

# The **GSE** REPORT™

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*"If you want to end up with the economy of Pakistan, the politics of Ukraine, and the inflation rate of Zimbabwe, bank nationalization is the way to go. "*

*Simon Johnson, former chief economist of the IMF*

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## Major Events

Under Treasury's worst case scenario, ten banks would lose \$599 billion that creates a \$75 billion capital short-fall

- Under the Supervisory Capital Assessment Program, the Federal Reserve projected under the “worst-case” stress test that 10 of the nation’s largest banks could suffer losses of up to \$599 billion through the end of 2010 and ordered the banks to raise a combined \$74.6 billion of additional capital to absorb future losses and “comfortably exceed” their minimum regulatory requirements [Tier 1 risk-based capital ratio of at least 6% which consisted of at least 4% common equity]. Regulators concluded that of the nearly \$600 billion of estimated losses projected, more than 75% of the losses (\$455 billion) would come from losses on the banks’ loan portfolio, particularly residential mortgages and other consumer-related loans. At year-end 2008, the banks’ capital needs totaled \$185 billion, but first quarter actions, along with “favorable” changes in marked-to-market accounting rules, reduced their collective capital needs by nearly 60% to \$74.6 billion.
- Under the Fed’s stress tests, Bank of America has the largest capital shortfall of \$33.9 billion, followed by Wells Fargo (\$13.7 billion), GMAC LLC (\$11.5 billion), Citigroup (\$5.5 billion), Regions Financial (\$2.5 billion), SunTrust Banks (\$2.2 billion), Morgan Stanley (\$1.8 billion), KeyCorp (\$1.8 billion), Fifth Third Bancorp (\$1.1 billion), and PNC Financial Services Inc. (\$600 million). *Wall Street Journal* provides an analysis of each bank’s stress test (click on the interactive graphics) at <http://online.wsj.com/article/SB124182311010302297.html#project%3DSTRESSTESTD0CS0905%26articleTabs%3Dinteractive>.
- Shortly after the release of the stress test results, Wells Fargo announced its completion of \$7.5 billion capital raise through a new stock offering and Morgan Stanley priced a \$4.0 billion offering of common stock and \$4 billion of senior notes. Bank of America has announced plans to raise up to \$17 billion of capital through the sale of common stock and conversion of preferred shares. On May 12<sup>th</sup>, BofA raised \$7.3 billion from its sale of its 5.7% ownership stake in China Construction Bank Corp. Separately, BofA announced it is “walking away” from the “special” assistance provided by the federal government to cover up to \$97 billion of losses on assets acquired through its Merrill Lynch transaction. [It remains unclear, however, if Treasury will allow the bank to opt out of this provision.] In a conference call with investors, the company said it plans to raise as much as \$34 billion through new stock issuance. Separately, Keycorp announced plans to sell \$750 million in stock “at the market” and is considering “additional actions” such as converting other securities to common stock to facilitate the capital raise. Fifth Third and PNC also announced plans to meet their increased capital requirements by working with (unspecified) private funding sources.

- Citigroup said it would issue common shares to private investors who hold preferred shares, which would drive the government's stake in the bank down to about 36% and result in a tangible capital ratio to a "strong looking" 4.5%, "We are seeking nothing further from the government," said Edward Kelly, the company's CFO. "This is a milestone for us and the industry." In an interview with *CNNMoney*, Citigroup's non-executive chairman Dick Parsons said regulators told him: "We don't have the capacity, we don't have the bandwidth, we don't have the expertise, and we don't have the interest in running Citigroup."
- The banks that have been directed to raise capital have until June 8<sup>th</sup> to develop a capital plan, which may include issuing new securities, restructuring current capital, restricting dividends or other such outlays, selling businesses or divesting other assets, and entering into mergers or joint ventures. The plan also must address repayment of TARP funds and reducing the bank's reliance on guaranteed debt issued under the Temporary Liquidity Guarantee Program (TLGP) and address whether existing management is "adequate." [Executive teams and board members are subject to this review.] The bank's primary regulator must approve the capital plan, in consultation with FDIC. Banks have until November 9<sup>th</sup> to have the new capital in place. While regulators would like to see the banks raise private sources, additional government assistance is available for the banks through TARP, if needed. [Bank regulators will conduct similar stress tests for smaller financial institutions in the future and will direct capital deficient institutions to raise capital accordingly.]
- Federal officials have repeatedly vowed to support the 19 largest banks, essentially labeling them "too big to fail" and driving the banks' stock prices to the highest levels in months. Regulators hope that by shoring up public confidence in the banks, private investors will invest in these companies and eliminate the need for taxpayer-funded assistance. Wall Street analysts say the banks' future stock sales will be a critical indicator of whether the stress tests have restored the market's confidence in these companies. "It's a test of the credibility of the results, and it's a test of the strength we've seen in the bank market lately, to see if they're willing to put the money in," said Frederick Cannon, a financial analyst with Keefe, Bruyette and Woods.
- Going forward, banks that repay their TARP capital also must abandon government-backing for future debt issuances under TLGP. [Under this rule, these 19 banks would have to "walk away" from TLGP guarantees which totaled \$336.6 billion through March 31<sup>st</sup>, and issue new debt with terms of five year or more.] In order to repay TARP funds, the banks' primary regulatory must assess the institutions' financial strength, capital adequacy and ability to lend before Treasury will approve any repayment plans. It remains to be seen if regulators will confront the banks over their risk management practices in a way that regulators have been afraid to do in years past, or whether regulators will revert to "business as usual" after the crisis eases. Financial institutions that have announced plans to repay their TARP funds include Goldman Sachs, JPMorgan Chase, American Express, Bank of New York Mellon, State Street Corp., US Bancorp, and BB&T Corp. Three banks which were found to be capital compliant under the stress tests, including Capital One, US

Bancorp, and BB&T Corporation, have announced plans to raise additional capital (\$1.75 billion, \$2.5 billion, and \$1.5 billion, respectively) to facilitate their repayment of their TARP funds.

- The regulator's worst-case estimates were smaller than industry analysts had feared, leading optimists to argue that the Fed's findings served as evidence that the worst of the financial crisis is over for the industry. Questions remain, however, about the stress test's "rigor" after the regulators scaled back some of projected losses in the face of pressure from banks. When the Fed informed the banks of their preliminary stress test findings, executives at Bank of America, Citigroup and Wells were furious at the central bank's "exaggerated capital holes," which one executive called "mind-numbingly" large. Bank of America executives were stunned by the initial capital shortfall of more than \$50 billion, said one person familiar with the negotiations. At least half of the banks "pushed back," arguing that the Fed had underestimated their ability to cover anticipated losses through revenue growth and aggressive cost cutting measures. Tempers boiled over, as Wells Fargo's chairman Richard Kovacevich publicly derided the Fed's stress tests as "asinine," causing government officials to worry that Wells might file a lawsuit contesting the Fed's findings. The central bank ultimately accepted some of the banks' pleas, but rejected others, by lowering the capital shortfalls for Bank of America (from "over" \$50 billion to \$33.9 billion), Wells Fargo (\$17.3 billion to \$13.7 billion), Citigroup ("about" \$35 billion to \$5.5 billion) and Fifth Third (\$2.6 billion to \$1.1 billion), but raising the estimate for PNC (from no shortfall to \$600 million).
- Peer Steinbrück, Germany's finance minister, publicly "branded" the stress tests of U.S. banks as "worthless," because their results had been altered before publication. "We are seeing that the stress test in the US is worthless because the central bank exercised influence as well as the Treasury," Steinbrück said to members Germany's parliament. However, the publication of unaltered results from stress tests was equally dangerous because it "could increase a pro-cyclical negative effect," he added.
- Critics also argue that the stress tests can have the unintended consequence of drying up the availability of consumer and mortgage loans, as banks restrict their lending to conserve capital. Jim Eckenrode, a banking research executive with TowerGroup, said the government's intense focus on increasing the banks' capital cushions might prompt banks to hoard cash and curtail future lending, which would undercut the administration's goal of pushing banks to lend more in order to jump-start the economy. In point of fact, Morgan Stanley analysts estimate that the 15 largest banks have shrunk their balance sheets by \$3.6 trillion to date during this financial crisis and project that the banks will shed an *additional* \$2 trillion by year-end 2009. Others caution that this crisis is far from over, arguing that the financial system remains highly leveraged—with the aggregate U.S. financial sector debt approximating 117% of GDP (versus 22% during the great bull market in 1982) and total household debt at 96% of GDP (versus 47% in 1982).

- In testimony before the Joint Economic Committee, Federal Reserve chairman Ben Bernanke said, “We have now satisfied ourselves that the data we have are accurate reflections of the financial conditions of these banks” and have quantified their capital needs. Bernanke added that the administration does not foresee a near-term need for additional TARP funding. [Administration officials estimate that it has \$110 billion of TARP funds remaining and expect \$25 billion of TARP repayments soon.] “I think we’re in far better shape today than we were in September and October,” he added. “...I do believe that the availability of [TARP] capital helped us dodge what would have been a truly cataclysmic collapse of the global banking system, which would have had terrifically bad effects on the US economy.”
- In a May 6<sup>th</sup> appearance on the *Charlie Rose Show*, Treasury Secretary Timothy Geithner said, “This crisis was deeply damaging in part because of this great loss of confidence in the quality of leadership at America’s financial institutions across the board. And these institutions, all of them, have a long way to go to rebuild that sense of confidence and trust that’s necessary for any financial system to run well. And that’s going to require a lot more work by them, all of them. To earn that confidence in the American people they are going to make sensible judgments about the incentives they create for risk taking in their firms, how they are using those resources, and that they are going to be in their communities they operate, in the markets they operate. Where they lend, that they are going to be part of the solution and they are going to be an important part of recovery, and they need to work very hard to earn that confidence again. All these institutions and not just those that as a result of the Fed’s test emerge with relatively strong capital so they can repay. And I say that because we can’t go back to the situation we had over the last ten years...”
- Geithner added, “...[W]e had a period where compensation practices just became completely un-moored from reality, defied gravity, and they created incentives for risk taking that overwhelmed all the basic checks and balances in the system. Overwhelmed the discipline shareholders are supposed to bring to management of firms. Overwhelmed the checks and balances of risk management, and of supervision. And we’re not going to go back to that situation. We’re going to make sure that, as part of our broader regulatory reform effort, that we are putting in place standards that help change those incentives. That’s a critical thing. That’s going to apply—has to apply across the financial system.”
- According to the *Wall Street Journal*, the Obama administration has begun serious discussions about how to broadly address the way financial services companies—including those that have not received TARP funds—pay their executives and employees so that pay is more closely aligned with long-term performance. Among the concepts being studied is the issuance of a “best practices” document to guide firms in structuring pay and developing rules which would curb banks’ ability to compensate employees that would threaten the firm’s safety and soundness. Concurrently, House Financial Services Committee chairman Barney Frank (D-MA) is drafting legislation which would strengthen the government’s ability to monitor compensation and curb incentives which threaten a company’s viability or pose a

systemic risk to the national economy. New compensation rules will likely be rolled along with a broader revamp of financial markets regulation that Treasury is advocating.

- In the *Wall Street Journal*, Matthew Richardson and Nouriel Roubini wrote, "...[T]he results of the government's stress tests on banks will not mark the beginning of the end of the financial crisis. The government should be able to dangle an insolvency law as an incentive to cooperate. This will result in a \$1 trillion game of chicken. But given the size of the stakes, and the alternative of the taxpayers continuing to foot the bill, it's the best way forward." (*Bureau of National Affairs*, Aaron Lorenzo and Stephen Joyce, 05/08/09; *Washington Post*, Binyamin Appelbaum and Neil Irwin, 05/08/09; *Wall Street Journal*, David Enrich, Dan Fitzpatrick, and Marshall Eckblad, 05/09/09; *CNNMoney.com*, David Ellis, 05/11/09; *New York Times Dealbook Blog*, 05/11/09; *American Banker*, Cheyenne Hopkins and Joe Adler, 05/06/09; *Wall Street Journal*, Peter Eavis, 05/02/09; *New York Times*, Edmund L. Andrews and Jackie Calmes, 05/08/09; *Wall Street Journal*, David Enrich, Robin Sidel, and Deborah Solomon, 05/08/09; *Bureau of National Affairs*, Aaron Lorenzo, 05/07/09; *Wall Street Journal*, David Enrich, Robin Sidel, and Deborah Solomon, 05/08/09; *Outside the Box*, John Mauldin, 05/11/09; *Bureau of National Affairs*, Aaron Lorenzo, 05/06/09; *Fortune*, Colin Barr, 05/08/09; *Transcript of the Charlie Rose Show*, 05/06/09; *Wall Street Journal*, Matthew Richardson and Nouriel Roubini, 05/05/09; *American Banker*, Paul Davis, 05/08/09; *RGE Global Economic Monitor*, 05/08/09; *Wall Street Journal*, Rick Carew and Costas Paris, 05/13/09; *Financial Times*, Bertrand Benoit and Scheherazade Daneshkhu, 05/14/09; *Wall Street Journal*, Deborah Solomon and Damian Paletta, 05/13/09)

Fannie and Freddie report aggregate loss of \$33 billion for first quarter, triggering a \$25.1 billion capital injection by Treasury to prevent insolvency

Fannie Mae reports a 23.17 billion loss for the first quarter

Freddie Mac reports first quarter loss of \$9.9 billion

Federal government has committed \$2 trillion to support Fannie and Freddie

#### Fannie Mae reports a \$23.17 billion loss for the first quarter

- Fannie Mae reported a \$23.17 billion loss for the first quarter, which was largely attributable to a \$20.3 billion provision for future credit losses, \$5.7 billion write-downs on private agency MBS, and fair value losses of \$1.5 billion. As a result, Fannie has asked Treasury for an additional \$19 billion in capital to keep the GSE solvent—on top of the \$15.2 billion investment made by taxpayers earlier this year. Fannie Mae said it will continue reporting losses for the remainder of the year, which will require additional funding by the government.

- During the first quarter, Fannie Mae's level of seriously delinquent loans increased 74 basis points to 3.15%, while its level of nonperforming assets increased 4.9% to \$110.3 billion over the period. The company said rising unemployment and a continued fall in home prices have caused delinquencies to rise throughout the guarantee portfolio "including loans with lower risk characteristics." Fannie said it has revised its methods for estimating losses because "the current state of the housing and mortgage markets is unprecedented in many respects, greatly reducing the usefulness of relying on our historical loan performance data." During the quarter, the company acquired 25,374 single-family homes, bringing the GSE's SF REO inventory to 62,371 units (versus 63,538 at yearend).
- Bose George, an analyst for Keefe, Bruyette & Woods, said Fannie's large loss reflects a need to catch up on reserves that were too low until recently. George expects both Fannie and Freddie to continue building up loss reserves rapidly over the next few quarters. He noted that the "fair" value of Fannie's assets was \$110.3 billion *less than* liabilities on March 31<sup>st</sup>, which provides a rough estimate of additional losses the company may need to record over future periods. George added, "The scenario where these guys [Fannie and Freddie] can earn money to pay that back is remote." (*Fannie Mae Press Release*, 05/08/09; *Bloomberg News*, Dawn Kopecki, 05/08/09; *American Banker*, Kate Berry, 05/11/09; *Wall Street Journal*, James R. Hagerty, 05/09/09; *Washington Post*, Zachary A. Goldfarb, 05/09/09; *Bureau of National Affairs*, 05/11/09)

#### Freddie Mac reports \$9.9 billion loss for the first quarter

- Freddie Mac reported a \$9.85 billion loss for the first quarter, triggering a \$6.1 billion Treasury capital infusion to keep the GSE solvent. The company's first quarter results were driven primarily by \$9.1 billion in credit related expenses, a \$7.1 billion in security impairments on Freddie's available-for-sale securities, and a \$3.1 billion valuation allowance against its net deferred tax assets. These charges were partially offset by the net mark-to-market gains of \$3.8 billion on the company's derivative portfolio, guarantee asset and trading securities. On March 31<sup>st</sup>, Freddie Mac reported that the fair value of its net assets deteriorated by \$75.7 billion during the period to a *negative* \$80.9 billion. On March 31<sup>st</sup>, Freddie Mac's single-family delinquency rate was 2.29%, up 57 basis points from yearend, while its multifamily delinquency rate rose 8 basis points to 0.09%. The company also had more than 29,000 homes held as real estate owned valued at \$2.9 billion on March 31<sup>st</sup>. The most significant amount of REO acquisitions made by Freddie during the first quarter were properties in the states of California, Arizona, Florida, Michigan, and Nevada. Freddie Mac said that while it expects "the coming quarters to be difficult," management sees "preliminary signs of slowing in house-price declines." In its SEC filing, Freddie Mac reiterated that it has insufficient internal controls, which are unlikely to be fixed while it operates in conservatorship.

- Freddie’s first quarter loss was less than half that reported by Fannie Mae for the corresponding period. In a research note to clients, Jim Vogel, a debt analyst for FTN Financial noted, “Freddie’s first-quarter benefited from various accounting items that Fannie didn’t log for the same period.” Vogel added that Fannie appears to have been more conservative in its provisions for credit losses, which totaled about \$20 billion in the first quarter—more than double that of Freddie’s total. [Fannie owns or guarantees approximately \$3.1 trillion of mortgage loans compared to Freddie’s total of about \$2.2 trillion.] (*Freddie Mac Press Release*, 05/12/09; *Freddie Mac Financial Statements and Core Tables*, 05/12/09; *Freddie Mac 10Q*, 05/12/09; *Bloomberg News*, Dawn Kopecki and Jody Shenn, 05/12/09; *Washington Post*, Zachary A. Goldfarb, 05/13/09; *Wall Street Journal*, James R. Hagerty, 05/13/09)

Federal government has committed \$2 trillion to support Fannie and Freddie

- To support Fannie Mae’s and Freddie Mac’s operations, the Federal Reserve has purchased \$366 billion of GSEs’ mortgage investments and \$70 billion of GSE debt to date, while Treasury has pledged \$200 billion to keep each GSE solvent and bought \$124 billion of their mortgages. In aggregate, the federal government has committed about \$2 trillion to supporting Fannie and Freddie and buying the mortgage-backed securities that they issue. (*Washington Post*, Zachary A. Goldfarb, 05/09/09; *Bureau of National Affairs*, 05/11/09)

<p>Congress poised to approve creation of a Pecora-style commission to determine the causes of the financial crisis</p>
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- On May 6<sup>th</sup>, the House passed legislation by a vote of 367-59 that would create a ten member, bipartisan Financial Markets Commission to investigate the causes of the U.S. financial crisis. The panel, comprised of six Democratic and four Republican appointees, would have subpoena power and the authority to refer any evidence of wrong-doing to the U.S. Attorney General and state attorneys general. The Commission would report its findings and recommendations for statutory or regulatory changes to improve oversight of the financial system to Congress by December 15, 2010.
- The Senate version of the bill has a six-four split on commission appointees, but doles out appointments differently than the House version—a difference that must be reconciled. Under the House-passed bill, the Senate majority leader and the Speaker of the House will each make three appointments to the commission, while the minority leaders of both chambers will appoint two members each. Under the Senate version of the bill, the Speaker of the House and Senate Majority Leader would make two appointments each and the minority leaders in both chambers would get a combined two appointments. In addition, the chairmen and ranking members of the House Financial Services Committee and Senate Banking Committee would make one appointment each. Current members of Congress and federal and state employees would not be allowed to serve on the panel.

- Republicans who fought for the bill cautioned against Democrats loading the commission with partisans. Rep. Darrell Issa (R-CA), the lead Republican co-sponsor, said, “It is imperative for the success and credibility of this commission that partisan politics not obstruct the commission’s work. The Speaker has stressed many times how important bipartisanship is to commissions like the one we approved today. I would encourage her to use one of her appointments to give this commission bipartisan balance so it can produce a truly independent and credible assessment.”
- Democrats cautioned that the establishment of the commission should not give Republicans an excuse to stop Congress from proceeding with passage of new financial markets legislation. “As the Commission performs its duties, Chairman Barney Frank and the House Financial Services Committee will continue their work as we strive to stabilize our financial markets, protect consumers, and ensure that this financial crisis never happens again,” said House Speaker Nancy Pelosi (D-CA). House Financial Services Committee chairman Barney Frank (D-MA) said, “I think it’s important to look at these things—[but] I don’t think anyone is arguing that we should wait on the regulation.” Previously, Senate Banking Committee Chairman Chris Dodd (D-CT) shot down the idea for a special commission, arguing it would delay needed reforms. (*CongressDaily*, 04/21/09; *The Hill*, Jared Allen and Silla Brush, 05/06/09; *Bureau of National Affairs*, Mike Ferullo, 05/06/09)
- In a May 12<sup>th</sup> editorial, the *Wall Street Journal* wrote, “The Earth stood still, the seas parted and a member of the U.S. political class admitted last week that the Federal Reserve helped to cause the financial meltdown. OK, only the last of those happened, but it’s a welcome miracle nonetheless. The revelation came from Timothy Geithner last Wednesday with PBS’s Charlie Rose, who asked the Treasury Secretary: ‘Looking back, what are the mistakes and what should you have done more of? Where were your instincts right, but you didn’t go far enough?’ ...
- “Mr. Geithner: ‘But I would say there were three types of broad errors of policy and policy both here and around the world. One was that monetary policy around the world was too loose too long. And that created this just huge boom in asset prices, money chasing risk. People trying to get a higher return. That was just overwhelmingly powerful. ...[Monetary policy] was too easy, yes. In some ways less so here in the United States, but it was true globally. Real interest rates were very low for a long period of time.’”
- “Mr. Geithner went on to cite a lack of supervision over bank risk-taking and the slow pace of government response to the problem—both of which are now conventional wisdom. But the real news here is Mr. Geithner’s concession that monetary policy was ‘too loose too long.’ The Washington crowd has tried to place all of the blame for the panic on bankers, the better to absolve themselves. But as Mr. Geithner notes, Fed policy flooded the world with dollars that created a boom in asset prices and inspired the credit mania. Bankers made mistakes, but in part they were responding rationally to the subsidy for credit created by central bankers.”

- “Mr. Geithner’s concession is important nonetheless because before he moved to Treasury he was vice chairman of the Fed’s Open Market Committee that sets monetary policy. His comments mark a break with the steadfast refusal of Fed Chairmen Alan Greenspan and Ben Bernanke to admit any responsibility. They prefer to blame bankers and what they call the ‘global savings glut,’ as if the Fed had nothing to do with creating that glut.”
- “Mr. Geithner’s remarks are a sign of intellectual progress, and they suggest that at least some in government are thinking about their own part in creating the mess. **The role of Fed policy should also be at the heart of the hearings that Speaker Nancy Pelosi is planning on the causes of the financial meltdown. We won’t begin to understand the credit mania and panic until we acknowledge their monetary roots.**” [Emphasis added.] (*Wall Street Journal*, 05/12/09)

Senate passes S. 896 to revamp FHA’s HOPE for Homeowners
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- By a vote of 91-5, the Senate passed Helping Families Save Their Homes Act of 2009 (S. 896) to broaden the safety net for homeowners on the brink of bankruptcy and boost the liquidity of the FDIC. S. 896 would revamp the FHA’s HOPE for Homeowners program [that has completed about 50 of the 400,000 loans refinancings originally targeted] and provide lawsuit protection to mortgage servicers who modify home loans. Provisions in the bill are intended to compliment the Obama administration’s \$75 billion foreclosure prevention program, which aims to help up to 9 million homeowners secure loan modifications or refinancings. The Senate bill would lower fees and requirements for participation in the HOPE for Homeowners program. The Senate passed amendments to the measure which would (i) require customers to be notified when their mortgage has been sold or transferred to a third party; (ii) allow tenants to remain at properties in foreclosure during the duration of their lease; (iii) provide GAO authority to access books and records of companies and partnerships that receive money from TARP; (iv) provide GAO authority to access information regarding specific actions taken by the Federal Reserve in its bailout and financial stabilization efforts; (v) provide a major expansion of a federal homelessness prevention program to include a \$600 million increase in homeless assistance grants and \$440 million in prevention initiatives; and (vi) allow the U.S. Treasury to retain warrants in banks after TARP funds are repaid.
- The Senate’s passage of the largely non-controversial bill now sets the stage for appointment of conferees to hammer out a final bill. In March, the House passed H.R. 1106, a more ambitious proposal that includes a broader safe harbor for mortgage servicers and a provision allowing bankruptcy judges to modify mortgage terms that are not “fixed” by the administration’s foreclosure prevention program. The Senate defeated a proposed mortgage cram-down provision by a vote of 45-51 [60 votes needed for passage]. Both bills contain similar—but not identical—FDIC provisions to increase FDIC’s line of credit with the U.S Treasury. The House

version would provide FDIC an immediate increase to \$100 billion, while the Senate version would increase FDIC's line from \$30 billion to \$500 billion until 2010, followed by a permanent increase to \$100 billion. Both bills would extend the agency's deposit insurance limit to \$250,000.

- A spokesman for House Speaker Nancy Pelosi said it was clear that the Senate will not pass the mortgage cram-down provision and would have to be dropped in conference. Senate Banking Committee Chairman Christopher Dodd (D-CT) concurred, calling in the bankruptcy provision a "dead letter." Pelosi's spokesman said a timeline has not been set yet for the appointment of conferees. Dodd said he thought it was possible for the House to approve the Senate version, but added he needed to confer with House Financial Services Committee chairman Barney Frank (D-MA). On May 7<sup>th</sup>, Frank said it was unlikely that the Senate bill (S.896) would be passed by the House. "In my perfect world, we would have a conference, but it could be an informal conference," said Frank. While Pelosi remains hopeful that the Senate and House could reach a compromise on the bankruptcy bill, a final deal on the legislation needs to be reached, he added. "Look, I'm sorry about bankruptcy," said Frank. "But the bill has some other very important elements." (*Bureau of National Affairs*, Mike Ferullo, 05/07/09; *CQ Today*, Phil Mattingly, 05/06/09; *Financial Times*, Saskia Scholtes, 05/07/09; *Bloomberg News*, Dawn Kopecki and Margaret Chadbourn, 05/06/09; *CQ Today*, Phil Mattingly, 05/07/09)
- As Congress retools the HOPE for Homeowners (H4H) program, the Obama administration faces a new headache for the beleaguered HUD program. According to senior federal housing officials, 50 of the 51 loans made through the H4H program made by Lend America are being held up by a pending on-going federal investigation. Officials said that the focus of the inquiries could range from "anything from inadequate documentation to unethical practices." Lend America has made a business out of getting borrowers' subprime mortgages refinanced into "government" loans. Michael Ashley, a business strategist and on-air personality-in-chief, serves as Lead America's pitch man in their 30-minute infomercials on how to participate in the "Obama Bailout Plan." In 1996, Ashley pled guilty to mail fraud after the Fed targeted Liberty Mortgage Banking, owned by his father, and was sentenced to probation and a \$30,000 fine to be paid to Freddie Mac. (*Forbes*, Maurna Desmond, 05/07/09)

House passes mortgage reform bill aimed at predatory lending
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- By a vote of 300-114, the House of Representatives approved the Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728), which would set new mortgage standards and curb some lending practices. Provisions in H.R. 1728 would (i) amend the Truth in Lending Act to direct the federal banking agencies to prohibit terms, acts, or practices relating to residential mortgage loans that are abusive, unfair, deceptive, predatory, or "not in the interest of the borrower"; (ii) require residential mortgage loans to meet a standard of providing a mandatory net tangible benefit to the

consumer, essentially creating a suitability requirement in the mortgage industry; (iii) prohibit a creditor from lending without due regard of the mortgagor's ability to repay as well as establishing other restrictions on what the bill defines as predatory practices in connection with "high cost" mortgages; (iv) require lenders that securitize loans to retain up to five percent of the loan or such other amount as set by the bank regulators; (v) provide that any liability in a civil action which may be maintained against a creditor may be maintained against any assignee or securitizer of the mortgage; (vi) preempts states from adopting laws that would impact provisions governing the determination of the ability of the borrower to repay or the requirement of a net tangible benefit [the authority of the states to adopt more stringent laws on other subjects in the bill is not constrained]; (vii) expand provisions relating to appraisal standards and mortgage servicing; (viii) require lenders to use IRS tax records to verify income; and (ix) require HUD to suspend implementation of its final RESPA rule establishing a new standardized Good Faith Estimate and work with the Federal Reserve Board to issue a new joint rule to be implemented no later than March 1, 2010. [Separately, HUD Secretary Shaun Donovan announced on May 11<sup>th</sup> his intention to implement the revised RESPA rules which are scheduled to take effect January 1, 2010.]

- The outlook for a predatory lending bill in the Senate remains uncertain. Senate Banking Committee chairman Christopher Dodd (D-CT) said that while he would like to move companion legislation aimed at curbing predatory practices, such a bill would spark fights in the Senate. Dodd added, there's little "impetus" to take up the measure at this time. "There isn't a lot of predatory lending going on right now, so while it would certainly plug a hole, these other issues I'm grappling with are current issues," Dodd told reporters. Instead, Dodd is placing a priority on addressing the systemic risks that still could arise in the financial sector. "I've got modernization issues [to deal with]," said Dodd. "We've got to block out some time for that, not to mention the oversight of TARP and oversight on things like the stress test." (*CQ Today*, Phil Mattingly, 05/07/09; *House Financial Services Press Release*, 05/07/09; *Bureau of National Affairs*, Heather M. Rothman, 05/11/09; *CQ Today Midday Update*, 05/12/09; *American Banker*, Stacy Kaper, 05/08/09; *American Banker*, Stacy Kaper, 05/13/09)

# TARP

## Treasury allocates \$22 billion of TARP funds to the insurance sector

- On May 14th, the Hartford Financial Services Group and Lincoln National announced they have received preliminary approval to receive funds from TARP's Capital Purchase Program of \$3.4 billion and \$2.5 billion, respectively. On May 14th, the *Wall Street Journal* also reported that Prudential Financial Group, Principal Financial Group, Allstate, and Ameriprise Financial have been approved to receive TARP funds. In aggregate, Treasury plans to allocate as much as \$22 billion of TARP funds to the life-insurance sector, according to a person familiar with the matter. A Treasury spokesman told the *Journal* that these insurers were approved because they had applied as bank-holding companies before the November 14 deadline. Last fall, a number of insurance companies purchased bank-holding companies with the express purpose of becoming eligible to receive TARP funds. (*Fox Business News*, Joanna Ossinger and Rich Edson, 05/15/09)

## Treasury plans to use TARP repayments to extend CPP funds to small banks

- In a May 13<sup>th</sup> speech to the Independent Community Bankers of America, Treasury Secretary Timothy Geithner said, "Using the proceeds of the [TARP] repayments we expect to receive from some of the largest banks, we plan to re-open the application window for banks with total assets under \$500 million under the Capital Purchase Program, and raise from 3% of risk-weighted assets to 5% the amount for which qualifying institutions can apply. This applies to all term sheets—public and private corporations, Subchapter S corporations, and mutual institutions. Current CPP participants will be allowed to reapply, and will have an expedited approval process. In addition, we will extend the deadline for small banks to form a holding company for the purposes of CPP. Both the window to form a holding company and the window to apply or reapply for CPP will be open for six months."
- With more than 300 small banks currently participating in the CPP, it is unclear whether Treasury's expansion will garner many new applicants. (*Treasury Press Release*, 05/13/09; *New York Times*, Stephen Labaton, 05/14/09)

Democrats look to extend federal support to the muni-bond market

California formally asks Treasury for access to TARP funds

Democrats look to extend federal support to the muni-bond market

- According to Congressional staff sources, House Financial Services Committee chairman Barney Frank (D-MA) will soon introduce legislation that would empower the federal government to reinsure, help purchase and regulate municipal bonds. Specifically, Frank plans to propose four separate bills providing massive government backing and intervention into the muni-bond market that would (i) create a liquidity facility through the Federal Reserve to purchase municipal bonds; (ii) form a temporary federal government program to reinsure municipal bond insurers; (iii) provide additional regulation for financial advisors to municipalities; and (iv) require municipal and corporate debt be rated on a “global” scale based upon the likelihood of timely repayment to the creditor. However, Frank decided not to include a provision that would have provided federal guarantees for general obligation debt sold by states and municipalities. The Committee has tentatively scheduled a May 21<sup>st</sup> hearing on municipal bonds, according to an internal staff schedule. (*Fox News*, Rich Edson, 05/12/09; *Bond Buyer*, Andrew Ackerman, 05/14/09))

California formally asks Treasury for access to TARP funds

- On May 13<sup>th</sup>, California Treasurer Bill Lockyer asked Treasury Secretary Timothy Geithner to authorize TARP assistance for his state, warning that depressed tax revenues may cut into basic services and halt the building of infrastructure. In a letter to Geithner, Lockyer wrote, “If we cannot obtain our usual short-term cash-flow borrowings, there could be devastating impacts on the ability of the State or other governments to provide essential services to their citizens,” particularly for fire and police protection, education and social services. Lockyer estimated that California’s cash flow shortfall will exceed \$13 billion in fiscal 2009-2010. California’s cash flow problems may lead to trouble accessing the long-term bond market, which could “eventually even halt our infrastructure construction programs.”
- Weakness in the credit markets will cause difficulties in short-term borrowing to make up the state’s \$13 billion shortfall, necessitating the use of TARP funds, wrote Lockyer. Under Lockyer’s proposal, Treasury would use TARP money to “purchase the non-performing assets,” if California is unable to repay loans made using TARP funds. Under that scenario, the state or local government would then directly repay the Treasury under the terms it had with the bank. Previously, Lockyer has said he believes the Obama administration has the authority to use TARP to guarantee state government borrowing. (*Marketwatch*, John Letzing, 05/13/09)

U.S. bailouts total \$2.98 trillion—and growing, says TARP “cop” Barofsky

- Neil Barofsky, special inspector for TARP, told lawmakers that the U.S. government has committed \$2.98 trillion to bail out portions of the private sector, which includes the \$700 billion TARP program and funding for 12 separate programs from the Federal Reserve and FDIC. “This is a huge, unprecedented financial commitment ...\$2.9 trillion is just short of what the entire federal government spent in fiscal year 2008,” said Senate Finance Chairman Max Baucus (D-MT). “It’s like having a second United States government budget dedicated solely to saving the financial system, and that is truly surreal.” (*Wall Street Journal*, Meena Thiruvengadam, 03/31/09)

TOTAL FUNDS SUBJECT TO SIGTARP OVERSIGHT, AS OF MARCH 31, 2009 (\$ BILLIONS)			
Program	Brief Description or Participant	Total Projected Funding	Projected TARP Funding
Capital Purchase Program (“CPP”)	Investments in 532 banks to date; 8 institutions total \$125 billion	\$218.0	\$218.0
Automotive Industry Financing Program (“AIFP”)	GM, Chrysler, GMAC, Chrysler Financial	\$25.0	\$25.0
Auto Supplier Support Program (“ASSP”)	Government-backed protection for auto parts suppliers	\$5.0	\$5.0
Unlocking Credit for Small Businesses (“UCSB”)	Purchase of securities backed by SBA loans	\$15.0	\$15.0
Systemically Significant Failing Institutions (“SSFI”)	AIG Investment	\$70.0	\$70.0
Targeted Investment Program (“TIP”)	Citigroup, Bank of America Investments	\$40.0	\$40.0
Asset Guarantee Program (“AGP”)	Citigroup, Bank of America, Ring-Fence Asset Guarantee	\$419.0	\$12.5
Term Asset-Backed Securities Loan Facility (“TALF”)	FRBNY non-recourse loans for purchase of asset-backed securities	\$1,000.0	\$80.0
Making Home Affordable (“MHA”) Program	Modification of mortgage loans	\$75.0	\$50.0
Public-Private Investment Program (“PPIP”)	Disposition of legacy assets; Legacy Loans Program, Legacy Securities Program (expansion of TALF)	\$500.0 – \$1,000.0	\$75.0
Capital Assistance Program (“CAP”)	Capital to qualified financial institutions; includes stress test	TBD	TBD
New Programs, or Funds Remaining for Existing Programs	Potential additional funding related to CAP; AIFP; Auto Warranty Commitment Program; other	\$109.5	\$109.5
<b>Total</b>		<b>\$2,476.5 – \$2,976.5</b>	<b>\$700.0</b>

Source: Office of the Special Inspector General for TARP Quarterly Report to Congress, April 21, 2009

- In an April 23<sup>rd</sup> Joint Economic Committee hearing, Barofsky told lawmakers that Treasury should take steps to better manage its financial rescue efforts to safeguard taxpayer dollars. Barofsky cautioned that fund managers who participate in the Public-Private Investment Program (PPIP) could take advantage of the program at taxpayer’s expense. According to the IG’s quarterly report to Congress, “The significant Government-financed leverage [for PPIP] presents a great incentive for collusion between the buyer and seller of the asset, or the buyer and other buyers, whereby, once again, the taxpayer takes a significant loss while others profit.” The program poses “significant fraud risk,” cautioned the Special Inspector General.
- Barofsky also renewed his calls for Treasury to disclose publicly how firms are using the TARP funds that they receive. The agency’s surveys of the banks’ lending activities isn’t adequate, said the Special Inspector General, who recommended that Treasury require TARP recipients to account for and report the use these funds on a regular basis.

- Barofsky also raised questions about the Federal Reserve’s Term Asset-Backed Securities Loan Facility (TALF) which is also vulnerable to fraud. The Special Inspector General recommends that the Fed abolish its plan to have credit –ratings agencies determine the quality of the loans. Instead, the central bank would screen each residential-backed security it takes as collateral, said Barofsky.” “Arguably, the wholesale failure of the credit-rating agencies to rate adequately such securities is at the heart of the securitization market collapse, if not the primary cause of the current credit crisis,” wrote Barofsky in his quarterly report to Congress.
- Barofsky told lawmakers that his office has opened 20 criminal investigations and conducted six audits into potential pilfering or waste of taxpayers’ funds. One of the SIG’s audits relates to Bank of America’s acquisition of Merrill Lynch and related news reports that Federal Reserve chairman Ben Bernanke and then Treasury Secretary Henry Paulson urged BofA CEO Ken Lewis to “keep mum” about the transaction’s financial drag. Barofsky said he hopes to have all of the audits “wrapped up” this summer. In his department’s criminal investigations, Barofsky is looking into whether bailout decisions were influenced by those who stood to benefit from them and whether companies receiving TARP funds are adhering to Treasury’s rules governing caps on executives’ compensation.
- Finally, Barofsky expressed concern that the Obama administration’s mortgage rescue plan could spur a wave of real estate fraud. He recommended that officials take steps to confirm the identities of the participants and inform homeowners that they aren’t required to pay fees to participate in the program. In response to these concerns, Senator Chuck Schumer (D-NY) introduced the Fighting Real Estate Fraud Act of 2009, which would establish a \$100 million grant program for local District Attorney’s offices for hiring specialized staffs to fight mortgage fraud. (*Wall Street Journal*, Maya Jackson Randall, 04/21/09; *CNNMoney.com*, Jennifer Liberto, 04/21/09; *HousingWire*, Kelly Curran, 04/21/09; *Bureau of National Affairs*, Aaron Lorenzo, 04/24/09)

Treasury’s warrants for only 30 of the 234 TARP institutions are “in the money”
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- According to an analysis by SubsidyScope (a project launched by the Pew Charitable Trusts), only 30 of the 234 warrant transactions listed by the Special Inspector General overseeing TARP were “in the money” on May 13<sup>th</sup>. SubsidyScope wrote, “Some of the biggest recipients of TARP funding are in the most difficult financial situations. For example, the closing stock price for AIG was \$1.60 on May 13, which is 36 percent below the strike price of \$2.50 of the warrants that the government received on November 25, 2008; and Citigroup’s closing stock price of \$3.41 on May 13 is 81 percent below the strike price of \$17.85 of the warrants the government received on October 28, 2008.” Information for each of the 234 warrant transactions is available at [www.subsidyscope.com/projects/bailout/tarp/warrants/](http://www.subsidyscope.com/projects/bailout/tarp/warrants/). (*Subsidyscope.com*, 03/13/09)

“The men who nearly ruined Bank of America have some explaining to do”

Hearings sought over the government’s role in Bank of America’s acquisition of Merrill

“The men who nearly ruined Bank of America have some explaining to do”

- In an April 27<sup>th</sup> editorial, the *Wall Street Journal* wrote, “The cavalier use of brute government force has become routine, but the emerging story of how Hank Paulson and Ben Bernanke forced CEO Ken Lewis to blow up Bank of America is still shocking. It’s a case study in the ways that panicky regulators have so often botched the bailout and made the financial crisis worse. In the name of containing ‘systemic risk,’ our regulators spread it. In order to keep Mr. Lewis quiet, they all but ordered him to deceive his own shareholders. And in the name of restoring financial confidence, they have so mistreated Bank of America that bank executives everywhere have concluded that neither Treasury nor the Federal Reserve can be trusted.”
- “Mr. Lewis has told investigators for New York Attorney General Andrew Cuomo that in December Mr. Paulson threatened him not to cancel a deal to buy Merrill Lynch. BofA had discovered billions of dollars in undisclosed Merrill losses, and Mr. Lewis was considering invoking his rights under a material adverse condition clause to kill the merger. But Washington decided that America’s financial system couldn’t withstand a Merrill failure, and that BofA had to risk its own solvency to save it. So then-Treasury Secretary Paulson, who says he was acting at the direction of Federal Reserve Chairman Bernanke, told Mr. Lewis that the feds would fire him and his board if they didn’t complete the deal. Mr. Paulson told Mr. Lewis that the government would provide cash from the Troubled Asset Relief Program (TARP) to help BofA swallow Merrill. But since the government didn’t want to reveal this new federal investment until after the merger closed, Messrs Paulson and Bernanke rejected Mr. Lewis’s request to get their commitment in writing.”
- “‘We do not want a disclosable event,’ Mr. Lewis says Mr. Paulson told him. ‘We do not want a public disclosure.’ Imagine what would happen to a CEO who said that. After getting the approval of his board, Mr. Lewis executed the Paulson-Bernanke order without informing his shareholders of the material events taking place at Merrill. The merger closed on January 1. But investors and taxpayers had to wait weeks to learn that the government had invested another \$20 billion plus loan portfolio insurance in BofA, and that Merrill had lost a staggering \$15 billion in the last three months of 2008.”
- “This was the second time in three months that Washington had forced Bank of America to take federal money. In his testimony to the New York AG’s office, Mr. Lewis noted that an earlier TARP investment in his bank had a ‘dilutive effect’ on existing shareholders and was not requested by BofA. ‘We had not sought any funds.

We were taking 15 [billion dollars] at the request of Hank [Paulson] and others,' Mr. Lewis testified.”

- “But it is the Merrill deal that raises the most troubling questions. Evaluating the policy of Messrs. Bernanke and Paulson on their own terms, this transaction fundamentally increased systemic risk. In order to save a Wall Street brokerage, the feds spread the risk to one of the country’s largest deposit-taking banks. If they were convinced that Merrill had to be saved, then they should have made the public case for it. And the first obligation of due diligence is to make sure that their Merrill ‘rescuer’ of choice—BofA—had the capacity to bear the losses. Instead they transplanted the Merrill risk to BofA shareholders, the bank’s depositors and the taxpayers who ensure those deposits. And then they had to bail out BofA too.”
- “Messrs. Bernanke and Paulson also undermined the transparency that is a vital source of investor confidence. Disclosure is not a luxury to be enjoyed only when markets are rising. It is the foundation of the American regulatory system and a reason investors have long sought to keep their money within U.S. borders. Could either man have believed that their actions wouldn’t eventually come to light, with all of the repercussions for their bank rescue plans?”
- “Mr. Paulson told Mr. Cuomo’s investigators that he also kept former SEC Chairman Christopher Cox out of the loop while forcing BofA to rescue Merrill. Mr. Cox wasn’t the only one. Mr. Paulson and Mr. Bernanke both sit on the Financial Stability Oversight Board, comprised of federal regulators who oversee TARP. Two days after Mr. Lewis told the dynamic duo that Merrill’s losses were exploding and that he was looking for a way out, Mr. Bernanke chaired and Mr. Paulson attended a meeting of this board. Minutes of the meeting show no mention of BofA or Merrill.”
- “At the next meeting on January 8, a week after the merger had closed, the minutes again make no mention of either regulator telling their colleagues that they had committed tens of billions of dollars. Yet the minutes helpfully note that among the topics discussed were ‘coordination, transparency and oversight.’ Meeting minutes suggest Messrs. Bernanke and Paulson finally informed fellow board members at 4:30 p.m. on January 15, after news outlets had already reported a pending new taxpayer investment in BofA. What exactly did Mr. Bernanke and Mr. Paulson tell their colleagues about their plans for TARP prior to January 15?”
- “Let’s hope they treated their government colleagues better than they’ve treated Ken Lewis, whom they hung out to dry. After making him an offer he could hardly refuse, they’ve let him endure a public flogging from shareholders and the press, lengthy discussions with prosecutors, plus new hiring and compensation rules that limit his bank’s ability to compete.”
- “No wonder no banker in his right mind trusts the Fed or Treasury, and no wonder nobody but Pimco and other Treasury favorites is eager to invest in the TALF, the

PPIP, or any of the other programs that require trusting the government as a business partner.”

- “The political class has spent the last few months blaming bankers for everything that has gone wrong in the financial system, and no doubt many banks have earned public scorn. But Washington has been complicit every step of the way, from the Fed’s easy money to the nurturing of Fannie Mae and Freddie Mac, and since last autumn with regulatory and Congressional panic that is making financial repair that much harder. The men who nearly ruined Bank of America have some explaining to do.” (*Wall Street Journal*, 04/27/09)
- “The Treasury is far more powerful because they’re giving out the TARP money, and as a result of that, power goes with money, said former FDIC chairman William L. Seidman [who passed away on May 13<sup>th</sup> at the age of 88]. “The TARP money is such that when they say, ‘Jump,’ the banks respond with ‘How High?’” (*American Banker*, Paul Davis and Steven Sloan, 04/24/09; *Bloomberg*, 05/14/09)

#### Hearings sought over the government’s role in Bank of America’s acquisition of Merrill

- In June, Bank of America chief executive Ken Lewis and top federal officials will be asked to testify under oath in a House Committee on Oversight and Government Reform Committee hearing about claims that the bank was pressured by the government to complete its acquisition of Merrill Lynch, said a person familiar with the investigation. The decision was made after investigators reviewed documents at the Federal Reserve, along with notes from conversations involving Federal Reserve officials and other information, which suggest “there’s fire there.” The Committee, chaired by Edolphus “Ed” Towns (D-NY), has yet to determine which U.S. officials will be called to testify.
- In an April 30<sup>th</sup> letter to Towns, Bernanke denied that he asked Lewis to hide any disclosures or withhold information. Bernanke wrote, “Let me be clear: At no time during these discussions did I or any member of the Federal Reserve direct, instruct or advise anyone at Bank of America to withhold from public disclosure information about Merrill Lynch.” In testimony before Congress’s Joint Economic Committee, Bernanke added, “I absolutely did not in any way ask Mr. Lewis to obscure any disclosure or fail to report information he should be reporting.” He also offered to turn over all “papers, documents, and notes related to the meetings.” [Now that the Fed has allowed congressional investigators to review its documents, the central bank also is likely waive their executive privilege claim and allow New York Attorney General Andrew Cuomo’s investigators to also review its documents.]
- Separately, the domestic policy subcommittee of the House Committee on Oversight and Government Reform also has asked Lewis to testify under oath to back up the assertions he made in his testimony to Cuomo. The subcommittee, chaired by Representative Dennis Kucinich (D-OH), has not yet set a date for the hearing, but staff members are plowing through thousands of pages of documents.

- House Financial Services Committee chairman Barney Frank (D-MA) said that there “probably should be some hearings” on the matter. He added that Lewis should get some credit for “doing the right thing” by going through with the Merrill acquisition, because he was acting “in the public interest” to help stabilize the financial system. Ranking member Spencer Bachus (R-AL) said he would probably seek testimony from Lewis, Bernanke, and Paulson, among others. “There is serious disagreement among the people involved, and we need to get a clearer picture of what transpired,” said Bachus. Senate Banking Committee chairman Christopher Dodd (D-CT) also said he plans to schedule a hearing on the matter. (*Wall Street Journal*, Michael R. Crittenden and Liz Rappaport, 05/01/09; *Washington Post’s Economy Watch Blog*, 05/07/09; *Wall Street Journal*, Michael Crittenden, 05/07/09; *Wall Street Journal*, 04/27/09)

The politicization of Chrysler and General Motors
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- In *American Thinker*, Alan Aronoff wrote, “The American automotive industry will not be nationalized under the Obama administration; it will be politicized. With Chrysler in bankruptcy, and General Motors soon to follow, we are provided with an opportunity to view the future of the automotive industry where the federal government not only sets the rules, but is also a major player. President Obama has said that he wants to remake the auto industry, and now he will have the mechanisms in place to do so.
- “...If the reorganization planned by the federal government for GM and the proposed bankruptcy for Chrysler go through, the ownership of two of the big three auto makers in the US will be concentrated to the UAW and the US government.”

<u>Chrysler reorganization</u>	%	<u>GM reorganization</u>	%
	ownership		ownership
UAW (healthcare fund)	55%	US gov’t	50%
US gov’t	8%		
Canadian gov’t	2%	UAW	39%
Fiat	20%	GM shareholders	1%
Fiat - earn out	15%	Secured debt (\$27B)	10%
Secured debt (\$6.9B)	\$2.2B		

- “The US government and the UAW will control Chrysler and GM. The UAW would retain a controlling interest in Chrysler as a result of putting the UAW employees health trust, an unsecured creditor, ahead of secured credit holders. This will serve as notice to investors that the government can and will override contractual terms in bonds offered and issued according to law in order to offer preferential favors to

political allies like the UAW which supported Obama for President. In the 2008 election, the UAW spent \$1.98 million to elect Democratic candidates and that does not include the \$4.875 million in independent expenditures to elect Obama president.

- “Industries in trouble tend to consolidate as this concentrates pricing power and specialized manufacturing and product capabilities that are critical to business execution. We are witnessing this consolidation as: Fiat plans to bid for Opel from GM in addition to obtaining a stake in Chrysler; China’s Geely Automobile Holdings Ltd. bids for Saab; Germany’s Daimler Benz and BMW are discussing ways to reduce costs; [and] Porsche and Volkswagen plan to merge. More consolidation should be expected. With the US government and UAW expecting to be in control of Chrysler and GM, cooperation here may be expected. And, if such cooperation were to occur, could the Ford Motor Company file suit against the UAW and the federal government under the Sherman Anti Trust Act? The federal government could claim exemption from such suits, and such a suit would matter if Chrysler and GM were viable in the market.”
- “The chances for Chrysler and GM to thrive are not good, based on the way this Administration is structuring GM and Chrysler. For Chrysler, Fiat gets a call on its future by providing its engine technology to Chrysler and puts up no cash. Fiat still needs to turn around Chrysler with the UAW and the federal government as its partners. Fiat can expect Uncle Sam to continue to pay the tab until it becomes a political nightmare for the Obama administration. For the near term, there is no real pressure on Fiat to turn Chrysler around. Fiat has planned to manufacture 2.8 million cars per year in 2010, but Fiat and Chrysler have excess assembly capacity.”
- “This Administration has stated that it wants to build alternative fuel cars in the US. The strength of the GM and the Chrysler product lines is found in the SUV and the pick-up truck market. Fiat and GM will need to compete with Japanese automakers, Toyota, Nissan, and Honda, as well as the other foreign owned car companies selling in the US. Fiat has little presence in the American market. Its website doesn’t even have a country page for the United States. Fiat will face fierce competition, unless the US tilts the playing field in favor of it, for example, by instituting punitive tariffs on imported vehicles which will drive up the cost of cars in the US, and most likely provoke retaliatory tariffs from our trading partners.”
- “To complete Obama’s vision for the American automotive industry, he needs to create the demand for alternative fuel cars, since the price signal from the cost of oil will not create sufficient demand for these vehicles. This is part of the rationale for a carbon tax or cap and trade system. The other part of the rationale is to raise lots of money on broad new taxes which Obama does not want labeled as a regressive tax, although that is indeed what a carbon tax is.”
- “Stacking the deck in favor of GM and Chrysler, and using new taxes to create demand for alternative fuel vehicles which Obama wants built in the U.S., won’t be enough to guarantee success for Chrysler and GM. The politicized auto industry will

still need to compete with the strongest players in this market. GM and Chrysler will need to have excellence in design, and to manufacture cars that are high quality to attract buyers.”

- “As we see in the banking industry, having the government as your investment partner creates huge disincentives to attract and retain top, capable, and motivated management. This is the fatal flaw of Obama’s politicization of the American automobile industry, and it will be shown that the money from the US Treasury was a poor investment, and the better outcome would have come from a regular Chapter 11 reorganization without the Obama’s heavy handedness.” (*American Thinker*, Alan Aronoff, 05/12/09)
- In a May 14<sup>th</sup> editorial, the *Washington Post* wrote, “...Extraordinary times call for extraordinary measures, and it was with this thought in mind that we endorsed the federal government’s decision to pump billions of dollars into the automakers. But the spectacle of creditors being stripped of their legal rights in favor of a labor union with which the president is politically aligned does little to attract private capital at a time when the government and many companies need these investors the most. Investors’ fears will only be compounded if the administration follows a similar blueprint with GM.” *Washington Post*, 05/14/09)
- Treasury will grant GM as much as \$5 billion of additional TARP funds and \$500 million to Chrysler, while the auto companies rework their restructuring plans. During the first quarter, GM “burned through” \$10.2 billion of cash, as revenues dropped faster (47%) than expenses could be cut. For the period, the automaker reported a \$6 billion loss. (*Bureau of National Affairs*, 05/08/09)
- Treasury Secretary Timothy Geithner also said GMAC LLC would probably require additional government funds, which his agency has committed to provide. [A stress test analysis of GMAC concluded that the company needs \$11.5 billion of capital.] Previously, GMAC received \$5 billion in funding through TARP. According to sources, GMAC will tentatively receive a \$4 billion injection on or around May 15<sup>th</sup> [although the final number isn’t set] and a second injection to fill the \$11.5 capital shortfall established by the stress test [assuming the company is unable to raise private capital]. (*Bureau of National Affairs*, Nora Macaluso and Aaron Lorenzo, 05/08/09; *Wall Street Journal*, Dennis K. Berman, 05/12/09; *Bureau of National Affairs*, Aaron Lorenzo, 05/08/09)
- Small auto suppliers are appealing the Treasury for aid, arguing that GM’s and Chrysler’s woes are devastating the auto industry’s supply chain. Chrysler’s Chapter 11 filing has left unpaid bills for million of auto parts. Suppliers fear that a GM bankruptcy would further exacerbate their cash flow problems. While Treasury has created a \$5 billion program to aid the so-called Tier 1 (biggest) suppliers, smaller firms—Tier 2 and Tier 3—which make small parts, such as screws and hinges, have no access to TARP funds. House Small Business Committee chairwoman Rep. Nydia M. Velázquez (D-NY) said, “Strengthening and supporting small firms will be

critical. Failure to do so will shrink the supplier base further, dealing a lethal blow to businesses like GM and Chrysler.” (*Washington Post*, Kendra Marr, 05/14/09)

- The auto companies’ restructuring plans call for shrinking the number of dealerships. On May 15th, GM plans to notify 1,000 to 1,200 auto dealers that they fail to meet the company’s franchise agreements. [Ultimately, GM plans to shrink its dealer network from 6,200 outlets to about 3,600.] Chrysler plans to terminate 789 franchise agreements—or roughly 25% of its 3,200 dealerships. The National Association of Auto Dealers is running advertisements in the *Washington Post* and at *Politico.com*, warning readers that the auto manufacturers’ plans to close dealerships will result in the loss of 150,000 jobs. The closing of these dealerships will also have a domino effect on the dealers’ inventory loans, which largely are financed by the auto companies. Traditionally, 75% of the GM and Chrysler dealers finance their inventories through GMAC and Chrysler Financial (CF), who have “claw back” clauses in their loan agreements. These clauses would allow GMAC and CF to demand at least a partial payment of the loans in the event of bankruptcy because the value of the vehicles being used as collateral would plummet. In filings with Treasury, GMAC said direct financing to dealers for inventory could cost taxpayers between \$2 billion and \$14 billion during the course of the company’s bankruptcy. Chrysler’s projections were “unclear” on this issue. (*Wall Street Journal*, John D. Stoll, 04/27/09; *Wall Street Journal*, Neal E. Boudette, 05/14/09; *Mish’s Global Economic Trend Analysis*, Mike Shedlock, 05/12/09)

AIG bailout: \$130 billion (drawn down) and counting...

- AIG’s bailout was expected to be a relatively quick process. However, eight months later, Treasury’s commitments to the insurer have more than to \$182 billion, of which AIG has taken down \$130 billion. The company’s efforts to sell off many of its businesses to pay-off the government’s loan have been hampered by AIG’s on-going operating losses. On May 8<sup>th</sup>, AIG announced a \$4.35 billion loss for the first quarter, the company’s sixth straight quarterly loss. “How long the plan will ultimately take will very much depend on how quickly and how strongly the global economy recovers,” AIG CEO Edward Liddy told lawmakers. (*CNNMoney.com*, David Goldman, 05/13/09; *Washington Post*, Brady Dennis, 05/08/09)

Federal Reserve Bank of New York’s chairman resigns  
amid questions about stock purchase

- Stephen Friedman, chairman of the Federal Reserve Bank of New York, resigned on May 7<sup>th</sup>, after questions were raised about a conflict of interest related to his purchase of stock in his former firm, Goldman Sachs. Friedman, a retired chairman of Goldman, has served as the NY Fed’s chairman since January 2008. In December, he purchased 37,300 shares in Goldman Sachs at an average price of \$80.78. Friedman then purchase 15,300 shares for an average price of \$66.19 and \$67.12 on January

22<sup>nd</sup>. Prior to making the second purchase, he obtained a waiver from the Fed which allowed him to hold the stock until the end of 2009. On May 7<sup>th</sup>, Goldman's shares closed at \$133.73, earning Friedman more than \$3 million on his two purchases. Denis Hughes, the president of the New York State AFL-CIO, will serve as acting chairman. Friedman's departure leaves three vacancies at the NY Fed.

- Fed insiders were troubled by the situation, concerned that Friedman's actions cast a question mark over the ethical standards of the central bank. "All the other banks are furious," said one Fed official (at a different bank). "No one else would have let this happen. We've always made people leave (to avoid a conflict of interest). (*Reuters*, Kristina Cooke, 05/07/09)
- In *National Review*, Larry Kudlow wrote, "...This whole Friedman episode looks like yet another unfortunate example in a long line of growing TARP corruption. Make no mistake: TARP is a corrosive, corrupting, and demoralizing influence on our banks and the rest of the economy. ...The Friedman mess is merely symptomatic of this growing problem inside our system. It is time we all opened our eyes to the mess before us. Enough already. We can do much better." (*National Review*, Larry Kudlow, 05/08/09)

Political risk is growing concern for U.S. investors
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- Political risk has become growing concern for U.S. investors, as the government plays a larger role in the private sector and some investors "howl" over perceived arbitrary intrusions by the government in business affairs. For example, some view the Obama administration's restructuring plan for bankrupt automaker Chrysler as an attempt to subvert the legal rights of lenders. Critics of the Chrysler plan, argue that the government unfairly favored the automaker's union and ignored the rights of (secured) senior lenders who are legally allowed to get paid back before unsecured creditors such as workers.
- Concerns about government policies are leading investors to demand a risk premium before they buy stocks or bonds or do a business deal. "There is a much larger political risk premium on investing in the United States than there has been in years," said Sean West, an analyst at Eurasia Group. "What we're seeing now in the United States is much more like what we see in emerging markets, where the government either by choice or as a result of circumstance is in a position to decide which companies or banks survive and which ones don't. These were almost unthinkable risks a year ago." He added, the risks now at play in the United States may not be a long-term trend, "but I would say for the foreseeable future, for the next two to three years, this is the name of the game." (*Reuters*, Martha Graybow, 05/07/09)

### Treasury nominates Fannie CEO to run TARP and names new asset managers

- President Barack Obama has nominated Fannie Mae CEO Herb Allison to oversee Treasury's Troubled Asset Relief Program. If confirmed by the Senate, Allison will serve as the assistant Treasury secretary for financial stability and counselor on policy matters to Treasury Secretary Timothy Geithner. Allison, 65, has served as Fannie's CEO since the enterprise was placed into receivership in September. (*Wall Street Journal*, Henry Pulizzi, 04/18/09)
- Treasury has selected AllianceBernstein LP, FSI Group LLC, and Piedmont Investment Advisors to serve as asset managers for the agency's growing portfolio of senior preferred shares, senior debt, equity warrants, and other equity and debt obligations issued by TARP participants. Over the next two months, Treasury will hire smaller asset managers [which administer less than \$200 billion in assets] to complement the three larger investment management firms. (*Bureau of National Affairs*, Aaron Lorenzo, 04/23/09)

### Federal Reserve expands TALF to aid the CMBS markets

- In June, five-year loans for commercial mortgage-backed securities (CMBS) and securities backed by insurance premium finance loans will be eligible collateral under the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF). By including CMBS, the Fed is attempting to help the markets address a "mountain" of maturing CRE loans over the near term. As much as \$100 billion of TALF loans could have five-year maturities, which meet the program's requirements of being highly rated and having been issued on or after January 1<sup>st</sup>. (*Bureau of National Affairs*, Aaron Lorenzo, 05/04/09)
- In a note to clients, Deutsche Bank analysts pointed out that 66% of \$410 billion of commercial loans that have been securitized and will mature between 2009 and 2018 are unlikely to qualify for refinancing without significant cash infusions from borrowers. For the 2007 vintage loans, more than 80% of these loans are unlikely to qualify. The analysts note that commercial property values have fallen about 25% to 30% from their peak—and prices are expected to fall even further to 40% to 50% of peak levels. (*American Banker*, Allison Bisbey Colter, 05/14/09)

## ***Financial Services Regulation Reform***

### The current regulatory system “invited failure”

- In the May 8<sup>th</sup> issue of *RGE Global EconoMonitor*, Nouriel Roubini wrote, “The financial crisis that currently engulfs the world is largely a consequence of deficient regulation. The world economy enjoyed a cyclical upswing for much of the 2000s, and it is true that such upswings inevitably end, but they do not all end up in financial crises. It seems to me that it was failures of the regulatory system, not the absence of regulation for certain institutions—the regulated and unregulated appear to have been equally prone to fail—that should be blamed for the severity of the current crisis. What I hold responsible is the fact that the system of regulation that we had did not penalize the right things—bigness, increasing leverage in a boom, maturity mismatches—and therefore invited failure.” (*RGE Global EconoMonitor*, Nouriel Roubini, 05/08/09)

### Secretary Geithner provides an on overview of the administration’s comprehensive regulatory reform efforts

- In a May 13<sup>th</sup> speech to the Independent Community Bankers of America, Treasury Secretary Timothy Geithner said, “I want to ...look ahead to the comprehensive regulatory reform efforts this Administration will propose in the coming weeks. We have focused initially on addressing systemic risk, making sure those risks that arise are less threatening to stability and that the government has tools necessary to contain the damage they pose to the American economy. As in any financial crisis, this damage has been brutally indiscriminate. Ordinary Americans, small business owners, and community banks who did the right thing and played by the rules are suffering from the actions of those who took on too much risk.”
- “Our goal is to limit the extent to which community banks and tax payers are forced to bear the burden of those institutions that take irresponsible risks. Capital, liquidity and risk management requirements must be more exacting for the largest, most interconnected institutions. They must be applied with a view not just to ensure the soundness of the individual institution, but to maintain the stability of the system as a whole. They need to be strong enough so that the system can withstand the impact of the failure of large institutions. As part of this we need to bring the markets where institutions come together, such as the derivatives markets, under a strong framework of oversight. These changes will help prevent future crises and limit their severity. They will have to be accompanied by stronger tools for resolving crises when they happen, including the ability for the government to act more quickly to contain the potential damage cause by the potential failure of a large complex financial institution.”

- “We have proposed resolution authority to help fill that gap. The proposal is structured as an extraordinary mechanism for extraordinary situations, and will be kept strictly separate from the existing FDIC deposit insurance fund. With this authority, the financial costs of intervention would no longer fall to those institutions that played by the rules and made conservative and prudent choices. We believe that the combination of smarter, tougher regulatory standards to mitigate risks and resolution authority to manage risks when they arise will create a system that is more stable and resilient.” (*Treasury Press Release*, 05/13/09)

<p>Federal Reserve Chairman Bernanke urges regulators to take a “macroprudential” approach to regulating systemic risks</p>
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- In a May 7<sup>th</sup> speech at the Federal Reserve Bank of Chicago’s annual conference on bank structure, Federal Reserve chairman Ben Bernanke said regulators should take a “macroprudential” approach to overseeing the financial system, which would enhance overall financial stability....“Our regulatory system must include the capacity to monitor, assess, and, if necessary, address potential systemic risks within the financial system [which would include monitoring] large or rapidly increasing exposures [to risk] across firms and markets.” The regulatory system should also assess the potential systemic risks of new products or practices; provide a resolution mechanism for winding down failing institutions; and identifying potential regulatory gaps, said Bernanke. “Precisely how best to implement a macroprudential agenda remains open to debate. ...However we proceed, a principal lesson of the crisis is that an approach to supervision that focuses narrowly on individual institutions can miss broader problems that are building up in the system.”
- Bernanke added, “The crisis has demonstrated that effective and timely risk management that is truly firm-wide is vitally important for large financial institutions. In its review of the U.S. financial architecture, we hope that the Congress will consider revising the provisions of Gramm-Leach-Bliley to help ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness concerns in all parts of an organization.”
- In speech at the Chicago Bank’s conference, FDIC chairman Shelia Bair concurred with Bernanke’s recommendations. Bair said, “Centralizing the responsibility for supervising individual institutions that are deemed systemically important would bring clarity and accountability to their oversight.” Although the Fed seems like “the perfect candidate for the job,” the roots of the financial meltdown came from across the financial system, making it difficult for regulators to identify and correct problems, she said. “So we need to think about systemic risk regulation not just through the lens of a financial institution, but also from a system-wide perspective,” said Bair, who recommends the creation of a “systemic risk council” to monitor developments and take action when needed. (*Bureau of National Affairs*, Nora Macaluso, 05/08/09; *American Banker*, Steven Sloan, 05/08/09)

- In April 21<sup>st</sup> testimony before the Joint Economic Committee, three top economists advised lawmakers that setting up a process to break up “too big to fail” institutions and disassembling the “oligarchy” they have created is a key element in the U.S. economic recovery. “We have little to lose, and much to gain, by breaking up these behemoths, which are not just too big to fail, but also too big to save and too big to manage,” said Columbia University professor Joseph Stiglitz. MIT professor Simon Johnson argued that policy makers need to revise antitrust laws to prevent banks from growing too large. These mammoth banks should be sold to new private equity owners and broken up—perhaps regionally or by type of business to avoid a concentration of power, added Johnson. “This may seem like a crude and arbitrary step, but it is the most direct way to limit the power of individual institutions, especially in a sector that, the last year has taught us, is even more critical to the economy as a whole than anyone ever imagined.” Thomas Hoenig, President of the Federal Reserve Bank of Kansas, told panel members that the federal government’s response to the financial crisis has been too heavily focused on propping up large companies like AIG. “Our actions so far risk prolonging the crisis, while increasing the costs and raising serious questions about how we eventually unwind these programs without creating another financial crisis as bad or worse than the one we currently face,” said Hoenig. (*Wall Street Journal*, 04/22/09; *Bureau of National Affairs*, Thecla Fabian, 04/22/09)
- At a May 6<sup>th</sup> hearing, Senate Banking Committee chairman Christopher Dodd (D-CT) embraced the concept of creating a systemic risk council from federal and securities regulatory agencies. Dodd said, “I believe there is a need for systemic risk regulation to ensure that we no longer need to treat any institution as too big to fail.” Bair recommended that Congress create a mechanism for resolving institutions considered too big to fail. Such a mechanism would allow FDIC to create a new entity out of the successful parts of a failing institution and sell off the other portions, she said. Bair also urged Congress to quickly pass legislation giving FDIC the authority to resolve banking holding companies. (*Bureau of National Affairs*, Jeff Day, 05/07/09)

Chairman Frank outlines the framework for his committee’s financial services reform bill
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- In a May 8<sup>th</sup> speech, House Financial Services chairman Barney Frank (D-MA) said his committee will begin voting on legislation to create a systemic risk regulator by the end of June and predicted the president would sign such legislation by year-end.
- Frank said the first step in reforming the regulation of the financial services industry is the creation of a systemic risk regulator. Such a step will “in no way meant to displace or diminish organizations like FINRA or the Securities and Exchange Commission or even the bank regulators, but is over and above the regulation of market integrity, of investor protection, of individual firms. ...When we empower this systemic regulator, its mandate will not be named institutions because ... if we say it is in charge of certain institutions, pretty soon there will be numerous institutions that no one ever heard of that will be outside the mandate. Essentially

they will be empowered to reduce leverage. They will be empowered to keep any entity from getting so overly leveraged that it is, a, likely to fail and, b, likely to do great damage if it does.”

- Frank said Congress needs to adopt a statutory form that provides a combination of regulators the authority to wind down non-banks. “Banks we can handle,” said Frank. “The problem has come when very large nonbanks, like Lehman Brothers, have failed because we do not have a statutory mechanism other than regular bankruptcy which doesn't fit very well to wind them down. If we had been able to deal with Merrill Lynch, and Lehman Brothers and AIG the way we did with Wachovia, we would be in a lot better shape today.”
- In the area of securities regulation, Frank said he will not be seeking dollar limits on executive compensation, although he believes there should be a push for stockholders to have a “say on pay.” Frank added, “What we will do beyond that is to adopt rules that say you cannot have incentives for top people that encourage them to take risks by rewarding them if the risk pays off but leaving them harmless if the risk blows up [including] ...clawbacks.”
- Frank believes that there is a need for more investor protection in the securities area and resources need to be “buffed up” and improved. He also expects that a new regulatory entity will be created which will be responsible for protecting retail investors. Frank suggested the possible creation of a Financial Safety Products Commission, which would operate in a manner similar to the Consumer Products Safety Commission. Frank also believes that there is a chance for establishing an optional federal charter system for life insurance, similar to the dual banking system. He also expects changes will be made to investment adviser regulations, particularly for advisors working with municipalities. (*Bureau of National Affairs*, Martha Kessler, 05/11/09)

Treasury Secretary Geithner seeks legislation to regulate the derivatives market
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- On May 13<sup>th</sup>, Treasury Secretary Timothy Geithner unveiled a proposal calling for Congress to strengthen the supervision of the over-the-counter derivatives market. In a three page letter to House and Senate leaders, Geithner outlined a new framework for derivatives legislation which would (i) prevent activities that threaten the stability of the entire financial system; (ii) promote the efficiency of those markets; (iii) deter market manipulation, fraud, and other market abuses; and (iv) ensure that OTC derivatives are not inappropriately marketed to “unsophisticated” retail investors. In the proposal, the Treasury Secretary sought statutory amendments to mandate the central clearing of all standardized OTC derivatives contracts with central clearinghouses or counterparties being subject to appropriate supervision. All OTC derivative dealers and firms with large exposures to counterparties should be subject to a prudential supervision and regulation which includes (i) conservative capital requirements; (ii) business conduct standards; (iii) reporting requirements; and (iv)

initial margin requirements with respect to bilateral credit exposures on both standardized and customized contracts. Geithner proposed that the SEC and CFTC have “unimpeded authority to police fraud, market manipulation and other abuses involving OTC derivatives.” The proposed reforms would affect hedge funds, which currently face the prospect of direct regulation by the SEC through registration, inspections and examinations.

- House Financial Services Committee chairman Barney Frank (D-MA) and House Agriculture Committee chairman Collin C. Peterson (D-MN) released a joint statement, applauding the Geithner’s proposal. The chairmen have wrestled over jurisdictional issues pertaining to the regulation of certain commodities trading instruments. In an interview, Frank said, “[The administration] is not proposing here any revision of jurisdictions, and that’s smart of them.”
- Senator Carl Levin (D-MI), said, “It was time to put some meat on the bones. And the administration provided some of that by calling for federal regulators to be given comprehensive authority, for the first time, to police all derivative markets and derivative dealers; for the establishment of clearing, margin, and capital requirements to reduce risk; and for authority to impose position limits on over-the-counter derivatives to prevent market manipulation and excessive speculation.” (*Bureau of National Affairs*, Malini Manickavasagam and Phyllis Diamond, 05/14/09; *CQ Today*, Phil Mattingly, 05/13/09)

GAO urges Congress to explore changes to the regulatory oversight of the insurance industry

- In a recently released report on insurance reciprocity and uniformity, GAO recommends that “as Congress considers changes to its oversight of the insurance industry, it explore ways to ensure all states and jurisdictions can conduct nationwide criminal background checks as part of their producer licensing and consumer protection functions. The GAO also recommends that NAIC and state insurance regulators work with the insurance industry to identify product approval differences among state regulators and improve how consistently state regulators review and approve product filings once received through SERFF.” The full report can be viewed by clicking the following link: <http://www.gao.gov/cgi-bin/getrpt?GAO-09-372>. (*Insurance Reciprocity and Uniformity GAO-09-372*, GAO, April 2008)

Is it time to revisit the principals governing Washington’s promotion of homeownership?

- In the Spring issue of *City Journal*, Steven Malanga, wrote, “Nearly a century of Washington’s efforts to promote homeownership has produced one calamity after another. Time to stop.”

- “...What principles ...should govern federal policy toward homeownership and the housing construction market? First, our experience since the Great Depression teaches us that a rising economy is the best and safest way to boost homeownership. By some estimates, the ‘natural’ rate of homeownership in America, without dicey government-enabled mortgages, would still be nearly 65 percent—among the highest rates in the world. Government’s most important role in the market should be to ensure a sturdy economy and a reliable judicial system that protects the interests of buyers and sellers in what is the largest transaction that most will ever undertake.”
- “At the same time, government should do no harm, especially when it comes to the cost of housing. One reason politicians and policymakers continue to feel that they must subsidize mortgage rates and launch ownership campaigns is that since the 1970s, local housing and zoning regulations have raised the price of home construction—sometimes by hundreds of thousands of dollars, as economist Randall O’Toole has shown—and thereby reduced the supply of affordable housing. Half a century ago, America’s cities boasted a rich stock of affordable housing, even as their populations grew. Today, even shrinking cities often complain of a lack of it. One solution is for the federal government to tie aid to states to local regulatory reforms that reduce the cost of construction and encourage additional building.”
- “The federal government should also consider eliminating or capping the home-mortgage tax deduction, which drives up the price of housing in ways particularly damaging to lower- and moderate-income buyers. Enshrined in our tax code since 1913, the deduction provides more disposable income to homeowners who itemize their taxes—mostly upper- and upper-middle-income buyers—who can use that money on bigger mortgages, increasing the price of housing. But many moderate-income households don’t itemize and thus don’t benefit from the tax break, and they’re left with fewer housing options as the cost of homes rises around them. In their study *Rethinking Federal Housing Policy*, Harvard’s Glaeser and Joseph Gyourko of the Wharton School of Business suggest capping the deduction at \$300,000 of mortgage debt. That way, it would still benefit those moderate-income families that do itemize, while ending the exemption for others.”
- “Ultimately, the goal should be to end subsidies that amount to a government project to direct homeownership to places where Washington believes it should be taking place. That kind of political meddling in this vast marketplace has wreaked havoc time and again, and will continue to do so—if we keep letting it.” (*City Journal*, Steven Malanga, Spring 2009)

## ***Fannie Mae and Freddie Mac***

The \$400 billion crater at Fannie and Freddie
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- At *Seeking Alpha*, Bruce Krasting wrote, "...Unfortunately, the two largest financial institutions in the United States were able to avoid the rigors of the stress test. Fannie Mae and Freddie Mac should be put under the same microscope as the commercial banks. This is very much a case of, 'What is good for the goose is also good for the gander.'"
- "Putting Fannie and Freddie to the stress test is relatively easy. Unlike the commercial banks they do not have a diversity of assets. The Agencies only risk is in residential mortgages. The two Agencies have the same business model. They both have a large book of funded mortgages and a significant off balance sheet guarantee business. The following chart sets out the Fed's criteria for mortgage assets."

**Table 1: Indicative Loss Rates Provided to BHCs for SCAP  
(cumulative two-year, in percent)**

	Baseline	More Adverse
First Lien Mortgages	5 – 6	7 – 8.5
Prime	1.5 – 2.5	3 – 4
Alt-A	7.5 – 9.5	9.5 – 13
Subprime	15 – 20	21 – 28

- "On a combined basis the Agencies have approximately \$1.4 Trillion of Sub Prime and Alt-A exposure. Based on the Fed's criteria this would require at least \$200 billion of new equity just from this category of the Agencies balance sheet. An average rate to evaluate the Agencies total book of business would have been in the 6-8% range if the Fed had used the same standards to evaluate the Agencies as they did when evaluating Wells Fargo Bank (WFC). For the basis of this discussion a modest 7% will be used to stress test Fannie and Freddie."
- "This chart ...shows the current amounts out standings in the Agencies funded and guarantee books."

	FNM	FRE
Funded Portfolio	\$3.1 trillion	\$2.2 trillion
Guaranteed Portfolio	\$2.8 Trillion	\$1.8 trillion
Total	\$5.9 Trillion	\$4.0 trillion
<b>Combined Agency Totals</b>	<b>\$10 Trillion</b>	

- “Multiplying the total risk book by the 7% haircut produces a suggested addition capital requirement of \$700,000,000. This amount is approximately 10 times the total amount of capital required for the 19 public financial institutions that were subject to the Fed’s stress test. Applying those same rules to the Agencies shows just how large our problem is. If one applies an average haircut rate of 4% to the total portfolio as suggested by the Fed in their ‘Baseline’ outlook the resulting capital shortfall is \$400 billion. This shows just how far under capitalized the two largest financial institutions in America are.”
- “The cost to the taxpayer for cleaning up the Agencies will take many years to calculate. It may take a decade to stabilize these important institutions. The guidelines established in the Fed stress test do provide some indication of the losses we might face. Those losses will certainly exceed the Baseline Case of \$400 billion. It is quite likely they will approach three quarters of a trillion.”
- “It is difficult to put these very big numbers into perspective. By way of comparison, the losses at the Agencies are likely to be larger than all of the costs that will be incurred in the Iraq war.” (*Seeking Alpha*, Bruce Krasting, 05/10/09)
- Over the next 10 years, the cost of the government rescue for Fannie and Freddie is projected to total \$389 billion—exceeding the costs of TARP investments made in banks and other financial firms, according to a recent study by Subsidyscope, a Pew Charitable Trust project which used CBO figures. (*Washington Post*, Zachary A. Goldfarb, 05/09/09)

The future of Fannie Mae and Freddie Mac is “uncertain,” says OMB

- With the future prospects for Fannie and Freddie “uncertain,” OMB concludes that the options for reforming the GSEs include (i) returning them to their previous status; (ii) gradual winding down of their operations and liquidation of their assets; (iii) nationalizing the GSEs by incorporating their functions into an existing government agency; (iv) adopting a public utility business model for the GSEs, in which the

government sets their profit margins, sets guarantee fees, and provides explicit backing for GSE commitments; (v) transiting the GSEs' guarantee function to providing insurance for covered bonds and issuing debt instruments backed by mortgage cash flows (which are recorded on the issuer's balance sheet); and (vi) breaking up Fannie and Freddie into many smaller companies.

- In a telephone interview with *Bloomberg News*, Bradley Hintz, an analyst with Sanford C. Bernstein, said, "The last entities that are going to be set free will be Fannie and Freddie because they are so key to the housing market."
- OMB estimates that the GSEs have received \$78.9 billion of capital from Treasury since they were placed in conservatorship in September and will require at least \$92.2 billion more capital by September 30<sup>th</sup> for an aggregate outlay of \$171 billion by the end of FY2009. The administration plans to keep the GSEs' \$6.1 trillion in unsecured debt and mortgage bonds backed by Fannie and Freddie off the federal budget, according to Obama's fiscal 2010 budget proposal issued May 7<sup>th</sup>. The budget also excludes projections of the GSEs' need for federal aid for FY2010. (*Bloomberg News*, Dawn Kopecki, 05/11/09; *OMB Budget Analysis*, 05/11/09)

#### FHFA proposes relaxing the GSEs' housing goals

- The Federal Housing Finance Agency has proposed relaxing the affordable housing goals for Fannie Mae and Freddie Mac. Citing market conditions, FHFA issued a proposed rule which would return the 2009 goals to the levels that prevailed between 2004 and 2006. Specifically, the companies' benchmark for buying and guaranteeing mortgages of low- to moderate-income buyers would be reduced from 56% to 51% and the GSEs' goal for underserved areas would fall from 39% to 38%. FHFA also wants the enterprises to receive credit for the loan modifications that they complete under the administration's Making Home Affordable Program towards their goals. "By giving them goals credit for loan modifications, FHFA further encourages this important activity, which is essential to preventing foreclosures and keeping people in their homes," said FHFA Director James B. Lockhart. The proposed rule will be open for 21 days of public comment before FHFA finalizes it. (*Wall Street Journal*, Jessica Holzer, 04/28/09)

#### The GSEs' loan modifications grew 26% in February

- In February, Fannie Mae and Freddie Mac's completed loan modifications increased 26%, while their repayment plans grew 38% and completed foreclosure prevention actions increased 9%. As the enterprises intensified their loan modification efforts, loan modifications comprised 43% of all completed foreclosure actions in February, up from 38% in January. Approximately 70% of these loan modification involved both interest rate reductions and term extensions. Completed alternatives to foreclosure, which included short sales and deeds in lieu, comprised 9% of

foreclosure prevention actions in February. (*Federal Housing Finance Agency, 05/12/09*)

- Fannie Mae has asked the South Carolina's Supreme Court to issue a temporary injunction to stop pending foreclosure sales for properties guaranteed by Fannie or Freddie to give homeowners more time to take advantage of the administration's program to help at risk borrowers. Fannie argued that the ruling was necessary under state law to ensure that foreclosure sales are conducted in a timely fashion and to provide borrowers adequate time to modify their loans and avoid foreclosure. The court granted the injunction through May 15<sup>th</sup> for all GSE loans and for lenders that are participating in the loan modification program. The injunction could affect about 5,000 South Carolina homes facing foreclosure, according to RealtyTrac, Inc. (*Associated Press, 05/05/09*)

Obama administration announces the Second Lien Program for the MHA Program
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- On April 28<sup>th</sup>, the Obama Administration unveiled an expansion of its \$75 billion Making Home Affordable (MHA) Program, by providing new subsidies for second mortgages. Under the Second Lien Program, servicers will automatically reduce payments on the associated second lien according to pre-set protocol. Alternatively, servicers have the option of extinguishing the second lien through a lump sum payment under a preset formula determined by Treasury. Servicers will receive \$500 for modifying the second mortgage plus \$250 a year for three years if the loan remains current. The borrowers will also be eligible for \$250 a year for five years to lower their principal balance. The administration estimates that the Second Lien Program will reach between 1 million to 1.5 million homeowners and potentially reduce payments by up to 50% for participants in the program. The administration also announced plans to incorporate FHA's HOPE for Homeowners program into the MHA. (*Treasury Press Release, 04/28/09; Second Lien Fact Sheet, Treasury Department, 04/28/09; Washington Post, Renae Merle, 04/29/09*)

## ***Fannie Mae***

### Fannie Mae board appoints Michael Williams to serve as president and CEO

- On April 20<sup>th</sup>, Fannie Mae's board of directors named Michael J. Williams to serve as the company's president and CEO, succeeding Herbert M. Allison, Jr., who has been nominated to serve as assistant Treasury secretary of financial stability. Williams ascends to this position after having served as Fannie's EVP and chief operating officer, where he oversaw the bolstering and restructuring of the company's foreclosure prevention and loss mitigation operations and led its Making Home Affordable loan refinance and modification initiatives. In an interview, Williams said he understands that Fannie Mae must now answer to "our customers, the government and the market." According to a company spokesman, his compensation will remain unchanged in his new position. As of December 31<sup>st</sup>, William's base salary was \$676,000. Prior to joining Fannie Mae in 1991, Williams held positions at KPMG Peat Marwick and the DuPont Company. Williams, 51, holds a master's degree in business administration and bachelor of science degree form Drexel University.
- In an April 20<sup>th</sup> statement, Federal Housing Finance Agency director James B. Lockhart said, "I am pleased that the Fannie Mae board has selected Michael Williams to become the president and chief executive officer of Fannie Mae. ...I am pleased that Mike is willing to serve as CEO to continue Fannie Mae's important efforts to operate effective during conservatorship, prevent foreclosures, and stabilize communities and the nation's housing finance system." (*Washington Post*, Zachary A. Goldfarb, 04/21/09; *Wall Street Journal*, James R. Hagerty, 04/21/09; *Fannie Mae Press Release*, 04/20/09; *Federal Housing Finance Agency Press Release*, 04/20/09)

### Fannie names new general counsel, EVP of operations and technology, and EVP of enterprise risk management

- On April 21<sup>st</sup>, Fannie Mae CEO Michael J. Williams announced the appointment of Timothy J. Mayopoulos to serve as EVP, general counsel and corporate secretary; Edward G. Watson to serve as EVP, operations and technology; and Kenneth J. Phelan to serve as EVP, enterprise risk management. "Each of these outstanding individuals brings extensive and distinguished experience in their respective field to the critical positions they assume," said Williams.
- Mayopoulos joins Fannie Mae, following a five-year tenure with Bank of America as EVP and general counsel, responsible for all legal services for the bank. Prior to joining BofA, he served as managing director and general counsel for America's for Deutsche Bank AG's Corporate and Investment Bank.

- Watson joins Fannie with more than 25 years experience in the financial services industry, most recently as Global Head, Capital Markets Operations and ICG Business Services at Citigroup, where he supervised 5,600 employees in 70 counties.
- Phelan joins Fannie with an extensive background in risk management, most recently as SVP, risk management group at Wachovia Corporation. Previously, he served as Head of Risk Management Services at JPMorgan Chase & Co. (*Fannie Mae Press Release*, 04/21/09; *Bloomberg News*, Dawn Kopecki, 05/21/09)

Fannie Mae's retained mortgage portfolio shrank at an annualized 1.3% in March
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- Fannie Mae's retained mortgage portfolio shrank at an annualized rate of 1.3% in March to \$783.9 billion, as its book of business grew at an annualized rate of 12.3% during the month. The company's refinance volume increased to \$77 billion, nearly twice the refinance volume in February and the company's largest refinance month since 2003. Fannie Mae's conventional single-family serious delinquency rate increased 19 basis points in February (the latest period reported) to 2.96%, while the company's serious delinquency rate of multifamily properties rose five basis points to 0.32%. The company's effective duration gap averaged negative two months versus positive one month in February. (*Aliaba.com*, 05/03/09; *Fannie Mae Monthly Summary*, March 2009)

## ***Freddie Mac***

### Freddie Mac's former CEO Moffett returns as consultant following the CFO's death

- David Moffett, Freddie Mac's CEO who resigned in March, will return to the company as a consultant after the death of CFO David Kellerman. Moffett will serve as interim CFO until a search for a permanent finance chief can be completed. Kellerman, who had served as acting CFO since September, committed suicide on April 22nd. Freddie CEO John Koskinen and the Federal Housing Finance Agency expressed their appreciation for Moffett agreed to return to the company "during this difficult time."
- According to sources, Kellerman, 41, had struggled for months with the pressures of his job as acting CFO and was visibly stressed over meeting a May 15<sup>th</sup> deadline for filing the company's first quarter's 10Q with the SEC. In addition, Kellerman also was contending with a "formal investigation" by the U.S. Attorney's Offices in New York and Virginia of Freddie Mac's accounting, disclosure, and corporate governance matters. He was a 16-year veteran of Freddie Mac, who previously served as SVP, corporate controller, and principal accounting officer. He is survived by his wife and four-year old daughter. In an SEC filing, Freddie Mac disclosed that it is paying out more than \$700,000 to Kellerman's family in retention and stock awards. (*Associated Press*, Matt Small, 04/23/09; *Wall Street Journal*, James R. Hagerty and Gary Fields, 05/06/09; *CNNMoney.com*, David Goldman, 04/24/09; *Associated Press*, Alan Zibel, 04/30/09)

### Freddie Mac receives a favorable accounting ruling from the SEC

- Freddie Mac has received a favorable ruling from the SEC which allows the company to avoid a potential \$30 billion charge against earnings related to the Obama administration's program to prevent foreclosures, said acting CEO John Koskinen. Specifically, the company was concerned that the loans modified under the Obama program might mean that those loans were no longer eligible for an exception from derivative accounting under SFAS 133. In late April, the SEC ruled that Freddie could maintain that exception, which avoided the charge to earnings.
- In an interview with the *Wall Street Journal*, Koskinen also said the company hopes to announce the hiring of a new CFO in May and a new CEO by mid-July. Koskinen said that the new CEO would likely be someone nearing the end of his/her career, who will see Freddie Mac as an "an exciting public-service opportunity. ...It has to be somebody who sees this as a unique and interesting opportunity to make a contribution—[not someone who wants] to run a company in the normal sense." Koskinen said Freddie had held serious talks with a former CFO at a major institution, but the GSE began to have second thoughts about the candidate because

his company was “particularly troubled.” Sources familiar with the talks identified the candidate as Tom Casey, former CFO for Washington Mutual. Koskinen declined to comment on the candidate’s identity. (*Wall Street Journal*, James R. Hagerty, 05/05/09)

Freddie Mac’s retained portfolio was up an annualized 65% in March

- In March, Freddie Mac’s retained mortgage portfolio increased at an annualized rate of 65.8% to \$867.1 billion. During the month, the company’s refinance-loan purchase volume was \$52 billion, Freddie’s largest refinance month since 2003. On March 31<sup>st</sup>, the Company’s single-family delinquency rate was 2.29%, up 16 basis points from February, while its multifamily delinquency rate increased 1 basis point to 0.09% during the month. Freddie’s duration gap average one month in March, unchanged from February. (*Reuters*, 04/24/09; *Freddie Mac’s Monthly Volume Summary*, March 2009)
- Separately, Freddie Mac disclosed in the *Refinance Report* that homeowners who refinanced their mortgages during the first quarter saved about \$160 a month on a \$200,000 loan, which would generate approximately \$2.5 billion in extra spending money over the coming year. (*Freddie Mac Press Release*, 05/02/09)

## ***Federal Home Loan Banks***

FHLB-Atlanta increases the discount on 1-4 family collateral to secure advances

- On May 1<sup>st</sup>, the FHLB-Atlanta increased the discount that it applies to residential 1-4 first mortgage collateral from 25% to 30% of the unpaid principal balance (UPB), along with discounts applied to residential 1-4 first mortgage interest only and interest only hybrids (from 75% to 60% UPB), 1-4 first mortgage negative amortization and payment-option ARM (50% to 45% UPB), and HELOCs and second mortgages (50% to 40% UPB). These changes take effect on June 1<sup>st</sup>. In a letter to members, Kirk Malmberg, EVP and chief credit officer, wrote, “The revised levels reflect decline in market values of mortgage loans and ongoing volatility in the mortgage and credit markets.” In conjunction with the implantation of this new policy, members will be required to supply the Bank with additional loan data in the Qualifying Collateral Report for residential 1-4 mortgages and HELOCs as of April 30<sup>th</sup>. (*Correspondence to Members*, Kirk Malberg, 05/01/09)

## Susan Elliott Named Boston FHLB's Interim CEO

- The FHLB-Boston has named M. Susan Elliott as its interim president and chief executive. Elliott, a 28-year veteran of the bank, also will continue to serve as the Bank's executive vice president and director of member services. (*American Banker*, Steven Sloan, 05/01/09)

## *Ginnie Mae*

### Will FHA be the next big bailout?

- In a May 4<sup>th</sup> editorial, the *Wall Street Journal* wrote, "Everyone knows how loose mortgage underwriting led to the go-go days of multitrillion-dollar subprime lending. What isn't well known is that a parallel subprime market has emerged over the past year—all made possible by the Federal Housing Administration. This also won't end happily for taxpayers or the housing market."
- "Last year banks issued \$180 billion of new mortgages insured by the FHA, which means they carry a 100% taxpayer guarantee. Many of these have the same characteristics as subprime loans: low downpayment requirements, high-risk borrowers, and in many cases shady mortgage originators. FHA now insures nearly one of every three new mortgages, up from 2% in 2006."
- "The financial results so far are not as dire as those created by the subprime frenzy of 2004-2007, but taxpayer losses are mounting on its \$562 billion portfolio. According to Mortgage Bankers Association data, more than one in eight FHA loans is now delinquent -- nearly triple the rate on conventional, nonsubprime loan portfolios. Another 7.5% of recent FHA loans are in 'serious delinquency,' which means at least three months overdue."
- "The FHA is almost certainly going to need a taxpayer bailout in the months ahead. The only debate is how much it will cost. By law FHA must carry a 2% reserve (or a 50 to 1 leverage rate), and it is now 3% and falling. Some experts see bailout costs from \$50 billion to \$100 billion or more, depending on how long the recession lasts."
- "How did this happen? The FHA was created during the Depression to help moderate-income and first time homebuyers obtain a mortgage. However, as subprime lending took off, banks fled from the FHA and its business fell by almost 80%. Under the Bush Administration, the FHA then began a bizarre initiative to 'regain its market share.' And beginning in 2007, the Bush FHA, Congress, the homebuilders and Realtors teamed up to expand the agency's role."

- “The bill that passed last summer more than doubled the maximum loan amount that FHA can insure -- to \$719,000 from \$362,500 in high-priced markets. Congress evidently believes that a moderate-income buyer can afford a \$700,000 house. This increase in the loan amount was supposed to boost the housing market as subprime crashed and demand for homes plummeted. But FHA’s expansion has hardly arrested the housing market decline. The higher FHA loan ceiling was also supposed to be temporary, but this year Congress made it permanent.”
- “Even more foolish has been the campaign to lower FHA downpayment requirements. When FHA opened in the 1930s, the downpayment minimum was 20%; it fell to 10% in the 1960s, and then 3% in 1978. Last year the Senate wisely insisted on raising the downpayment to 3.5%, but that is still far too low to reduce delinquencies in a falling market.”
- “Because FHA also allows borrowers to finance closing costs and other fees as part of the mortgage, the purchaser’s equity can be very close to zero. With even a small drop in prices, many homeowners soon have mortgages larger than their home’s value -- which is one reason FHA’s defaults are rising. Every study shows that by far the best way to reduce defaults and foreclosures is to increase downpayments. Banks know this and have returned to a 10% minimum downpayment on their non-FHA loans.”
- “In a rational world, Congress and the White House would tighten FHA underwriting standards, in particular by eliminating the 100% guarantee. That guarantee means banks and mortgage lenders have no skin in the game; lenders collect the 2% to 3% origination fees on as many FHA loans as they can push out the door regardless of whether the borrower has a likelihood of repaying the mortgage. The Washington Post reported in March a near-tripling in the past year in the number of loans in which a borrower failed to make more than a single payment. One Florida bank, Great Country Mortgage of Coral Gables, had a 64% default rate on its FHA properties.”
- “The Veterans Affairs housing program has a default rate about half that of FHA loans, mainly because the VA provides only a 50% maximum guarantee. If banks won’t take half the risk of nonpayment, this is a market test that the loan shouldn’t be made.”
- These reforms have long been blocked by the powerful housing lobby—Realtors, homebuilders and mortgage bankers, backed by their friends in Congress. They claim FHA makes money for taxpayers through the premiums it collects from homebuyers. But keep in mind these are the same folks who said taxpayers weren’t at risk with Fannie Mae and Freddie Mac.”
- “A major lesson of Fan and Fred and the subprime fiasco is that no one benefits when we push families into homes they can’t afford. Yet that’s what Congress is doing once again as it relentlessly expands FHA lending with minimal oversight or taxpayer safeguards.” (*Wall Street Journal*, 05/04/09)

FHA will ask Congress for \$800 million to cover losses on reverse mortgage program

- The FHA plans to ask Congress for nearly \$800 million in taxpayer money to cover projected losses in its Home Equity Conversion Mortgage (HECM) program for seniors in FY2010, created by falling home prices. The states with large concentrations of seniors that use the HECM program—Florida, Arizona, California and Nevada—are the same ones that have seen the biggest house prices declines over the past two years. The administration is asking Congress to provide a subsidy for the program instead of charging seniors, said HUD Secretary Shaun Donovan.
- “Imagine a situation where a senior took out a loan for \$200,000, but they die 10 years later and the house is only worth \$150,000,” said Guy Cecala, CEO and publisher of *Inside Mortgage Finance*. “That means the lender can only recoup \$150,000 even though it insured a \$200,000 loan. That’s what they’re worried about.”
- However, the FHA single-family program is projected to generate a \$1.7 billion budget surplus which will cover the HECM shortfall. According to the administration’s budget estimates, FHA lenders are expected to originate \$300 billion in single-family loans in FY2010, up 5.3% in FY 2009 (\$285 billion), while HECM originations are projected to be \$30 billion in FY 2010, unchanged from this year’s budget estimate.
- FHA’s reserves totaled about \$12.9 billion on September 30, 2008, approximating 3% of all mortgages insured by the agency. FHA’s reserves were above the 2% percent required by law, but below 6.4% level from a year earlier. Secretary Donovan expects FHA’s reserve ratio to remain above 2% during the next fiscal year. (*Washington Post*, Dina ElBoghdady, 05/08/09; *National Mortgage News*, 05/08/09)

FHA to permit first time homebuyers to use \$8,000 tax credit for down payment

- In a speech at the National Association of Realtors Midyear Legislative Meetings and Trade Expo, HUD Secretary Shaun Donovan said the FHA will allow its lenders to permit first-time homebuyers to use their \$8,000 tax credit as a down payment. FHA intends to permit “trusted” FHA-approved lenders and FHA-approved nonprofits, along with state and local government entities, to “monetize” the tax credits through short-term bridge loans which will be a “real win” for all concerned, he said. Donovan added that the FHA will soon publish its new policy on the “monetization” of the of this tax credit, which should stimulate 190,000 home sales nationwide. (*Bureau of National Affairs*, Thecla Fabian, 05/13/09)

- HUD has requested an increase in its budget to allow FHA to insure about 33% more loans in FY2010, up from \$300 billion in FY2008, said Donovan. FHA plans to keep coverage premiums at today's levels through FY2010, he added. (*Bloomberg News*, 05/12/09)

MBA proposes that Treasury establish a temporary lending facility administered by  
Ginnie Mae

- The Mortgage Bankers Association has worked closely with Ginnie Mae in the development of a warehouse lending proposal that could be administered by the agency. In an outline and term sheet sent to Treasury Secretary Timothy Geithner, MBA calls for Treasury to initiate a temporary lending facility administered by Ginnie Mae to provide warehouse loans to lenders making FHA, VA and Rural Housing Service guaranteed loans. "MBA would like to meet with you in order to obtain Treasury's input and refine the proposal," wrote MBA chief John Courson in a letter to the Secretary. An MBA spokesman added, "Treasury has not made a commitment to the proposed program." (*National Mortgage News*, 05/08/09)

Ginnie Mae's MBS guarantees total \$34.5 billion in April

- Ginnie Mae guaranteed \$34.5 billion in mortgage-backed securities in both April and March, up 23% from February's total of \$28 billion. "We are steadily growing," said Ginnie president Joseph Murin. In April, the agency's single-family MBS totaled \$33.8 billion and multifamily totaled \$707 million. Ginnie I single-family MBS totaled \$26.8 billion in April [\$1.4 billion less than in the previous month], while its Ginnie II single-family multiple issuer pools totaled \$6.6 billion [up \$1.1 billion from the previous month]. (*National Mortgage News*, 05/11/09)

## ***Proposed National Infrastructure Bank***

Obama administration proposes \$5 billion for creation of a national infrastructure bank

- In the 2010 budget, the Obama administration proposed an initial allocation of \$5 billion for the creation of a national infrastructure bank, which would invest funds directly in large capital infrastructure projects which are "nationally and regionally significant." The proposal contemplates setting aside \$836 million of direct loan subsidies, \$1.15 billion for grants, and \$1.7 billion for direct loan financing to "attract and coordinate state, local, and private co-investment."
- Legislation that would create a national infrastructure bank was introduced last year in Congress, but was not passed out of committee. Senate Banking Committee

chairman Chris Dodd (D-CT), a cosponsor of the bill, said the legislation will be a priority of his committee this year. (*Bureau of National Affairs*, Kate Naseef, 05/08/09)

## ***Farm Credit System / Farmer Mac***

Farm Credit System Reports net income of \$615 million for the first quarter

- The Farm Credit System reported combined net income of \$615 million for the quarter ended March 31, down 19% from the same period last year, as a result of increases in the provision for loan losses and noninterest expenses and a decrease in noninterest income. Net interest income increased \$136 million to \$1.273 billion during the first quarter of 2009, as compared with \$1.137 billion for the first quarter of the prior year. The System's average earning assets grew \$16.078 billion or 8.6% to \$202.408 billion for the first quarter of 2009, as compared with the first quarter of 2008. Total capital increased \$697 million during the first quarter of 2009 to \$27.821 billion (12.9% of total assets).
- "During the first quarter of 2009, the System achieved favorable earnings despite the continued global economic and financial crisis," said Jamie B. Stewart Jr., president and CEO of the Federal Farm Credit Banks Funding Corporation. "During the first quarter of 2009, the System's loan growth remained relatively flat and its capital to assets ratio improved. System managements have taken steps to increase liquidity and ensure capital availability to fund farmers and ranchers in the future. Additionally, managements of System institutions continue to be vigilant in applying prudent loan underwriting standards and monitoring the credit quality of their loan portfolios." (*USAgNet*, 05/05/2009)

Some FCS institutions have become "real road warriors"

- In the April issue of *Farm Credit Watch*, Bert Ely wrote, "FCS associations are assigned specific territories. However, associations can assume credit risk outside their territories in two ways. First, they can purchase participations in loans originated by other FCS institutions and in loans made by non-FCS lenders. Second, they can make loans in the territories of other associations, with the consent of the other association. A review of the 2008 annual reports of several associations indicates great differences in the degree to which FCS associations have assumed out-of-territory credit risks. Some associations have become real road warriors. This is an issue the FCA needs to address more aggressively as FCS credit quality, and the FIRS ratings, continue to decline."

- “Especially striking in this regard is ArborOne, a \$476 million association chartered to serve just twelve counties in South Carolina. At the end of 2008, ArborOne was the 51st largest FCS agricultural credit association (ACA), of the FCS’s 83 ACAs. Yet according to ArborOne’s 2008 annual report, 40% of its “credit and credit-related services” were provided to borrowers located in 27 other states. ArborOne has been one of the most aggressive associations in using the “investments in rural America pilot project” and has aggressively sought hospital financing deals all over the United States. Additionally, at the end of 2008 ArborOne had loans outstanding in 25 South Carolina counties. Quite possibly, more than half of ArborOne’s credit risk lies outside its home territory, which should raise a bright red flag at the FCA.”
- “AgStar, the sixth largest ACA, and Northwest FCS, the third largest, also are big out-of-territory lenders. According to AgStar’s 2008 annual report, 45.2% of its credit exposure was outside its chartered territory in Minnesota and Wisconsin, with most of that exposure outside those two states. Northwest, which principally serves Idaho, Montana, Oregon, and Washington, had 18.7% of its credit exposure outside those four states. Some of that exposure, though, may have been in Alaska and in the small portions of California and North Dakota that Northwest serves. The two largest ACAs, FCS of Mid-America and FCS of America appear to be more constrained in their out-of-territory lending, at 16% and 11%, respectively, while Greenstone, the seventh largest ACA, appears to have little out-of-territory credit risk. The FCA should mandate a uniform format for the disclosure of extra-territorial lending as FCS associations have a responsibility to disclose out-of-territory lending to their farmer-owners.” (*Farm Credit Watch*, Bert Ely, April 2009)

Farmer Mac: All’s great but the ethanol
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- In *Today’s Financial News*, Andrew Snyder wrote, “We have all heard of Fannie Mae and Freddie Mac, the two government-created entities at the heart of the mortgage meltdown. The mortgage buyers have been filled with controversy, scandal and, most recently, tragedy. But how about their hillbilly cousin, Farmer Mac? What’s he been up to?”
- “Well, if you happen to look at today’s action [May 12<sup>th</sup>] from the Federal Agricultural Mortgage Corporation (NYSE:AGM), or Farmer Mac..., you will like what you see. Shares of the company, which buys loans from farmers, ranchers and other rural real estate buyers, are soaring by over 125% today on news the firm somehow managed to record a profit. This time last year, the company reported a loss of \$8.3 million. Today it announced a net income of \$33.5 billion. Not a bad turnaround. But I would not get too excited. The profits were mostly made from trading and positive shifts in derivative prices. The fundamental mission of the company, profiting from mortgage cash flows, remains risky.”
- “In fact, the company had to set aside an additional \$3.5 million to cover potential future bad loans in the ethanol sector. (Is there even an ethanol sector left?) **About**

**65% of the Farmer Mac's past-due loans, \$58.5 million worth [1.29% of the Farmer Mac's total portfolio], were related to the ethanol industry.** [Emphasis added.] I hope the company is not making any wind, solar or geothermal loans.”

- “Today’s surge in share price is certainly good to a handful of investors fortunate enough to grab shares while they were bouncing off scary-low prices. But for the folks that bought back in September for over \$30, today’s news means their loss went from 87% of their principal to just 73%. Not enough to dry many tears.”
- “Going forward, however, Farmer Mac looks quite stable, unlike its wild and reckless cousins, Fannie and Freddie. The rural markets are full of potential as the nation re-thinks (or re-brands) its energy industry. And rural land prices are drastically more stable than the McMansions dotting suburbia. It will be away before Farmer Mac’s crop is ready to harvest, but the time will come. Now is certainly a good time to be planting some seeds.” (*Today’s Financial News*, Andrew Snyder, 05/12/09)

Robert Boone named the Farm Credit Council’s VP of government affairs
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- Robert Boone has joined The Farm Credit Council as its new vice president for government affairs. Previously, Boone served as former Senator Elizabeth Dole’s legislative counsel, managing Dole’s Banking Committee membership and advising on banking, trade and economic development issues. “Robbie will help us with a broad range of government affairs issues as we help the cooperative Farm Credit System serve agriculture and rural America,” said Council President & CEO Ken Auer. “We are very excited that he brings significant Capitol Hill experience and knowledge in both the House and Senate, as well as his finance background, to our staff.” (*Farm Credit Council Press Release*, 05/07/09)

## ***Postal Service***

USPS faces \$1.5 billion cash shortfall in FY2009
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- The USPS reported a loss of \$1.9 billion for the second quarter, bringing its year-to-date net loss is to \$2.3 billion. During the second quarter, the Postal System’s volume was down over 7.5 billion pieces, representing a decline of 14.7% over the same period last year. The agency’s mail volume has now declined nine consecutive quarters at accelerating rates. The Postal Service has recently developed incentive programs to increase mail volume, including advertising mail and Priority Mail. In addition USPS has proposed a summer sale for Standard Mail, which is currently under review by the Postal Regulatory Commission. The Postal Service is well on its

way to meeting its 100 million work-hour reduction goal, having cut 58 million work-hours in the first six months of this fiscal year, which is the equivalent of a reduction of 33,000 full-time employees.

- “The economic recession has been tough on the mailing industry, and we have seen an unprecedented decline in mail volumes and revenue that continued to accelerate during the second quarter,” said Postmaster General John Potter. “We are aggressively realigning our costs to match the lower mail volumes, while also maintaining the high level of service and reliability our customers expect. We are also taking a number of steps to grow revenue.” Despite the agency’s aggressive actions to reduce costs and grow revenue, the Postal Service will likely face a cash shortfall of over \$1.5 billion at the end of the fiscal year, said Potter.
- In a letter to selected Members of Congress, Postmaster General Jack Potter wrote: “We are facing an unprecedented decline in mail volume, and the resulting loss of revenue is critically affecting our ability to maintain mail service to the American people. Fiscal year (FY) 2009 is proving to be every bit as challenging as we had projected, providing us with our most challenging financial environment in 60 years. We are on track to lose roughly \$6.4 billion this year... This loss will come despite our target to cut \$5.9 billion [of expenses] in FY2009 [of which] ...we have already cut costs by \$2.4 billion this year. ...However, despite these efforts, the financial picture of the Postal Service remains bleak. We anticipate an additional loss of more than \$6 billion in FY2010. We have outlined additional cost reductions of \$3.8 billion in FY2010, which will yield savings of \$8 billion when combined with the recurring savings generated by this year’s cost-cutting efforts. These forecasts take into account the May 11 price increase for mailing products. In addition, our financial picture is compounded by the fact that current economic forecasts state that the Consumer Price Index, which caps products yielding 90 percent of our revenue, will not increase sufficiently to allow us to raise prices in May 2010.”
- The Postal Service continues to support H.R. 22, a House bill that would redirect a portion of the Postal Service’s prior payments to the Postal Service Retiree Health Benefits Trust Fund to pay its share of contributions for current retiree health benefits through 2016. If enacted, the legislation would reduce the projected 2009 net loss by approximately \$2 billion and help enable the Postal Service to meet its 2009 financial obligations. (*Postcom.org*, 05/06/09; *USPS Press Release*, 05/06/09; *Postcom.org*, 05/06/09)

USPS needs to be transformed into a “regulated, competitive enterprise”
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- In a commentary on the financial crisis at the USPS, A. Lee Fritschler, professor at George Mason University’s School of Public Policy and former Chairman of the Postal Rate Commission, wrote, “Government bailouts of high profile private corporations have obscured the fact that one of the largest government enterprises, the U.S. Postal Service, is also in dire financial straits. Its requests for immediate relief,

however, should be turned into long term, and long overdue, reforms that will strengthen a great national institution for the future.”

- “The base problem confronting the contemporary Postal Service is that the environment in which it operates has changed drastically. It is less and less a conduit for exchanging first class letters and more and more a broadcast medium, primarily for the distribution of advertisements, periodicals, and parcels. None of these classes of mail is covered by the monopoly on first class mail, a monopoly adopted by Congress in 1872! Today, the reasons for establishing the Postal Service as a government monopoly are fast disappearing. First class mail is shrinking rapidly as telephone and Internet have replaced most hard copy correspondence. Advertisements now comprise most of the mail.”
- “We need to think seriously about transforming the Service from a government monopoly into a regulated, competitive enterprise. There are numerous examples from abroad on how the transition might be made. The European Union has ordered the end of virtually all national postal monopolies by the end of the year 2010. And in this country, there ample precedents and lessons to be learned from regulatory reform in other industries.”
- “A restructured postal system would give the Postal Regulatory Commission, an independent and impartial body of experts, the authority to define the truly public interests which must be protected. For example, the Commission might require delivery of individual first class letters to, say, 98 percent of all addresses in the U.S. within three business days at a maximum rate of 50 cents for the next five years. It would be up to the Postal Service to figure out how to do that. If the Postal Service cannot do the job at a profit, the Commission might contract with a private carrier to provide the necessary service. Meanwhile, the Postal Service might find it commercially sensible to reduce rates for some types of letters -- for example, local utility bills. If it can offer lower rates in some places or to some mailers (without unfair price discrimination), it should do so. And if mailers want enhanced service, they should be able to get it and be willing to pay for it. We need to get away from the idea that the same level of service should be provided to all mailers everywhere. The true public interest lies in a guarantee of a reliable nationwide delivery service at an affordable maximum price.”
- “Public policy towards the Postal Service has grown unwise by not changing with changing times. We now have a system in which Congress feels obliged to oversee the execution of a public monopoly granted in the nineteenth century, while the Postal Service is struggling to adapt to life in the twenty-first century. This mismatch between policy and reality endangers the future of the Postal Service. It is time to allow the Postal Service to manage itself subject to clearly stated and impartially implemented rules that protect—and where necessary pay for—the essential minimum level of nationwide postal services required by the people.”  
[www.postcom.org/public/articles/2009articles/Liberating%20the%20Postal%20Service-1.pdf](http://www.postcom.org/public/articles/2009articles/Liberating%20the%20Postal%20Service-1.pdf)

### USPS reverses plans to eliminate backcountry airmail plane service

- According to *National Public Radio*, “Beginning in June, the owner of a remote and historic ranch in central Idaho’s wilderness faced a rugged three-day hike up and over snowbound mountains 7,000 feet high to get to the free post office box the U.S. Postal Service promised to provide. Or, he could hike 4 miles, then drive 6 bone-jarring miles up a rough road hugging a canyon wall, and then continue driving more than 250 miles—to get to the same post office box. That’s what the Postal Service offered as an alternative when it canceled the last backcountry airmail plane service in the lower 48 states. The \$46,000-a-year route in the Frank Church-River of No Return Wilderness was cut as part of the agency’s effort to trim a \$6 billion deficit. But the plan proved embarrassing to the Postal Service. Postmaster General John Potter reversed course in a letter acknowledging that none of the alternatives to the mail plane route ‘would provide acceptable service levels to our customers.’ The weekly (every two weeks in winter) deliveries will continue.” (*National Public Radio*, Howard Berkes, 05/07/09)

### First-class “rip-off”

- The *New York Daily News* reports that Postal Service customers who shell out extra bucks to send letters by priority mail rather than first-class mail aren’t getting their money’s worth. The paper concluded that Priority Mail service, which costs more than 10 times as much as first-class mail, doesn’t get a letter to its destination any faster in many cases. In eight of 10 tests conducted by *NYDN* in April, letters sent priority and first-class were delivered to the same location on the same day.
- In a May 5<sup>th</sup> editorial, the *New York Daily News* wrote, “Mail fraud is a federal crime, isn’t it? Yes, except if you’re the U.S. Postal Service. Then you’re free to engage in one of the most blatant cons around. ...At almost \$5 a shot, the Post Office is making a killing on each [Priority mail] delivery without guaranteeing speed. But customers do get the opportunity to buy insurance or tracking and what a spokesman called the ‘ooh factor.’ There’s a reason for this money grab: Thanks to e-mail - and a plummeting volume of deliveries, the Post Office is going broke. But that’s no excuse for making it a priority to scam the public.” (*New York Daily News*, 05/05/09; *New York Daily News*, Tracy Connor, 05/05/09)

### Sign of the times

- A Michigan postal worker has admitted to stealing approximately \$20,000 worth of first-class postage stamps since September and selling them on eBay to help his family make delinquent payments on their mortgage. John Auito, the 42 year old

employee who joined the USPS in 2003, confessed to contacting customers of eBay and offering to sell them stolen stamps at below-retail prices. (*CNN.com*, Melissa Roberts, 05/11/09)

## TVA

### TVA's power sales decline 9.4% in the second quarter

- Citing the slumping economy, TVA said its sales for power in the fiscal second quarter fell 9.4% from the same period a year ago. For the three months ended March 31<sup>st</sup>, TVA reported net income of \$133 million, [down 0.2% from the same period last year of \$135 million], which included a \$150 million charge for the expected cleanup cost for the ash spill. TVA reported a net loss of \$172 million for the six months ended March 31<sup>st</sup> [compared to year-ago net income of \$143 million], which included a \$675 million charge for the spill's expected cleanup cost.
- “The effects of the economic downturn are resulting in less demand for power in the TVA region,” said Kim Greene, TVA’s CFO. “The decrease in power sales, continuing expenses to clean up the Kingston ash spill [\$77 million during the second quarter], and the impact of the market decline on our pension and other investments are among the factors that make this a challenging year financially.” Sales could decline further if commercial and industrial customers continue to cut back production or even cease operations, said Greene. “On the positive side, our customers are benefiting from lower fuel and purchased power costs, which resulted in reductions in our fuel cost adjustment in January and April of this year. We have now rolled back the majority of the increase in power rates from Oct. 1 ... and continue to provide reliable service at competitive prices.” To offset financial pressures, TVA is reducing its operating costs and capital expenses. (*Huntsville Times*, 05/07/09)

### The estimated cost of the cleanup of TVA's ash spill nears \$1 billion (and growing)

- In a May 10<sup>th</sup> editorial, the *Knoxville News* wrote, “As if things aren’t going badly enough these days for [TVA], rain and money last week were causing new headaches for the federal utility—in too much rain and too much money to clean up an environmental mess. Both stem from the 5.4 million cubic yards of fly ash from the Kingston Fossil Plant that spilled on Dec. 22 into the nearby Emory River and a lakeside community, covering about 300 acres and damaging about two dozen homes. Now, more than four months after the disaster, TVA said it still does not know what caused the massive spill, although outside consultants have been hired. Further, it doesn’t know the extent of the environmental damage or what will be needed to restore the land to its previous condition.”

- “Earlier this month, TVA raised its top assessment for the cleanup to close to \$1 billion and acknowledged that the recovery could take several years. ...The new estimates for cleaning up the fly ash spill are \$150 million higher than previous projections, putting the top of the range at \$975 million. The low end is \$675 million.”
- “TVA also learned earlier this month that it might have to pay the state of Alabama \$25,000 and dredge a creek there following an ash spill that occurred about three weeks after the one in Roane County. The creek empties into the Tennessee River. The state of Alabama also wants TVA to conduct engineering analyses of other storage ponds in the area. The \$25,000 is a drop in the bucket to what TVA eventually will pay for the cleanup of the Roane County spill, but the fine and requested scrutiny shows that the federal agency needs to keep attention on its storage facilities.”
- “Closer to home last week, the heavy rains of early May began to swell the Emory River, pushing some of the fly ash downstream. State environmental officials said they won’t know how much of the ash has moved until the rains stop... What happened involving rain and money the last 10 days might well affect the answers to questions on East Tennesseans’ minds concerning the spill. The big one is this: How much will the cleanup, the lawsuits—one asks for \$300 million in damages—and related matters cost the 8.7 million consumers served by TVA distributors?”
- “[TVA’s] financial report noted that TVA has property and liability insurance to cover some of the costs, but two insurers have denied coverage. There also are questions about health concerns from the fly ash, but environmental agencies say that drinking water and air quality remain safe for now. Meanwhile, the cleaning and the dredging go on, hampered by the rains of spring and overshadowed by the bills that loom larger and larger.” (*Knoxville News*, 05/10/09)

EPA to oversee cleanup of TVA’s ash spill
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- The EPA will oversee the cleanup of TVA’s massive coal ash spill in Tennessee that brought national attention to the environmental risks of storing the power plant byproduct. EPA Administrator Lisa Jackson said her agency will be taking charge and “bringing to bear its resources and expertise” under the federal Superfund law. Previously, EPA had assisted state regulators with the cleanup of 5.4 million cubic yards of coal ash that spilled December 22<sup>nd</sup>. TVA will reimburse the federal environmental agency for the costs of the oversight, said the utility’s officials. TVA also will pay \$50,000 for a community group to contract an independent technical advisor to help interpret technical documents and keep the community apprised of what is taking place in the clean up. (*Associated Press*, 05/11/09; *The Tennessean*, Anne Paine, 05/11/09)

NuStart abandons its joint licensing effort with TVA at its Bellefonte nuclear facility

- NuStart, a consortium of utility companies and reactor manufacturers, announced it is shifting its initial licensing efforts for the new reactor design from TVA's Bellefonte nuclear plant to Southern Power's Vogtle nuclear plant near Augusta, Ga. TVA said it would continue its efforts to receive NRC approval of the site despite the decision by NuStart's announcement. "With the reference designation transitioning to the Plant Vogtle project, the NRC can complete the licensing process sooner and pave the way for subsequent combined construction and operating license applications," said TVA Vice President of Nuclear Generation Development and Construction Ashok Bhatnagar. "Though TVA has not made a decision to build a new large-scale, base-load generation nuclear plant at this time the transfer of the reference designation will not affect our pursuit of a license for Bellefonte Units 3 and 4." (*The Daily Sentinel*, Ken Bonner, 05/04/09)

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