fannie Mae faced the danger that the market would pass us by,” said Mudd. “We were afraid that lenders would be selling products we weren’t buying and Congress would feel like we weren’t fulfilling our mission. The market was changing, and it’s our job to buy loans, so we had to change as well.” Mudd faced pressure on all fronts to take on more risk. Lenders, such as Countrywide, told Mudd that Fannie was “becoming irrelevant.” Investors also pressured Mudd to take greater risks. “Are you stupid or blind?” screamed an investor, according to a Fannie executive, who heard the call. “Your job is to make me money!” And, lawmakers bore down on Mudd, as Democratic lawmakers demanded that the company buy more loans that had been made to low-income and minority homebuyers.
- However, Fannie Mae’s computer system wasn’t capable of analyzing risky loans, such as balloon-rate mortgage or no doc loans, said several company executives. According to two people present at the meeting, Mudd told employees to “get aggressive on risk-taking or get out of the company.” Mudd said he does not recall the conversation, and said he always stressed taking only prudent risks. A former senior executive for Fannie disagreed, saying, “Everybody understood that we were

now buying loans that we would have previously rejected, and that the models were telling us that we were charging way too little. But our mandate was to stay relevant and to serve low-income borrowers. So that's what we did." Between 2005 and 2007, the company's number of mortgages with less than 10% down almost tripled. As the market for risky loans soared to \$1 trillion, Fannie expanded its presence in "white-hot" real estates markets in California and Florida.

- From 2004 until 2006, Mudd operated without a permanent chief risk officer to help the company manage its risks. When Enrico Dallavecchia was hired as the company's risk officer in 2006, he told Mudd that the company should be charging more for risky loans. Later, Dallavecchia warned that some markets were becoming overheated and a housing bubble had formed, said a person with knowledge of the conversations. But these warnings were rebuffed. Mudd told Dallavecchia that the market, shareholders and Congress all thought the companies should be taking more risks, not fewer, according to a person who observed the conversation. "Who am I supposed to fight with first?" asked Mudd. Dallavecchia was among those fired by Mudd in reorganization in August. In an interview, Mudd said he never made those comments. He said Fannie sought to balance market demands prudently and that executives always sought to avoid unwise risks. "You're dealing with massive amounts of information that flow in over months," said Mudd. "You almost never have an 'Oh, my God' moment. Even now, most of the loans we bought are doing fine." (*New York Times*, Charles Duhigg, 10/05/08)
- On December 31, 2007, Fannie Mae held \$32.5 billion in private label securities (PLS) backed by Alt-A mortgages and \$41.4 billion in PLS collateralized by subprime mortgages. At year-end 2007, Freddie Mac held \$51.3 billion of PLS backed by Alt-A mortgages and \$101.3 billion in PLS collateralized by subprime mortgages. In aggregate, the two GSEs held \$226.5 billion of PLS collateralized by Alt-A (\$83.8 billion) and subprime mortgages (\$142.7 billion) on December 31, 2007. (*Fannie Mae 2007 10K*; *Freddie Mac 2007 Annual Report*)
- In a commentary a *Bloomberg News* commentary, Kevin Hassett wrote, "...The economic history books will describe this episode in simple and understandable terms: Fannie Mae and Freddie Mac exploded, and many bystanders were injured in the blast, some fatally. Fannie and Freddie did this by becoming a key enabler of the mortgage crisis. They fueled Wall Street's efforts to securitize subprime loans by becoming the primary customer of all AAA-rated subprime-mortgage pools. In addition, they held an enormous portfolio of mortgages themselves."
- "...As of last June, Fannie alone owned or guaranteed more than \$388 billion in high-risk mortgage investments. Their large presence created an environment within which even mortgage-backed securities assembled by others could find a ready home."
- "...For the first time in history [in 2005], a serious Fannie and Freddie reform bill was passed by the Senate Banking Committee. The bill gave a regulator power to

crack down, and would have required the companies to eliminate their investments in risky assets. If that bill had become law, then the world today would be different. In 2005, 2006 and 2007, a blizzard of terrible mortgage paper fluttered out of the Fannie and Freddie clouds, burying many of our oldest and most venerable institutions. Without their checkbooks keeping the market liquid and buying up excess supply, the market would likely have not existed.”

- “But the bill didn’t become law, for a simple reason: Democrats opposed it on a party-line vote in the committee, signaling that this would be a partisan issue. Republicans, tied in knots by the tight Democratic opposition, couldn’t even get the Senate to vote on the matter. That such a reckless political stand could have been taken by the Democrats was obscene even then. [AEI fellow Peter] Wallison wrote at the time: ‘It is a classic case of socializing the risk while privatizing the profit. The Democrats and the few Republicans who oppose portfolio limitations could not possibly do so if their constituents understood what they were doing. Now that the collapse has occurred, the roadblock built by Senate Democrats in 2005 is unforgivable...’ (Bloomberg News, Kevin Hassett, 09/22/08)

Underwriting standards? <i>What</i> underwriting standards?

- Credit rating agencies, which had little if any underwriting standards, are also culpable in today’s crisis. Frank Raiter, Standard & Poor’s former managing director [whose unit rated 85% of all mortgage deals at the time] said his agency placed a “For Sale” sign on its reputation on March 20, 2001. On that day, a member of an S&P executive committee ordered Raiter to grade Pinstripe I CDO Ltd, a \$484 million real estate investment that he’d never reviewed. The proposed transaction, which was buying mortgage securities rated by another credit agency, was a form of piggybacking, a practice which violated S&P’s policies. “I refused to go along with some of this stuff, and how they got around it, I don’t know,” said Raiter, 61. “They thought they had discovered a machine for making money that would spread the risks so far that nobody would ever get hurt.” Joseph Stiglitz, the Nobel laureate economist at Columbia University, said, “I view the ratings agencies as one of the key culprits. They were the party that performed that alchemy that converted the securities from F- rated to A-rated. The banks could not have done what they did without the complicity of the ratings agencies.” In the chase for fees and market share, Standard & Poor’s, Moody’s, and Fitch “stamped out” ratings on debt pools, totaling \$3.2 billion for borrowers with bad credit and undocumented income between 2002 and 2007. Today, these “highly-rated,” toxic loans are now being referred to as the so-called NINJA loans—”No Income, No Jobs, Approved! Now, the taxpayers are left footing the bill. (Bloomberg News, Elliot Blair Smith, 09/24/08)

Fannie and Freddie receive subpoenas from the U.S. Attorney and SEC and face formal investigations by the FBI into possible accounting misstatements

- On September 26th, the U.S. Attorney for the Southern District of New York and the SEC issued subpoenas to Fannie Mae and Freddie Mac, seeking documents related to their accounting, disclosure and corporate governance. Freddie Mac said the inquiry by the SEC and a federal grand jury subpoena seeks papers from January 1, 2007 to present. The GSEs have been directed to preserve their documents.
- “Given the mood of the country and the pressure on the FBI, the SEC and Justice Department to hold people responsible, the officers, directors and employees at Fannie and Freddie may have many sleepless nights in the future,” said Frank Razzano, a former federal prosecutor and currently a SEC trial attorney with Pepper Hamilton LLP in Washington. Former SEC enforcement attorney Bryan Sillaman, currently with Hughes Hubbard & Reed LLP, said investigators will scrutinize what the GSEs’ executives knew about the value of their company’s assets, relative to what management told investors about the companies’ overall health. “They’ll check whether those were consistent with what they were communicating,” said Sillaman.
- A Treasury review of the GSEs’ books immediately before FHFA’s September 7th takeover concluded that some accounting methods the companies were using obscured the “low quality” of capital reserves. The FBI has already launched an investigation about possible accounting misstatements by the former executives of Fannie, Freddie and 24 other companies in a probe of the subprime-mortgage market collapse. In recent testimony before Congress, FBI Director Robert Mueller pledged to “pursue these cases as far up the corporate chain as necessary to ensure those responsible receive the justice they deserve.” (*Bloomberg News*, Romaine Bostick, 09/29/08)

Fannie Mae and Freddie Mac

FHFA director Lockhart outlines how his agency
is managing Fannie and Freddie in conservatorship

- In testimony before the Senate Banking Committee, Federal Housing Finance Agency director James B. Lockhart, III described how his agency will manage Fannie Mae and Freddie Mac, as conserved entities. On the first day of the conservatorship for Fannie and Freddie, the businesses “opened as normal,” said Lockhart. As conservator, FHFA has assumed the power of the board and management. The director has named Herb Allison to serve as the new CEO of Fannie Mae and David Moffett to be CEO of Freddie Mac. These executives will receive compensation that is significantly lower than the out-going CEOs. Although it is not necessary in a conservatorship, new boards are being formed at Fannie and Freddie, as a matter of good governance. In light of Treasury’s senior preferred stock facility, FHFA will closely monitor the GSEs’ capital levels, but existing regulatory capital requirements will not be binding during conservatorship, said Lockhart. As SEC registrants, Fannie and Freddie will continue to report their financial results quarterly.
- Since Fannie and Freddie opened as conserved entities on September 8th, FHFA examiners have been continuously on site at both companies’ headquarters and the locations of other key operations facilities to re-assure the firms’ employees that the objective of the conservatorship is “business as usual.”
- During this conservatorship period, FHFA will continue to work expeditiously on the many regulations the agency needs to implement under the Housing and Recovery Act of 2008 (HRA), said Lockhart. “It is critical to complete these regulations so that any new investor will understand the investment proposition,” he said. The GSEs’ new CEOs have been instructed to examine their firms underwriting standards and pricing and to make changes to “reflect both safe and sound business strategy and attentiveness to the Enterprise’s mission [of providing affordable housing].” He has also directed the enterprises to facilitate the loan modification program the FDIC has undertaken with IndyMac Federal. Lockhart added, “I expect the ongoing work on loan modifications being done there, and with other seller servicers, to continue to be a high priority for the conservatorships, both as a matter of good business and as a matter of supporting the Enterprises’ mission.” Lockhart also assured lawmakers that Fannie and Freddie would remain dedicated to—and actively involved in—multifamily lending.
- “I recognize the importance of the Housing Trust Fund to many members of Congress,” said Lockhart. “In the near term, these funds will be used to fund ...the FHA Hope for Homeowners Program, which will be funded by Treasury, if the Enterprises do not.” Under the Housing and Recovery Act of 2008, the FHFA director must consider annually circumstances in which the Housing Trust Fund

allocations would be suspended. “Accordingly, I intend to make that determination only after a careful and through review of existing conditions,” Lockhart told lawmakers.

- Lockhart concluded by saying, “...The decision to appoint a conservator for each Enterprise was a tough one for the FHFA team members... Unfortunately, all the good and hard work put in by the FHFA teams and the Enterprises’ managers and employees was not sufficient to offset the consequences of the [GSEs’] antiquated capital requirements and the turmoil in housing markets. Conservatorship will give the Enterprises the time to build on progress already made, to address more recent developing concerns, and ultimately, to restore the balances between safety and soundness and affordable housing market stability and liquidity. I want to thank the FHFA employees for their work during this intense regulatory process. They represent the best in public service. I also recognize that many employees at each company have been working extremely hard through years of remediation and through the past year of market volatility. Employees have lost personal savings as a result of the plummet in their company’s stock price and they have been working, and continue to work, long hours in the face of uncertainty. To them, I say thank you and pledge that, as conservator, we share the common goal of stabilizing your company while ensuring it continues to serve its public purpose of providing stability, liquidity, and affordability to the mortgage market. Working together we can finish the job of restoring confidence in the Enterprises and with the new legislation build a stronger and safer future for the mortgage markets, homeowners and renters in America.”
(Statement of the Honorable James B. Lockhart III, director of the Federal Housing Finance Agency before the Senate Banking Committee, 09/23/08)
- In a September 25th hearing of the House Financial Services Committee, Fannie Mae CEO Herbert M. Allison and Freddie Mac CEO David M. Moffett testified about their companies efforts to pursue the enterprises’ mission to “support the mortgage market, provide liquidity and prevent foreclosures since the conservatorship began.” Allison told lawmakers, “We are focused on meeting the goals of conservatorship—conserving our assets, restoring sound operations and meeting our mission” through daily communications with FHFA. Allison said Fannie’s top priority was to ensure that the company’s business continued uninterrupted and ensure that everyone knows that Fannie Mae is open for business. During the first three weeks of September, Fannie securitized \$31 billion of single-family mortgages—an amount roughly equal to the company’s securitization during the first three weeks of August in spite of a much more challenging market. Days after the conservatorship became effective, Fannie sold \$7 billion in two-year Benchmark Note securities—the largest debt issuance of its kind in the company’s history—to strong (worldwide) market demand at substantially lower rates relative to pre-conservatorship levels.
- Fannie’s multi-family business continues unabated, said Allison. Fannie Mae’s actions to helping reduce home foreclosures and increase market liquidity include, (1) increasing staff in our servicing operations to work with loan servicers and ensure that as few loans as possible are referred to foreclosure proceedings; (2) increasing

our use of specialty servicers, who are skilled in problem loan workouts; (3) providing bridge loans to nearly 38,000 homeowners, who have fallen behind on their mortgage payments due to serious illness, job loss, or other temporary issues; and (4) providing \$1 trillion of liquidity to the mortgage market through its guaranty and purchases since early 2007, which averages about \$3 billion a day. Allison said Fannie Mae is looking at every aspect of its business with the goal of improving funding, pricing, trading, risk management and foreclosure prevention efforts. He concluded, “Our goals are to align Fannie Mae to deliver on its mission, to develop realistic plans to achieve stability, and to eventually remove the need for government assistance.” (*Statement of the Herbert M. Allison, president and CEO of Fannie Mae, before the House Financial Services Committee, 09/25/08*)

- Moffett told lawmakers, “I consider it an honor to have been chosen to lead Freddie Mac at this critical time. Nothing could be more important to our country’s long-term economic strength than to support the housing markets with a stable supply of low-cost mortgage money. Along with Freddie Mac’s dedicated employees, I am firmly committed to achieving the goals of the conservatorship...—namely, those of market stability, mortgage availability and taxpayer protection. ...While the conservatorship means more coordination with our regulator than in the past, I can tell you that FHFA is responsive and works with us to facilitate decision-making and planning. Moffett reiterated that his company is open for business and that Freddie’s core business has been strengthened by the conservatorship by Treasury’s funding commitment and credit facility. Freddie Mac remains focused on meeting its affordable housing mission and is actively engaged in reducing foreclosures. By working diligently with their servicers to provide borrowers viable workout alternatives, Freddie Mac is on track to enable 83,000 families avoid foreclosure by year-end, said Moffett. (*Testimony of David M. Moffett, CEO of Freddie Mac, 09/25/08*)
- In the midst of the market crisis, foreign investors are taking a wait-and-see stance toward agency debt, said Timothy Bitsberger, Freddie Mac SVP and Treasurer in an interview with *Reuters*. “The whole world is changing ...and the whole financial services landscape is changing. No one is quite sure how it’s going to evolve and how it’s going to end up yet,” said Bitsberger, who was attending the Euromoney conference in Tokyo. “I don’t think we’ve lost investors’ confidence in our debt. I think that all investors want to see clarification and specificity as to what the future is going to bring.” He acknowledged that Asian investors, in particular, have pulled back from the agency market and are on the sidelines “for now.” (*Reuters, Masayuki Kitano, 09/24/08*)

FHFA suspends the capital requirements for Fannie Mae and Freddie Mac

- In a September 12th letter, FHFA suspended the capital requirements for Fannie Mae and Freddie Mac. In the letter the regulator directed the GSEs to maintain positive shareholder equity “in order to reduce the likelihood that our financial position will

trigger mandatory purchases” of preferred stock by the U.S Treasury. (*Bloomberg News*, Dawn Kopecki, 09/18/08)

Fannie and Freddie cancel planned adverse market delivery charge

- On October 2nd, Fannie Mae cancelled its planned 25-basis point increase in the adverse market delivery charge, scheduled to go into effect for whole loan purchases and mortgage loans delivered into MBS with issue dates on or after November 1, 2008. “Our expectation is that this decision to forgo the across-the-board increase in our delivery charges will be passed on to borrowers in the form of lower mortgage costs,” said Fannie Mae president and CEO Herb Allison. “The market has changed substantially since we announced this increase to our pricing in early August. We are evaluating all of our risk-management, underwriting guidelines, pricing and costs in light of these changing conditions. As we move forward, we will seek to balance our responsibility to provide the most market support possible with our obligation to protect the company and its many stakeholders, including taxpayers.” On October 3, Freddie Mac announced that it also would be holding its equivalent fee steady “to help stimulate the [mortgage] market.” (*Fannie Mae Press Release*, 10/02/08; *American Banker*, Harry Terris, 10/03/08)

FHFA publishes a loss mitigation performance ratio
for Fannie and Freddie for the 1st quarter of 2008

- In the FHFA’s Mortgage Metric Report, the agency reported that during the first quarter of 2009, the GSEs’ loss performance ratio was 53%, which consisted of 36,577 mitigation actions that were completed for 68,984 loans for which foreclosure was likely. Fannie and Freddie, combined, offered an average of 12,193 workouts a month, including payment plans and loan modifications, during the first quarter—an increase of 54% above the monthly average for 2007. Fannie Mae and Freddie Mac initiated 36,173 foreclosures a month during the first quarter, 60% more than last year, according to the report. (*FHFA Press Release*, 09/24/08)
- Observers say that Fannie and Freddie have greatly ramped up their loan modification efforts since being placed into conservatorship. "Because of the government takeover, they're getting all the money they need, so they're increasing loan modifications and recasting mortgages based on what the borrower can pay," said Terry Couto, a partner in Newbold Advisors LLC. Jeffrey Garfinkle, a partner at law firm Buchalter Nemer who represents several mortgage servicers, agreed that there’s been "a change in terms of how aggressive they've become at saving borrowers." Garfinkle added, “They are going to extraordinary lengths, spending a lot of time, effort, and money to make loans current and performing, and to avoid foreclosure — even if it's at extremely low rates and converting balloon rates."

- Fannie Mae spokesman Brian Faith said over the past five weeks the company kept 3,100 borrowers from being foreclosed on—roughly 40% of its foreclosed loans which were under review. In addition, 13,847 delinquent at-risk borrowers have received loan modifications and were kept out of foreclosure, representing 80% of at-risk loans that were reviewed, said Faith. Fannie also is reviewing an additional 27,000 foreclosures that have been referred by seller-servicers and, in some instances, is pulling back cases from foreclosure attorneys and returning the loans to servicers for review, he added. “[Fannie servicers] will lower the interest rate below market for a period of time to let a borrower get back on their feet [and] will extend the term to 40 years in some cases to help lower the monthly payment,” depending on the circumstances, said Faith.
- Freddie Mac spokesman Brad German said the company has completed 48,000 loan modifications or workouts by mid-September and is on track to modify a total of 82,000 delinquent loans this year that had been headed into foreclosure. Under the company’s mass modification pilot program, servicers will lower the interest rates by 2 percentage points below a borrower's current rate and extend the term to 40 years. "It is showing an increase in momentum, month to month, as it becomes more embedded within servicer shops," said German.
- Gibran Nicholas, the chairman of the CMPS Institute of Ann Arbor, MI, said a continued drop in housing prices could make many loan modifications moot. "If you just modify the interest rates ... but don't write down the principal, then if the market doesn't recover the borrower will still owe more than the value of their home," said Nicholas. "If housing values continue to decline and there's no recovery over the next five years, then perhaps everyone would have been better off foreclosing. That's the big unknown." (*American Banker*, Kate Berry, 10/02/08)

Subprime and beyond

- In July, the Standard & Poor’s/Case-Schiller 20-city index fell a record 16.3% from a year earlier. Home price declines which occurred in July in many housing markets reflect a historically-recurring mid-summer lull and the sometimes-extreme pressure being exerted on many markets by a growing number of foreclosures, according to data released by Radar Logic Inc. on October 2nd. Twenty-four MSAs of the 25 markets tracked by Radar Logic exhibited an annual price decline during July with Milwaukee reporting the only yearly gain in prices. The highest price declines occurred in California, Arizona, Nevada, and several areas in Florida. According to Radar Logic, the single largest price decline occurred in Las Vegas, where the price per square foot has fallen 33.4% over the past 12 months. Markets with the most severe price declines overall were largely affected by foreclosures. “On one hand, there is the traditional market process in which sellers and buyers negotiate a price and sellers frequently prefer to wait rather than significantly lower their asking price,” said Radar Logic CEO Michael Feder. “On the other hand, there is the foreclosure

sale process in which homeowners, banks and other financial institutions are motivated to sell quickly, so they discount their prices to effect a transaction.”

- For example, 34.3% of all sales in the Los Angeles market were “motivated sales”—a 578.2 % increase from levels seen in July 2007. Radar Logic’s data indicates that distressed real estate sales in Los Angeles average less than \$250 per square foot, while regular retail transactions remain above \$300 per square foot. As REO inventory continues to swell, more traditional sellers will find it increasingly difficult to demand such higher prices relative to bank-owned real estate, say analysts. (*RPX Monthly Housing Market Report*, Radar Logic, July 2008; *HousingWire*, Diana Golobay, 10/02/06; *CNNMoney.com*, David Goldman, 10/02/08)
- According to RealtyTrac, the number of foreclosed homes totaled 91,000 in August, an increase of 18% from the prior year. (*CNNMoney.com*, David Goldman, 10/02/08)
- In August, the HOPE Now Alliance said it helped 189,000 homeowners avert foreclosure, down 1.7% from July. The Alliance permanently modified the mortgage terms for nearly 79,000 at-risk borrowers in August, with a lower interest rate or reduced loan principal or both. An additional 110,000 homeowners, representing 58% of the month’s workouts, were given repayment plans. To date, HOPE Now has helped 2.3 million homeowners since the program’s inception in July 2007. “Without HOPE Now, the current mortgage and U.S. financial crisis would be more serious and harder to turn around, said Faith Schwartz, executive director of the Alliance. “We will continue to work hard to help homeowners and stabilize communities.” (*CNNMoney.com*, David Goldman, 10/02/08)
- Addie Polk, who was facing eviction from the Akron, OH home she had lived in for 38 years, was found by sheriff deputies with a self-inflicted gun shot wound when they attempted to evict her after the residence after Fannie Mae foreclosed on the property. The 90-year old widow survived the shooting and is being treated in a local hospital. Court records show that Polk took out a 30-year, 6.375% mortgage four years ago for \$45,620 from Countrywide Home Loan’s office in Cuyahoga Falls and, on the same day, took out an \$11,380 line of credit, bringing her total indebtedness to \$57,000. In 2004, Polk’s home was appraised by Summit County for \$31,230. Spokesman Brian Faith said Fannie Mae has decided to halt eviction action against Polk and sign the property “outright” to her. “We’re going to forgive whatever outstanding balance she had on the loan and give her the house,” Faith said. “Given the circumstances, we think it’s appropriate.” (*CNN*, Jim Kavanagh, Brad Lendon and Mallory Simon, 10/03/08; *Beacon Journal*, Phil Trexler, 10/03/08)
- As a result of the financial crisis, more than 55% of the commercial banking industry’s assets [as of June 30, 2008] will be concentrated in the hands of the country’s four largest banks— Citi (\$2.1 trillion of assets); JPMorgan Chase (\$2.1 trillion, including its acquisition of Washington Mutual); Bank of America (\$1.8 trillion, which includes Merrill Lynch’s assets); and Wells Fargo (\$1.4 trillion, which includes its proposed acquisition of Wachovia). Collectively, the “Gang of 4” held

approximately \$3.3 trillion of retail deposits, representing 47.6% of commercial bank deposits on June 30th. (*Reuters*, 10/03/08)

- However, Citigroup has filed a lawsuit to block Wells Fargo's acquisition of Wachovia. On October 5th, New York State Supreme Court Justice Charles Ramos issued an order temporarily blocking the \$14.8 billion sale of Wachovia to Wells, which was subsequently set aside by a state appellate court. In an October 3rd statement, FDIC said it "stands behind its previously announced agreement with Citigroup," in which the Bank would absorb up to \$42 billion of losses on Wachovia's \$312 billion pool of loans with FDIC absorbing any additional loan losses. If Citigroup is successful in acquiring Wachovia, 30% of American's bank deposits will be concentrated in just *three* commercial banks—Bank of America, JPMorgan Chase, and Citigroup. Together, these three institutions will be so large that they have the potential to dominate the industry with unrivaled power of setting prices for their loans, deposits, and other services. (*Associated Press*, 10/05/08)
- Citigroup announced it will provide \$1 million of "planning grants" to help nonprofits apply for the Housing and Economic Recovery Act's \$3.9 billion of funding for local communities to acquire, renovate, and sell vacant REO. Citi's grants will enable to nonprofits to "better understand the REO space," said Eric Eve, SVP of global community relations. Grants of \$50,000 to \$100,000 will be available in 12 cities—Oakland, Atlanta, Chicago, Boston, Detroit, Charlotte, Rochester [NY], Cleveland, Columbus [OH], Pittsburgh, and Houston. (*American Banker*, Kate Berry, 09/23/08)
- In September, payrolls fell by 159,000, marking the biggest monthly drop in five years and the ninth month of job contraction. The U.S. unemployment rate held at 6.1%, which is up from 5.0% as recently as April. "We're in this self-reinforcing negative cycle," said Mark Zandi, chief economist for Moody's *Economy.com*. "It's going to be a very significant recession." Economists, such as Goldman Sachs' Jan Hatzius, predict that the unemployment rate may rise to 8%, as the credit crunch restricts corporate growth and impacts consumers. (*Bloomberg News*, Rich Miller and Shobhana Chandra, 10/04/08)

FASB pushes ahead with "securitization killer"
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- According to *HousingWire*, "[On September 15th], the FASB announced the release of three exposure drafts that would amend the accounting and related disclosures for transfers of assets including securitizations, and consolidation of certain off-balance sheet entities — what one market participant has called the 'securitization killer.' In particular, the proposed changes seek to amend two key accounting standards critical to modern securitization: FAS 140, which establishes the concept of a qualifying special-purpose entity, commonly called the Q; and FIN 46(R), which currently provides an exception for QSPEs. Both proposed changes would effectively kill the mechanism for off-balance sheet securitization."

- “Analysts have suggested that as much as \$5 trillion would need to come back on the balance sheets of various financial institutions as a result of the proposed changes, tentatively ‘effective at the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009,’ according to the FASB’s statement. Which would force massive core capital needs at a time when liquidity is, at best, an endangered species; at the very least, regulatory capital ratios would come under severe stress. The Federal Reserve said in a brief statement that ‘federal banking agencies are evaluating the amendments,’ but said little more, beyond alluding to the proposal’s effect on securitization. The primary exposure drafts surrounding FAS 140 and FIN 46(R) are now subject to a 60 day comment period...” (*HousingWire*, Paul Jackson, 09/16/08)
- In a “bluntly worded” speech on September 18th, Robert Herz, chairman of the Financial Accounting Standards Board urged a redrawing of the “highly fragmented, balkanized regulatory structure [in the U.S.]” and suggested he favors a cap on executive pay at \$20 million. “Our financial system architecture has been built up on a patch-work basis and it is time to rethink it,” said Herz, at a technical forum held by PricewaterhouseCoopers. “It really rubs many people the wrong way when the CEO of a large company [is paid \$150 million per year and] then, after he’s run the place into the ground, is given another \$50 million to leave, “ said Herz. “Personally, I am concerned that it may be eating away at the fabric of our capitalist society. I know this may be unreasonable and overly harsh, but I think almost any CEO should be able to get along with \$20 million annually. Call me crazy!” He reminded the audience that his comments were his personal opinion and did not reflect the position of the FASB. (*Bureau of National Affairs*, Steve Burkholder, 09/22/08)

Lawmakers again urge HUD to withdraw its pending RESPA rule

- In a September 16th letter to OMB director Jim Nussle, Representatives Rubén Hinojosa (D-TX) and Judy Biggert (R-IL) urged the Bush administration to withdraw the pending RESPA rule, work with the Fed and other relevant government agencies on a combined rule, and publish a new rule for comment. (*Correspondence to OMB director Jim Nussle*, Representatives Rubén Hinojosa and Judy Biggert, 09/16/08)

SEC seeks authority to regulate credit derivatives
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- During a September 23rd Senate Banking Committee hearing, SEC chairman Chris Cox called for the regulation of certain derivative swaps (CDS)—a \$62 billion market which he said is “overrun” with fraud and contributed to the housing crisis. Cox testified, “Legislation has expressly excluded CDS from regulation, even of the most modest kind—even disclosure. We have a big regulatory hole around CDS It’s vitally important that we regulate this so we can have disclosure, we can have transparency.” Cox added, “The potential for unfettered naked shorting and the lack

of regulation ...are cause for great concern.” The SEC is focusing on CDS in the agency’s investigation of the manipulation of financial institutions’ securities, said Cox.

- Committee Chairman Chris Dodd asked Treasury Secretary Henry Paulson, whether giving the SEC power to regulate credit default swaps should be included in the Emergency Economic Stabilization Act, but Paulson advised against it. “We can’t deal with this immediately,” said Paulson, who argued that the credit default market was too big to risk disrupting with an emergency regulation. Paulson said, “It’s not as simple as saying, ‘let’s regulate it.’ There’s a lot more that needs to be done to focus on this market.” Paulson added that New York Fed President Timothy Geithner is taking measures to regulate the market.
- Cox reiterated that the issue required “urgent” attention, but indicated that he was not seeking to add provisions to the bailout bill. (*American Banker*, Emily Flitter, 09/24/08; *Financial Times*, Joanna Chung and Aline van Duyn, 09/24/08; *Financial Bureau of National Affairs*, Yin Wilczek, 09/24/08)

Fannie Mae

FHFA announces appointment of Philip A. Laskawy to serve as Fannie's non-executive chairman

- Federal Housing Finance Agency director James B. Lockhart announced the appointment of Philip A. Laskawy as the new non-executive chairman of Fannie Mae. Previously, Laskawy served as chairman and CEO of Ernst & Young from 1994 to September 2001. Laskawy joined E&W in 1961, after graduating from the Wharton School of the University of Pennsylvania with a BS in economics, where he became a partner in 1971 and managing partner in 1985. He currently serves of on the boards of General Motors Corp, Henry Schein, Inc., Lazard Ltd., and Lowes Corp. He also serves on the non-profits boards of Dance Theater Foundation and the Educational Broadcasting Corporation (Channel 13-New York). (*FHFA Press Release, 09/16/08*)

Fannie Mae streamlines its management team through the resignation of four executives and revamps its compensation

- On September 22nd, Fannie Mae's CEO Herb Allison announced that Chief Business Officer Peter Niculescu, General Counsel Beth Wilkinson, Chief Information Officer Rahul Merchant and chief lobbyist Duane Duncan had resigned. In a statement, Allison said, "Fannie Mae is building out a new management structure and team as we take the company in a new direction to serve a dramatically changing market." In addition, the company announced that three directors have resigned from Fannie's board, including Leslie Rahl, founder of a New York financial advisory firm; Greg C. Smith, a principal with a Colorado consulting firm; and John Wulff, the head of the board of a Vermont manufacturing concern.
- Fannie Mae also announced that it is ending its performance-based cash payment programs and long-term incentive awards. Instead, Fannie will introduce a new cash reward program designed to encourage employees to stay with the company. Approximately 75% of the funds allocated to the company's performance payment plan will be allocated to the employee retention program. The company's salary and benefits remain unchanged. There has been discontent among some managers at Fannie and Freddie. "We didn't sign up to be public servants," one executive told the *Wall Street Journal*. (*Washington Post, Zachary A. Goldfarb, 09/22/08; Wall Street Journal, James R. Hagerty, 09/20/08*)

Fannie Mae's retained mortgage portfolio grew at an annualized rate of 3.3% in August

- In August, Fannie Mae's retained mortgage portfolio grew at an annualized 3.3% to \$760.0 billion on August 31st, while net retained commitments totaled \$4.0 billion. In August, the company's mortgage-backed securities issuances totaled \$32.1 billion.

Fannie's conventional single-family serious delinquency rate rose nine basis points to 1.45% in July (the latest data available), while its multifamily serious delinquency rate rose two basis points to 0.13%. The effective duration gap of Fannie's portfolio averaged two months in August. (*Fannie Mae Monthly Volume Summary*, August 2008)

Fannie Mae's preferred shareholders sue
the company's former executives and five investment banks

- The California law firm Cotchett, Pitre & McCarthy has filed a law suit against Fannie Mae, claiming class action status on behalf of holders of the company's preferred stock. "We will be filing tomorrow ... against Fannie Mae for preferred shareholders who were told just two months ago, 'Buy the preferred shares, you can never go wrong,'" said attorney Joseph Cotchett. The suit alleges misrepresentations related to a \$2 billion preferred share offering by the company in May 2008. The filing at the U.S. District Court of Manhattan alleged that the defendants made false and misleading statements regarding Fannie's capitalization and assertions by management that the offering would be adequate to see the company through year's end. The complaint names as defendants Stephen B. Ashley, Fannie Mae's chairman; Daniel H. Mudd, the company's outgoing CEO; Stephen M. Swad, its former CFO; and Robert J. Levin, its ex-chief business officer. The complaint also names the offering's five managing underwriters as defendants: units of Morgan Stanley Inc., Merrill Lynch & Co., UBS AG, Wachovia Corp. and Citigroup Inc. (*Reuters*, Gina Keating, 09/15/08; *Dow Jones Newswires*, Chad Bray, 09/16/08)

Fannie Mae tightens its eligibility requirements for loan sellers and servicers

- In a September 16th memo to lenders, Michael Quinn, a single-family risk officer for Fannie Mae, announced that the company is revising and clarifying its eligibility requirements for loan sellers and servicers "to ensure that Fannie Mae's funds are protected and that business partners are capable of fulfilling their obligations." These standards cover issues such as minimum net worth and capital ratios—a change which affect "hundreds of small lenders and servicers, said Joe Garrett, a principal at Garrett, Watts & Co. Now that taxpayers are "on the hook" at Fannie Mae, the company is "being more careful about who they're doing business with," said John Socknat, a member of Weiner Brodsky Sidman Kider PC. "This is all part of their attempt to add greater transparency to their risk assessment analysis." James Deitch, chairman and CEO of American Home Bank, said these minimum capital requirements would give Fannie a cushion for "counterparty risk up front." He added, "The same issues of counterparty risk that we're seeing on Wall Street exist for Fannie and Freddie seller-servicers. What most of these changes are doing is raising the ante [so] that banks and lenders have to have sufficient capital to absorb losses on repurchases." Dan Ferris, SVP of secondary marketing at NetMore America, said he was concerned about the remedies that Fannie suggested for lenders in breach of contract. In addition to requiring more frequent financial reporting,

Fannie Mae may require the lender to indemnify it “for actual and prospective losses [which] ...raises concerns about how they’re going to define ‘prospective losses.’” Ferris also questioned if raising the minimum net worth requirements would necessarily have the desired effect of improving the loan quality. “Guys that have a \$250,000 net worth could actually be a better risk because they can’t afford buybacks—they’d be out of business,” he argued. (*American Banker*, Kate Berry, 09/22/08)

Freddie Mac

FHFA announces appointment of John A. Koskinen to serve as Freddie Mac’s non-executive chairman

- Federal Housing Finance Agency director James B. Lockhart announced the appointment of John A. Koskinen as the new non-executive chairman of Freddie Mac. Previously, Koskinen worked at Palmieri Company, where he served as president and CEO from 1979 to 1993. There, he participated in the restructuring and turnarounds of many companies, including the Penn Central Transportation Company and Mutual Benefit, the largest insurance company in the U.S. to fail. More recently, Koskinen served as the president of the United States Soccer Foundation. He also served as the deputy mayor and city administrator for the District of Columbia, where he was responsible for the operation of all of the city’s departments. Koskinen also worked for the federal government, where he served as deputy director for management in OMB, where he coordinated the work of the chief financial officers, the chief information officers and inspectors general for all government agencies. (*FHFA Press Release*, 09/16/08)
- Freddie Mac also said that board members Richard Karl Goeltz and Stephen Ross resigned from the board on September 22nd; Michelle Engler and William Lewis Jr. on September 23rd; and Geoffrey Boisi, Thomas Johnson and Jerome Kenney on September 26th. (*Marketwatch*, Wallace Witkowski, 09/26/08)

Freddie Mac announces management changes

- Freddie Mac announced that Chief Business Officer Patricia L. Cook, and Timothy J. McBride, SVP, Government & Industry Relations, and Rob Zimmer, VP, Government & Industry Relations have left the company. The company also said that it had fired “without cause” CFO Anthony Pizel and that FHFA has determined that golden parachute payments for Pizel should not be paid. With the departure of the chief executives, Freddie Mac has made changes to its organization structure, effective immediately. The company’s three business lines—Single Family Credit Guarantee, headed by SVP Donald J. Bisenius; Multifamily Sourcing, headed by SVP

President Michael C. May; and Investments and Capital Markets, headed by SVP Gary D. Kain—will report directly to Freddie Mac CEO David M. Moffett. All of Freddie Mac’s credit management activities will be consolidated under a single new position, Chief Credit Officer, reporting directly to Moffett. Raymond G. Romano, SVP, Credit Risk Oversight, will be the acting chief credit officer reporting directly to Moffett while the company conducts an external search. Freddie Mac also has named SVP and Corporate Controller David Kellermann to serve as acting chief financial officer, reporting directly to Moffett, while it undertakes an external search to fill the position on a permanent basis. The company’s Mission Division, headed by Senior Vice President Robert Y. Tsien, will move into its Compliance & Regulatory Affairs Division, headed by Senior Vice President Jerry Weiss. (*Freddie Mac Press Release*, 09/26/08; *Marketwatch*, Wallace Witkowski, 09/26/08; *The Hill*, Ian Swanson 09/26/08)

Lehman Brothers owes Freddie Mac at least \$1.6 billion

- Lehman Brothers Holdings, Inc owes Freddie Mac at least \$1.6 billion in loans and repurchase agreements—with about \$1.2 billion that amount related to unsecured lending transactions that were due to be paid in full with interest on September 15th and \$400,000 in repurchase agreements and servicing related fees. Freddie Mac said it hasn’t received any payments from Lehman yet and “actual losses could materially exceed current estimates.” Fannie Mae has yet to disclose any potential losses related to Lehman’s bankruptcy. [According to the investment banker’s filings, Lehman executed a \$5 billion repurchase agreement with Fannie Mae during the first quarter.] (*Bloomberg News*, Dawn Kopecki, 09/18/08)

Freddie Mac’s retained mortgage portfolio shrinks in August

- In August, Freddie Mac’s retained mortgage portfolio shrank at an annualized 56% to \$560.9 billion, as the company curtailed mortgage purchases to conserve its capital. Year-to-date, however, Freddie’s retained mortgages are still up by an annual 8.3%. The company’s purchase and sales agreements for future months declining \$15.4 billion in August, following a decline of \$324 million in July. Freddie Mac’s delinquencies jumped ten basis points to 1.11% in August.
- According to the *Washington Post*, Freddie Mac’s August report results confirmed what Treasury and FHFA claimed when they placed the company into conservatorship on September 6th: Freddie was sharply cutting back on its role in supporting the mortgage market and facing potentially bigger losses on its loans. (*Reuters*, Lynn Adler, 09/26/08; *Freddie Mac Monthly Volume Summary*, August 2006; *Washington Post*, Zachary A. Goldfarb, 09/27/08)

United Guaranty to submit remediation plan to Freddie Mac

- United Guaranty Residential Insurance Company (United Guaranty) will submit a remediation plan to Freddie Mac for restoring a minimum AA- credit rating within 45 days of Standard & Poor's recent downgrade of the insurer from AA+ to A+ with Negative Implications. After reviewing United Guaranty's remediation plan, Freddie Mac will then determine, at its sole discretion, whether or not to impose additional requirements on the insurer and the nature of those requirements. (*Freddie Mac Press Release, 09/25/08*)

Freddie Mac funds \$548 million multi-family housing debt

- On September 17th, Freddie Mac announced the completion of a \$548 million securitized debt transaction, collateralized with multifamily housing debt—the company's second largest tax-exempt bond securitization (TEBS). The deal, which was completed with Citigroup Inc. unit Municipal Mortgage Holdings Inc, may help ease the market's concern that the government's recent takeover of Freddie and Fannie would force the GSEs to pull back from commercial markets where they have been crucial players during the credit crunch. "When it comes to running our business, we are not missing a beat," said Mike May, Freddie Mac's SVP for multifamily housing. (*Reuters, 09/17/08*)

Freddie Mac's Hoops for the Homeless raises \$600,000

- On September 13th, Freddie Mac raised more than \$600,000 through its Hoops for Homeless to support six local homeless nonprofits in the District of Columbia. (*Freddie Mac Press Release, 09/13/08*)

Federal Home Loan Banks

FHFA plans regulation providing FHLBs temporary authority to use Affordable Housing Program funds to help finance loans in the Hope for Homeowners Program

- In September 23rd testimony before the Senate Banking Committee, Federal Housing Finance Agency director James B. Lockhart, III said, "...I am pleased to report that FHFA expects to have a regulation in place by October 1 to implement Section 1218 of HERA, which provides temporary authority for the Federal Home Loan Banks to use a portion of the subsidy money in Affordable Housing Program to refinance mortgages for families at or below 80 percent of area median income. In broad terms, we intend to issue a regulation implementing this program so that it supports the refinance program in HERA's Hope for Homeowners program by permitting AHP funding of additional principal write-downs or payment of closing costs. We've discussed this initiative with the FHA, which is very supportive of the prospect of added support on this initiative." (*Statement of the Honorable James B. Lockhart III, director of the Federal Housing Finance Agency before the Senate Banking Committee, 09/23/08*)

JPMorgan Chase assumed Washington Mutual's FHLB advances

- On September 25th, JPMorgan Chase announced the acquisition of the deposits, assets, and certain liabilities of Washington Mutual's banking operations. The FHLB-San Francisco has been informed that JPMorgan Chase has assumed the advances outstanding from the Bank to Washington Mutual. (*FHLB-San Francisco Press Release, 09/25/08*)

FHLBs hope to play a bigger role in the MBS market

- The Housing and Recovery Act of 2008 lays the groundwork for the FHLB System to play a larger role in purchasing and securitizing residential mortgages in the future. The legislation, which creates the Federal Housing Finance Agency to oversee the FHLBs, directs the FHFA to conduct a study of "benefits and risks" of allowing the System to securitize mortgages that the Banks purchase from their members. It's a "good time" for the new regulator to examine this issue, said FHLB-Indianapolis president Milton Miller. "With securitization, the FHLBanks will benefit by having a new risk management tool to better manage balance sheet growth, making our programs more reliable and cost competitive with other secondary market purchasers," said Miller. FHLB-Des Moines president Richard Swanson said that the FHLBs don't have to follow the traditional model of guaranteeing MBS. "It doesn't have to be like Fannie Mae and Freddie Mac," Swanson added. (*Mortgage Servicing News, Brian Collins, October 2008*)

FHLB-Chicago introduces the MPF Xtra™

- On September 23rd, the FHLB-Chicago has entered into an agreement with Fannie Mae to offer the MPF Xtra™. The Bank will provide the same infrastructure support and customer care for the new product, which will be similar to the MPF products previously offered by the Bank. The major difference with the MPF Xtra™ program is that the loans sold to the Bank will be concurrently sold to Fannie Mae. Neither the participating members nor the FHLB-Chicago will hold these mortgages in portfolio. There is no credit enhancement for these loans, so there is no risk-based capital requirements for these loans. The FHLB-Chicago's relationship with Fannie Mae will allow its members to access the secondary market at competitive price point that would not otherwise be available due to volume. (*FHLB-Chicago Press Release, 09/23/08*)

Ginnie Mae

Mortgage servicers aren't optimistic that FHA's HOPE for Homeowners program will help many troubled homeowners

- On October 1st, the Bush administration launched the HOPE for Homeowners program to work with struggling borrowers to refinance into affordable, government-backed mortgages. HUD Secretary Steven Preston said, "The [Housing and Recovery Act of 2008] allowed us to begin no earlier than today and we are launching today. We moved very quickly to get a program of this scale and complexity up in such a short period of time. The three-year program is authorized to insure up to \$300 billion in reworked loans, which potentially will help up to 400,000 homeowners, according to CBO. Preston declined to say whether the program would need to be expanded to comply with loan modification provisions that were included in \$700 billion rescue bill. Under the legislation, the Federal Housing Finance Agency will use HOPE for Homeowners to rework loans that are owned or have been securitized by Fannie Mae and Freddie Mac. "If the program is expanded or modified to include more people based on the legislation then we will work hard to expand it appropriately," said Preston.
- In the HOPE program, borrower's payment-to-income ratio cannot exceed 31%, and the debt-to income ratio cannot exceed 43%, for the FHA to insure a new mortgage immediately. Borrowers with higher ratios—of up to 38% for payments and 50% for debt—may still participate in the program, but borrowers must complete a three-month trial period in a new loan before FHA would insure it, said HUD. Some analysts say these stipulations may be problematic. "Some folks thought the credit ratios would have been a little more liberal, particularly in light of the FDIC's

experience with the IndyMac portfolio," said Brian Chappelle, a partner at Potomac Partners LLC. Rod Dubitsky, the head of Credit Suisse Group's asset-backed securities research division, said the three month trial period may result in clashes between the original servicer and the new lender over decision-making authority. "There's a 'he said, she said' potential from the borrower's standpoint," he said. "[The structure] requires the servicer and the FHA lender to work hand in glove." Borrowers are eligible for the HOPE program if (1) the collateral property is their primary resident and the borrower has no ownership interest in any other residential properties; (2) their existing mortgage was originated on or before January 1, 2008 and the borrower has made at least six payments; (3) the borrower is not able to pay their existing mortgage without help; (4) the mortgage monthly payments due are more than 31% of borrowers' gross monthly income as of March 2008; and (5) they certify that they have not been convicted of fraud in the past 10 years, intentionally defaulted on debts, and did not knowingly provide false information to obtain their original mortgage.

- Under the Housing and Recovery Act, it is unclear who will pick up the tab for defaults under the new FHA program. The legislation funnels an estimated \$500 million of new fees to Fannie and Freddie to cover defaults. However, the law allows the suspension of fees if regulators determine that the payments could contribute to Fannie or Freddie being undercapitalized or hinder the GSEs' ability to restore capital. FHFA director James Lockhart said he would make a decision on whether to halt payments after his agency has made a more thorough financial review of the enterprises. "It is certainly something on our radar screen," said a program official. "We have had discussions with Director Lockhart about this issue and we expect to be getting a decision from him very soon." (*Bureau of National Affairs*, Mike Ferullo, 10/02/08; *American Banker*, Emily Flitter, 10/02/08; *HUD Press Release*, 10/01/08)
- In testimony before the House Financial Services, key executives from the nation's largest mortgage servicing shops testified about the recently-passed Hope for Homeowners (HFH) program. Steven Hemperly, senior vice president of real estate default servicing at CitiMortgage, Inc said, "We look forward to the initiation of the Hope for Homeowners program and view it as a useful lending and servicing tool for struggling borrowers." Wells Fargo executive vice president Mary Coffin estimated that 30,000 to 40,000 borrowers might qualify for the Hope for Homeowners program. Coffin added, "We will use this program where it is needed." Bank of America loss mitigation head Michael Gross said his company has actively engaged in forbearances for customers they believe will qualify for the FHA program. "We are proactively contacting ...customers to confirm their eligibility for, and interest in, participating in the [FHA] program," said Gross. "Subject to investor consent and state procedural considerations, we will avoid completing foreclosure sales for the customers identified while the implementing regulations are being drafted."
- HUD commissioner Brian Montgomery assured lawmakers that everything would be in place in time for the HFH program launch on October 1st. Montgomery also alluded to perhaps the program's largest sticking point—second liens. "One of the

greatest challenges to successful loan modifications is obtaining the consent of all existing lien holders, including the holders of junior mortgages,” said Montgomery. HUD is close to proposing rules under the HFH program that would have second lien holders share in the government’s interest in the property, suggested Montgomery. Such a policy wouldn’t sit well with first lien holders—particularly for financial institutions that portfolio their loans. “It seems counter intuitive that the second lien holder moves into a favored position in sharing future appreciation,” said Molly Sheehan, SVP for Chase Home Lending. “We believe it would enhance the success of the program were a similar incentive provided to the first lien holders.”

- Montgomery also warned lawmakers that his agency’s FHF program would have a higher interest rate than other comparable loan programs — which would seem to undermine the program’s intent to make mortgages more affordable for troubled borrowers. “Given the distressed nature of the borrowers likely to participate in the program, as well as the 1.5 percent annual mortgage insurance premium mandated for HOPE for Homeowner loans, early indications are that HOPE for Homeowner loans likely will have a higher interest rate than other FHA-insured products, including FHA Secure, because they will cost more than standard FHA loans,” said Montgomery.
- According to *HousingWire*’s sources, mortgage servicers believe that the new FHA program will have less impact than lawmakers hoped. Other servicers provided similar estimates, but said the total number of loans pushed to the program would likely end up being lower. “We do believe, based on our experience of the last year and a half, that the numbers of borrowers who ultimately take advantage of the program could be lower than the number that preliminarily qualify, as there may be several crucial barriers to the program’s widespread use,” said Molly Sheehan. (*HousingWire*, Paul Jackson, 09/17/08)

HECM loan limit to be increased to \$417,000
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- At a recent Mortgage Bankers Association's reverse mortgage lending conference in Atlanta, FHA Commissioner Brian Montgomery revealed that the loan limit for Home Equity Conversion Mortgages will be increased to \$417,000 and HECM origination fees will be capped at \$6,000. While the new single, nationwide maximum is higher than the current \$200,160 floor and \$362,790 maximum in high-cost markets, the new limit is not as high as some had hoped. Lending interests had lobbied that agency to adopt the new national \$625,000 ceiling on Fannie Mae-Freddie Mac loans, which went into effect October 1st. “We tried to convince HUD that [reverse mortgages] should be tied to the higher limit, but the lower ceiling is still going to be very helpful,” said Daryl Hicks, vice president of communications at the National Reverse Mortgage Lenders Association. While HUD plans for these changes to go into effect on November 1st, the exact date will not be finalized until the agency issues a mortgagee letter on the new loan limit. (*National Mortgage News’ MortgageWire*TM, 10/01/08)

FHA implements policy to stop “buy and bail” practice in mortgage market

- The FHA has moved to stop the so called “buy and bail” practice, where borrowers are buying homes for less money and then immediately default on their current residence. In a Mortgagee Letter, the FHA said, “FHA and others in the mortgage industry have observed an increasing number of homeowners who have chosen to vacate [i.e. default on] their existing principal residence and purchase a new residence.” Under the guidance, underwriters can’t [any longer] consider rental income from a property being vacated in most circumstances, and must ensure that the homebuyer can manage payments on of the full debt service of both mortgages—at least temporarily, while the FHA establishes a permanent set of measures to address the trend. This guidance applies even in situations where the FHA has not insured the mortgage to be “bailed” on, said the letter. Exceptions to FHA’s temporary rule include formal relocations and situations where the homebuyer has sufficient equity in the vacated property with an loan-to-value of 75% or less. (*HousingWire*, Paul Jackson, 09/24/08)

Ginnie Mae tightens its requirements for new issuers of FHA mortgage originations

- Citing “recent industry and market conditions,” Ginnie Mae said it will double its minimum net worth requirement for issuers in single-family MBS and HMBS programs effective October 2009, said EVP Michael Frenz. All new issuers will now be subject to a one year probationary period, starting on first issuance or upon the acquisition of a Ginnie Mae servicing portfolio, said Frenz. The agency will conduct an onsite review six months into the probation period and the issuer will have to resolve any deficiencies before they end of the 12-month period. “During this time, Ginnie Mae will closely evaluate performance metrics, including, but not limited to loan level insurance statistics, delinquency levels and early payment defaults.” Said Frenz. “Delinquencies and insurance rates must remain beneath our established thresholds.” (*HousingWire*, Paul Jackson, 07/17/08)

International Markets

Contagion spreads in Europe

- In the October 1st *RGE Monitor's Newsletter*, economist Nouriel Roubini wrote, “The risk of a total systemic meltdown is now as high as ever since the credit crunch is gripping European banks as well. In the past four days, the governments of no less than seven European countries were required to nationalize banks or guarantee the deposits of large cross-border banking institutions. The exposure of European banks is threefold: first, as direct buyers of ABS based in U.S. originated assets; second, there is substantial credit enhancement for EU banks provided by AIG and U.S. based monolines; and third, because of the bursting of domestic housing bubbles in UK, Ireland, Spain, France, emerging in Europe with a 2-year lag with respect to the U.S.” (*RGE Monitor's Newsletter*, Nouriel Roubini, 10/01/08)
- After days of “squabbling,” the leaders of Europe’s largest economies vowed on October 4th to work together to stop the growing financial panic but failed to develop a system-wide answer to the credit crisis. The leaders of France, Germany, Britain and Italy pledged to prevent bankruptcy, which brought down Lehman Brothers. “We are fully aware of the responsibility that weights on our shoulders,” said Sarkozy, who hosted the meeting. The leaders stopped short of calling for an overarching banking regulator for Europe, but proposed the creation of a panel of EU regulators to jointly oversee large financial institutions with operations in different countries. (*New York Times*, Nelson D. Schwartz, 10/05/08)
- On October 5, the German government moved to back Hypo Real Estate with a \$50 billion euro rescue package, after a \$35 billion rescue package fell through. German Chancellor Angela Merkel also moved to guarantee deposits held by German banks. (*MarketWatch*, Tom Bemis, 10/05/08)

Farm Credit System / Farmer Mac

Farmer Mac is rescued by five FCS banks’ injection of \$65 million of capital

- Five Farm Credit System banks injected \$65 million of new capital into Farmer Mac to enable the GSE to meet its September 30th capital requirement. In September, Farmer Mac’s capital fell below its \$180 million regulatory requirement, after the GSE wrote off its \$44 million on its investment in Fannie Mae Preferred Stock and \$60 million investment in Lehman debt securities. The Farm Credit Systems’ five banks—AgFirst FCB, AgriBank, FCB, CoBank, ACB, Farm Credit Bank of Texas and U.S. AgBank—purchased in aggregate \$60 million of senior cumulative perpetual preferred stock of Farmer Mac. Zions Bancorporation [Salt Lake City,

UT], which has owned 20% of Farmer Mac's outstanding shares, purchased an additional \$5 million of the cumulative perpetual preferred stock. The new issue pays an initial 10% dividend for the first year with the rate increasing 2% in each of the first three years and remains fixed thereafter. The stock, which is senior to all other Farmer Mac capital, can be repurchased by Farmer Mac in the future with cash or qualifying assets.

- As part of the recapitalization, Farmer Mac replaced CEO Henry D. Edelman, who has held this position since it was created in 1989. Edelman is succeeded by Michael A. Gerber, the CEO of Farm Credit of Western New York, who will serve as interim CEO. In addition to Gerber's appointment, Farmer Mac has formed a new executive committee of the Board, consisting of Gerber, Lowell Junkins, the Acting Chairman of the Board, and Dennis Everson, President of First Dakota National Bank, Agri-business Division, which will deal with the GSE's operations, capital structure and transition issues, including the search for a permanent chief executive officer. The FCS banks will also have the right to nominate three observers to Farmer Mac's board of directors. Following news of the recapitalization of Farmer Mac, the GSE's nonvoting Class C shares jumped 66%—or \$2.69—to \$6.79 a share. Shares had fallen 86% in September, following the announcement of the GSE's investment write-offs. (*Wall Street Journal*, Scott Kilman, 10/02/08; *Bloomberg News*, 10/02/08; *RTT News*, 10/01/08; *Business Wire*, 10/01/08)
- On October 1st, Farmer Mac issued and reported to the Farm Credit Administration's Office of Secondary Market Oversight its capital surplus number for the quarter ended September 30, 2008. As a result of the agency's successful issuance of \$65 million of preferred stock, Farmer Mac reported a quarter-end capital surplus of approximately \$29 million above its minimum statutory requirement. (*FCA Press Release*, 10/01/08)

Mark Keenum nominated to serve on the FCA board

- The Bush administration has nominated Mark E. Keenum, the under secretary for farm and foreign agricultural services at the U.S. Department of Agriculture, to serve on the board of directors of the Farm Credit Administration. On September 24th, Keenum said during his confirmation hearing, "With the turmoil our nation is currently facing in the financial markets coupled with the historic uncertainties of the agricultural economy, it is more imperative today than ever to ensure that the Farm Credit Administration continues its diligence of a strong surveillance system in its regulatory and examination challenges." He told lawmakers, "If commodity prices were to decline to near historic levels, debt payment capacity would be seriously affected and the [Farm Credit] System's credit risks would increase. Going forward, agricultural producers face increasing risk of a squeeze in their cash flows due to the volatility of commodity prices and ... rising costs."

- “The Farm Credit Administration plays an important role in ensuring the delivery of safe, sound, and dependable credit and related services to rural America,” said Senator Saxby Chambliss (R-GA). “The credit crisis affecting many financial institutions and national and international markets may challenge the Farm Credit Administration; however I believe the agency is up to any challenge the markets may throw its way today or in the future. Dr. Keenum has dedicated his life to agriculture and I am confident he will continue to focus the agency and the Farm Credit System on fulfilling its mission in a safe and sound manner.” Senator Chambliss also warned that banks and FCA members should not make land loans based on the current historically high commodity prices. The agricultural sector must be “very careful that we don’t fall in the ... same trap that the subprime folks have gotten this market into,” added Saxby. (*National Journal’s CongressDaily*, Jerry Hagstrom, 09/25/08; *Farm Futures*, 09/25/08; *Reuters*, Christopher Doering, 09/24/08)
- “The fallout from the general financial malaise is being felt worldwide, especially in countries that may be already facing slowing economies due to the high price of energy,” said Terry Francel, an economist for the American Farm Bureau Federation. “This will most likely moderate the demand for agriculture products and ingredients, reduce the demand for U.S. agricultural exports and ultimately affect U.S. farm prices. Likewise, a slower domestic economy would also weigh on the demand for farm commodities and prices. Fertilizer prices have basically doubled in the past two years and continue to rise. Farmers are currently being asked to make commitments for their 2009 fertilizer needs and to pay a substantial portion of that commitment, sometimes 100% up front. The credit function of these transactions is being shifted from the fertilizer producers and retail dealers to the farmers. The net result is that it increases the farmer’s cost. The net impact of either the higher cost or lower prices is the same—less income for farmers. There are many factors other than just credit availability affecting the returns to U.S. agriculture, but the current financial instability simply serves to exacerbate the already volatile input/output price situation. So the sooner action can be taken to stabilize the credit market the better it will be for agriculture and the country as a whole.” (*Feedstuffs*, 09/26/08)
- Eleven major farm groups wrote to USDA Secretary Ed Schafer last week, asking for USDA assistance to forestall a potential liquidity crunch in the agribusiness sector should commodity prices rise later in the year. The groups argue that USDA is authorized under laws such as the Commodity Credit Corporation Charter Act to establish a temporary loan guarantee program that would ensure efficient marketing of farm commodities in the event of liquidity problems. The letter’s signatories included American Farm Bureau Federation; American Soybean Association; National Association of Wheat Growers; National Corn Growers Association; National Cotton Council; National Council of Farmer Cooperatives; National Farmers Union; National Grain and Feed Association; National Sorghum Producers; U.S. Rice Producers Association, and USA Rice Federation. (*Pork Magazine*, 09/18/08)

Does the government's nationalization of Fannie and Freddie
have any short- and long-term implications on the FCS?

- In a September 24th press release, the Farm Banks Credit Funding Corp (FBCFC) said, “The financial position of the [FCA] system, including its capital levels and credit quality, is strong, supporting the system’s AAA credit rating” and that the agricultural economy is strong. FBCFC also said that federal government’s takeover of Fannie Mae and Freddie Mac “has no direct impact” on the farm credit system and that the farm credit system has its own insurance fund and will not have access to the GSE Credit Facility being established to help Fannie and Freddie. Todd Van Hoose, senior vice president for government affairs at the Farm Credit Council, noted that the problems in the credit markets might result in higher borrowing costs for farm credit institutions. (*National Journal’s CongressDaily*, Jerry Hagstrom, 09/25/08)
- In the September issue of *Farm Credit Watch*, Bert Ely wrote, “The federal takeovers of Fannie Mae and Freddie Mac have dramatic implications for FCA’s regulatory responsibilities... Although agriculture is strong today and farmland prices are rising, similar to the 1970s, the FCS could stumble again. To reduce the likelihood of another FCS taxpayer bailout, the FCA should tighten its regulatory reins by withdrawing the pending off-farm investment regulation, ending the so-called ‘pilot program,’ and unwinding the program’s investments.”
- “Of much more immediate relevance was the government’s protection of principal and interest on subordinated debt Fannie and Freddie had issued. Because subordinated debt is considered to be quasi-equity risk capital, it can be counted as regulatory capital. An institution’s asset size, in turn, is a function of its regulatory capital -- the more capital it has, the larger it can grow. Issuing subordinated debt is especially valuable for cooperatively owned institutions, such as the FCS, as it allows them to grow faster. For example, CoBank, an FCS bank, issued \$1 billion of subordinated debt since 2006 as it grew its assets nearly 50% to meet higher loan demand. Government protection of Fannie’s and Freddie’s subordinated debt strongly suggests that FCS subordinated debt would be protected from loss, too, should the FCS experience another financial crisis. Therefore, FCA should immediately exclude all subordinated debt issued by FCS institutions from being treated as capital under any of the FCA’s capital regulations.”
- “The intense debate over the fate of Fannie and Freddie, including possibly privatizing or dissolving them, should trigger a comparable debate over the future of the FCS. Given the evolution of rural finance in recent decades and the broad availability of credit from many sources in rural America, there no longer is a need for a GSE supposedly dedicated to financing farmers, ranchers, and their closely related activities, especially a GSE increasingly focused on showering its substantial tax and credit subsidy on rural America’s strongest borrowers. In reports I have written for the ABA, I presented specific proposals for privatizing the FCS while redirecting its subsidy to those farmers most in need of them. As the committees most directly involved with GSE issues, the Senate Banking and House Financial

Services Committees should extend their deliberations over what to do with Fannie and Freddie to include the FCS.” (*Farm Credit Watch*, September 2008)

FCS continues its push to expand the system’s “off-farm” activities and investments

- In *Farm Credit Watch*, Bert Ely wrote, “...Despite strong warnings from the leaders of the Senate Banking and House Financial Services Committees that the FCS needs to rein in its off-farm lending and investing activities, the FCS presses ahead, with strong FCA encouragement, to expand its off-farm activities. In recent weeks the FCS and the FCA have twice demonstrated how out of touch they are.”
- “First, Carolina Farm Credit (CFC), which serves western North Carolina, in the Spring 2008 issue of its shareholder magazine, carried an article headlined ‘Rural America Bond Program Saves 75 Jobs in North Carolina.’ The article reported that CFC’s ‘second Rural Bond’ (amount unstated) was ‘made to Hygiene Systems of Richmond County, N.C.’ to purchase the assets of a bankrupt business. Hygiene Systems ‘is a paper converting company that makes commercial paper towels, toilet paper and paper rags for garages and shops.’ As a manufacturer, Hygiene clearly makes products for which there is a market demand and it obviously provides employment in a rural area, but there is no connection between Hygiene’s manufacturing activity and agriculture.”
- “CFC justifies this investment by stating that ‘agriculture is now dependent on the success of rural America.’ Apart from the questionable logic of that statement, Congress clearly rejected this rationale when it refused to expand the FCS’s off-farm lending powers when enacting the current Farm Bill. CFC further attempted to rationalize its Hygiene investment by citing a portion of the preamble to the Farm Credit Act governing the FCS: ‘and to provide for an adequate and flexible flow of money into rural areas.’ However expansive that may seem, it is trumped by the Act’s restrictions on FCS lending, specifically ‘to farmers and ranchers and their cooperatives, for rural residences, and to associations and other entities upon which farming operations are dependent.’ No one can argue with a straight face that farming operations are dependent on Hygiene Systems. This is a company a taxpaying bank would finance.”
- “Second, FCA staff presented a ‘Mission Investments Update’ to the FCA board of directors on September 11. After giving a questionable legal justification of ‘mission investments,’ FCA staff reported on the status of its ‘pilot program’ for mission investments, such as the Rural Bond that CFC used to finance Hygiene. As of June 30, Pilot Program debt securities of the type used to finance Hygiene totaled \$328.3 million while FCS equity investments accounted for another \$1.9 million. These pilot program investments are up from \$77.8 million eighteen months earlier. Clearly this pilot program is anything but—it represents a major broadening of FCS lending disguised as investments. Congress should take note.” (*Farm Credit Watch*, September 2008)

Postal Service

Postal Service's "perfect storm"

- In a speech to the National Association of Postal Supervisors, Postmaster General Jack Potter said the Postal Service will lose more than \$2 billion by the end of the fiscal year. "We are struggling," Potter said, as a result of declining mail volume and a weakening economy. "We're in a dynamic situation, with greater losses in volume than we'd expected." He added that his agency needs to do more to "reduce bureaucracy, cut costs and embrace technology." The Postmaster General's comments were similar to those he delivered to the Public Customer Council, in which he warned of a "perfect economic storm" that threatens to further deteriorate mail volume. With fluctuating oil prices, inflation in paper prices and strife in financial markets, Potter said the impact of current economic conditions on his agency is the most difficult since the 1960s. The USPS's financial deterioration is further exacerbated by the impact of email and environmental concerns about direct mail marketing, which has dramatically lowered the agency's mail volume. "But the economy will bounce back—and we have to be ready to adapt," said Potter.
- The USPS reported a net loss of approximately \$960 million in August. While year-to-date revenue was slightly above the same period last year, revenue for August was about 10% below August 2007, despite a 2.9% increase implemented in May. (*National Association of Postal Supervisors Legislative and Regulatory Update*, National Association of Postal Supervisors, 09/18/08)

USPS expects mail volume to be down 9 billion pieces this year

- The USPS will request a 23% increase in its federal appropriation in the next fiscal year as it copes with a dramatic decline in mail shipping this year. The Postal service expects mail volume to be down 9 billion this year, largely because of the downturn in the U.S. economy. The agency is cutting costs by reducing its employees' work hours in an effort to "shore up its business." The Postal Service also is considering moving to 4-day/ten-hour shifts. Postmaster General Jack Potter said his agency will not offer financial incentives with its voluntary early retirement program. "We have to be prudent," said Potter. "In 1992, we paid 46,000 employees a half-year's salary to go, then ended up rehiring 70,000." [That's *not* a typo – the Postal Service "retired" 46,000 employees and then rehired them along with an additional 24,000 employees.]
- On September 23rd, the Postal Board of Governors approved a \$144.6 million appropriation request for the 2010 fiscal year, up from \$117.7 million the USPS requested for the 2009 fiscal year. (www.trafficworld.com, 09/24/08; *National*

APWU's election year message to members

- In an update to members, APWU president William Burrus wrote, "...The 2008 deficit is not the largest the USPS has ever suffered, but for the first time in postal history, the losses cannot be recovered by postage rate increases. The 2006 Postal Accountability and Enhancement Act, which was hailed by many in the postal community as the savior of the Postal Service, may ultimately be the single most damaging factor in its demise. Under the law, the only means for the USPS to recover the losses are: substantial mail volume increases; significant productivity improvements, or invoking the law's 'exigency' clause. (The exigency clause offers an exception to the law's prohibition against increasing postage rates above the rate of inflation; it permits such increases in "extraordinary or exceptional" circumstances.)"
- "Regrettably, there are no prospects for increases in mail volume or for productivity improvements sufficient to offset the current losses. Invoking the exigency clause — in order to increase postage rates more than the rate of inflation—would run the risk of accelerating the transformation from hard-copy communication to electronics. (Industry observers suggest that if postage rates rise too sharply, major mailers would abandon hard-copy communication in favor of e-mail and other technologies.)"
- "To make matters worse, the 2008 deficit of \$2.3 billion is expected to be matched in Fiscal Year 2009 with losses of an additional \$2 billion. This means it will be necessary for the Postal Service to borrow \$5 billion over a two-year period. Although the Postal Service has the authority to borrow up to \$15 billion, far in advance of reaching that limit, the Postal Regulatory Commission, Congress and the next president will be under tremendous pressure to privatize the Postal Service."
- "In response to the financial crisis, the Postal Service has announced a hiring freeze. And, in a meeting with union leaders and management association presidents, the Postmaster General pointed out that 16,000 USPS employees lack the six years of continuous service required to achieve protection against layoffs. The PMG's message was clear: For the first time in our history, postal employees may experience layoffs."
- "This looming crisis is the reason that the 2008 election for president and Congress is so important to postal employees. When serious discussions occur about the future of the Postal Service—and they will—postal unions must have a Congress and a president who understand our concerns. In the face of mounting federal deficits, the nation will decide the future role of the government in providing postal services."

- “As postal employees cast their votes in the 2008 election, protecting our employment must be a decisive factor in the choices we make. This time the decision cannot be based on abortion, guns, terrorism, or experience. This time it’s about your job. And simply put, John McCain favors privatization; Barack Obama believes in public services. The candidates haven’t had an opportunity to vote on postal privatization—yet—but they have voted on the privatization of other federal jobs: Obama voted against the Bush Administration plan to outsource and privatize hundreds of thousands of federal jobs; McCain voted for Bush’s program and voted to privatize federal jobs in 2006, 2004, and 2003.”
- “I know that I cannot tell a member who to vote for. However, it is my responsibility to share with our members what I believe is in their interest as postal employees. I strongly advise you against jumping from a five-story building without a parachute, but if you chose to do so, that is your right. You also have the right to vote for John McCain, but that decision is no different than the decision to jump. This election is about your future as a postal employee. It’s about your job.” (*APWU Burris Update #11-08*; William Burrus, 09/30/08)

The <i>next</i> push for postal reform
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- In a September 30th commentary, Gene Del Polito wrote, “*Who'da think* that after seven successful years of cost-cutting and after the enactment of a new postal law, ...[USPS] once would again find itself stuck between a fiscal rock and hard place? Of course, this time, it's different. This time, no one can blame the leadership of the USPS for not doing their mightiest to trim postal costs to reflect rapidly changing postal realities. So what's the cause of the current fix? Very simply, the largest part of the Postal Service's current financial woes can be found within the Postal Accountability and Enhancement Act of 2006.”
- “Am I saying that Congress passed a rotten postal law? Not at all. What I am saying is that some of the ambitiousness that made up some of the ardor for reform needs to be tempered with fiscal realities that no one could have envisioned. Who would have thought that the nation's fisc would be crippled by a banking crisis that rivaled the days of the Great Depression? Who would have thought that the desire for home ownership would have been at the root of a financial disaster from which the U.S. may take years to recover? But what has all this to do with the Postal Service?”
- “One of the Administration's main objectives in encouraging Congress' enactment of PAEA was to make sure that users of the mail, not the Federal Treasury, would be responsible for paying all the costs of operating a universal postal service. Key among these costs were those pertaining to postal retiree health insurance costs. In PAEA, Congress required the Postal Service (that is, postal users) to make an amortized payment of five billion dollars a year toward the funding of postal retiree health-related obligations. Five billion dollars is a heaping sum in anyone's way of thinking, but, with the eagerness to get a new postal law finally enacted, most of the

supporters of PAEA were willing to pull a Scarlet O'Hara by simply putting off thinking about the issue to another day. Well, with today's financial crises, "another day" has finally arrived, and postal leaders (and postal users) are awakening to the reality, and the challenge, of figuring how to pay an enormous expense without bankrupting the postal fisc."

- "...Far be it from me to say that postal constituents should petition Congress to be relieved of this PAEA obligation. Given the current state of the nation's finances, there is little chance such request would be seriously entertained. There is every good reason, however, to let Congress know that these PAEA funding expectations are a little step with today's fiscal realities. There is absolutely no reason whatsoever why postal officials and customers alike should not be asking Congress to relax the amortization funding schedule to comport a little better with today's realities. For instance, instead of expecting postal users to pony up five billion a year, where would be the crime in asking Congress to reduce that payment by about two billion a year by extending the payment amortization schedule over time. Even if Congress applied at the idea of extending the payment schedule permanently, there's nothing wrong or imprudent with relaxing this payment schedule during these times a great financial distress. In fact, if the USPS' fiscal 2008 payment amounted to three instead of five billion, the USPS would have completed FY 2008 on nearly a break-even basis."
- "So who should make the first call on Congress? Who should be the first to tell the men and women on Capitol Hill that a payment adjustment is in order? Who should take responsibility for drafting the language for a bill that would make this possible? Well, mailers can do it, and, indeed, they should. On the other hand, it's the Governors of the Postal Service who are vested with the responsibility for stewarding our nation's postal system. It would be really nice for them to take the leadership on bringing about this sorely needed postal change." (*Association of Postal Commerce*, Gene Del Polito, 09/30/08)

The Senate confirms Ruth Goldway to the Postal Regulatory Commission

- On October 2nd, the Senate confirmed the nomination of Ruth Goldway to a third term on the Postal Regulatory Commission, expiring November 22, 2014. Goldway was originally nominated by President Bill Clinton in 1998 and re-nominated to serve a second term by President George W. Bush in 2002. (*Bureau of National Affairs*, Adam Snider, 10/03/08)

USPS publishes its five-year strategic plan

- On October 2nd, the UPSP released its five-year strategic plan, called Vision 2013, which focuses on the three main principles of customer service, leveraging the agency's strengths and embracing change. The Postal Service's plan calls for greater customer service, better outreach to customers, and better communications about the

future of the mail industry. The USPS's goals also include improving the agency's utilization of the Internet and encouraging environmentally-sustainable practices.

- The Vision 2013 plan strongly advocates Intelligent Mail that would facilitate tracking mail from pick-up to delivery through the use of barcodes. The IM product, scheduled to launch in May 2009, also will reduce undeliverable mail by updating addresses. According to Vision 2013, "Intelligent Mail has the powerful potential to make mail 'visible' from its creation to delivery. System-wide visibility is the essential next step to improving service and adding value. Intelligent Mail should also be a boon to efficiency. Mailers will know when their mail is sent and received, creating opportunities to improve cash flow, inventory turns, and staffing. Postal managers will use the data to closely align operations to actual mail flows." (*Bureau of National Affairs*, Adam Snider, 10/03/08)

USPS would lose as much as \$10 billion in revenue if all 50 states passed "Do Not Mail" legislation

- According to a study by the Congressional Research Service, the Postal Service would lose between \$4 billion and \$10 billion in revenue, if all 50 states were to pass "Do Not Mail" legislation to curb the delivery of unsolicited advertising mail. In 2008, 12 states have "DNM" bills under consideration in their legislatures. Estimates suggest that \$60 billion is spent annually in the U.S., representing 21% of all advertising dollars spent. According to the Direct Marketing Association, nearly 460,000 people are directly employed by the direct mail marketing industry, along with an additional 3.1 million people who are indirectly employed in jobs affected by the industry. (*CRS Report for Congress: Do Not Mail Initiatives and Their Potential Effects—Possible Issues for Congress*, Wendy Ginsberg, 09/24/09)

Small weekly newspaper takes on the USPS and wins!
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- *The Shelter Island Reporter*, "the official newspaper of the Town of Shelter Island [NY] and the Village of Dering Harbor" with a circulation of 3,000, published a September 25th article about the Postal Service prohibiting post offices from distributing applications for absentee ballots, triggering outrage from the League of Women Voters and members of Congress. Cathy Kenny, president of Shelter Island's chapter of the League of Women Voters, said, "It's disturbing if the U.S. Post office is not open about letting this information flow through their own facility." Senator Charles E. Schumer (D-NY) added, "With a national election less than 40 days away, we should be flooding our post offices and other federal agency offices with absentee ballot applications, not ripping them off the shelves." In response to the public outcry, USPS reversed the policy—a day after *The Shelter Island Reporter* published its article.

- The Postal Service’s reason for allowing voter registration materials in general, but prohibiting applications for absentee ballots, was that while voter registration happens all year, applying for an absentee ballot is more akin to a campaign activity, said agency spokeswoman Joanne Veto. “We believe that encouraging people to register to vote is different from encouraging people to vote, and we see applications for absentee ballots as encouraging people to vote,” said Veto. “We have routinely tried to put into place uniform services in post offices across the country, but we have found that some post offices did have absentee ballot applications and some did not. But now, we’re going to institute a policy making applications for absentee ballots available everywhere.” (*The Shelter Island Reporter*, Cara Loriz, 09/25/07; *New York Times*, Tamar Lewin, 09/27/08)

TVA

TVA’s ability to sell agency debt is uncertain
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- For TVA to build additional nuclear reactors and install pollution controls at existing plants, Congress may have to raise the agency’s debt ceiling. Former TVA chairman Craven Crowell said, “The debt of TVA is a serious problem, and raising the cap above the current \$30 billion limit would be difficult, if not impossible, in the current environment. [The process] would be a highly politicized debate and would bring out people that don’t like TVA and utilities who don’t like TVA competing against them for economic development.” Former TVA chairman, S. David Freeman added, “The debt cap is the one major remaining control Congress has on TVA spending, and I don’t think they will give that up lightly.”
- However, TVA officials insist times have changed over the past 30 years, and that the utility may need to borrow more money over the next couple of decades to meet growing power demands in an increasingly costly power market. William B. Sansom, TVA’s current chairman, said the utility is just beginning to study whether it will need to ask Congress to raise its debt ceiling. Sansom said, “It’s not immediate at all, but I think it’s going to have to be looked at. Right now, what we’re trying to pay down as we build back and our debt is staying pretty even. But we’re still working on nailing down our projections for the future.” TVA president Tom Kilgore said, “As we grow, eventually that debt cap will be a problem. But for Bellefonte, we’re paying down enough (to stay beneath the cap).” TVA’s total debt obligations total about \$25.2 billion, which is \$4.8 billion below the agency’s \$30 billion debt ceiling set by Congress in 1979. The utility’s debt obligations are projected to rise slightly over the next couple of years as TVA spends \$2.5 billion to finish a second reactor at the Watts Bar Nuclear Plant.

- Senator Lamar Alexander (R-TN), chairman of the TVA Congressional Caucus, said TVA’s board has not requested any increase in its debt cap and “my hope would be that we would not have to change TVA’s debt limit.” He added, “For it to be a reasonable request, it would have to be part of a long-term plan. This new (TVA) board is doing a good job of developing a strategic plan, and it is being faced with what every utility is being faced with, and that’s the increased cost of coal, higher costs for building new nuclear power plants and higher costs for air pollution controls as well.” (*Chattanooga Times Free Press*, 09/16/08)

TVA will have to wait for the next Congress—and president—
for two board seats to be filled

- Senator Lamar Alexander (R-TN) conceded today that two nominees to TVA’s board of directors are unlikely to be confirmed by the Senate this year. The nominations of Susan Richardson Williams of Knoxville and Michael B. Beis of Madison, MS have been in limbo for months because of a dispute between Senate Democrats and Republicans over the makeup of the board. “It would be difficult for those to be approved by the end of the session,” said Alexander. “I’m going to keep trying, and there’s no reason they shouldn’t be [confirmed].” (*Knoxville News Sentinel*, Michael Collins, 09/24/08)

TVA urges customers to conserve to minimize rate impact

- Dr. Joe Hoagland, TVA’s SVP of energy conservation, is urging the utility’s customers to conserve their energy uses as a means of coping with a 20% increase in rates that became effective October 1st. The average TVA customer uses 41% more electricity than the typical American household, said Hoagland, who is determined to lessen that disparity. “Certainly, higher rates make everyone more conscious of how they use electricity,” he said. “We think there are some real opportunities to promote more energy efficiency and to help lessen the amount of expensive power that we have to generate or buy during peak periods.” Hoagland heads TVA’s \$99 million conservation program, whose goal is to cut energy demand by at least 1,400 megawatts—the power generated by one nuclear reactor—by 2012. (*Chattanooga Times/Free Press*, 10/01/08)
- In an October 4th editorial, the *Daily Journal* [of Northeast Mississippi] wrote, “TVA’s 20 percent rate increase this week challenges its more than 8.8 million customers...to use conservation measures and energy-efficient practices to control rising utility costs. ...The rate increase, approved in August by TVA’s independent and autonomous board of directors, comes on the heels of sharply rising electricity production costs, driven by coal and natural gas prices plus a prolonged drought that has diminished hydroelectric capacity. The rate rise is forecast to add \$15.80 to \$19.80 a month to the average residential bill; variations will be driven by both

consumption factors and, to a lesser degree, by local utility board, district or co-op pricing. The increase is TVA's largest in 30 years.”

- “The rate increase ...could not come a worse time in relation to public concerns about the national economy and direct household impacts. It is particularly problematic in the context of the nationwide financial crisis, which could threaten many jobs, pensions and assets in a complex web of squeezed credit and marketplace excesses. Consumers everywhere are justifiably concerned about rising prices for basic goods, including electricity, and adding another layer for higher, and uncertain, gasoline costs.” (*Daily Journal*, 10/04/08)

A fallen hero

- A Nashville [TN] TVA worker is the latest casualty in the war in Iraq. On September 17th, Darrick D. Wright, 37, died from a massive heart attack in Baghdad, while serving in Operation Iraqi Freedom for the U.S. Army Reserve as a captain in the Engineering Brigade. This was Wright’s second tour of duty in Iraq, as a member of the 926th Army Reserve Unit based out of Alabama. In October 2000, Wright joined TVA as an electrical engineer. He is survived by his wife, Katina, who is expecting their first child. (*WSMV* [Nashville, TN], 09/19/08)

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