

The **GSE** REPORT™

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Major Events

U.S. implements bold actions to strengthen the financial industry
and restore market liquidity

Treasury announces in \$125 billion commitment for the equity purchase plan

Experts' reaction to the administration's actions

And the editorial boards add their 2¢

Credere...

U.S. implements bold actions to strengthen the financial industry and restore market liquidity

- On October 13th, President George W. Bush announced four new measures his administration is taking in coordination with the G7 to for strengthening the financial industry and to provide new liquidity to the financial markets.
- First, the Treasury Department is investing \$250 billion in the banking system to help institutions unfreeze lending and spur economic growth. Commercial banks, savings and loans, and some holding companies may elect to apply for a preferred, stock investment by the U.S. Treasury. The government's senior preferred shares will be non-voting, transferable stock, which will count as Tier 1 capital. The shares will pay cumulative dividends at a rate of 5% annually for the first five years and thereafter an annual rate of 9%. In addition, the government's shares also will have warrants to purchase common stock with an aggregate price equal to 15% of Treasury's senior preferred investment. While participating financial institutions can continue paying dividends to shareholders [so long as they continue to pay dividends to the government], they will not be able to increase their dividends to shareholders or repurchase common stock for a three year period. Institutions that sell the preferred shares to Treasury also will agree to the following restrictions on executive compensation [so long as Treasury owns the shares]: (i) the Board will certify that the contracts of the top five executives do not encourage or reward risk-taking; (ii) any compensation payments made based on earnings, gains, or other criteria, which are later proven to be materially inaccurate, must be repaid; (iii) no golden parachute payments will be made; and (iv) and Board agrees not to deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive. Treasury's short-term investment in financial institutions will ensure the viability of America's banking system by allowing healthy banks continue to make loans to businesses and consumers and by helping struggling banks replenish their capital base so they can resume lending.

- Second, FDIC will temporarily guarantee the senior debt of all FDIC-insured institutions and their holding companies for a three-year period and insure fully deposits in non-interest bearing deposit transaction accounts. The guarantees, which will cover as much as \$1.9 trillion of debt and funding, will put government support behind interbank lending, which has virtually ceased, and reassure large depositors that their accounts are safe. All FDIC-insured institutions will be covered by the guarantees for 30 days without any additional costs. Thereafter, participating institutions will pay the FDIC a 75 basis point fee for new debt protection and an additional 10 basis points to the bank's current insurance assessment to cover the cost for insuring noninterest-bearing deposit accounts. The FDIC's guarantee of debt will expire on June 30, 2009 and its full protection of noninterest bearing transaction deposits will revert to the statutory limits on December 31, 2009. These steps will allow the money to flow more freely among banks, which will improve market liquidity and bring greater stability to the banking system.
- Third, the Federal Reserve will expand its Commercial Paper Funding Facility to include the purchase of commercial paper of three-month maturity from high quality issuers, beginning October 27th. This expansion of the CPFF will help unfreeze the market for commercial paper and help American businesses meet payrolls, purchase inventories, and invest to create jobs. [PIMCO will manage the CPFF's commercial paper assets and State Street Bank and Trust Co. will serve its custodian and administrator.]
- Fourth, in separate actions, the Fed joined forces with the central banks of the U.K., Canada, Sweden and Switzerland to cut interest rates by 50 basis points on Wednesday, October 8th. On October the 13th, the Federal Reserve also announced that it will offer an unlimited amount of dollars to the central banks of U.K., EU, Japan and Switzerland to facilitate the foreign banks' offering unlimited tenders of U.S. dollar funding at fixed interest rates with maturities of seven, 28 and 84 days. "This plan allows the central banks to exchange assets on their books for more liquid assets," said John Silvia, Wachovia's chief economist. "It will then allow institutions that need dollars to conduct the business they need to conduct." Federal Reserve Chairman Ben Bernanke also left the door open for more actions, saying: "Our strategy will continue to evolve and be refined as we adapt to new developments and the inevitable setbacks."
- The Bush administration's actions are designed to significantly strengthen the capital position and funding ability of U.S. banking system and enable the financial institutions to perform their role of underpinning overall economic growth. Bush reiterated that the government's role will be "limited and temporary," adding— "These measures are not intended to take over the free market, but to preserve it." These actions reinforce the U.S. government's commitment to take all necessary actions to unlock the credit markets, to restore the health of the global financial system, and to minimize the impact of the current instability on the overall U.S. economy. These steps also bring U.S. policy more in line with that of the U.K., Germany, France, Spain, and Italy, who also have announced plans to buy stakes in

struggling banks and offer lending guarantees. In a press statement, House Minority Leader Roy Blunt (R-MO), said, “[The administration’s plan] is a national investment in these banks, but it’s nowhere close to the nationalization effort being made in Europe. ...The government is not running banks; it’s taking an investment position in the banks. Hopefully it won’t have to last very long.”

- Congressional leadership applauded the aggressive steps taken by the Bush administration to address the financial crisis. “I am pleased that the administration is now acting more aggressively to address this crisis,” said Senate Majority Leader Harry Reid (D-NV). House Speaker Pelosi called the administration’s moves “steps in the right direction,” while Joint Economic Chairman Charles Schumer (D-NY) said he hoped “this strong approach is the dynamite needed to blast through the clogged-up financial system.”
- In an October 16th interview with the *Wall Street Journal*, FDIC chairman Sheila Bair criticized the federal government for failing to take more aggressive steps to prevent home foreclosures, as part of its moves to stabilize the financial markets. “Why there’s been such a political focus on making sure we’re not unduly helping borrowers but then we’re providing all this massive assistance at the institutional level, I don’t understand it,” said Bair. “It’s been a frustration for me.” White House spokesman Tony Fratto responded, “We just did a massive bill that does a lot for homeowners [through the HOPE for Homeowners Program]. “You are always going to have different views on some specifics on policy. But I think we’re all trying to pull in the same direction.” (*U.S. Treasury Press Release*, 10/14/08; *White House Press Release*, 10/14/08; *Wall Street Journal Online*, Deborah Solomon, Damian Paletta, Jon Hilsenrath, and Aaron Lucchetti, Michael M. Phillips, David Enrich, Daniel Fitzpatrick, Susanne Craig and Robin Sidel, 10/14/08; *Bureau of National Affairs*, R. Christian Bruce, 10/15/08; *CongressDaily PM*, Dan Friedman, Christian Bourge, Humberto Sanchez, and Ben Schneider 10/14/08; *Dow Jones Newswire*, Jessica Holzer, 10/14/08; *The Wall Street Journal’s Real Time Economics Blog*, 10/14/08; *Bureau of National Affairs*, Thecla Fabian, 10/15/08; *CNNMoney*, 10/13/08; *Wall Street Journal*, Sudeep Reddy and Joellen Perry, 10/08/08; *Wall Street Journal*, Damian Paletta, 10/16/08)

Treasury announces an initial \$125 billion commitment for the equity purchase plan

- To jump start the agency’s equity purchase plan, Treasury announced plans to purchase preferred stock in Goldman Sachs Group, Inc (\$10 billion), Morgan Stanly (\$10 billion), J.P. Morgan Chase & Co. (\$25 billion), Bank of America Corp. (\$25 billion, which includes the bank’s pending acquisition of Merrill Lynch), Citigroup, Inc. (\$25 billion) and Wells Fargo (\$25 billion, which includes the bank’s pending acquisition of Wachovia), Bank of New York Mellon (\$3 billion), and State Street Corp (\$2 billion). Although several of the banks’ CEOs weren’t happy about the government taking equity stakes in their firms, the executives acquiesced to pressure from Treasury Secretary Henry Paulson during an October 13th meeting.

- An additional \$125 billion will be allocated to thousands of healthy small and midsized banks, who apply to participate in the program by the close of business on November 14th. Under the terms of the plan, institutions can apply through their primary regulator for a capital injection of up to 3% of risk-based assets. Neel Kashkari, interim assistant secretary of financial stability, said the plan's aggregate \$250 billion of resources being dispensed is sufficient to cover 3% of all banks' risk-based assets. "That means there won't be any rationing," said Wayne Abernathy, the ABA's assistant secretary for financial institutions. "There will be enough for any bank that wants to participate. There's not going to be a need for any kind of Oklahoma land rush." Institutions not eligible to participate in the program include foreign banks, insurance companies, credit unions, mutual thrifts and mutual holding companies, and approximately 2,500 banks that are organized as subchapter-S corporations, which are unable to issue preferred shares.
- On October 19th, *The American Banker* reported, "[S]ecurities and accounting regulators are poised to clarify that warrants issued to the government by banks taking part in the Bush administration's recapitalization efforts can be recorded as equity. The move would settle one of the final hurdles to the Treasury Department's plan to boost the banking system's capital levels by taking equity stakes in nine financial institutions. In a draft letter to David Nason, the Treasury's assistant secretary for financial institutions, top officials from the [SEC] and [FASB] said they would not object 'if the warrants ... were to be classified as permanent equity.' The draft letter, obtained by *American Banker*, was signed by James Kroecker, the SEC's deputy chief accountant and Russell Golden, the technical director at FASB. The decision should resolve technical problems that surfaced on Friday when many bank executives determined that the warrants would be treated as liabilities under generally accepted accounting principles."
- Mark Fitzgibbon, the director of research at Sandler O'Neill & Partners LP, expects many community banks to take advantage of the Treasury's plan, whether they need the capital or not. "If you are a company in need of capital, this ... may be your only opportunity to raise capital," said Fitzgibbon. Healthy banks might be willing to sell shares to the government and use the proceeds to fund acquisitions, he added. "I think this will accelerate the pace of consolidation," said Fitzgibbon. "The nine [large banks] that took the capital and the ones that take it after are likely to be more acquisitive. I think the government will orchestrate those transactions behind the scenes."
- While the equity purchase plan initially focuses on healthy institutions, Treasury also wants another equity purchase plan (EPP) that would offer direct assistance on a case-by-case basis to prevent "systemically significant failing institutions" for going under. Officials are discussing the possible expansion of the EPP with Treasury possibly seeking an additional \$100 billion in funding—over and above the agency's \$250 billion commitment—which would dedicate half of the \$700 billion rescue program enacted by Congress to the EPP. In a press conference, Senate Banking Committee chairman Christopher Dodd (D-CT) said that the remaining \$350 billion of available

bailout funds could be authorized by Congress between now and mid-November, if necessary. Dodd also argued that institutions participating in the EEP, should take a more active role in minimizing foreclosures. Dodd said he told Paulson: "...[I]f we're going to be taking equity positions in these lending institutions, that the very least we can do is insist that they mitigate the foreclosures that they may have an ability to affect.' And my hope is they'll insist on that." Dodd also said he plans to offer a four-part legislative package during the lame-duck session after the November 4th election, which (i) calls for a temporary moratorium on foreclosures; (ii) bans unfair and deceptive mortgage lending practices, in addition to new regulations that prohibit those practices; (iii) reforms credit card marketing and billing practices; and (vi) provides bankruptcy protection to borrowers seeking modification of their mortgage terms. Dodd anticipates that this legislative package may be added to the Democrats' stimulus package, which they plan to push through during the session.

- House Financial Services Committee Chairman Barney Frank (D-MA) said Treasury's issuance of the executive compensation restrictions marks the first time that the federal government has applied such restrictions to top corporate officials. "We will be watching how the Treasury implements these important provisions to ensure that the restrictions are binding and enforceable," said Frank, who predicts that in the 111th Congress "my colleagues and I will seek to build on these measures and apply them more broadly." Frank also suggested that support could grow on Capitol Hill for bankruptcy modifications if foreclosures aren't reduced as a part of the administration's rescue plan. "They have the option of showing us you don't need bankruptcy reform to do foreclosure relief and I hope they take it," said Frank.
- In addition to the restrictions placed on banks by the Treasury investment, Brian W. Smith, a partner with Latham & Watkins LLP and a former chief counsel at the Office of the Comptroller of the Currency, said, "The price that will be paid for all of this injection of capital and the removal of troubled assets of banks' balance sheets will be heightened regulatory scrutiny. I think the banks will see a palpable difference in their contacts with their regulators. ...There will be tightened controls over lending standards [and] heightened emphasis on disclosures and the clarity of those disclosures."
- Joseph Mason, an associate professor of finance at Louisiana State University and former OCC economist, said the potential for the government to direct banks' practices in a new and undefined way is "one of the risks" of its new role as an investor. "Without the standard corporate governance avenue to control through voting rights, we're left to an ad hoc approach," said Mason. "We're kind of inventing a new role for the government in private enterprise, [which could be a] huge potential threat and a potential unintended consequence." Changes made by the government should be made through more traditional channels, he added. "Every financial crisis, this one included, is caused by a lag in regulations," said Mason. "We need to continuously improve regulations going forward, not set it and forget it in the same way. ...We should hope that regulations in general do the job, not the

specific intervention of having to have a government manager look over your shoulder.”

- “Banks are still going to be a little hesitant about lending, particularly to borrowers with lower credit ratings,” said William Isaac, a former chairman of the FDIC. “My hunch is [the economy] will come back faster than we think [it] might, but it’s still something that’ll likely takes months, perhaps a year.” (*Wall Street Journal Online*, Deborah Solomon, Damian Paletta, Jon Hilsenrath, and Aaron Lucchetti, Michael M. Phillips, David Enrich, Daniel Fitzpatrick, Susanne Craig and Robin Sidel, 10/14/08; *Bureau of National Affairs*, R. Christian Bruce, 10/15/08; *American Banker*, Maria Aspan and Kate Berry, 10/15/08; *American Banker*, Alan Kline, 10/15/08; *CNNMoney*, Chris Isidore, 10/14/08; *American Banker*, Steven Sloan and Stacy Kaper, 10/17/08; *CQ Today Online News*, Benton Ives, 10/15/08; *American Banker*, Steven Sloan, 10/19/08)

Experts’ reaction to the administration’s actions

- William Poole, former president of the Federal Reserve Bank of St. Louis, expressed support for the administration’s actions. “Investors need to be confident that the banks they’re dealing with are unquestionably solvent, and it’s in the interest of banks to assure investors that that’s the case,” said Poole. “One way banks can provide that assurance is to raise additional capital, in some combination of private and government capital.”
- Wayne Abernathy, the ABA’s assistant secretary for financial institutions, said, “They [Treasury and the Bush administration] see it as a stimulus. If it works that way it could dwarf any of the stimulus projects that are being contemplated on Capitol Hill. We are talking about capital and every dollar of capital usually results in about \$10 of lending, so if they can get all \$250 billion placed that’s about \$2.5 trillion of new financial activity.”
- Dean Baker, co-director of the [left-of-center] Center for Economic and Policy Research, believes the country may have turned a corner on the financial panic, which has kept banks and investors from making even the most prudent loans. “I think we’re through the worst on that,” said Baker. “Maybe I’ll be proven wrong, but it really was at an extreme last week.”
- “The Europeans not only provided a blueprint, but forced our hand,” said Kenneth S. Rogoff, a Harvard professor of economics and an adviser to Senator John McCain’s presidential campaign. “We’re trying to prevent wholesale carnage in the financial system.” Simon Johnson, a former chief economist of the International Monetary Fund, said, “Over the weekend, I thought it could come out very badly. But we stepped back from the cliff.”
- Lakshman Achuthan, managing director of the Economic Cycle Research Institute, said, “All of this unsticks the credit market, but at best that’s half of the problem. The

other half of the problem is that we're in a recession here and in Europe and Japan." Global recessions are nasty." Job losses are likely to accelerate because of the recent credit problems, which will put more downward pressure on housing prices, regardless of steps taken to minimize foreclosures, he said. If house prices continue to fall, the financial sector will—at best—limp along for the foreseeable future, he added. The government made the right move, said Achuthan, because the alternative would have been much worse. "What we were looking at when credit markets froze up was a recession totally out of control, a recession on steroids."

- On October 14th, the counterparty credit risk in the derivatives market fell sharply after the U.S. government unveiled plans to invest in the banking industry. Overall, the CDS Counterparty Risk Index, which tracks credit-default swaps on leading banks and brokerage firms dropped 68.6 basis points—or roughly 25%—to 210.7 in afternoon trading. If Lehman Brothers were excluded, the Index would be trading below 130 basis points, a level not seen since late June. (*Wall Street Journal Online*, Deborah Solomon, Damian Paletta, Jon Hilsenrath, and Aaron Lucchetti, Michael M. Phillips, David Enrich, Daniel Fitzpatrick, Susanne Craig and Robin Sidel, 10/14/08; *New York Times*, Mark Landler, 10/14/08; *CNNMoney*, Chris Isidore, 10/14/08; *American Banker*, Steven Sloan and Stacy Kaper, 10/17/08; *MarketWatch*, Alistair Barr, 10/14/08)

And the editorial boards add their 2¢

- In an October 15th editorial, the *Wall Street Journal* wrote, "...Despite the risks, directly recapitalizing the banks is likely to prove a better tool than buying up 'troubled assets,' though the Treasury seems on course to do some of that too. Giving banks this additional capital cushion should give them some leeway to sell those assets at market prices without risking insolvency. At the same time, it avoids the vexing problem of how to price securities that the smartest minds in finance are having trouble assigning a value to. And unlike buying dodgy mortgage paper, recapitalizing banks is something the government has done before and knows how to do, more or less. The FDIC has done so from time to time via open-bank interventions, and the Depression-era Reconstruction Finance Corp. recapitalized thousands of banks in the 1930s."
- "...[F]or the program to do the most good, someone needs to make sure that this capital is used to shore up the larger system, not just any banks that wants it, while also protecting taxpayers. In that connection, Mr. Paulson still needs a heavyweight to run this thing. Acting Assistant Secretary Neel Kashkari seems smart and capable, but whether he can resist the imprecations of Congress to use this program to serve its parochial ends is another matter. House Financial Services Chairman Barney Frank is on record as preferring financial institutions that he can bend to his will ...and he can be nasty. It would be a disaster if Congress were able to bully banks into pursuing Congress's priorities instead of rebuilding their balance sheets and exiting the program as quickly as possible... The goal should be to rebuild the financial system so Americans can once again trust their banks enough that government can

then recede to its normal supervisory role. We are under no illusions that government will cede its new powers easily, but if it doesn't the economic damage will be far greater than anything we've seen so far." (*Wall Street Journal*, 10/15/08)

- In an October 14th editorial, the *Washington Post* wrote, "In the disorienting seesaw of the financial crisis, yesterday [October 13th] was an upswing—one of those good days in which stock markets soared, inter-bank lending rates dipped and panic seemed that it might be giving way to concerted government intervention. It was not the first such day, to be sure, but both Wall Street and Main Street had to hope that the day represented more than a breather on the way down. That's because this time, intervention came in the form of massive and unprecedented coordinated action by U.S. and European governments. If the \$2.3 trillion committed to backstopping European banks yesterday, and the emerging plans for the Bush administration to announce parallel measures today, do not restore confidence in markets, it's hard to imagine what will."
- "The relief brought about by the linked steps taken by Britain, Germany, France, Spain, the Netherlands and other governments was pronounced, in part, because it appeared as late as last Friday that such international cohesion might not be possible. British Prime Minister Gordon Brown, who first proposed the twin measures of injecting capital directly into banks and guaranteeing bank debts, was initially rebuffed when he proposed that the remedy be adopted by the Group of Seven nations. Yet on Sunday, the 15 nations in the euro currency zone essentially adopted Mr. Brown's plan, along with other measures, while allowing for differences in implementation. The Fed facilitated yesterday's massive commitment of funds to the European markets by agreeing to make dollars available in unlimited amounts. More important, Treasury Secretary Henry M. Paulson Jr. yesterday appeared to be moving toward harmonizing the U.S. rescue strategy with Europe's. Mr. Paulson is to be commended for showing the flexibility and pragmatism to help fashion what amounts to a global bailout—a necessary response to globalized markets that nevertheless was all but inconceivable a few weeks ago. There will be wrinkles in implementing the global solution from country to country, and the United States has no shortage of them. ...[W]hat's most vital is that the United States fully support and subscribe to the global rescue effort. It had a good first day; whether yesterday's upturn continues will depend in part on whether that international alliance remains solid. (*Washington Post*, 10/14/08)

Crede...

- In the throes of this worldwide economic crisis, French President Nicolas Sarkozy is calling for world leaders to hold a summit by yearend to lay out proposals for a new approach to international and monetary relations. Sarkozy held out the possibility that all is not lost and what is broken can be fixed, by saying: "The financial crisis is not the crisis of capitalism. It is the crisis of a system that has distanced itself from the most fundamental values of capitalism, which betrayed the spirit of capitalism." In a *Wall Street Journal* commentary, Judy Shelton wrote, "...If we are to build a

new foundation for global financial and monetary relations on the scale of the Bretton Woods Agreement conceived as World War II was still raging, we must summon the intellectual depth and political will that can only derive from a strong sense of moral purpose. Give credit to Mr. Sarkozy for demonstrating leadership in attempting to salvage what we know is true—that democratic capitalism is the best hope for mankind—while jettisoning the abuses and fraudulent practices that have distorted the outcomes of free-market competition. The French president’s call for a global summit should be heeded.”

- “What are the basic principles that we can forge together toward this ‘true capitalism’ that Mr. Sarkozy has described, this market economy that utilizes the power of genuine competition to serve the needs of individual producers and consumers? It is a capitalism that accords primacy to the entrepreneur—that compensates hard work, innovative solutions, stalwart commitment and personal discipline. The values that define the character of individuals should find expression in the policies that underpin the legitimacy of governments. Honest capitalism requires the following: [free-market clarity, monetary integrity, financial validity, regulatory responsibility, and entrepreneurial opportunity.]”
- “If we can build a new financial and monetary order to serve the needs of these people—wherever they exist around the world—we will help to bring about the fulfillment of the highest ideals of capitalism. With freedom comes choice; with choice comes responsibility. What is true within one’s own life and one’s own community should be true for the world at large. Integrity matters, competence counts, and earnest effort finds its reward. The Latin root of the word ‘credit’—*credere*—means ‘to believe.’ There is no better starting point for restoring morality to capitalism.”
- “Who would have guessed that it would take a Frenchman to remind us that hope is the limitless source of power that drives the human spirit to create, to improve, to achieve its dreams; it is the greatest civilizing influence in our culture. Yet it was Mr. Sarkozy, speaking before Congress last November, who offered the most profound assessment of our nation’s gift to the world. ‘What made America great was her ability to transform her own dream into hope for all mankind,’ he said. ‘America did not tell the millions of men and women who came from every country in the world and who—with their hands, their intelligence and their heart—built the greatest nation in the world: “Come, and everything will be given to you.” She said: “Come, and the only limits to what you’ll be able to achieve will be your own courage and your own talent. It’s a lesson that should never be lost or forgotten.”’ (*Wall Street Journal*, Judy Shelton, 10/13/08)
- In an October 17th speech to the United States Chamber of Commerce, President Bush reiterated that the government’s actions that have been taken in response to the financial crisis are limited in size, limited in scope, and limited in duration. “We must never lose sight of the enormous benefits delivered by the free enterprise

system,” said Bush. “Democratic capitalism remains the greatest system ever devised. Around the world, free market policies have lifted millions of people out of poverty and given them the opportunity to build a more hopeful life. In the United States, it has given our large and dynamic economy the flexibility and resilience to absorb shocks, adjust, and bounce back.” (*White House Press Release*, 10/17/08)

- On October 18th, President Bush announced he will host an international meeting of the G8 members on the financial crisis “in the near future.” Bush said, “...As we make the regulatory and institutional changes necessary to avoid a repeat of this crisis, it is essential that we preserve the foundations of democratic capitalism—a commitment to free markets, free enterprise, and free trade. We must resist the dangerous temptation of economic isolationism and continue the policies of open markets that have lifted standards of living and helped millions of people escape poverty around the world. This is a trying time for all our nations. I am confident that we will overcome the challenges we face. With determination and focused action, we will weather this crisis, return our economies to the path of prosperity and long-term growth.” (*White House Press Release*, 10/18/08)
- At the October 18th press conference, Sarkozy added, “...[W]e believe that insofar as the [financial] crisis began in New York, then the global solution must be found to this crisis in New York—all of us putting our heads together, we must look on the fundamental rules that will apply to this 21st century of ours. We live in the 21st century, but we continue to apply 20th century rules. Hedge funds cannot continue operating as they have in the past; tax havens, neither; financial institutions that are under no supervisory control -- this is no longer acceptable, this is no longer possible. Together, among friends, among allies, we must be able to say to the world that we are determined to find a solution together, to find answers together. ... Why must we make haste? We must make haste because we must stabilize the marketplace as swiftly as possible by coming up with answers. Once calm has been restored, we must avoid at all costs that those who have led us to where we are today should be allowed to do so once again. We believe in the capacity and the ability of the American people to come up with the answers the world is waiting for, is expecting, because this sort of capitalism is a betrayal of the sort of capitalism we believe in.” (*White House Press Release*, 10/18/08)

TARP

Interim Assistant Secretary Kashkari outlines
how Treasury is building the \$700 billion TARP from scratch

- In an October 13th speech, Interim Assistant Secretary Neel Kashkari outlined how the Treasury Department is building the \$700 billion Troubled Asset Relief Program (TARP) from scratch. Three days after Congress passed the Emergency Economic Stabilization Act of 2008 (EESA) which created the TARP, Treasury Secretary Henry Paulson nominated Kashkari to head the program. Treasury's goal for TARP is a simple one—to restore capital flows to consumers and businesses, said Kashkari. To achieve this goal, the EESA empowered Treasury to design and deploy numerous tools to attack the root cause of the turmoil in the credit markets—illiquid troubled assets.
- Treasury has created seven policy teams to develop the tools and elements that are required for TARP. These teams specifically are developing plans for:
 - a mortgage-backed securities purchase program, which will identify troubled assets to buy and develop the processes to buy them;
 - a whole loan purchase program, which will identify loans held by financial institutions that the government will purchase, how to value them, and how to buy them;
 - an insurance program, which will insure troubled assets;
 - an equity purchase program, which will purchase equity stakes in financial institutions;
 - a homeownership preservation program, which will attempt to help holders of mortgages purchased under the relief program to stay in their homes;
 - executive compensation, which will ensure that firms participating in the plan comply with EESA requirements regarding executive compensation; and
 - a compliance and oversight program, which will ensure that TARP complies with oversight procedures detailed in the EESA.
- TARP's interim team members include a chief financial officer, chief risk officer, chief of homeownership preservation, chief compliance officer, and chief investment officer. Tom Bloom, CFO of the OCC and former CFO of the Commerce Department, is serving as TARP's interim CFO. Jonathan Fiechter, Deputy Director of the IMF Monetary and Capital Markets Department and former board member of

RTC and FDIC, has been tasked to serve as interim Chief Risk Officer. Donna Gambrell, the Director of Community Development Financial Institutions Fund, is serving as TARP's interim Chief Homeownership Preservation. Don Hammond, the Deputy Director of the Federal Reserve Bank Operations and Payment Systems, is the program's interim chief compliance officer. And, Reuben Jeffrey, the Under Secretary of State for Economic Affairs and former Chairman of the Commodity Futures Trading Commission, is the program's interim investment officer. On the operational front, Treasury's Assistant Secretary for Management and CFO Pete McCarthy and his team is working to establish the institutional and logistical framework of TARP.

- Operationally, Treasury has issued procurement documents addressing procurement authorities and procedures; conflict of interest mitigation procedures; small business participation; and asset management selection procedures for the TARP program. Under the department's initial procurement, Treasury is seeking securities asset managers who have at least \$100 billion of dollar denominated fixed income assets under management. Treasury also is asking vendors to demonstrate their commitment to working with small, veteran, minority and women-owned businesses.
- Treasury has begun the process of awarding contracts with the private sector to execute the TARP. To date, Treasury has engaged Simpson Thacher & Bartlett to advise the agency on plans to make equity investments in banks and thrifts. New York partner Lee A. Myerson will lead Simpson Thatcher's representation of Treasury. EnnisKnupp and Associates has been selected to serve as Treasury's investment advisor in the implementation of TARP. Among other things, EnnisKnupp will conduct research on mortgage whole loan managers and on servicing organizations and be responsible for developing and maintaining investment policies and guidelines and assist with oversight of TARP's multiple asset managers. The investment advisor will also identify qualified minority- and women-owned businesses to provide services for portfolio. The Bank of New York Mellon will serve as the master custodian firm for TARP, providing custodial, accounting, auction-management, and other infrastructure services.
- As prescribed by EESA, Treasury has released Executive Compensation Guidelines for participants in the agency's Troubled Asset Auction Program, Capital Purchase Program, and Programs for Systemically Significantly Failing Institutions. These guidelines are available <http://www.ustreas.gov/press/releases/hp1208.htm>.
- On October 4th, TARP's Financial Stability Oversight Board held its first meeting. The board, which consists of the Secretary of the Treasury, the Chairman of the Federal Reserve and SEC, the HUD Secretary, and the director of FHFA, adopted bylaws, reviewed the work-streams and procurement documents. The board also selected Chairman Ben Bernanke to serve as the Oversight Board's chair. The Board also is working with the White House to identify candidates for possible nomination as the Special Inspector General for the TARP program. On October 6th, TARP's management met with Treasury's Inspector General to review the department's work-

streams, procurement and operational plans. The Acting Comptroller General and his staff met with the TARP team to review their activities on October 9th and the GAO staff reviewed the TARP procurement contracts on October 12th.

- Acting Comptroller General Gene Dodaro said his agency has “close to 20” employees overseeing the TARP and that number could grow through the use of independent contractors, if necessary. The GAO, which is required to report to Congress every 60 days about the program’s performance, stands ready to issue an oversight report before that deadline in light of the fund’s \$250 billion injection into banks, announced October 14th. “The legislation [EESA] requires that we submit additional reports if necessary, so we’re prepared to do that as well,” said Dodaro, spoke to the press after a joint staff briefing between his department and the House Financial Services Committee. The session followed Dodaro’s weekend visit to Treasury to review the department’s first group of contracts awarded to the private sector. In an October 8th letter to Treasury Secretary Paulson and Federal Reserve Chairman Bernanke, House Speaker Nancy Pelosi (D-CA) called on Treasury to strengthen the conflicts of interest guidelines governing those hired to manage the program. In a letter to Paulson and Bernanke, Senator Charles E. Grassley (R-IA), wrote, “[Y]our circle of advisors appears to be recruited from Wall Street firms that may have a vested interest in the success of the program.” Grassley asked Paulson and Bernanke to “describe what policies and procedures you have implemented to ensure the independence of your advisors and to prevent any current or future conflicts of interest.” Grassley also questioned if enough was being done to curb high pay and other compensation for executives at companies that benefit from the government rescue. “Despite assertions to the contrary, the executive compensation provisions in [EESA] are turning out to be window dressing rather than a legitimate attempt to prevent golden parachutes and multi-million dollar paychecks for failed leadership,” wrote Grassley.
- House Financial Services Chairman Barney Frank (D-MA) said his concerns about TARP were assuaged for the time being by the meeting with Dodaro. “Sometimes the GAO comes in after the fact,” said Frank. “In this case, with the importance of this, we are expecting that they will be doing contemporaneous overseeing of the lending. I’m pleased to say they are moving that way.” Frank believes GAO is in prime position to mitigate conflicts through its oversight of each contract Treasury executes. Although GAO doesn’t have authority to approve or reject contracts, the agency receives them quickly and “knowing that someone is going to see the contract you’ve signed within a few hours” provides some form of transparency, said Frank. On October 14th, Frank said that he expects his panel and the Government Oversight and Reform Committee, chaired by Representative Henry Waxman (D-CA), to head the oversight efforts of the TARP for the House. Senate Banking Committee Chairman Chris Dodd (D-CT) said he presumed that other panels than his would be involved in oversight activities of TARP, but was not specific. Dodd described a “contemporaneous” monitoring of the program by two staff members, who are assigned to keep tabs on TARP on a daily basis, instead of more conventional oversight activities, requiring reports and monitoring “at the end of all of it.”

- (*Bureau of National Affairs*, Stephen Joyce, 10/16/08; *Treasury Press Release*, 10/13/08; *New York Times*, Eric Dash, 10/15/08; *Wall Street Journal*, Matthew Karnitschnig, 10/14/08; *Treasury Department Press Release*, 10/13/08; *Bloomberg News*, John Brinsley and Vidya Bhaktavatsalam, 10/14/08; *Treasury Department Press Release*, 10/14/08; *Treasury Department Press Release*, 10/13/08; *CQ Today Online News*, Phil Mattingly, 10/14/08; *Bureau of National Affairs*, 10/09/08; *Bureau of National Affairs*, Jonathan Nicholson, 10/09/08; *Treasury Press Release*, 10/14/08)

<p>Treasury seeks public comments on the development of a guarantee program for troubled assets</p>

- On October 16th, the Department of Treasury published a notice the *Federal Register*, requesting for public comment on the development of a guarantee program for troubled assets, as authorized under Section 102 of the Emergency Economic Stabilization Act of 2008. The filing is available on the Internet at: <http://regulations.justia.com/view/123882/>. Comments are due by the close of business on October 28, 2008. (*Federal Register*, Vol. 73, No. 201, 10/16/08)

<p>EESA gives Treasury “extraordinarily broad power”</p>
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- A single provision of the 451-page Emergency Economic Stability Act of 2008 provides Treasury to do far more than many realize, according to legal experts. This provision, which was not scrutinized during the Congressional debate, allows Treasury to use “any other financial instrument” to stabilize the market. “It’s extraordinarily broad,” said Michael Barr, a former Treasury official for the Clinton administration and law professor at the University of Michigan. “I guess conceivably it could include anything.” Mark Flannery, a finance professor at the University of Florida, agreed, saying “It grants the secretary an immense amount of discretion. It’s unprecedented.”
- Observers say that while the bill was designed for financial institutions, it was purposely crafted to allow Treasury to backstop other industries as well. “They could conceivably buy stock in a manufacturing company, said Oliver Ireland, a former Federal Reserve official. “We are still sort of at the front end of corporate defaults, and they have to recognize the sheer magnitude and impact of job creation and job loss,” said Josh Rosner, a managing director at the research firm Graham Fisher. “The answer is they obviously have to be sitting there figuring out how they can actually use these authorities to expand into the corporate sector.” (*American Banker*, Stacy Kaper, 10/17/08)

Bond insurers to propose selling troubled assets to TARP

- Ambac Financial and other bond insurers are working on a plan to submit to Treasury, which would allow the insurers to sell troubled assets to TARP. “We’re working hard to put together a proposal and it’s got to be an industry proposal,” said Ambac CEO Michael Callen. The proposal does not propose that Treasury take a stake in Ambac, added Callen. “We’re not going to be asking the government to give us a big gift.”
- Michael Cox, an analyst for Royal Bank of Scotland Plc, wrote that Treasury’s TARP program to buy troubled assets may allow the two guarantors to dispose of bonds backing collateralized debt obligations that they guaranteed. He added that banks also may be more willing to cancel credit-default swap contracts they bought from bond insurers if the banks can sell the underlying CDOs to the government. (*Bloomberg News*, Christine Richard, 10/16/08)

Fannie Mae and Freddie Mac

Fannie and Freddie are directed to begin purchasing troubled assets

- *Bloomberg News*' Dawn Kopecki reported that Fannie Mae and Freddie Mac have been directed by federal regulators to start purchasing \$40 billion a month of underperforming mortgage bonds, according to three people familiar with the plan. In early October, the companies began notifying traders that each enterprise needs to buy \$20 billion a month of mostly subprime, Alt-A, and nonperforming prime mortgage securities, said sources who asked not to be identified because the GSEs' plans are confidential. Fannie's and Freddie's asset purchases would be separate from Treasury's \$700 billion TARP. The GSEs' purchases would be on top of the \$210 billion of bad debts that the companies currently hold and may be eligible for TARP.
- "For now, [Fannie and Freddie are] under conservatorship and they have to be used to keep the flow of capital going to the housing market," said former Treasury Secretary Lawrence Summers during an interview on *Bloomberg Television's Conversations with Judy Woodruff*. "They're important to maintaining the flow of government finance and need to be used actively," said Summers.
- When the GSEs were placed into conservatorship, Treasury Secretary Henry Paulson said that the enterprises would be allowed to "modestly increase" their retained mortgage portfolios to as much as \$1.7 billion through the end of 2009 and that the companies would no longer be run to "maximize shareholder returns." Less than two weeks later, Fannie and Freddie were told to ramp up their MBS purchases, after the credit crisis deepened and the credit markets seized. In the Housing and Recovery Act of 2008, Fannie Mae and Freddie Mac were also provided access to \$200 billion in emergency financing by the Treasury Department. (*Bloomberg News*, Dawn Kopecki, 10/11/08)
- "So this is why they wiped out shareholders in the GSEs? So the government could use the GSEs to take on toxic mortgage debt?" asked an unnamed ABS/MBS analyst. "The private GSEs would have stayed far, far away from this market, because all it will do is pass losses on to taxpayers via the new GSE conduit." (*HousingWire*, Diana Bolobay and Paul Jackson, 10/13/08)
- During the first eight months of 2008, the GSEs' net mortgage purchases for portfolio exceeded the retained portfolio's liquidations in the mortgage market. Fannie and Freddie appear to have the capacity to purchase, in aggregate, up to approximately \$179 billion of additional assets before reaching their retain portfolio ceilings. The following table summarizes the GSEs' loan origination and sales activities for the eight months ended August 31st, based the latest Monthly Volume Summary

published by Fannie and Freddie. (*Monthly Summary*, Fannie Mae, August 2008; *Monthly Volume Summary*, Freddie Mac, August 2008)

GSEs' Retained Portfolios (\$ in millions)	<u>Fannie Mae</u>	<u>Freddie Mac</u>
Retained mortgage portfolio ceiling	850,000	850,000
Retained Portfolio on 8/31/08	<u>759,980</u>	<u>760,883</u>
“Excess” retained portfolio	90,020	89,117
YTD retained portfolio liquidations	<u>64,499</u>	<u>81,496</u>
Avg. monthly retained portfolio liquidations*	8,062	10,187
YTD retained portfolio purchases	129,498	187,411
YTD retained portfolio sales	<u>28,995</u>	<u>65,845</u>
Net YTD retained portfolio purchases	100,503	121,566
Avg. monthly net retained portfolio purchases*	12,563	15,196

* Average for eight months ended 08/31/08

- In an interview with *Bloomberg News*, FHFA director James Lockhart estimated that Fannie’s and Freddie’s troubled assets total between \$105 billion to \$210 billion, representing 2% to 4% of their \$5.25 trillion assets. In a C-Span interview, Lockhart said, “[Treasury’s] new facility will be looking at troubled loans and will certainly look at the possibility of buying some loans from Fannie and Freddie as well as some securities. Whether they will or not, certainly the decision has not been made.” (*Bloomberg News*, Dawn Kopecki, 10/06/08)
- Although Fannie and Freddie are under government control, FHFA director James Lockhart has said that he wants the GSEs to remain competitive. Lockhart provides both enterprises loose guidelines—such as quantity of mortgages to buy—and lets each firm’s management decide how to accomplish the goal. The director then signs off on their plans and keeps a close eye on their progress. Lockhart has assigned 15 liaisons from his agency, who are paired with each of the members of senior management at the enterprises. Len Reid, a former director at OFHEO [FHFA’s predecessor] who was plucked from retirement, now serves as liaison to CEO Herbert M. Allison, Jr., while Chris Dickerson, a senior FHFA officer, serves as liaison to Freddie Mac CEO David Moffett. (*Washington Post*, Zachary A. Goldfarb, 10/06/08)

FHFA determines that Fannie and Freddie are undercapitalized
and suspends the GSEs' capital requirements

- On October 9th, the Federal Housing Finance Agency designated Fannie Mae and Freddie Mac as undercapitalized and indicated that it would suspend the GSEs' capital requirements so long as the companies were operating under conservatorship. Under provisions of the Housing and Recovery Act of 2008, FHFA was provided the discretion to classify Fannie and Freddie as undercapitalized, even if the enterprises meet their statutory requirements for minimum capital. FHFA director James B. Lockhart, III utilized this provision in classifying Fannie and Freddie as undercapitalized on June 30, 2008. In an October 9th statement, FHFA wrote, "Although both Enterprises' capital calculations for June 30, 2008, reflect that they met the FHFA and statutory requirements for capital, the continued market downturn during late July and August raised significant questions about the sufficiency of capital." On June 30th, Fannie had \$9.4 billion more capital than required and Freddie had \$2.7 billion above the requirement, said FHFA. However, the regulator concluded that both companies were undercapitalized, due to "accelerating safety and soundness weakness" of the GSEs with regard to credit risk, earnings outlooks, and capitalization. FHFA noted that Fannie and Freddie were unable to raise capital according to normal practices and prices and had a "growing proportion of intangible assets" on their books. Further, the enterprises also experienced a significant deterioration in equity, debt, and conditions in the mortgage-backed securities (MBS) market, said the agency. "FHFA will continue to closely monitor capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship," said the agency. The regulator concluded that this move was "prudent and in the best interests of the market." (*Bureau of National Affairs*, Mike Ferullo, 10/13/08)
- Fannie Mae and Freddie Mac plan to release their third quarter earnings in November as scheduled, said FHFA. Wall Street analysts project losses for both companies through 2009, according to a *Bloomberg News* survey. In an October 5th interview on C-Span, FHFA director James B. Lockhart, III said it was "hard to predict" when Fannie and Freddie would return to profitability. A lot would depend, said Lockhart, on how well Treasury's plan to buy \$700 billion of distressed assets works. (*Bloomberg News*, Dawn Kopecki, 10/11/08; *Bloomberg News*, Dawn Kopecki, 10/09/08)

FDIC may allow banks to hold more GSE debt

- On October 7th, the FDIC proposed a rule which would significantly reduce the capital requirements for financial institutions that hold bonds and other non-equity debt issued by Fannie Mae and Freddie Mac. The proposed rule would reduce the risk weighting for all credit exposures, including senior and subordinated debt and counterparty credit risk exposures, from 20% to 10%. The rule does not apply to the GSEs' common or preferred shares, which have lost virtually all of their value since

the enterprises were placed into conservatorship on September 7th. The FDIC said, “Agency staffs believe the equity support [of up to \$100 billion] provided by the agreements [with Treasury] significantly reduces the credit risk associated debt and guarantees issued by Fannie Mae and Freddie Mac. As such, the agency staffs have developed a notice of proposed rulemaking to permit a bank organization to assign a 10 percent risk weight.” The reduced capital requirements, would remain in effect so long as Fannie Mae and Freddie Mac remain in conservatorship. The proposal, which has been tentatively approved by the FDIC, the OCC, OTS, and the Federal Reserve System, is subject to a 30-day public comment period.

- Comptroller of the Currency John Dugan expressed concern that the proposed rule does not include the debt of the FHLB System. Dugan argued that the FHLBs may face increased debt costs, if their debt remains subject to the 20% risk weighting. If the FHLBs’ debt isn’t included in the proposed rule, the System’s debt costs—which have risen about 30 basis points above Fannie’s and Freddie’s costs—may increase even more. “[FHLB debt securities were already] trading so far behind Fannie and Freddie,” said Rajiv Setia, a Barclays Capital mortgage strategist. “Not having them analogous ... would solidify the perception that Fannie and Freddie are special and the others aren’t.”
- The proposed rule, which is intended to lower the banks’ capital requirements and allow them to increase their lending and investing, could free up approximately \$15 billion of reserves according to mortgage analysts at JPMorgan Securities Inc. On June 30th, U.S. commercial banks and thrifts held \$875 billion of Fannie Mae, Freddie Mac and Ginnie Mae mortgage-backed securities, according to *Inside MBS & ABS*. Bank of America was the largest holder of Fannie Mae and Freddie Mac MBS (with \$173.2 billion), followed by JP Morgan Chase & Co. (\$75.8 billion), Wachovia (\$60.9 billion) and Wells Fargo (\$44.5 billion). At the end of the second quarter, the top 25 investors among the 50 largest commercial bank holding companies owned more than \$490 billion of the GSEs’ MBS.
- Some Wall Street analysts argue that the FDIC’s proposal just won’t work. Ira Jersey, a U.S. interest rate strategist at Credit Suisse Holdings USA Inc., said the loosening of capital constraints may not spur the boost in purchases of Fannie and Freddie debt that regulators may have been seeking. “Are financials willing to take on more risk just because they have additional capacity?” asked Jersey. “In this environment, they’re unwilling to take on much additional risk. They don’t want to spend capital, they want to preserve capital.” He added that the change should incrementally improve Fannie and Freddie’s funding costs—“just perhaps not what would be hoped.” Paul Miller, a bank analyst at Friedman Billings Ramsey & Co., said, “I know what they’re trying to do, but it’s not going to work. Just go down the list of all these programs that the market rallied on only to lose their steam later because they didn’t solve the underlying problem. People aren’t paying their mortgages and the banks are overleveraged.” (*Bureau of Financial Affairs*, Mike Ferullo, 10/08/08; *Bloomberg News*, Dawn Kopecki and Jody Shenn, 10/07/08)

FHFA plans to announce the 2009 conforming loan limits by November 7th

- The Federal Housing Finance Agency expects to announce the 2009 conforming loan limits for Fannie Mae and Freddie Mac by November 7th. Under the Housing and Recovery Act of 2009, FHFA was directed to set conforming loan limits each year for the nation as a whole as well as for high-cost areas. To determine high-cost area limits under HERA for 2009, FHFA will use median home values estimated by the FHA, which will be calculate in the coming weeks. (*FHFA Press Release*, 10/17/08)

Fannie and Freddie CDSs recover 91.5% to 99.9%

- In an October 6th auction, sellers of protection on Fannie Mae and Freddie Mac will be repaid between 91.5% and 99.9% of protection they sold. Protection sellers of the GSEs' subordinated debt were the biggest winners with contacts on Fannie's sub debt recovering 99.9% of the amount insured and swaps on Freddie's sub debt recovering 98%, according to auction results published by Creditex and Markit. The GSEs credit default swaps will recover less with Fannie's senior swaps recovering 91.51% of the sum insured, while Freddie's senior swaps recovered 94%. (*Reuters*, Karen Brettell, 10/06/08)

FHFA releases its FY2009 budget

- FHFA director James B. Lockhart released his agency's \$120.8 million budget for FY2009, which reflects the costs of regulating Fannie Mae, Freddie Mac, and the FHLB System. The component of the budget to cover supervision costs for Fannie and Freddie totals \$75.8 million, a 14.8% increase from FY2008 to reflect the costs associated with the agency's new responsibilities as conservator of the GSEs. The FHLBs' component totals \$42.0 million, an 8.2% increase from FY2008 to reflect the Banks' share of start-up costs for FHFA's new infrastructure and strengthened supervision program. FHFA also established a working capital fund of \$3 million in its FY2009 budget, which is in line with other federal financial regulators. (*FHFA Press Release*, 10/10/08)

Subprime and beyond...

- According to Integrated Services' House Price Index, home prices were off 11.6% from year-ago levels in August and were down 0.2% from July totals. All nine census divisions reported declines in values year-over-year with the Pacific division, which includes California, experiencing a 19.5% decline. (*HousingWire*, Paul Jackson, 10/14/08)

- The relentless fall of home prices has left nearly one in six U.S. homeowners owing more on their mortgage than their home is worth, raising the potential for higher home foreclosures. According to *Moody's Economy.com*, approximately 12 million households—or 16% of all homeowners—owe more than their homes are worth, compared to 4% in 2006 and 6% in 2007. For home buyers who purchased their homes in the past five years the outlook is even worse with 29% of these homeowners being underwater, according to *Zillow.com* [a real estate website]. Moody's chief economist, Mark Zandi, said, "It is very possible that there will ultimately be more homeowners under water in this period than any time in our history." (*Wall Street Journal*, James R. Hagerty and Ruth Simon, 10/08/08)
- According to a September 9th report by FTN Financial Capital Markets, approximately 35% of subprime mortgages in non-agency MBS are at least 60 days delinquent, while 15% of Alt-A mortgages are delinquent. (*Bloomberg News*, Dawn Kopecki, 10/11/08)
- On October 14th, 30-year fixed rate mortgage rates averaged 6.46%, up 52 basis points from 5.94% a week earlier and 6 basis points from 6.40% a year earlier, according to Freddie Mac. The average mortgage rate for 15-year, fixed-rate loans rose to 6.14% from 5.63% last week and 6.08% a year earlier. "Interest rates for 30-year fixed-rate mortgages rose this week to an eight-week high," said Freddie Mac VP and chief economist Frank Nothaft. "ARM rates, which tend to be based on shorter-term benchmarks, showed smaller gains in part due to the Federal Reserve's Oct. 8 inter-meeting rate cut in the overnight lending rate" (*Bureau of National Affairs*, Diana I. Gregg, 10/17/08)
- According to the latest Global Financial Stability Report, IMF economists now expect mortgage-related losses of up to \$1.4 trillion—a 48% increase from their April estimate of \$945 billion. "While roughly \$560 billion of the losses had already been realized through end-September 2008, bank share prices have continued to plummet and their revenue prospects have stalled," said IMF officials in a press release. "Raising new capital has become much harder, making it much more difficult for banks to repair their aching balance sheets." The IMF forecast projects a zero credit growth in the U.S. through the end of the year. The agency also indicated concerns about the U.S. Treasury's \$700 billion bailout of the country's financial markets. According to the IMF report, "A major issue for the [TARP] plan is the difficulty for anyone, including a cadre of government-chosen experts, to determine future cash flows from these assets under such uncertain conditions." (*HousingWire*, Paul Jackson, 10/07/08)
- Foreign central banks' holdings of U.S. agency securities at the Federal Reserve fell \$18.64 billion during the week ended October 15th to \$926.2 billion, as government steps to back short-term bank debt led to a heavy sell-off in securities issued by mortgage agencies. The U.S. government's plan to guarantee short-term bonds issued by banks put them on a similar footing from a credit standpoint relative to securities

issued by from Fannie Mae, Freddie Mac and the FHLB System. (*Reuters*, 10/16/0/08)

- Foreign institutions continue to expand their investments in U.S. financial market. Mitsubishi UFJ Financial, Japan's largest financial firm, recently completed its \$9 billion investment in Morgan Stanley in exchange for 21% ownership of the investment bank, which converted to a bank holding company in September. The Spanish bank, Banco Santander SA, has agreed to purchase Sovereign Bancorp, a \$79 billion Wyomissing, PA-based bank holding company, for \$1.9 billion in stock. Santander currently owns a 24% stake in Sovereign, which operates 750 branches in the mid-Atlantic and northeastern U.S. (*Wall Street Journal*, Robin Sidel, 10/14/08; *Washington Post*, Zachary A. Goldfarb, 10/14/08)
- On October 10th, the FDIC closed the Main Street Bank in Northville, MI (with assets \$98 million) and Meridian Bank in Eldred, IL (with assets \$39 million), marking the 14th and 15th bank failures in 2008. The FDIC plans to more than double its deposit insurance premiums in 2009 to replenish its reserves for bank failures. According to the agency, banks would pay approximately 13.5 basis points by the second quarter of 2009, versus the 6.5 basis points which are the banks currently pay. The proposal, which was adopted by the FDIC board unanimously, is open for a 30-day comment period. (*American Banker*, Steven Sloan and Rob Blackwell, 10/07/08; *American Banker*, Emily Flitter, 10/10/08)
- Attorneys general for eleven states have called on the mortgage lenders and servicers to develop comprehensive loan modification programs similar to that of Countrywide, as part of an \$8 billion multi-state settlement. "Given the significant losses associated with foreclosures, and your fiduciary duty to maximize the return for your investors, we believe that every major servicer of sub-prime loans should adopt these types of programs as soon as possible," wrote the AGs, representing California, Arizona, Colorado, Iowa, Illinois, Massachusetts, Michigan, New York, North Carolina, Ohio and Texas, along with the state banking departments of New York and North Carolina and the Conference of State Bank Supervisors. "We believe that doing so is in the interests of homeowners, servicers, investors, and the economy at large." As part of the AGs' settlement, Bank of America agreed to modify the terms of as many as 390,000 subprime mortgages and option adjustable rate mortgages serviced by Countrywide, which BofA acquired on July 1st. The \$8.6 billion settlement aims to initially reduce borrowers' mortgage-related payments to 34% of their monthly income at least for the first year. BofA also said it will set aside \$150 million for borrowers who have already lost their homes due to foreclosure and \$70 million to assist borrowers for whom foreclosure is the only option available to them. (*Bureau of National Affairs*, Anne Marsh, 10/13/08; *Wall Street Journal*, Ruth Simon, 10/08/08; *HousingWire*, Paul Jackson, 10/06/08)
- On October 7th, House Financial Services chairman Barney Frank (D-MA) wrote a letter to the heads of largest mortgage lenders, urging them to work with troubled homeowners rather than foreclosing on their homes. Frank pointed to the BofA

settlement which offers “mass modifications of troubled mortgages” as the model for action that he wants to see lenders use to help ease the housing crisis. Frank wrote, “It is essential that every mortgage servicer firmly commit to implement plans for immediate mass modifications based on, or stronger than, the measures Bank of America/Countrywide has undertaken.” (*Dow Jones Newswires*, Corey Boles, 10/08/08)

- State legislatures continue their push to forestall mortgage foreclosures. A bill recently passed by the California legislature to impose significant new requirements on lenders prior to filing foreclosure resulted in 47% decline in the number of trustee sale filings in August. In New Jersey, the state legislature is considering levying a \$2,000 fee for every foreclosure filed in the state, which would be placed in a trust fund to pay for borrower counseling and fund community groups’ foreclosure prevention efforts. Cook County Sheriff Tom Dart said he’s the first sheriff in a major metropolitan area [Chicago, IL] which has stopped participating in foreclosure evictions. “We will no longer be a party to something that’s so unjust,” said Dart, angry that his office has helped evict renters who have done nothing wrong. The sheriff is now requiring banks to provide him a court affidavit, proving that the home’s occupant is either the owner or has been properly notified of the foreclosure proceedings. In a press release, the Illinois Mortgage Bankers Association said Dart’s refusal to honor eviction notices likely will place him in contempt of court and would risk the willingness of lenders to underwrite mortgage loans in Cook County in the future. (*HousingWire*, Paul Jackson, 10/10/08; *Associated Press*, 10/08/08; *HousingWire*, Paul Jackson, 10/07/08; *HousingWire*, Paul Jackson, 10/15/08)
- On October 16th, California sold an “unexpected” \$5 billion in revenue anticipation notes to individual and institutional investors, which insures that the state will have adequate cash into 2009 and virtually eliminating the state’s need for a federal bailout. (*Financial Times*, Matthew Garrahan and Nicole Bullock, 10/17/08)
- The slowing, economy, coupled with the housing crisis, plummeting equity values on Wall Street, and growing unemployment, are sending state lawmakers scrambling for ways to offset deep plunges in tax revenues. In at least fifteen states and the District of Columbia, mid-year revenue gaps total more than \$5.9 billion, according to the Center for Budget Priorities. These shortfalls are in addition to \$48 billion in gaps that the states have already had to fill in their FY2009 budgets earlier this year. (*Bureau of National Affairs*, Tripp Baltz, Jerry Silverman, Tom Alkire, Chris Brown, William Carlile, Jeff Day, Drew Douglas, Martha Kessler, Nora Macaluso, Laura Mahoney, Susanne Pagano, and Bebe Raupe, 10/10/08)
- The U.S posted \$454.8 billion deficit for FY2008, the largest budget deficit ever. OMB deputy director Steve McMillin said the bipartisan economic stimulus plan agreed to in February and the sluggish economy, added \$169 billion to the deficit. According to analysts, the fiscal 2009 deficit could be in the range of \$1 trillion—more than double the administration’s projected deficit of \$482 billion—largely because of the financial market crisis and Congress’s recently enacted financial sector

rescue plan. (*Bureau of National Affairs*, Jonathan Nicholson, 10/15/08; *CQ Today Online News*, David Clarke, 10/14/08)

The “economic blue screen of death”

- In his October 18th newsletter, John Mauldin wrote, “...The psyche of the American consumer has been seared, and perhaps permanently, reminiscent of the manner in which our grandparents who lived during the Great Depression were permanently scarred with the memories of that time. ...[O]ne thing that is very likely is a major impact on consumer spending going forward. Retail sales have fallen for the last three months. This is the first time sales have fallen in such a manner since the record keeping began. They are falling at an annual rate of 2%, which is unprecedented.”
- “Auto sales are down, virtually in freefall, with many auto company sales down more than 30% (Volvo is down 50%!). And it may get worse. GMAC, the financing arm of GM, has announced it will not lend to anyone whose credit score is not 700 or more! Only 58% of Americans qualify. That means, for a large swath of the consumer marketplace, cheap auto financing is a thing of the past, unless auto companies underwrite loans with guarantees. However, what we are seeing is auto companies abandoning leasing programs and other traditional marketing avenues in order to search for elusive profits. Where you could buy a car two years ago for little or no money down, many dealers are now requiring an average of 12% down. While this makes sense, it is definitely a change. And it is not just in the US. Auto sales throughout Europe are off significantly, especially in countries that had their own equivalent of the US housing bubble.”
- “Falling consumer and retail sales are not surprising, given the fact that almost one million jobs have been lost in the last 12 months, bringing unemployment to 6.1%. California, which is a bellwether state, has seen its unemployment rise to 7.7%. That is a (sadly) reasonable target for nationwide unemployment. Back-of-the-napkin analysis suggests that means at least another million jobs will be lost this cycle.”
- “...The delinquency rate on auto loans is 3.8%, up from 2.9% two years ago. Consumer finance? Up to a very high 8.3%. Credit card delinquencies are 4.8%, rising from 4%. Is it any wonder credit card companies are cutting credit lines and raising interest rates to try and stem the bleeding? Mortgage delinquencies have doubled from 2.5% to a current 5%. Consumer credit in general is up to 5% delinquent, more than two-thirds higher than two years ago. This is all illustrative of a consumer in trouble.”
- “...[N]ew home sales forecasts are at all-time lows. Traffic (potential buyers) looking at new homes is dismal. ... [On October 18th,] housing permits fell to a 26-year low, around 786,000. But that statistic can be misleading. Back in 1982, the population of the US was 230 million. Today it is 305 million. We are roughly one-third larger. If you adjust for population, the number would be in the 600,000 range,

which is far worse than a mere 26-year low. Those permits mean jobs, and permits need to rise with the population to maintain the job base.”

- “...Mortgage applications for purchase are down by over 30% since the end of 2007, and down much more than that from the peak of 2006, as the subprime lending market has disappeared. Let’s pay particular attention to the fall-off in applications for re-financing, down by almost 60%. This was the source of mortgage equity withdrawals, which fueled consumer-spending growth even in the face of the last recession....[I]n both 2001 and 2002, the US economy continued to grow on an annual basis (the “technical” recession was just a few quarters). Their work suggests that this growth was entirely due to [mortgage equity withdrawals or MEWs]. In fact, MEWs contributed over 3% to GDP growth in 2004 and 2005, and 2% in 2006. Without US homeowners using their homes as an ATM, the economy would have been very sluggish indeed, averaging much less than 1% for the six years of the Bush presidency. Indeed, as a side observation, without home equity withdrawals the economy would have been so bad it would have been almost impossible for Bush to have won a second term.”
- “...[W]e [now] have the actual numbers for new mortgage equity withdrawals through the second quarter of this year. And what they show is MEWs simply withering on the vine. The engine of our GDP growth has essentially been turned off. In 2005 there was almost \$595 billion in mortgage extractions that went into some kind of consumer spending. Remember ...that translated into a 3% rise in GDP. In 2007, MEWs were down to \$470 billion, for a boost of 2% to GDP. The second quarter of 2008 saw an anemic \$9.5 billion. At that run rate, we could see a drop-off of over 90% from 2005! Now, think what the second quarter would have been without the federal stimulus program of \$150 billion. It might have looked and felt like this quarter! While credit card growth has indeed risen to take up some of the “slack,” it is nowhere near the previous levels of MEWs. With almost 20% of American mortgages either now or soon to be ‘under water,’ and because lending standards are tightening, it will be a long time before we see a significant upsurge in home equity withdrawals. Whatever growth we see in the next few years will have to come from old-fashioned sources, like real productivity and reality-based lending. Homeowner hallucinations are a thing of the past.”
- “It is likely that whatever recovery we see will be slow in coming. Without MEWs, the period from 2001-2007 would have seen GDP growth of less than 1%! What has changed for the better? It is going to be a rather serious recession and a slow Muddle Through recovery of several years. Unless Obama, Pelosi, and Reid push through their tax increase. Then it will be a lot longer. Maybe even a repeat of 1980 and 1982, where we had back-to-back recessions in two years. Increasing taxes in a recession is the worst possible economic policy. You increase taxes, from an economic perspective, in good times...” (*Thoughts from the Frontline*, John Mauldin, 10/18/08)

So *when* will Congress hold hearings on the failure of Fannie Mae and Freddie Mac?

- As Congress rushes to fix blame for the financial crisis through hearings on AGI, and hedge funds and rating agencies—two names are notably absent: the former executives of Fannie Mae and Freddie Mac, which are now in conservatorship. In the October 14th debate, Republican nominee John McCain said, “Fannie and Freddie were the catalysts, the match that started this forest fire. There were some of us that stood up two years ago and said, we’ve got to enact legislation to fix this. Meanwhile the Democrats in the Senate ... and some members of Congress defended what Fannie and Freddie were doing. They resisted any change.”
- Democratic nominee Barack Obama responded, “Let’s first of all understand that the biggest problem in this whole process was the deregulation of the financial system. Senator McCain, as recently as March, bragged about the fact that he is a deregulator. I never promoted Fannie Mae. In fact, Senator McCain’s campaign chairman’s firm was a lobbyist on behalf of Fannie Mae, not me.” Obama failed to mention, however, that he ranked number two in financial contributions from Fannie’s and Freddie’s employees (\$120,349), second only to Senator Christopher Dodd (\$165,400), who chairs the Senate Banking Committee. In contrast, Senator John McCain (R-AZ) received political donations totaling \$21,550 from employees of Fannie and Freddie.
- In a rare mea culpa, Representative Artur Davis (D-AL), a member of the Black Caucus, issued a statement saying: Like a lot of my Democratic colleagues I was too slow to appreciate the recklessness of Fannie and Freddie. I defended their efforts to encourage affordable homeownership when in retrospect I should have heeded the concerns raised by their regulator in 2004. Frankly, I wish my Democratic colleagues would admit when it comes to Fannie and Freddie, we were wrong.”
- In an October 6th statement, House Minority Leader John Boehner (R-OH) said, “We will never have a full and complete understanding of the roots of this financial crisis without shedding light on Fannie Mae and Freddie Mac’s role in it, and Chairman Waxman’s refusal to hold hearings to examine their role says a lot about where the Democrats’ priorities lie. There is no debate that these government-sponsored enterprises share responsibility for the housing crisis that has preceded today’s market turmoil. Over the last decade, Republicans have consistently sought fundamental reform of Fannie Mae and Freddie Mac, but our efforts were blocked by Members on the other side of the aisle who said no reform was needed. At the very same time that Democrats claimed there was ‘no crisis’ at Fannie and Freddie, predatory subprime lending ran rampant under Franklin Raines’ watch, laying the foundation for the economic troubles that are playing out today. Congress has the responsibility to find out why this was the case—and what we must do to ensure these sorts of activities at Fannie and Freddie never happen again. Yet Chairman Waxman has flatly refused numerous requests by Republicans to hold even a single hearing on Fannie Mae and Freddie Mac’s role in the financial crisis that is having an impact on families, seniors, small businesses, and every single taxpayer in America. Let’s be clear: Congress must get to the bottom of why executives at Fannie and Freddie ran amok, and the

request by Committee Republicans to call on Franklin Raines to testify as part of these hearings must be granted. Chairman Waxman's refusal to shed light on the true roots of the problem solely to shield his fellow Democrats politically is irresponsible and cheats the American people of key facts that could help all of us learn how we got here - and what we must do to make certain this situation never repeats itself."

- In an October 1st article in the *Spectator* [UK], Dennis Sewell concluded, "...So that's how we get from there to here, from crude attempts at social engineering during the early, heady days of the first Clinton administration to the turmoil on Wall Street today. There may be many technical lessons to be learned about selling and buying mortgages, about the best ways to price and manage risk, and about the regulation of financial markets, but I believe the most important lesson of all is an ethical one: it's about not behaving ruthlessly when trying to change the world for the better. Bill Clinton's team, like so many progressives here in Britain, were not content to wait and see what fruits equal opportunities might bring. They felt compelled to secure their equal outcomes by any means necessary, even if that meant debauching institutions, corrupting professions and trying to skew the operation of markets. That only ever leads to chaos." (*Spectator*, Dennis Sewell, 10/01/08)
- In an interview with *USA Today*, Harvard economist Kenneth Rogoff said, "There was tremendous coddling of Fannie and Freddie in the face of a lot of evidence that they really weren't helping homeowners all that much. I think it was very, very clear what was coming, and that they were a huge, huge risk to the American financial system. ... It really was criminal neglect."
- In an October 13th editorial, the *Augusta Chronicle* wrote, "Americans should welcome hearings currently underway in Congress on the roots of the financial system's meltdown. ... Yet here's our problem with the hearings. They're only looking at part of the cause of the disaster. Yes, Wall Street honchos who did wrong should be exposed and, when appropriate, legally punished. But what about Congress' own role in the subprime mortgage mess that is currently tumbling our economy into what may be the harshest recession since the early 1970s? Without the subprime catastrophe, caused by a burst housing bubble that Congress not only encouraged, but mandated and protected, none of the awful strains on the nation's financial system could have happened. ... Minority Republicans are rightly calling for the Democrat-controlled Congress to hold hearings not only on the fallen CEOs, but also their own members' role in the subprime mess. Fat chance. Democrats aren't going to investigate their own, although some of them are as much or more to blame for what's gone wrong as the 'golden parachute' CEOs they're grilling. Here's the final sickening irony: Frank and Dodd, the very congressmen who contributed so mightily to the Freddie Mac and Fannie Mae debacle, are the key congressional players charged with 'reforming' them. And so the foxes will stay in charge of the henhouse."
- During hearings of the House Committee on Government Oversight and Reform, Republicans members challenged chairman Henry Waxman (D-CA) for not

scheduling a hearing to investigate the role of Fannie and Freddie in the current financial crisis. “As Fannie and Freddie went, so went AIG, so went Lehman, and so went the entire American financial market,” said Representative Tom Davis (R-VA), the ranking Republican on the oversight panel. Representative Christopher Shays (R-CT) asked, “Given that the housing market is what brought down everyone else, why wouldn’t we start with Fannie Mae and Freddie Mac [who worked their will in Congress]? Why are we looking at everyone else but Congress?” At the hearing, Republican members also called on Attorney General Michael Mukasey to name a special prosecutor to look into the failure of Fannie Mae and Freddie Mac.

- Initially, Waxman told the panel that the majority staff is looking into the failure of the GSEs. “Freddie and Fannie had people in charge when Clinton was president that got excessive salaries and bonuses, but so did [appointees] by President Bush,” said Waxman. Representative Rosa DeLauro (D-CT) argued, “You have to take a look at what happened with regulation over the last eight years. Fannie and Freddie have been the institutions that have been counted on for that American dream of home ownership. It may be there were some unintended consequences.” The GSEs were also powerful players on Capitol Hill, who contributed more than \$9.7 million to federal campaigns since 1990, according to Center for Responsive Politics, spent \$175 million in lobbying over the past decade, and managed vast charitable operations that touched nearly every congressional district.
- After the session, Waxman acknowledged that his committee “would probably” hold hearings on Fannie and Freddie. Waxman’s carefully chosen words failed, however, to address (1) exactly when the hearing would occur; (2) if the hearing would focus on why Democrats blocked Republican’s efforts to pass GSE reform over the past decade; and (3) if Fannie Mae’s former CEO Franklin Raines would be called to testify. (*The Christian Science Monitor*, Gail Russell Chaddock, 10/09/08; *Press Release from Representative John Boehner*, 10/06/08; *USA Today*, Ken Dilanian, 10/12/08; *Augusta Chronicle*, 10/13/08; *The Hill*, Mike Soraghan, 10/07/08; *Press Release from Representative Christopher Cox*, 10/08/08; *Wall Street Journal*, Representative Artur Davis, 10/08/08)
- Interesting fodder for a Congressional hearing on the GSEs would be *Associated Press*’s October 19th report about Freddie Mac’s covert lobbying campaign in 2005, which targeted 17 GOP senators in 13 states to build opposition to a GSE regulatory reform bill, sponsored by Senator Chuck Hagel (R-NE). According to *AP* reporter Pete Yost, Freddie Mac secretly paid the Republican consulting firm DCI \$2 million to kill the GSE reform legislation. As a result of DCI’s efforts, targeted Republican senators were contacted by prominent constituents and financial contributors, who all urged the lawmakers to defeat Hagel’s bill because it might harm the housing market. According to three people familiar with the campaign, the few dozen Freddie Mac employees who were aware of the DCI initiative called it “the stealth lobbying campaign.” The *AP* sources requested anonymity, saying they feared retaliation if their names were made public. According to sources, Freddie Mac executive Hollis McLoughlin oversaw the DCI project. “Hollis’s goal was not to have any Freddie

Mac fingerprints on this project and DCI became the hidden hand behind the effort,” said one source. On October 16th, Freddie Mac acknowledged that the company “did retain DCI to provide public affairs support at the state and local level.” On October 17th, DCI issued a statement saying it complied with all applicable federal and state laws and regulations in representing Freddie Mac. (*Associated Press*, Pete Yost, 10/19/08)

“Fannie and Freddie must go”

- In an October 9th commentary in the *Christian Science Monitor*, David G. Oedel, professor of law at Mercer University Law School wrote, “At the time, it was perhaps the biggest bailout in US history. Today, one month later, the federal takeover of mortgage giants Fannie Mae and Freddie Mac has been all but forgotten in the drama of the global credit crunch. Washington careened off to pass a bigger bailout before a clear plan emerged about Fannie’s and Freddie’s future. The uncertain cost of their conservatorship is sobering enough, but a more subtly troubling matter is what to do with them after things settle down. There are several options, but history gives a clear warning: Nationalization of industry is easy; privatization is hard.”
- “...As Russia and China have discovered, it’s very hard to privatize any sector of the economy long dominated by government. But at least those countries know something about the subject. In a rather strange turnabout, America might be well served by looking into their experience in privatization for useful lessons (while perhaps snaring some advice on the interim problem of how to run a hale and hearty system of financial socialism). In any event, our own limited experience on the subject of privatizing the secondary mortgage market is definitely not worth repeating.”
- “One promising alternative to consider is to have the users of the service—the banks and other mortgage originators—create and mutually own new loan clearinghouses to do the useful business conducted by Fannie and Freddie. That basic concept of mutual ownership has worked well in the credit card business. However, those kinds of cooperatives can only work if government competitors clear out. When government gets into a clearing business or regulates it to the point of close confinement, the private entities and innovation disappear, as happened in the check-clearing business early in the 20th century.”
- “Whatever the path to privatization of the secondary mortgage market, though, one precondition for success seems likely: Fannie and Freddie must go.” (the *Christian Science Monitor*, David G. Oedel, 10/09/08)

- On October 15th, the EU approved an amendment to its accounting legislation that will allow companies to adopt changes to fair value accounting rules that ease the impact of the financial crisis on their balance sheets. In “near-record” time for the EU legislative process, the EU-member states and European Parliament adopted changes approved by the International Accounting Standards Board on Oct. 13, in which the board relaxed the requirements of its financial instrument standard to permit, in certain circumstances, reclassification of financial instruments “for companies applying International Financial Reporting Standards, which were already permitted under U.S. generally accepted accounting principles in rare circumstances” In a statement the European Commission said, “These amendments ensure that EU companies have the same flexibility as their American competitors to reclassify assets held-for-trading into the held-to-maturity category. The current financial crisis justified the use of reclassification by companies. In these circumstances financial institutions in the EU would no longer have to reflect market fluctuation in their financial statements for these kinds of assets.” (*Bureau of National Affairs*, Joe Kirwin, 10/16/08)
- On October 16th, Senate Banking Chairman Christopher Dodd said Congress would not meddle in restructuring accounting rules that banks contend have forced them to write off massive losses on their poorly performing mortgages. The action taken by the SEC on Sept. 30 to provide some guidance to lenders on mark-to-market accounting rules was sufficient to steady the market, said Dodd. Some in Congress are calling for elimination of the accounting standard to help stabilize the housing market. Former SEC Commissioner Arthur Levitt Jr. said, “I think it would be a dreadful mistake for Congress to get involved in a standard-setting process.” Dodd responded, “I promise you, we won’t do that. ...That would be a total mistake in my view.” (*Congress Daily*, Bill Swindell, 10/16/08)
- According to a notice in the October 14th *Federal Register*, the SEC is soliciting comments on its study of fair value accounting, as required by the EESA. As a part of this study, the SEC will host the first of two roundtables on marked-to-market accounting and current market conditions on October 29th. SEC Chief Accountant Conrad Hewitt said the roundtables will provide the agency “with valuable insights from investors, issuers, and others affected by recent developments in the marketplace ...We are interested in hearing participants’ views on transparency and usefulness of reported financial information in times of market turmoil.” The first roundtable will consist of two panels. According to the SEC, “The first panel will discuss the interaction between mark-to-market accounting for financial institutions and the current economic situation. The second panel will focus on potential improvements to the current accounting model and implications of possible changes.” (*Bureau of National Affairs*, 10/17/08)
- In an October 13th letter to the SEC, the American Banker’s Association president Edward Yingling argued that the recent guidance provided by FASB on marked-to-

market accounting was “circular” and refused to “to recognize the realities of the current situation” by requiring companies to still evaluate liquidity risk in their calculations. “Given the importance of this issue, the impact it has on the crisis in the financial markets, and the seeming inability of the FASB to address in a meaningful way the problems of using fair value in dysfunctional markets, we believe it is necessary for the S.E.C. to use its statutory authority to step in and override the guidance,” wrote Yingling. (*Reuters*, 10/14/08)

- In an October 15th letter to the SEC, representatives of the Center for Audit Quality [an affiliate of the American Institute of Public Accountants], the CFA Institute, the Consumer Federation of America and the Council of Institutional Investors, warned the Commission against calls for the agency to effectively overrule FASB on fair value accounting. “[S]uch urgings are decidedly not in the public interest,” they wrote. “No one disputes that these are trying economic times. However, the current crisis of liquidity, credit and confidence was not caused by fair value accounting. [Instead,] sound accounting principles helped expose the problem.” (*Bureau of National Affairs*, Steve Burkholder, 10/16/08)
- In an analysis of marked-to-market standards, Bracewell & Giuliani wrote, “Proponents of FASB 157’s suspension suggest that because the vast majority of loans supporting the securities at issue are not in foreclosure and are performing, a better approach is to value these securities based on projected cash-flows and not an unknown market value in a market where there are no buyers. Opponents to the rule’s suspension ...argue that suspending the rule would only delay resolving genuine doubts about the value of the assets. More specifically, opponents note that ‘investors have a right to know the current value of an investment, even if the investment is falling short of past or future expectations.’”
- “Questions Remaining: First, of course, the substantive guidance to be issued by the SEC ...and the FASB’s final staff position ...will be crucial. It will be useful, however, only if the bank regulators and accounting firms embrace it. Second, of much interest to financial institutions is the study to be conducted by the SEC, in consultation with Treasury and the Fed... For now, any suspension of the mark-to-market rules by the SEC would only affect companies registered with the SEC. Banks would still be subject to the rules and regulations of their primary regulators. It is important to banks that the result of the SEC study be ‘in consultation with’ federal bank regulators in an effort to obtain the agreement of those regulators with the SEC on the applicability of those rules.” (*Current Status of “Marked-to-Market Accounting Standards*, Bracewell & Giuliani, 10/07/08)

House schedules hearing on financial regulation

- House Financial Services Committee Chairman Barney Frank (D-MA) has scheduled a hearing for October 21st to address the need for broad regulatory restructuring and reform for the financial markets, including financial institution oversight and

regulation, systemic risk and housing finance. This hearing will focus on the extent to which an outdated and weak regulatory system contributed to the current market turmoil and whether adoption of a stronger and more robust financial regulatory system could contribute to a more rapid recovery in the financial markets and the economy. The hearing will examine (i) the current state of the financial regulatory system, both in the United States and abroad, and ways to measure and limit risk without stifling innovations while improving market liquidity and breadth; (ii) the implications of current governmental lending and support facilities for the regulatory structure; (iii) proposals to improve the regulatory structure to restore confidence in financial markets and institutions through a stronger system of regulation and oversight; (iv) the need for enhanced capital and reserve requirements for financial firms; and (v) the adequacy of current powers and coverage of the existing regulatory structure. (*House Financial Services Press Release*, 10/10/08)

- During an October 15th speech at the Exchequer Club, Marshall N. Carter, chairman of the New York Stock Exchange, said the U.S is on the cusp of what may be the “largest financial re-engineering endeavor” in the country’s history. The financial crisis has harmed U.S. businesses and investors, and resulted in great loss of value and confidence in the financial services industry, said Carter, “[As a result,] we’re about to transform the way our financial markets and institutions do business, and likely alter the familiar role of the Fed and the SEC, as well as possibly the 1933 [Securities] and 1934 [Securities Exchange] Acts.” Carter said one of his biggest concerns in this period of regulatory reform is “Congress’s inability to act in the best interests of the country.” Carter said the U.S. needs to “combine and streamline” its regulatory agencies by combining the nine agencies charged with handling the crisis, including the Federal Reserve, the Treasury, the SEC, and the FDIC, into three or four agencies. He also suggested that the SEC issue general guidance on fair value and mark-to-market accounting requirements. Carter warned that unless an overriding guidance is given on what it means to mark to market, as opposed to recent small “tweaks” made to accounting standards by the SEC—including its recent “clarification” of mark-to-market rules—will not prevent the credit crisis from happening again. (*Bureau of National Affairs*, Yin Wilczek, 10/16/08)
- In an October 16th editorial, the *Financial Times* noted, “...Allowing an opaque [\$58 trillion credit default swaps] market—[“largely unfettered by regulation”]—to grow unchecked was an inexcusable oversight of regulation. It must not be repeated: clearing houses for CDS are coming belatedly; others, such as for inter-banking lending, should follow. Investors may finally get some sleep, but regulators must knuckle down.” (*Financial Times*, 10/16/08)
- In an October 16th speech at the Economic Club, Federal Reserve Chairman Ben Bernanke said that the role of the central bank needs to be revisited. “One of the key issues that’s going to be debated as we look at the problem of bubbles in the future is what should be the leading approach. Should it be monetary policy, or should it be supervision and regulatory policy? I do believe the latter does have a significant role

to play in constraining excessive leverage, excessive risk taking, and the other elements that lead to bubbles.” (*American Banker*, Steven Sloan, 10/16/08)

- At its October 16th quarterly summit, the EU backed a resolution at to “recast the capitalist system,” by establishing a comprehensive international economic supervisory architecture fit for a globalized economy. According to the resolution, the reform of the international financial system must “aim to take early decisions on transparency, global standards of regulation, cross-border supervision and crisis management, as well as to avoid conflicts of interest and to create an early warning system so as to engender confidence among savers and investors in every country.” French President Nicolas Sarkozy said the issues that must be addressed include revamping the mandate of the International Monetary Fund, a crack down on international tax havens, the regulation of hedge funds and credit rating agencies, restrictions on company executive bonuses, and resolving how to deal with the inter-relationship of the currencies of large economies, including those in India and China. The EU member states also gave full backing to the EU massive bailout program and supported plans to examine how the EU industrial sector can be assisted in the face of the current economic crisis. (*Bureau of National Affairs*, Joe Kirwin, 10/17/08)

Fannie Mae

Fannie Mae announces change in its MBS collections in an effort to boost the liquidity of the financial system

- On October 10th, the FDIC adopted an interim final rule designed to simplify the deposit insurance rules for mortgage servicers’ deposit accounts, which are insured by the FDIC. Under the interim rule, FDIC said coverage of these accounts will be provided to the lenders/investors as a collective group, based upon the cumulative amount of the borrowers’ payments of principal and interest into the account. FDIC said they expect to see the per-borrower coverage provided under this interim rule to enable the agency to make deposit insurance determinations on mortgage servicing accounts more quickly and to pay deposit insurance more rapidly to affected servicing shops. Previously, FDIC insurance was based upon the ownership interest of each lender or investor of the servicing accounts. (*HousingWire*, Paul Jackson, 10/14/08)
- On October 10th, statement, Tom Lund, EVP of the Single-Family Mortgage Business, said, “With the FDIC’s announcement today, Fannie Mae will begin to allow institutions servicing our mortgage-backed securities (MBS) to continue to hold the principal and interest payments from loans in our MBS in eligible depository institutions, thereby freeing additional liquidity for these institutions and the financial system. Recently, Fannie Mae exercised its option to collect the principal and interest

on its MBS from certain institutions on a daily basis and place the payments in a trust account to safeguard the funds on behalf of the MBS holders. Given that the FDIC's new policy effectively safeguards these principal and interest payments, we believe collecting the payments daily and holding them in trust may no longer be necessary. We will begin working with our customers to effectuate this change, consistent with our trust agreements and servicing guide." (*Fannie Mae Press Release*, 10/10/08)

Fannie Mae to be more "forthright" in its disclosures about certain liquid assets

- In an October 6th *Washington Post* article, Fannie Mae CEO Herbert M. Allison, Jr. said that after reviewing his company's accounting, he decided that the company had to be more forthright in how its reports information on the liquidity of certain assets. Specifically, Fannie Mae made reference in previous disclosures about \$90 billion in assets, ranging from super-safe certificates of deposit to more risky unsecured corporate notes, as "liquid investments," suggesting they could be easily bought and sold. Instead, Allison has decided that these assets should be simply classified as "other investments." He said, "I felt that in the liquidity portfolio we should break out the various groups of assets, so readers could see what securities are truly sellable on short notice and which ones might take a little longer to trade." (*Washington Post*, Zachary A. Goldfarb, 10/06/08)

Franklin Raines, Fannie's former CEO, moves into his \$4.9 million bachelor pad

- According to a *USA Today's On Deadline* [blog]: "Millions of Americans are caught up in the nation's housing crisis. Franklin Raines, the Democratic insider who ran Fannie Mae between 1999 and 2004, isn't one of them. *Washingtonian* says Raines just paid \$4.9 million for 'a three-bedroom, seven-bath penthouse condominium' in Washington's Ritz-Carlton Residences. The *Washington Post* says Raines and his wife are splitting up and agreed to sell their old house for \$7.6 million."
- "Fannie Mae, a mortgage finance company that is now controlled by the government, had to restate billions in earnings because of accounting problems during his tenure. 'Regulators have said that of the \$90 million paid to Mr. Raines from 1998 to 2003 at least \$52 million—more than half—was tied to bonus targets that were reached by manipulating accounting,' *The New York Times* reported two years ago." (<http://blogs.usatoday.com/ondeadline/2008/10/ex-fannie-mae-c.html>, Mike Carney, 10/09/08)

Freddie Mac

The more things change, the more they stay the same...

- According to the Denver 2008 Convention Host Committee's financial disclosure report, three embattled mortgage lenders—AIG, Freddie Mac, and Lehman Brothers—were among the donors to the Democratic National Convention, held from August 25th through August 28th. The Democrats' records show that AIG, which received the largest government bailout of a private company in U.S. history *totaling \$122.8 billion*, contributed \$750,000 to the Convention, while Freddie Mac donated \$250,000 and Lehman Brothers added \$100,000. In total, \$60.9 million in private support was contributed, which included more than \$55 million in cash contributions and \$5.46 million in in-kind support; the remaining funds came from interest income and miscellaneous income. The 1,400-page report outlines \$53.67 million in operating expenses and total disbursements of \$53.86 million. (*WLWT-Channel 5* [Cincinnati, OH], 10/17/08; *CQ Today Online News*, Benton Ives, 10/15/08)
- In addition, Freddie Mac and AIG each contributed \$250,000 to last month's Republican National Convention, according to Federal Election Commission filings. (*Bloomberg News*, Jonathan D. Salant, 10/18/08)

Freddie Mac allows officers to speed up deferred compensation payouts

- Freddie Mac executives, holding the title of vice president and higher, may elect to cash out their deferred compensation payments in three payments by May 15, 2010. Previously, the plan's payouts had been deferred for at least five years. Freddie's deferred compensation plan allowed the participants to postpone a portion of their annual salary and defer receipt for as long as 15 years after leaving the company. According to a company filing, Michael May, who runs Freddie's multifamily division, and interim CFO David Kellerman had balances of \$2.5 million and \$120,472, respectively, in the plan. (*Bloomberg News*, Dawn Kopecki, 10/15/08)

Freddie Mac temporarily suspends foreclosures in areas hit by Hurricane Ike

- Freddie Mac announced that it is suspending foreclosures in the federally declared disaster areas in Texas and Louisiana, as a result of Hurricane Ike. This suspension, which extends from October 8th to December 31st, will include all mortgages that were in default prior to the hurricane. "Freddie Mac is taking this step because the extensive damage Hurricane Ike caused has made it difficult for our servicers to get the information they need to make case-by-case decisions about forbearance or other

workout options,” said Ingrid Beckles, Freddie’s vice president of servicing and asset management. (*Freddie Mac Press Release*, 10/09/08)

Federal Home Loan Banks

FHLB-Chicago and Fannie Mae partner to improve mortgage market liquidity
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- On October 7th, the FHLB-Chicago and Fannie Mae announced a new partnership in which Fannie will purchase 30- and 15-year fixed rate mortgages from the Bank’s Mortgage Partnership Finance Program. This relationship was recently made available to the Bank’s members through this MPF Xtra™ program. Through this announcement, other FHLBs that participate in the MPF program may seek to offer the MPF Extra™ option to them members in the future.
- “The high-quality conventional mortgage loans originated by our members throughout the history of the MPF Program continue to perform well, even in this tumultuous market,” said Matt Feldman, president and CEO of the FHLB-Chicago. “Our partnership with Fannie Mae facilitates access to the secondary market through the familiar infrastructure of the MPF Program. Most importantly, this program will make it easier for the majority of our members to continue to offer competitively priced fixed-rate mortgages to their customers in their communities.” Herb Allison, Fannie Mae’s president and CEO, said, “Partnering with the Federal Home Loan Bank of Chicago helps us to fulfill our mission to provide the most support possible to the market, while prudently managing risk.”
- FHFA director James B. Lockhart, III, said, “I am pleased that the Federal Home Loan Bank of Chicago, partnering with Fannie Mae, will provide greater liquidity to the mortgage market through its new mortgage product, MPF Xtra. This is an excellent example of how the synergies created by merging OFHEO and FHFB into the new FHFA can help to provide greater liquidity and stability to the mortgage markets. Through MPF Xtra, the FHLBank of Chicago can offer its membership a mortgage acquisition service without taking onto its balance sheet the associated credit or market risk.” Lockhart added, “Fannie Mae may find it more efficient to manage one relationship—with the FHLB-Chicago—than to work with a number of smaller, individual institutions. The Federal Home Loan Banks continue to be an integral part of the nation’s housing finance system, playing a vital role in helping to finance homeownership for millions of Americans.” (*American Banker*, Kate Berry, 10/08/08; *Fannie Mae Press Release*, 10/07/08; *FHFA Press Release*, 10/07/08; *HousingWire*, Kelly Curran, 10/07/08)

FHFA approves an interim affordable housing rule

- On October 8th, the FHFA published an interim final rule, which amends its Affordable Housing Program (AHP) regulation, requiring the FHLB System to contribute 10% of each bank's earnings to support affordable housing. The amended rule permits the AH funds to be used for two new purposes: (1) to reduce the outstanding principal balance of the refinanced loan below the maximum 90% loan-to-value ratio established by the HOPE for Homeowners Program to make monthly payments affordable for the household; and (2) to pay FHA-approved loan closing costs. "The use of AHP set-aside funds with the HOPE for Homeowners Program will enhance the effectiveness of each program, ensure that the full range of federal assistance to homeowners is available quickly, and provide the flexibility that the FHLBanks and their members need to make the AHP refinancing program successful," said FHFA Deputy Director for Housing Mission and Goals Edward DeMarco. The interim final rule will become effective on the date of publication in the Federal Register. The FHFA will accept comments on the interim rule for 60 days after publication. (*FHFA Press Release*, 10/08/08)

FHLB System had \$260 million credit exposure to Lehman Brothers entities

- According to the FHLBanks Office of Finance, each of the 12 FHLBs has terminated essentially all of its swaps with Lehman Brothers' entities under its ISDA master agreements with Lehman counterparties. Based upon the settlement statements prepared by, or management estimates from, each of the Banks, the System has an aggregate credit exposure to Lehman of approximately \$260 million, including \$179 million of excess collateral pledged by the FHLB-Atlanta and approximately \$41 million of excess collateral pledged by the FHLB-Pittsburgh. (*FHLBanks Office of Finance*, 10/09/08)

Grange Insurance joins the FHLB-Cincinnati

- Grange Insurance, a \$1 billion-plus insurance provider headquartered in Columbus, OH, has joined the FHLB-Cincinnati. Rated A (excellent) by A.M. Best, Grange is the 18th insurance company to join the Cincinnati-based FHLB and is the 180th insurance company to join the FHLB System. "We're pleased to be a member of the Federal Home Loan Bank of Cincinnati," said Phil Urban, Grange's president and CEO. "This membership will give us additional financial flexibility and resources to serve our policyholders and agents." (*FHLB-Cincinnati Press Release*, 10/07/08)

Ginnie Mae

Is the FHA—and Congress—up to the task of properly handling the risks of the distressed mortgage market?

- For borrowers with less than a 20% down payment in today's market, FHA offers the only "consumer friendly" mortgage product with a 3% down payment requirement for a 30-year, fixed rate mortgage for even jumbo loans in high-cost areas of California and the East Coast. [In August, one in ten borrowers was from California.] With the agency's loan volume tripling over the past 12 months, there's trouble looming on the horizon for FHA, which has been given the responsibility by Congress to keep distressed homeowners out of foreclosure by refinancing their unaffordable loans on terms they can afford. To handle the onslaught of applicants, FHA says it needs to hire more staff and upgrade its computer system, and complains that Congress hasn't appropriated the \$65 million of necessary funds for the agency to get the job done fast enough to prevent foreclosures.
- While Capitol Hill appropriations committee staff dispute FHA's claims, the specifics of the arguments over dollar amounts doesn't address the core issue. Instead, one must ask if a government agency, whose market share dropped below 3 percent during the subprime boom, now properly handle explosive volume rocketing it to an estimated market share of 30% in 2008? Are the FHA and Congress, which controls the purse strings, up to this task?
- Many in the mortgage industry are concerned about the unintended consequences of shifting too heavy a share of the mortgage market too quickly to the FHA, which may be inadequately staffed or funded. Howard Glaser, who served as acting general counsel for HUD during the Clinton administration as acting general counsel for HUD, said he's concerned that requiring HUD to handle too much business without proper funding staff and technology upgrades raises the odds of breakdowns. "FHA is assuming the risks of a mortgage market abandoned by private investors—without the risk management tools," said Glaser. "My fear is that next year at this time, we will be debating an FHA bailout." Steve O'Connor, senior vice president of the Mortgage Bankers Association, concurred. "You just can't expect to fit that amount down the same size pipe—you've got to expand the size of the pipe [by funding additional staff and technology]," said O'Connor. "It's a very serious concern." Dick Gaylord, president of the National Association of Realtors, said "If [the FHA] is truly going to serve its growing constituency," it will need more money and people.
- According to agency statistics, the FHA is now insuring more than 140,000 new loans a month and has \$400 billion in outstanding loans in its insurance portfolio. The agency currently employs a staff of 937 in offices spread around the country. FHA has requested from Congress authorization to add 160 employees immediately.

- For many mortgage lenders, the FHA is now the main game in town. “Nothing competes with them,” said Paul Skeens, chief executive of Colonial Mortgage Group in Waldorf. “[Fannie and Freddie] just aren’t competing with FHA on down payments or costs.” In 2001 and 2002, Skeens’ firm did just 0.25% of its volume in the FHA. Today, his firm does 60% of its volume through the agency. “The last thing we need right now, with the shape the housing market is in, is for FHA not to function well,” said Skeens. (*Washington Post*, Kenneth R. Harney, 10/06/08)

Ginnie Mae’s role is essential to the recovery of the mortgage market

- In a speech at 4th Annual Mortgage Lending Industry Strategic Markets and Diversity Conference, Ginnie Mae president Joseph Murin said his agency is essential to the recovery of the market. After the government takeover of Fannie Mae and Freddie Mac, Ginnie Mae has assumed a leadership role in helping secure affordable housing and secondary market funding. According to projections for 2008, Ginnie Mae’s MBS volume will reach \$210 billion, an 133% increase over the agency’s volume of only \$90 billion in 2007. By the end of 2009, Murin expects Ginnie’s volume to top \$1 trillion and account for over 40% of the mortgage-backed securities business. (*National Mortgage News*, October 11-12, 2008)
- In an interview with *American Banker*, Murin said that his agency’s “biggest area is issuer risk.” He added, “We’ve put a number of checks and balances in place. We look at every venue for risk. This is part of the re-engineering of the risk environment here. ...We look at cash flow because with everybody struggling, balance sheets [and profit and loss statements] are not good indicators. Cash flow is a better indicator, and it gives us some insight, a sort of early warning. ...[Servicers] are having trouble with advances. They’re all suffering from the backlog, the bubble. We’re constantly developing analytics to monitor issuers.”
- In 2008, four servicers have defaulted on \$1 billion of Ginnie loan pools. When Family Home Mortgage Corp stopped making advances, Ginnie seized its \$26.7 million portfolio and began servicing the loans itself. The agency pulled servicing rights from three other who defaulted on covenants—Lehman Brothers’ servicing unit, Aurora Loan Services; the mortgage unit of R7G Financial Corp., and a San Juan, Puerto Rico banking company, that had been plagued with problems. The rights for these loans were transferred to Countrywide Financial, which serves as the agency’s master subservicer. (*American Banker*, Kate Berry, 10/17/08)

Farm Credit System / Farmer Mac

FCS remains financially strong

- During the first six months of this year, the FCS remained financially strong and continued to meet significant credit demand, particularly from cooperatives and farm customers in the grain belt. “Despite unprecedented market volatility, the System has continued to have access to the credit markets and to raise funds at competitive rates,” said Andrew Jacob, Director of FCA’s Office of Regulatory Policy. While the System’s asset quality remains high, FCA examiners expect to see a slight deterioration in the coming months. Chief Examiner Tom McKenzie said adjustments are being made in both FCS and FCA programs in response to the volatile environment. System capital ratios have continued a downward trend due to rapid asset growth. However, capital levels remain strong overall and generally well above regulatory minimums, while earnings and liquidity levels remain excellent.
- Because of the volatility in the agricultural and credit markets, stress from the deteriorating general economy, and stress on certain portions of the agricultural sector, especially livestock, examiners are closely monitoring the portfolios and management actions of System lenders.
- Overall, the CAMELS (capital, asset, management, earnings, liquidity, and sensitivity) ratings of System institutions remain very good, with 80 of 99 institutions rated 1 on a scale of 1 to 5 [with a 1 rating being the highest, indicating that the institution is sound in every respect]. Five institutions received a rating of 3, which is an increase of one institution from the previous quarter. Institutions receiving a rating of 3 exhibit higher than normal risk and receive increased supervision. No institution received a rating lower than 3. “The Farm Credit System banks and associations remain safe and sound amid the current financial market turmoil,” concluded McKenzie. (*FCA Press Release, 10/09/08*)

Effects of financial crisis appear to be limited in ag sector thus far

- While money is still available for farm lending, the turmoil in the U.S. financial markets has surfaced in the form of tighter credit and depressed crop prices. The seizing up of the financial markets hasn’t (yet) affected the bond sales of the Farm Credit System. “[Despite the financial crisis,] the system has been able to access funds,” Steve Gabriel, a senior financial analyst in the office of examinations at the Farm Credit Administration (FCA). “It’s a more challenging environment. But the Farm Credit System is triple A rated and it’s a GSE (government sponsored enterprise). When there’s a flight to quality, the System tends to benefit.” Because of market conditions, FCS interest rates have gone up only slightly, added Gabriel.

(*AgricultureOnline*, Dan Looker, 10/11/08; *Milwaukee Journal Sentinel*, Rick Barrett, 10/07/08)

UN agency calls for urgent review of biofuel subsidies

- The U.N.'s Food and Agriculture Organization has called for an "urgent" review of agriculture and biofuel subsidies and trade barriers, arguing that their removal would increase opportunities for developing countries to take advantage of rising biofuel demand. "Current policies tend to favor producers in some developed countries over producers in most developing countries," said FAO Director-General Jacques Diouf. "The challenge is to reduce or manage the risks while sharing the opportunities more widely." The U.N. has called on the international community to issue guidelines to ensure biofuel crops do not compete with food crops and do not encourage deforestation. From 2000 to 2007, biofuel production based on agricultural commodities has more than tripled and resulted in a dramatic increase in corn and sugar cane prices. (*Associated Press*, Marta Falconi, 10/08/08)

Postal Service

These challenging times demand that a *qualified* person be nominated to the Postal Service's Board of Governors

- In an October 17th commentary, *Reader's Digest* postal consultant and former PostCom Chairman Cary Baer, wrote, "A couple of weeks ago I was sitting in my office thinking about the current quandaries facing the Postal Service. The most prominent among them is the weak U.S. economy and its resultant impact on mail volume. Volume continues to decline, most significantly First-Class Mail. First Class is getting a double whammy; the economy and the unrelenting movement of more bill presentment and bill payment to the Internet. This volume decline, together with continued population growth and the Postal Service's universal service obligation, means the Postal Service is delivering less mail to more locations. Basic economics tells us this trend just doesn't compute. Indeed, the Postal Service has indicated that they will have lost more than \$2 billion in the just-ended FY 2008."
- "As luck would have it, at this most unpropitious time, there is a vacancy, a Democratic seat, on the Postal Service's Board of Governors [BOG]. Into this breach the Bush Administration has nominated, for the BOG seat, an individual who is the elected property assessor from Washoe County, Nevada. That's right, an individual, without any obvious experience in dealing with large corporate issues, including

labor/management, technological changes, marketing, corporate finance, and numerous public policy issues.”

- “I’m sure that this BOG nominee has a stellar professional and personal background and has passed muster with Senator Harry Reid, the Senate Majority Leader, also of Nevada. In another time, perhaps this BOG nominee would be approved by the Senate as a favor to whoever is behind the nomination. But this is a different time. The mailing industry and the Postal Service need a board member who can provide relevant advice, direction and oversight in this difficult and trying time. It’s been suggested that to fight the nomination, the mailing industry needs to provide an alternative to the nominee. I reject that contention. By law this is a political appointment. I’m suggesting the political process be restarted to find a qualified nominee.”
- “A study conducted a number of years ago by a joint Postal Service mailing industry task force found that the mailing industry accounted for nine million jobs and nine percent of the GDP [gross domestic product]. The Board of Governors oversees the USPS, which is the most important element underpinning this industry. Can we please find someone qualified for this role? I trust the mailing industry will unite to petition the Administration to withdraw the nomination, or as an alternative, urge the Senate to reject the nominee.” (*Association for Postal Commerce’s Postcom Bulletin*, Cary Baer, 10/17/08)

Nanci Langely named Vice-Chairman of the Postal Regulatory Committee
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- Postal Regulatory Commission Chairman Dan G. Blair announced that Commissioner Nanci Langely has been named Vice-Chairman of the Commission, succeeding Vice-Chairman Mark Acton to serve a one-year term. (*Postal Regulatory Commission Press Release*, 10/06/08)

Are layoffs around the corner at the USPS?
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- In September, 3,700 Postal Service employees accepted the agency’s early retirement offer in the agency’s first of three rounds of EROs, which it will extend to more than 156,000 employees, representing 20% of its workforce. Observers fear that the subsequent rounds will not be as successful, given the recent turndown in the economy. If so, the USPS may be forced to layoff employees. Postmaster General John Potter recently told the largest postal union that the agency has identified as many as 16,000 employees who lack seniority and can be laid off without the need for a collective bargaining process. The USPS says that layoffs will be a last resort, as it seeks to trim the payroll and cut expenses because of sharp drops in mail volume, which has sharply reduced revenues. If the Postal Service can’t increase mail volume, the agency won’t have enough money to pay staff, said postal expert Murray Comarow. “Unless they tell Congress they don’t have the money to pay these guys,

they will have to lay people off,” said Comarow. “I don’t know what else they could do except trying to change various constraints in the [postal] law that are more limiting of USPS management than any other company in the private sector.”
(*Federal Times*, Elise Castelli, 10/11/08)

USPS issues report on universal service obligation and postal monopoly to PRC

- On October 15th, the Postal Service submitted a report to the Postal Regulatory Commission (PRC) on its position related to the agency’s universal service obligation (USO) and postal monopoly. The USPS confirms its continued commitment of trusted, affordable universal service to the American public. The report supports that no changes to the USO and monopoly are necessary at this time while additional flexibilities will be required to ensure affordable, universal service into the future. The full report can be accessed from the USPS website at the following address: <http://www.postcom.org/public/2008/Postal%20Service%20Committed%20to%20Continued%20Affordable%20Universal%20Service.htm>. (*USPS Press Release*, 10/15/08)

Busted!

- Two weeks being questioned about his travel expenses and gambling habits by *ABC News*, Alexander Lazaroff, the head of the US Postal Service’s Inspection Service, abruptly announced his retirement. Lazaroff said, “After 37 years of federal service, I feel that it’s time for me to begin a new chapter in my life, “ but made no mention of the *ABC News*’ questions of the ongoing investigation of his travels by the USPS Inspector General. The IG’s investigation of Lazaroff was triggered by complaints from his own inspectors to Senator Charles Grassley (R-IA) that their boss squandered postal service money to arrange travel to resorts and other locations near casinos. Lazaroff, who managed a staff of 1,700 employees and an annual budget of \$464 million, spent more than five times as much money for traveling as any of his predecessors. He told *ABC News* that his travel budget for the last two years was around \$100,000. However, sources in his office say that budget was actually closer to \$300,000. Lazaroff’s departure will not stop the IG’s investigation, said Grassley.
- In late September, an *ABC News* investigative team recorded Lazaroff at Casino Arizona in Phoenix, AZ, while was he attending a conference that he had arranged at a nearby resort. The news team observed Lazaroff’s two hours at the casino and saw him leave in a white stretch limousine provided by the casino. When asked six days later by *ABC News* if he had been to the casino, Lazaroff said, “I’m not sure, I’m not sure.” When shown pictures of him at the casino, Lazaroff then remembered the visit, but insisted he’d gone to the casino on his “own time” and did not have a gambling problem. “I don’t have any debt as a result of gambling, I am not a high roller,” said Lazaroff. (*ABC News*, Brian Ross, Asa Eslocker, and Joanna Jennings, 10/17/08)

TVA

TVA distributors to buy interest in power plant

- Seven States Power Corp., the non-profit entity created by the Tennessee Valley Public Power Association, has announced plans to pay TVA \$325 million for a nearly 70% interest in Southhaven, a, 810-megawatt power plant. Jack Simmons, who heads Seven States and TVPPA, said the goal of the investment is to “let the distributors have some kind of voice and choice.” Simmons added, “This is the first such arrangement, but we hope to eventually have more.” TVA executive Ken Breeden said the transaction is “an important first step ...towards a long-term arrangement that could benefit TVA, our distributor partners, and power customers in the Tennessee Valley region ...[by helping] reduce TVA’s costs and keep TVA’s wholesale electric rates as low as possible.” Seven States and TVA will have until 2010 to work out the details of the joint ownership of the plant. (*Associated Press*, Duncan Mansfield, 10/06/08; *Chattanooga Times/Free Press*, 10/06/08)

Energy conservation “needs to be built into our way of life”

- At a speech at Appalachian State University in Boone, NC, TVA president Tom Kilgore said, “We are slightly spoiled [with regard to our energy consumption]. Our tradition of having cheap energy has made us more than a little wasteful. We really have to become more efficient in how we use energy, and plan our lives better in regard to our energy footprint. Efficiency needs to be built into our way of life. ... We believe we can change by order of magnitude, the efficiency of the way people use electricity.” (*The Watauga Democrat*, Cara Kelly, 10/14/08; *Appalachian State University News*, 10/10/08)

TVA’s retirement plan fell 14.6% in FY2008

- For the 12 months ended September 30th, TVA’s value of its retirement plan fell by 14.6%. In a notice to the utility’s employees before the Columbus Day holiday, pension officials stressed TVA’s fund remains healthy and benefits will continue to be paid to thousands of TVA retirees. “In these unprecedented markets, the system is well-positioned to provide the liquidity needed to meet the system’s approximately \$44 million in monthly benefit payments,” said Frank Alford, vice chairman of the TVA Retirement System Board. Despite TVA’s market losses in FY2008. the government fund still lost far less than most major market indices, said Alford. TVA’s retirement fund was down 14.6 percent for the 12 month period versus a 22% decline for the Dow Jones Industrial Averages and the S&P 400 index over the corresponding period. (*Chattanooga Times Free Press*, Dave Flessner and Andy Sher, 10/14/08)

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