September 21, 2009

The GSE REPORT ™

"A government big enough to give you everything you want is strong enough to take everything you have."

Thomas Jefferson

"In 1909, the U.S. federal government had an annual budget of $0.8 billion. With this it governed a population of just over 90 million people. The cost of government was about $9 per capita. In 2009, the U.S. federal government has an annual budget of $3,550 billion. With this it governs a population of just over 300 million people. That's a cost of about $11,675 per capita. Are we 1200 times better off?"

John Mauldin
September 11th *Frontline Weekly Newsletter*

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Contents of GSE Report ™

Major Events

President Barack Obama urges bankers "to embrace serious financial reform, not fight it"

Without real reform, it's only a matter of time before the next crisis hits

- In a September 14th speech in New York, President Barack Obama told Wall Street to "embrace financial reform, not fight it." In a speech marking the first anniversary of collapse of Lehman Brothers, Obama told the leaders of the financial community, that he was pressing forward with his plan to impose new regulations to protect the U.S. from financial crises in the future.

- Obama said, "…We will not go back to the days of reckless behavior and unchecked excess at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses. Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

- "… [W]e need strong rules of the road to guard against the kind of systemic risks we have seen. And we have a responsibility to write and enforce these rules to protect consumers of financial products, taxpayers, and our economy as a whole. Yes, they must be developed in a way that does not stifle innovation and enterprise. And we want to work with the financial industry to achieve that end. But the old ways that led to this crisis cannot stand. And to the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself."

- "… [W]e are calling on the financial industry to join us in a constructive effort to update the rules and regulatory structure to meet the challenges of this new century. … [W]e are proposing the most ambitious overhaul of the financial system since the Great Depression. But I want to emphasize that these reforms are rooted in a simple principle: we ought to set clear rules of the road that promote transparency and accountability. That's how we'll make certain that markets foster responsibility, not recklessness, and reward those who compete honestly and vigorously within the system, instead of those who try to game the system."

- "First, we're proposing new rules to protect consumers and a new Consumer Financial Protection Agency to enforce those rules. This crisis was not just the result of decisions made by the mightiest of financial firms. It was also the result of decisions made by ordinary Americans to open credit cards and take on mortgages. And while there were many who took out loans they knew they couldn't afford, there were also millions of Americans who signed contracts they didn't fully understand offered by lenders who didn't always tell the truth."

- “This is in part because there is no single agency charged with making sure it doesn’t happen. …The Consumer Financial Protection Agency will have the power to ensure that consumers get information that is clear and concise, and to prevent the worst kinds of abuses. Consumers shouldn’t have to worry about loan contracts designed to be unintelligible, hidden fees attached to their mortgages, and financial penalties – whether through a credit card or debit card – that appear without warning on their statements. And responsible lenders, including community banks, doing the right thing shouldn’t have to worry about ruinous competition from unregulated competitors. …For example, we had ‘teaser’ rates on credit cards and mortgages that lured people in and then surprised them with big rate increases. By setting ground rules, we’ll increase the kind of competition that actually provides people better and greater choices, as companies compete to offer the best product, not the one that’s most complex or confusing.”

- “Second, we’ve got to close the loopholes that were at the heart of the crisis. Where there were gaps in the rules, regulators lacked the authority to take action. Where there were overlaps, regulators often lacked accountability for inaction. These weaknesses in oversight engendered systematic, and systemic, abuse. Under existing rules, some companies can actually shop for the regulator of their choice – and others, like hedge funds, can operate outside of the regulatory system altogether. We’ve seen the development of financial instruments, like derivatives and credit default swaps, without anyone examining the risks or regulating all of the players. And we’ve seen lenders profit by providing loans to borrowers who they knew would never repay, because the lender offloaded the loan and the consequences to someone else. Those who refuse to game the system are at a disadvantage.”

- “Now, one of the main reasons this crisis could take place is that many agencies and regulators were responsible for oversight of individual financial firms and their subsidiaries, but no one was responsible for protecting the whole system. In other words, regulators were charged with seeing the trees, but not the forest. And even then, some firms that posed a ‘systemic risk’ were not regulated as strongly as others, exploiting loopholes in the system to take on greater risk with less scrutiny. …That’s why we’ll create clear accountability and responsibility for regulating large financial firms that pose a systemic risk. While holding the Federal Reserve fully accountable for regulation of the largest, most interconnected firms, we’ll create an oversight council to bring together regulators from across markets to share information, to identify gaps in regulation, and to tackle issues that don’t fit neatly into an organizational chart. We’ll also require these financial firms to meet stronger capital and liquidity requirements and observe greater constraints on their risky behavior. That’s one of the lessons of the past year. The only way to avoid a crisis of this magnitude is to ensure that large firms can’t take risks that threaten our entire financial system, and to make sure they have the resources to weather even the worst of economic storms.”

- “… [W]e’ve also proposed creating what’s called ‘resolution authority’ in the event that such a failure happens and poses a threat to the stability of the financial system.

This is intended to put an end to the idea that some firms are "too big to fail." For a market to function, those who invest and lend in that market must believe that their money is actually at risk. And the system as a whole isn't safe until it is safe from the failure of any individual institution. If a bank approaches insolvency, we have a process through the FDIC that protects depositors and maintains confidence in the banking system. …And it works. Yet we don't have any kind of process in place to contain the failure of a Lehman Brothers or AIG or any of the largest and most interconnected financial firms in our country."

- "…Finally, we need to close the gaps that exist …among countries. …At a summit in London in April, leaders agreed to work together in an unprecedented way to spur global demand but also to address the underlying problems that caused such a deep and lasting global recession. This work will continue next week in Pittsburgh when I convene the G20, which has proven to be an effective forum for coordinating policies among key developed and emerging economies and one that I see taking on an important role in the future. …As the United States is aggressively reforming our regulatory system, we will be working to ensure that the rest of the world does the same..."

- "…I have urged leaders in Congress to pass regulatory reform this year and both Congressman Frank and Senator Dodd, who are leading this effort, have made it clear that that's what they intend to do. Now there will be those who defend the status quo. There will be those who argue we should do less or nothing at all. But to them I'd say only this: do you believe that the absence of sound regulation one year ago was good for the financial system? Do you believe the resulting decline in markets and wealth and employment was good for the economy? Or the American people?"

- "…I certainly did not run for President to bail out banks or intervene in the capital markets. But it is important to note that the very absence of common-sense regulations able to keep up with a fast-paced financial sector is what created the need for that extraordinary intervention. The lack of sensible rules of the road, so often opposed by those who claim to speak for the free market, led to a rescue far more intrusive than anything any of us …would have proposed or predicted."

- "… [W]hat took place one year ago was not merely a failure of regulation or legislation; it was not merely a failure of oversight or foresight. …It was a collective failure of responsibility in Washington, on Wall Street, and across America that led to the near-collapse of our financial system one year ago."

- "…Here on Wall Street, you have a responsibility. The reforms I've laid out will pass and these changes will become law. But one of the most important ways to rebuild the system stronger than before is to rebuild trust stronger than before – and you do not have to wait for a new law to do that. You don't have to wait to use plain language in your dealings with consumers. You don't have to wait to put the 2009 bonuses of your senior executives up for a shareholder vote. You don't have to wait for a law to overhaul your pay system so that folks are rewarded for long-term performance instead of short-term gains."

- "The fact is, many of the firms that are now returning to prosperity owe a debt to the American people. Though they were not the cause of the crisis, American taxpayers through their government took extraordinary action to stabilize the financial industry. They shouldered the burden of the bailout and they are still bearing the burden of the fallout – in lost jobs, lost homes and lost opportunities. It is neither right nor responsible after you've recovered with the help of your government to shirk your obligation to the goal of wider recovery, a more stable system, and a more broadly shared prosperity."

- "So I want to urge you to demonstrate that you take this obligation to heart. To put greater effort into helping families who need their mortgages modified under my administration's homeownership plan. To help small business owners who desperately need loans and who are bearing the brunt of the decline in available credit. To help communities that would benefit from the financing you could provide, or the community development institutions you could support. To come up with creative approaches to improve financial education and to bring banking to those who live and work entirely outside the banking system. And, of course, to embrace serious financial reform, not fight it."

- "…Common-sense rules of the road do not hinder the markets but make them stronger. Indeed, they are essential to ensuring that our markets function, and function fairly and freely. …[I]t is incumbent on us to put in place those reforms that will prevent this kind of crisis from ever happening again; that reflect the painful but important lessons we've learned; and that will help us move from a period of recklessness and crisis to one of responsibility and prosperity. That is what we must do. And I'm confident that is what we will do." (*Prepared Remarks by President Barack Obama*, 09/14/09)

<u>Without real reform, it's only a matter of time before the next crisis hits</u>

- In a September 15th commentary, Mark A. Calabria, director of financial regulation studies for the Cato Institute, wrote, "Today President Obama took his financial reform plan to the airwaves. While there is no doubt our financial system is in need of financial reform, the President's plan would make bailouts a permanent feature of the regulatory landscape. Rather than ending 'too big to fail'—the President wants us to believe that with additional discretion and power, the same Federal Reserve that missed the boat last time will save us next time."

- "The truth is that the President's plan will result in a small number of companies being viewed by debt holders as 'too big to fail.' These companies would see their funding costs decline, allowing them to gain market-share at the expense of their rivals, making these firms even larger. Greater concentration in our financial services industry is the last thing we need, yet the Obama plan all but guarantees it."

- “Obama also chooses myth’s over facts. The President claims that de-regulation and competition among regulators caused the crisis. The facts could not be more different. Those institutions at the center of the crisis—Fannie Mae, Freddie Mac, Bear Stearns, Lehman–could not choose their regulator.”

- “The President’s plan chooses convenient targets and protects entrenched interests, rather than address the true underlying causes of the crisis. At no time have we heard the President discuss the expansionary monetary policies that helped fuel the bubble. Nor has the President talked about the global imbalances—the global savings glut that poured surplus savings from the rest of the world into the US. But then the President appears to hope that loose monetary policy and continued American consumption funded by China will get him out of his own political problems with the economy. It is especially striking that the President makes little mention of the housing bubble, as if it was only the bust that was the problem.”

- “The President continues to say he inherited this crisis. While true, he did not inherit the same individuals — Tim Geithner and Ben Bernanke — who were at the center of creating the crisis. All Obama needs to do is find a position for Hank Paulson and he will have completely re-assembled the Bush financial team.”

- “Without real reform—fixing Fannie and Freddie, scaling back the massive subsidies for leverage in our tax code, loose monetary policy—it will only be a matter of time before the next crisis hits. If we implement the President’s plan, we will, however, guarantee that the next crisis will be even larger and more severe than the current one.” (*Cato Institute*, Mark A. Calabria, 09/15/09)

Federal Reserve steps up its efforts to regulate the financial sector:
Central bank extends its regulatory umbrella to cover non-bank subsidiaries
The Fed proposes to place sweeping curbs on bankers’ pay

<u>Central bank extends its regulatory umbrella to cover non-bank subsidiaries</u>

- On September 15th, the Federal Reserve announced it will extend its regulatory umbrella to begin examining potentially hundreds of nonbank subsidiaries of bank holding companies to ensure compliance with federal laws to protect consumers of mortgages, credit cards, and other financial products. The central bank’s announcement came a day after President Obama reiterated his support for the creation of a new agency to oversee consumer protection. The Federal Reserve said its action stemmed from a 2007 pilot project with the FTC and OTS, in which the regulators examined non-depository subsidiaries of banks that had significant subprime lending operations. Fed officials also said that the change reflects a renewed conviction at the central bank about the importance of protecting consumers, particularly after having seen the role that abusive lending played in the collapse of the housing market and the resulting damage to the broader economy.

- In a September 14th letter to the 12 regional Fed banks' officials, Sandra Braunstein, the central bank's director of consumer and community affairs, wrote that the new policy "is designed to enhance our understanding of consumer compliance risk profile of nonbank subsidiaries and to guide our supervisory activities for these entities." The plan for implementing the policy "would be developed by consumer compliance examiners who have the appropriate experience, training and expertise to do so," she wrote. While the new supervision program will begin immediately, the first round of examinations are expected to begin in the summer of 2010. In the meantime, the central bank will begin gathering information from holding companies to determine how many lenders will be covered by the Fed's new polity. The central bank also will begin investigating consumers' complaints about non-bank subsidiaries. For the time being, the Fed will not increase its staff, but additional guidance would be included in the central bank's 2011 budget, Braunstein added.

- Observers say that the central bank is focused on Capitol Hill, where Democratic leaders are crafting legislation to create the Consumer Financial Protection Agency. The CFPA structure, as proposed by the administration, would remove the power of banking regulators to write and enforce consumer-related powers and transfer that function to the new agency. The Federal Reserve has been the most vocal in its concerns about the proposed removal of its responsibilities for consumer protection. Now, the question appears to be if Congress will appreciate the central banks' efforts in this area. Jim Carr, the COO of the National Consumer Reinvestment Coalition, said, "Even if the Fed were proposing a regime that was as comprehensive as the law, it wouldn't take away the inherent conflicts between the Fed's support for the banks versus its protection of consumers. We think it's important that they try, but this doesn't supplant the need for an agency whose first priority is protecting consumers."

- FDIC chairman Sheila C. Bair has voiced concern that the CFPA, while good for consumers in theory, would hurt bank regulation as a whole by eliminating the ability of existing regulators to oversee the safety and soundness of the system. Under the Administration's proposed regulatory structure, will financial institutions have to answer to two masters—the demands of a consumer activist regulatory agency and demands of a safety and soundness banking regulator? If and when the demands are at cross-purposes, which agency will prevail? And, how much will the conflict ultimately cost taxpayers? (*American Banker*, Steven Sloan, 09/16/09; *Washington Post*, Binyamin Appelbaum, 09/16/09; *CQ Today*, Benton Ives and Phil Mattingly, 09/08/09)

<u>The Fed proposes to place sweeping curbs on bankers' pay</u>

- In late September or early October, the Federal Reserve plans to announce new regulations governing risk-based compensation for bankers to curb risk-taking by its regulated banks, thrusting the central bank into a murky area where regulation has generally failed. The Fed's move is the latest and most sweeping effort to curb risk-taking by the commercial banking industry in the wake of the financial crisis. Although details on the regulation haven't been finalized, the *Wall Street Journal* reports that the Fed will propose to review pay packages for tens of thousands of bankers to guard against the encouragement of excessive risk and to allow banks to "claw back" compensation in certain cases.

- Such a move by the central bank would greatly broaden the scrutiny that Obama administration pay czar Kenneth Feinberg has applied to seven banks receiving large amounts of federal aid to the broader banking industry. Among other things, the Fed's new rules could require boards of directors and the central banks' staff to become more deeply involved in the pay packages of senior executives and many mid- and low-level employees. Under the Fed's draft proposal, banks' policies setting pay for tens of thousands of bank employees would require regulatory approval, and insert bank regulators "deep" into compensation decisions traditionally made by the banks' corporate boards and management. Under the proposal, the central bank would be able to reject compensation policies it believes encourage any bank employee to take too much risk. While bank regulators wouldn't set the pay of individuals, they would review and, as necessary, amend the bank's salary and bonus policies to ensure harmful incentives aren't created. The Federal Reserve believes it has the authority to govern this area under its powers as the "safety and soundness" regulator for these financial institutions. Initially, the nation's 25 largest banks would receive particularly close scrutiny with the central bank comparing compensation practices of the group to identify any practices that stand out as unusually dangerous for a specific bank. According to people familiar with the proposal, the proposal could be revised in coming weeks, before the Federal Reserve Board of Governors votes to adopt the rule in final form.

- In the past, previous legislative efforts to regulate pay have often failed or backfired, sending pay higher. In the 1980s, a law restricting "golden parachutes" in fact spread the use of what had been a rare practice. In 1993, a law limiting annual salaries resulted in bigger stock-option grants, pensions and deferred compensation—a law belonging in the "Museum of Unintended Consequences," according to former SEC chairman Christopher Cox.

- Reaction to the Fed's plans to regulate bankers' compensation was mixed on Capitol Hill. Several Republican lawmakers harshly criticized the Fed's plan, while some Democrats expressed skepticism as well. However, House Financial Services Committee chairman Barney Frank (D-MA) endorsed the central bank's move. In an interview, Frank said the Fed's planned move "very much validates" actions he has taken in the House, adding "it's very similar to what we're doing here," The House has passed legislation that would direct all bank regulators to take steps similar to what the Fed is doing. Frank added that it's important for the Senate to pass similar legislation to remove any ambiguity about the central bank's powers in this area. Frank also scoffed at Republican criticism, saying: "What they would prefer is

Americans to throw up their hands and say, 'Go ahead, take all the money.' I can understand the Republicans' frustration, but sometimes reality bites."

- Representative Spencer Bachus, (R-AL), ranking member on the House Financial Services Committee, said, "Greed got out of hand on Wall Street, but does that make the government becoming the risk manager for corporations the right thing to do? I'm very uneasy with that." Senator Richard Shelby (R-AL), the ranking member on the Senate Banking Committee, said there were "important unanswered questions regarding the basis for the Fed's authority and approach on this matter."

- On September 18th, Senator Bob Corker (R-TN) called Fed Chairman Ben Bernanke and urged him to be cautious about this plan. "You need to be very careful," Corker said he told Bernanke, who assured him that the Fed was taking a principles-based approach rather than the pay caps being considered by other countries. Corker and Bernanke also discussed former Fed Chairman Paul Volcker's suggestion that banks be barred from taking trading bets with their own capital. Corker told Bernanke that could be a better remedy than the regulation of bankers' compensation.

- Some Democrats have also expressed their reservations about the Fed's proposed actions. "It's nice to see the Fed make a play at populism," said Representative Dennis Kucinich (D-OH), chairman of the House Domestic Policy subcommittee that has been probing the Fed's role in the financial crisis. "It's just I would suggest that it's an ill-fitting suit." While it's right for the Fed to be looking at executive compensation practices, Kucinich said that bankers' pay structures aren't nearly as important as issues of high unemployment and a widening gap between the "finance economy and the real economy." Kucinich asked, "What does the Fed do at this moment? They play the executive compensation card. In a deck of cards…on Wall Street, that would be like a two of clubs. It has some significance, but in light of the larger issues which they have they to address, one certainly cannot be led to take comfort at the role of the Fed with this kind of a move."

- "This action should finally dispel the myth of the political independence of the Fed," said Representative Scott Garrett (R-NJ). "We have never seen this action before. Unless the Fed has evidence that we don't have, why are they stepping out now before congress, which has said they want to investigate this matter?" (*Wall Street Journal*, Damian Paletta and Jessica Holzer, 09/18/09; *Wall Street Journal*, Aaron Lucchetti and Scott Thurm, 09/18/09)

FDIC may tap its Treasury credit line

Just how large is the hole at FDIC?

The coming deposit insurance bailout

FDIC may tap its Treasury credit line

- In a September 18th speech in Washington, FDIC chairman Shelia Bair said her agency may tap its $500 billion line of credit with Treasury to replenish its insurance fund—but appeared to be cautious in taking this action. She noted that there are different views on how FDIC's lines used be used, saying some believed that it should be used only for emergencies, rather than covering losses that are already known. "We are carefully considering all options [including borrowing from Treasury]," said Bair after her speech. She has already warned banks that they may face an assessment to bolster the agency's insurance fund. Other options are available to FDIC, including requiring banks to prepay assessments, Bair added. The FDIC board will meet later in the month to determine how to replenish the agency's fund. (*Dow Jones Newswires*, Jessica Holzer, 09/18/09)

Just how large is the hole at FDIC?

- In the September 18th edition of *Frontline Weekly Newsletter*, John Mauldin asked, "Just how large is the hole at FDIC?" He continued, "While the FDIC has a little over 400 banks on its current 'watch' list, [Institutional Risk Analytics] gives 2,256 banks an 'F.' They project that over 1,000 banks will either fold or be taken over during the current cycle. To date in 2009, a total of 92 banks have failed across the country, compared with 25 for all of 2008, according to the FDIC. 900 more to go…"

- "How much money are we talking about? The banks rated F have total insured assets of $4.46 trillion. So far in this cycle banks that have been taken over by the FDIC are showing losses of 25%!"

- "Turning to a note from IRA: 'An important point in the analysis is that estimated losses for failed bank resolutions by the FDIC are running around a quarter of failed bank assets, a level much higher than between 1980 and 1995, when failures cost an average 11 percent. Our firm's long-held view of the likely loss rate peak for the US banks in this credit cycle is 2x 1990 loss rates or, as noted by the IMF, around 4 percent of total loans. Since total loans and leases held by all FDIC-insured banks was some $7.7 trillion as of Q2 2009, the IMF estimate implies a cumulative loss of over $300 billion.'"

- "If you start with the internal assumptions used by Institutional Risk Analytics that roughly half of the banks currently rated 'F' or some 1,000 banks will fail and/or be merged with another institution and that the loss to the FDIC bank insurance fund will be approximately 20-25% of total assets, then the cost of these resolutions to the FDIC through the full credit downturn could be in excess of $400-500 billion. Keep in mind that in making this alarming estimate we ignore other banks currently in ratings strata above 'F' and that some of these institutions may indeed fail as well. Also, our overall 'worst case' or maximum probable loss (MPL) for large US banks above $10 billion in assets is $800 billion through the current credit cycle."

- "From almost $60 billion last fall, the FDIC's reserves have been drawn down to only about $10 billion today (after set-asides), a 16-year low. A quick look at the FDIC's own data shows us how inadequate those reserves are compared to the deposits they are now insuring. The FDIC only has about two-tenths of one cent for every dollar of assets it covers. …The FDIC can borrow $100 billion in an emergency line of credit, and through 2010 it can get another $500 billion. But if and when that money is borrowed, it will have to be paid back. Remember the money that was lost in the savings and loan crisis 20 years ago? The FDIC had to borrow a mere $15 billion. We are still paying that 30-year loan back."

- "The FDIC has two options to replenish its insurance fund in the short run: it can charge banks higher fees or it can take the more radical step of borrowing from the US Treasury. It has already levied a 'special fee' that garnered over $5 billion."

- "…If the FDIC borrows the money, and it is highly likely they will, they are going to have to raise the rates they charge member banks for the government backing. And to pay back $3-400 billion? Rates will have to be raised quite high, on the very banks struggling to raise capital and make a profit. This is going to be a huge drain on future profits of US banks for a very long time. It is going to make it even harder for them to increase their capital–and they need to. But it has to happen. Zombie banks, those that are bound to fail, need to be taken out and put into stronger hands so that credit growth can once again start to rise. But this will not happen overnight. It is going to take time." (*Frontline Weekly Newsletter*, John Mauldin, 09/18/09)

<u>The coming deposit insurance bailout</u>

- In a September 1st editorial, the *Wall Street Journal* wrote, "Americans are about to re-learn that bank deposit insurance isn't free, even as Washington is doing its best to delay the coming bailout. The banking system and the federal fisc would both be better off in the long run if the political class owned up to the reality."

- "We're referring to the federal deposit insurance fund, which has been shrinking faster than reservoirs in the California drought. The Federal Deposit Insurance Corp. reported …that the fund that insures some $4.5 trillion in U.S. bank deposits fell to $10.4 billion at the end of June, as the list of failing banks continues to grow. The fund was $45.2 billion a year ago, when regulators told us all was well and there was no need to take precautions to shore up the fund."

- "The FDIC has since had to buttress the fund with a $5.6 billion special levy on top of the regular fees that banks already pay for the federal guarantee. This has further drained bank capital, even as regulators say the banking system desperately needs more capital. Everyone now assumes the FDIC will hit banks with yet another special insurance fee in anticipation of even more bank losses. The feds would rather execute this bizarre dodge of weakening the same banks they claim must get stronger rather than admit that they'll have to tap the taxpayers who are the ultimate deposit insurers."

- "It isn't as if regulators don't understand the problem. Earlier this year they quietly asked Congress to provide up to $500 billion in Treasury loans to repay depositors. The FDIC can draw up to $100 billion merely by asking, while the rest requires Treasury approval. The request was made on the political QT because, amid the uproar over TARP and bonuses, no one in Congress or the Obama Administration wanted to admit they'd need another bailout."

- "But this subterfuge can't last. Eighty-four banks have already failed this year, and many more are headed in that direction. The FDIC said it had 416 banks on its problem list at the end of June, up from 305 only three months earlier. The total assets of banks on the problem list was nearly $300 billion, and more of these assets are turning bad faster than banks can put aside reserves to account for them. The commercial real-estate debacle is still playing out at thousands of banks, even as the overall economy bottoms out and begins to recover."

- "Meantime, even as it 'resolves' and then sells failed banks, the FDIC is also guaranteeing the buyers against losses on tens of billions of acquired assets. This is known in the trade as 'loss sharing,' which is another form of taxpayer guarantee that taxpayers aren't supposed to know about. Most of the losses won't be realized if the economy recovers. But this too is a price of taxpayers guaranteeing deposits. Even as Treasury and the press corps broadcast that the feds are making money on TARP repayments, these guarantees go largely unnoticed."

- "FDIC Chairman Sheila Bair continues to say that deposits will be covered up to the $250,000 per account insurance limit, and of course she's right. But we wish she'd force Congress—and the American public—to face up to the reality of what deposit insurance costs. Amid the panic last year, Congress raised the deposit limit from $100,000. While this may have calmed a few nerves—though the worst runs were on money-market funds, not on banks—it also put taxpayers further on the hook."

- "The $250,000 limit was supposed to expire at the end of 2009, but in May Congress extended it through 2013, and no one who understands politics thinks it will return to $100,000. The rising bank losses mean that the FDIC's ratio of funds to deposits is down to 0.22%, far below its obligation under the insurance statute to keep it between 1.15% and 1.50%."

- “Rather than further soak capital from already weak banks, the FDIC ought to draw down at least $25 billion from its Treasury line of credit. Ms. Bair is going to have to ask for the cash sooner or latter, and she might as well do it before the fund hits zero and we get another round of even mild depositor anxiety. We suppose Congress could raise a faux fuss, but these are the same folks who ordered the FDIC to broaden the insurance limit. They need to face the political consequences of their promises.” (*Wall Street Journal*, 09/01/09)

FHA reserves to fall below their statutory minimum at end of FY2009

- FHA Commissioner David Stevens announced plans to tighten its credit requirements against mortgage loan losses, but contended his agency will be able to absorb unexpected claims without a taxpayer bailout. “There will be no taxpayer bailout,” said Stevens in a news conference.

- The FHA has acknowledged that it will fall short of its 2% minimum statutory reserve requirement as of September 30th. In a *Washington Post* interview, Stevens said, “It’s very serious. There’s nothing more serious that we’re addressing right now, outside the housing crisis in general, than this issue.”

- In Senate testimony earlier this year, HUD Inspector General Kenneth Donohue said that when FHA’s reserve’s minimum fell below the statutory requirement then an “increase in premiums or congressional appropriation intervention to make up the shortfall” would be required. However, Stevens insisted these options are not on the table. “We are absolutely not going to Congress and asking for money for FHA,” said Stevens. “We’re not going to need a special subsidy or special funding of any kind.”

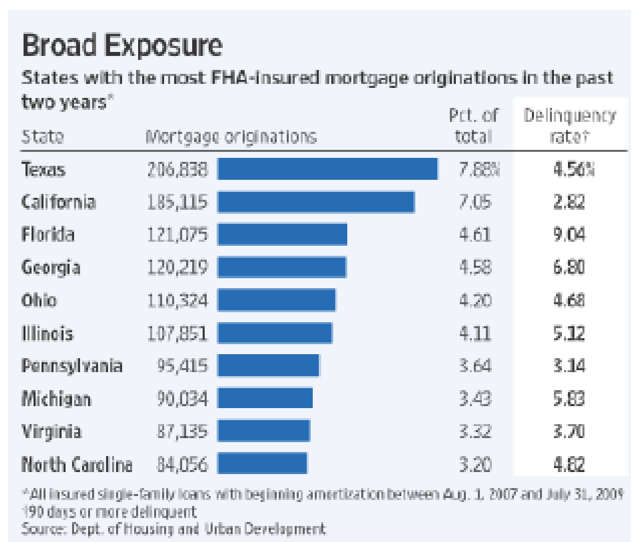
- Instead, Stevens proposes that banks and other lenders that do business with the FHA increase their reserves four-fold from $250,000 to at least $1 million [and may be raised further], which can be used to repay the agency for losses if the lender is involved in fraud. In addition, the FHA will stop certifying mortgage brokers to handle FHA loans. Instead, lenders that underwrite and fund the mortgage brokers’ loans will be responsible for paying any failures to meet FHA standards. For refinances of FHA loans, the agency will impose (i) new requirements for verifying income and other quality-control items and (ii) a new maximum loan to value of 125% of the current value of the collateral property. FHA also plans to adopt new rules for appraisers consistent with the new rules adopted earlier this year by Fannie and Freddie. In addition, appraisal will be valid for a period of no more than four months, down from six to 12 months previously. To reduce the FHA’s risks and potential for losses, Stevens plans to hire a chief risk officer by yearend—something the agency has never done in its 75-year-history.

- The FHA’s audit for 2009 appears to be especially dire because it provides a snapshot of the agency’s financial standing at the depths of a severe recession, and it does not take into account the new loans FHA will insure and the new premiums it will collect, argued Stevens. However, the 2009 audit does show that even without his proposed measures, FHA's reserves will rebound to the required statutory level within two or three years as the result of the recovery in the housing market, based upon projections of future home prices, interest rates and the volume and credit quality of FHA's business.

- Stevens also pointed out that FHA's reserves are only one of two funds used to cover the agency's loan losses. In addition to its reserves, FHA maintains a second "reserve" fund, intended as a backup fund should losses exceed forecasts, from which it pays for losses directly. In total, FHA's two funds totaled $30.4 billion as of June 30, up from $28.3 billion on September 30, 2008, said Stevens.

- However, critics were skeptical of the administration's assertion that FHA doesn't need a bailout in face of eroding loss reserves. "[Shrinking loss reserves] is just the tip of the iceberg as job losses continue to mount, and more and more homeowners are expected to lose value in their homes," said Senator Christopher S. Bond (R-MO). "It's critical we address FHA's problems now because the taxpayer credit card is maxed out." Mark Calabria, director of financial regulation studies at the Cato Institute, said, "The only way they will survive without taxpayer assistance is if the housing market turns around and the labor market turns around fairly soon. Nobody has a crystal ball right now."

- In 2009, the FHA has captured 23% of all new loans made to date, up from 3% in 2006. Earlier, the agency reported that 7.8% of all FHA-insured loans are 90 days or more delinquent, up from 6.6% a year earlier. FHA's sudden popularity has alarmed many lawmakers, who question if FHA has the resources and expertise to handle its increased workload, and manage the *risks of new defaults. (Washington Post*, Dina ElBoghdady, *09/18/09; Wall* Street *Journal*, James R. Hagerty, 09/18/09; *Wall Street Journal*, Nick Timiraos, 09/05/09; *Washington Post*, Dina ElBoghdady, 09/19/09)



TARP

The first anniversary of the federal government's bailout efforts

- *Moody's Economy.com* estimates that the total cost to taxpayers for the financial crisis will approach $1.2 trillion, roughly 10% of the $12 trillion committed by the federal government to fight the country's financial crisis and 8% of GDP. With the federal government injecting trillions of dollars into the U.S. economy, Washington has become the dominant player in American business. Pimco, the world's largest bond fund, recently added a new risk assessment to their financial criteria for making investments—the impact of any change in federal policy. "We're having to think much more about the role of government in the economy," said Pimco CEO Mohamed A. el-Erian.

- Richard H. Clarida, an assistant Treasury secretary in the Bush administration who is now an economics professor at Columbia University, said, "This crisis has and will fundamentally change the relationship between Wall Street and Washington for decades to come. It's often said that Wall Street is no longer the financial capital, that it's Washington, D.C., and that's certainly true. I don't think this is destined to change. I think this is going to be a fact of life." (*New York Times,* 09/09/09; *Washington Post,* David Cho, Steven Mufson, and Tomoeh Murakami Tse, 09/13/09)

- While the government has begun the process of winding down some of its bailout programs, there remains more than $2.2 trillion of loans yet to be reclaimed by Treasury, the Fed, and FDIC. As of mid-September, the following federal government's programs were in place:

    - Corporate debt purchases by the Fed to shore up commercial paper, which peaked on January 22nd at $350 billion. Fed purchase of corporate debt is now down 86% to $47.7 billion;

    - Money market rescue by the Fed, which loaned money to funds and to banks that lend to money markets, peaking on October 2nd with $152.1 billion outstanding with $79 billion outstanding in mid-September. This program ended on September 18th;

    - Discount window for investment banks opened by the Fed to stave off the collapse of investment banking firms. The program, which peaked on October 2nd with $146.6 billion outstandings, was ended in May.

    - Term Auction Facility, set up by the Fed in December 2007 to provide liquidity for hard-to-sell assets, peaked on November 13th with $415.3 billion outstanding. In mid-September, TAF outstandings are down 49% to $212.3;

- TARP, which provided banks capital investments by Treasury, peaked on June 16th at $436 billion; in mid-September, TARP investments were down 14.6% to $372.5 billion;

- TALF, a Federal Reserve program to provide up to $1 trillion in financing to private investors to purchase securities collateralized by consumer and small business loans, now has $36.3 billion outstanding;

- Temporary Liquidity Guarantee Program, established by FDIC to guarantee newly issued senior unsecured debt of member institutions, covered $300 billion of bonds in mid-September; FDIC announced its intentions to phase out the program at the end of October with all FDIC debt guaranteed expiring no later than year-end 2012;

- The Public-Private Investment Program, designed by Treasury for the purpose removing illiquid assets from banks' balance sheet, never got off the ground and now does not appear to be needed, according to a Treasury official speaking to reporters on background;

- Fannie and Freddie investments, including Treasury capital investments to preserve the GSEs' solvency ($95.6 billion), the Fed's and Treasury's purchases of agency mortgage-backed securities ($876.5 billion) and the central bank's purchase of GSE debt ($86.4 billion). According to the Federal Housing Finance Agency, the federal government's aggregate investment in Fannie and Freddie was $1.059 trillion on August 20th;

- Making Home Affordable, Treasury's foreclosure prevention program, has helped approximately 12% of four million eligible borrowers modify their loans and nearly 30% ($22.1 billion) of the program's $75 billion has been expended;

- American Recovery and Reinvestment Act of 2009, the largest federal spending bill ever passed by Congress, provided an array of spending initiatives to help with the economic downturn, including federal tax cuts, expansion of unemployment benefits and other social welfare provisions, and domestic spending in education, health care, and infrastructure. In mid-September, $151.4 billion—or 19.2% of the stimulus money had been spent.

- At a Congressional hearing on TARP, Treasury Secretary Timothy Geithner told lawmakers, "Today, because of comprehensive policy actions put in place [in October], we are back from the edge of the abyss."

- At a TARP Congressional Oversight Panel hearing, Geithner strongly hinted that the administration would renew the TARP program, set to expire at year-end, because of fears that a lack of liquidity could stall the economic recovery. "I think the classic mistake people make is they declare victory too soon; they put on the brakes too early; they withdraw these things and then the system has to go back and build more insurance against the risk of a bad outcome, and that could intensify the recession or reignite [it]," said Geithner.

- Treasury officials are now contemplating how and when to send a letter to Congress, concerning an extension of the program. Under the authorizing legislation for TARP, the Treasury Secretary must provide lawmakers "a justification of why the extension [of TARP] is necessary to assist American families and stabilize financial markets, as well as the expected cost." The administration, which is weighing what to do with the remaining TARP funds, plans to roll out new plans this fall. Specifically, officials are developing an initiative to inject capital into community banks, which by virtue of their smaller size are at greater risk of failure than their larger counterparts and carry a higher risk of loss for taxpayers.

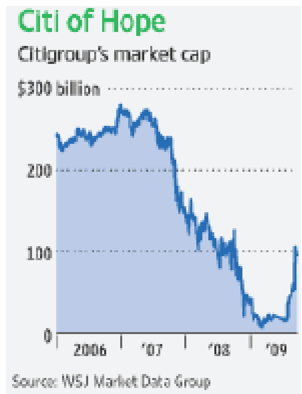
- Representative Jeb Hensarling (R-TX), who is a member of the COP, said, "I think many Americans share a fear that I have that an emergency piece of legislation that was meant for economic stability has now morphed into essentially a $700 billion evolving bailout fund for the administration." In a letter to Geithner, 39 of the Senate's 40 Republicans and one Democrat called on the administration to allow the $700 billion bailout fund to expire on December 31st, as scheduled. The lawmakers wrote, "While we understand that our economy is still recovering, we believe it can function without added TARP funding. Additionally, the cost to the taxpayer if TARP authority was extended could be substantial." The lawmakers called for any unused funds and TARP repayments to be used toward reducing the federal deficit. *CNNMoney*, David Goldman, 09/14/09; *Current Data on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*, Federal Housing Finance Agency, 08/20/09; *New York Times*, 09/14/09; *Bureau of National Affairs*, 09/10/09; *CongressDaily*, 09/10/09; *American Banker*, Cheyenne Hopkins, 09/11/09; *Washington Post*, Neil Irwin and David Cho, 09/11/09; *CongressDaily*, Bill Swindell, 09/11/09, Reuters, Tim Ahmann and Ayesha Rascoe, 09/19/09)

The "monsters" are still rattling in AIG's closet

- One year, two CEOs, and $82 billion [in government assistance] later, AIG continues to battle its monsters. The latest AIG problem to surface is its subsidiary, International Lease Finance Corp, the world's largest airplane finance company which can't pay its bills. Already, the consensus is that that ILFC doesn't make financial sense—its $47 billion balance sheet holds approximately 1,000 aircraft and some $30 billion of debt, whose cost has tripled during the past 12 months. The subsidiary is clearly in a liquidity crisis with a shortfall of $5 billion to $6 billion, say sources familiar with the matter. While bankruptcy would be the normal route for a company in these straits, neither AIG nor the federal government are willing to give up on ILFC and their hopes of extracting some value from what had once been considered AIG's crown jewel. Treasury and the Fed could agree to refinance ILFC's debt, but such a move would increase the government's risk and potentially attract more headlines for AIG, which has drawn $82 billion in loans and investments from taxpayers over the past year. Company officials are considering a plan to break up ILFC by grouping leases into pools and skimming some of the best ones to use as collateral for investment vehicles to generate cash. Other holes to be "plugged" include equity investments made in ILFC by AIG subsidiary National Union Fire Insurance ($4.5 billion) and AIG ($3 billion), which will likely have to be "flushed." Somehow, ILFC will have to be fed and it's likely that taxpayers will have to do some (more) of the feeding. (*Wall Street Journal*, Dennis K. Berman, 09/15/09)

- Capping an 18-month investigation, federal prosecutors are impaneling a grand jury in Brooklyn, NY to consider the indictment of Joseph Cassano, whose AIG Financial Products unit nearly brought down AIG a year ago, say people familiar with the matter. The grand jury could consider charges against Cassano for securities fraud for allegedly misleading investors by overstating the value of mortgage-related contracts and failing to disclose material facts about these products to AIG's auditor. Charges against other AIG employees may also be considered by the grand jury. (*Wall Street Journal*, Amir Efrati and Susan Pulliam, 09/11/09)

Citigroup explores ways to reduce the government's 33.6% stake in the bank



- Citigroup is eager to shed the stigma of being a "ward of the state" in hopes of selling stock to reduce the federal government's 33.6% stake in the bank. Top Citi executives have been devising plans for a possible multi-billion dollar public stock offering which might be used to repay outstanding bailout funds. During an informal conversation between bank and Treasury officials, Citi was told that the federal government wouldn't object to the company paying back some of the government's funds, so long as Citi first raised offsetting capital. Although the Bank has reported earnings for the past two quarters, Citi continues to struggle with swelling loan defaults and holds tens of billions of dollars in risky, illiquid assets.

- *Wall Street Journal* reporter Peter Eavis questions if the cost of reducing the government's stakes outweighs the benefits to the bank. Eavis wrote, "The bigger question is whether to pay off the government's $27 billion of trust-preferred securities, which have characteristics of both debt and equity, and cost about $2 billion a year to service. If Citi wanted to pay down, say, $20 billion of these with proceeds from a new common stock issue, it would be about 20% dilutive to existing shareholders, given that Citi's market value is $97 billion."

- "For both Citi and the government to get out with credibility, they'll have to show at least a few quarters of decent results [and] be on a clear path toward consistent profitability," said John McDonald, a banking analyst for Sanford C. Bernstein & Co.

(*Wall Street Journal*, David Enrich and Deborah Solomon, 09/15/09; *Wall Street Journal*, Peter Eavis, 09/16/09)

Bank of America: The bailout scapegoat

- In a September 21st editorial, the *Wall Street Journal* wrote, “When Bank of America bought Merrill Lynch last winter, the political class applauded and called CEO Ken Lewis a solid citizen. Now, from the safety of noncrisis hindsight, our politicians claim the bank’s shareholders may have been mistreated. Few of those shareholders are complaining, given the profits Merrill has been generating for the bank in recent months, but the pols apparently want a scapegoat for bailouts and bonuses. Mr. Lewis fits the bill.”

- “The Securities and Exchange Commission has already taken a whack at BofA and pounded out a $33 million fine, with the bank not admitting or denying guilt. However, a federal judge tossed the settlement last week on grounds that it hit shareholders a second time (for the cost of the fine) rather than fingering the individual corporate culprits. If the SEC doesn’t appeal, the case is headed to court on the merits next year.”

- “Meanwhile, New York Attorney General Andrew Cuomo and House Oversight and Government Reform Chairman Edolphus Towns are also investigating whether BofA properly disclosed details of the transaction. Mr. Cuomo claims BofA ‘allowed Merrill to make $3.6 billion in undisclosed bonus payments.’ The SEC and the AG say that the proxy materials sent to BofA shareholders prior to their December 5, 2008 vote for the transaction didn’t make clear that these checks would soon be heading out the door.”

- “Of course, proxies rarely make anything clear, because, like all SEC-mandated disclosures, they are created to ensure regulatory compliance rather than to inform investors. Was this one worse than the average? Reasonable people could probably disagree, but let’s look at the context: Was it surprising to investors that Merrill paid $3.6 billion in bonuses? This figure leaned toward the low end of estimates that had appeared in the press, and it was significantly less than the $6.7 billion that some news outlets had forecast. Just two days before the shareholder vote last December, the *Wall Street Journal’s Deal Journal* cited a *Bloomberg* report estimating a 50% cut in Merrill bonuses compared to 2007 (a year when the firm also lost billions and also paid billions in bonuses). A 50% cut suggested Merrill bonuses in the range of $3 billion—not too far from the actual amount paid.”

- “A week earlier, the *Journal* reported that 4,500 Merrill brokers would receive retention bonuses for agreeing to stick around after the deal closed. Anyone who cared enough to read the proxy probably consumed enough financial news to understand that BofA was willing to pay to maintain Merrill’s principal asset—its employees. Ironically, Ken Lewis is one bank CEO who didn't pay himself a bonus last year, yet he's the one who may have to pay this political bill."

- "Mr. Cuomo also claims that the rising trading losses at Merrill that ultimately motivated Mr. Lewis to consider breaking the deal were known to BofA before the shareholder vote. The record suggests that from late November through much of December the estimates of Merrill's losses kept rising. Since losses could more easily be used to justify a lower price for Merrill before the vote, rather than after the deal was approved, it defies explanation why the acquirer would not wish to disclose and use this information, if he thought it was truly material."

- "Mr. Cuomo has already interviewed senior BofA managers and received close to 450,000 pages of documents. Mr. Towns has given the bank a Monday noon deadline to cough up even more records, and who knows what these will reveal. But count us as skeptical that BofA managers would risk violating securities laws in order to make sure that other people could collect large bonuses, or to hide another firm's losses so they could have the privilege of overpaying to acquire it. Messrs. Cuomo and Towns are nonetheless going further and demanding that BofA release documents protected by attorney-client privilege, barely more than a year after the U.S. Department of Justice repudiated such a demand in its guidelines for prosecutors."

- "If Messrs. Towns and Cuomo use political muscle to force the bank to waive this privilege, the damage will be felt far beyond the banking world. The ability to communicate candidly with a lawyer and to seek legal advice has been recognized by the Supreme Court as a valuable means of facilitating compliance with the law. If there is no longer any zone of privacy for such contacts, expect all sensitive legal matters in business to be driven to oral communications, with all of the inefficiencies and misunderstandings sure to result."

- "If Mr. Cuomo wants to do a public service, he could focus on the government's own role in this episode. In late December then-Treasury Secretary Hank Paulson threatened that Mr. Lewis and the board would be fired if they didn't complete the Merrill deal. Mr. Lewis was considering invoking his rights under a material adverse condition (MAC) clause to kill the merger. Mr. Paulson has argued that his intervention helped everyone, including BofA shareholders, because in fact the MAC clause would not have allowed Mr. Lewis to get out of the deal. A more likely scenario is that Mr. Lewis would have used Merrill's exploding losses and the threat underlying the MAC to get Merrill CEO John Thain to lower his price."

- "Under oath, Mr. Lewis told the New York AG's office that he would have tried to renegotiate for a better price—if Mr. Paulson hadn't told him not to. When asked several times if this were true at a July Congressional hearing, Mr. Paulson refused to give a straight answer. After one such response, an exasperated Mr. Towns observed, 'I'm still trying to find out whether that was a yes or no.'"

- “Here’s a theory of this case that won’t help Mr. Cuomo become governor, and won’t help Mr. Towns make headlines, but might even be true and fair: Amid the autumn and winter financial panic, everyone involved was operating under enormous pressure with incomplete information. Federal officials all but ordered Mr. Lewis to buy Merrill and they certainly knew all about the bonuses.”

- “Maybe this is a case in which instead of looking for a villain to punish, our political class should thank Mr. Lewis and BofA for coming to their rescue when they really needed it.” (*Wall Street Journal*, 09/21/09)

Auto bailout news:
Taxpayers face heavy losses on auto bailouts
Chrysler was worse than we thought, says Fiat CEO
May the best car win…

<u>Taxpayers face heavy losses on auto bailouts</u>

- The Congressional Oversight Panel for TARP said taxpayers face losses on a significant portion of the $81 billion of bailout funds provided to General Motors and Chrysler. The report said that $5.4 billion of the government’s $10.billion investment in Chrysler is highly unlikely to be repaid. Further, a full recovery of Treasury’s investment of $50 billion in GM would be largely dependent upon the company’s shares rising to unprecedented levels. In total, the government has invested $74 billion in the nation’s automobile industry, including $12.5 billion in GMAC and $3.5 billion in auto suppliers. (*Associated Press*, Christopher S. Rugaber and Ken Thomas, 09/09/09; *Washington Post*, Peter Whoriskey, 09/09/09)

- The panel has called for greater legal and financial transparency for Treasury’s handling of the GM and Chrysler bailouts and asked the government to release its legal analysis, which justified the use of bailout funds to aid the auto industry. The panel also recommended that Treasury consider placing its shares in GM and Chrysler in an independent trust to avoid conflicts of interest and “facilitate an effective exit strategy.” (*CQ Today*, Joseph J. Schatz, 09/09/09)

<u>Chrysler was worse than we thought, says Fiat CEO</u>

- Sergio Marchionne, CEO of Italy’s Fiat, said Chrysler was in even more dire straits than first thought, when his company rescued the Detroit auto maker. “We were surprised by how little had been done in the past 24 months,” he told reporters. “In November, Chrysler will present a revised business plan to Fiat,” said Marchionne. “We have to be absolutely clear about what we want to do with Chrysler and, as a management team, where the organization is going to be in five years." Unlike GM, which continued to roll out new and redesigned products as it entered and exited bankruptcy, Chrysler has had little to tout. Its most recent new market entries are the Dodge Challenger muscle car, a re-bodied Dodge Charger sedan, and the Ram pick-up. (*CNNMoney.com*, Peter Valdes-Dapena, 09/16/09)

May the best car win…

- On *Autoextemist.com*, Peter M. De Lorenzo wrote, "…If Detroit is ever going to have a shot at long-term survival, then consumer attention must be shifted to the integrity and inherent competitive goodness of the products themselves, rather than the deal [such as Cash for Clunkers]. Consumers have to understand *why* vehicles like the Cadillac CTS and SRX, Chevrolet Equinox and Malibu, Ford Fusion, Flex and Taurus, etc., etc., are worth consideration on their own merits. And until that happens, I'm afraid that this inexorable commoditization of the domestic-sourced automobile will continue." (www.autoextremist.com, Peter M. De Lorenzo, 08/05/09)

- In a September 4th editorial, the *Washington Post* wrote, "Even CASH for Clunkers could not ignite General Motors' sales. August monthly figures show that Toyota, Hyundai and Ford sold more cars than they did a year ago, whereas GM sales were down 20 percent. To be sure, the formerly bankrupt, government-owned company had an uptick earlier this year, thanks to other incentives. But it is still in a deep hole."

- "All the more reason that the Obama administration's overriding priority for GM should be the fastest-possible restoration to profitability—and the fastest-possible government exit from ownership. And that means sticking to President Obama's pledge to leave major business decisions up to GM. Economics, not politics, must determine the firm's course, if there is to be any hope of protecting the taxpayers' $50 billion investment."

- "So far Congress has meddled in some plant-closing decisions. But the biggest test of the president's pledge originates in Germany, where Chancellor Angela Merkel is urging GM to close a sale of its distressed Opel unit to a consortium made up of Magna International of Canada, the Russian carmaker GAZ and a state-owned Russian bank. Ms. Merkel, a Christian Democrat facing elections on September 27, favored this group because it made the biggest job-saving promises and because she and her coalition partners, the Social Democrats, wanted to cement ties to Moscow. Germany has offered $6.3 billion to finance the sale; in the meantime, Opel is surviving on a separate loan from Berlin."

- "The deal looked smart for GM before its bankruptcy filing and the infusion of U.S. and Canadian government money. Now, not so much. The company is no longer quite so desperate for cash. And its new board is properly having second thoughts about ceding a share of the European market to a government-funded competitor.

Selling Opel to Ms. Merkel's favored purchasers could mean the loss of valuable technology. It might be wiser to seek better terms from other European countries where Opel has plants, sell to a private equity firm for restructuring with a chance at later repurchase -- or just liquidate. To be sure, all options carry risk, and GM's management is not exactly known for genius. Still, the new directors and the executives who know the firm are in the best position to make this call."

- "Berlin has all but pleaded with the Obama administration to influence GM—which, as the majority shareholder, it obviously could. U.S. officials have done an admirable job of deflecting those entreaties. Germany is an ally with whom the United States shares many interests. Mr. Obama must cultivate his relationship with Ms. Merkel, who will probably still be running Germany after the election. Her goal of saving German jobs is understandable. But the president's first duty is to U.S. taxpayers. Opel's fate shouldn't be a political decision, much less a personal one. This is just business."

- Since Cash for Clunkers didn't work, GM is trying a new gimmick—a *May the Best Car Win* advertising campaign, which offers a 60-day money back guarantee for all GM purchases. In an ad featuring GM's new CEO, Ed Whitacker, says: "...We're putting our money where our mouth is. Buy a new Chevy, Buick, GMC or Cadillac, and if you're not 100% happy, return it. We'll take it back. That's our new 60-day satisfaction guarantee. ...That's how strongly we feel about our cars and how committed we are to you. So, put us to the test. Put us up against anyone and may the best car win."

- While there are a number of restrictions on the program, generally GM customers have 30-60 days to return a 2009-2010 GM vehicle if they are not satisfied and have not driven more than 4000 miles or have more than $200 in damage. Alternatively, customers may elect to receive a $500 cash discount in lieu of the money-back guarantee offer. (http://www.youtube.com/watch?v=jpqr4_ONew0; *Motor Trend*, Zach Gale, 09/18/09)

Treasury backs off from its effort to rein the authority of SIG-TARP

- Treasury has withdrawn its request for the Justice Department to provide a legal opinion on the independence of the special inspector general of TARP, said SIG-TARP Neil Barofsky in September 2nd letter to lawmakers. Barofsky wrote, "We applaud Treasury's decision to bring to a close this needless distraction." (*Associated Press*, Jim Kuhnhenn, 09/04/09)

- The House is moving forward with passage of the SIG TARP Small Business Awareness Act of 2009 (H.R. 3179), which would instruct the SIG-TARP to examine whether smaller financial institutions are receiving their fair share of benefits from TARP. The bill would also require the SIG-TARP to examine the effects of TARP financial assistance on small businesses, including an analysis by type of business and region. (*Bureau of National Affairs,* Thecla Fabian, 09/16/09)

Financial Institution Regulatory Reform

The focal points of Congress' debate on the regulatory reform of the financial industry

- The Obama administration and Congress are developing sweeping legislation, which would fundamentally change how financial products and services are regulated in the United States. Among the many issues being debated by lawmakers in this reform legislation, the focal points of discussion include:

    - Separating the safety and soundness regulator from the consumer protection regulator;

    - Providing expansive power to the Consumer Financial Protection Agency to regulate products and services and those entities who provide them, either directly or indirectly;

    - Debating the issue of "too big to fail;"

    - Developing uniformity of regulations and repealing federal preemption;

    - Granting the Federal Reserve Board additional powers; and

    - Reforming credit rating agencies [or lack thereof]. (*Canfield & Associates,* 09/15/09)

President Obama explains the need for the Consumer Financial Protection Agency on his weekly radio address

Criticism voiced over the power and scope of the proposed Consumer Financial Protection Agency

<u>President Obama explains the need for the Consumer Financial Protection Agency on his weekly radio address</u>

- In his September 18th radio address, President Barack Obama said, "Leaders of the world's largest economies will gather next week in Pittsburgh for the second time this year. The first meeting of the G-20 nations in April came at the height of the global financial crisis—a crisis that required unprecedented international cooperation to jumpstart the world's economies and help break the downward spiral that enveloped all our nations. … [T]he good news is that we've made real progress since last time we met - here at home and around the world…"

- "Because of the steps taken by our nation and all nations, we can now say that we have stopped our economic freefall. But we also know that stopping the bleeding isn't nearly enough. … [W]e know we still have a lot to do, in conjunction with nations around the world, to strengthen the rules governing financial markets and ensure that we never again find ourselves in the precarious situation we found ourselves in just one year ago."

- "… [A] return to normalcy can't breed complacency. To protect our economy and people from another market meltdown, our government needs to fundamentally reform the rules governing financial firms and markets to meet the challenges of the 21st century. We cannot allow the thirst for reckless schemes that produce quick profits and fat executive bonuses to override the security of our entire financial system and leave taxpayers on the hook for cleaning up the mess. And as the world's largest economy, we must lead, not just by word, but by example, understanding that in the 21st century, financial crises know no borders. All of us need to act more responsibly on behalf of a better economic future."

- "That is why, at next week's G20 summit, we'll discuss some of the steps that are required to safeguard our global financial system and close gaps in regulation around the world - gaps that permitted the kinds of reckless risk-taking and irresponsibility that led to the crisis. And that's why I've called on Congress to put in place a series of tough, common-sense rules of the road that will protect consumers from abuse, let markets function fairly and freely, and help prevent a crisis like this from ever happening again."

- "Central to these reforms is a new Consumer Financial Protection Agency. Part of what led to this crisis were not just decisions made on Wall Street, but also unsustainable mortgage loans made across the country. While many folks took on more than they knew they could afford, too often folks signed contracts they didn't fully understand offered by lenders who didn't always tell the truth. That's why we need clear rules, clearly enforced. And that's what this agency will do."

- "Consumers shouldn't have to worry about loan contracts written to confuse, hidden fees attached to their mortgages, and financial penalties—whether through a credit card or debit card—that appear without a clear warning on their statements. And responsible lenders, including community banks, trying to do the right thing shouldn't have to worry about ruinous competition from unregulated and unscrupulous competitors."

- "Not surprisingly, lobbyists for big Wall Street banks are hard at work trying to stop reforms that would hold them accountable and they want to keep things just the way they are. But we cannot let politics as usual triumph so business as usual can reign. We cannot let the narrow interests of a few come before the interests of all of us. We cannot forget how close we came to the brink, and perpetuate the broken system and breakdown of responsibility that made it possible."

- "In the weeks and months ahead, we have an opportunity to build on the work we've already done. An opportunity to rebuild our global economy stronger that before. An opportunity not only to protect the American people and America's economy, but to promote sustained and balanced growth and prosperity for our nation and all nations. And that's an opportunity I am determined to seize." (*Weekly Radio Address: President Obama Promotes Tougher Rules on Wall Street to Protect Consumers*, 09/18/09)

<u>Criticism voiced over the power and scope of the proposed Consumer Financial Protection Agency</u>

- The U.S. Chamber of Commerce has launched a multi-million-dollar advertising campaign to "kill" the administration's proposed Consumer Financial Protection Agency. The Chamber argues that the CFPA would place burdensome regulations on businesses beyond the financial sector, which would raise the cost of credit. Specifically, the legislation would establish a "massive" new bureaucracy, limit consumer choice and add a new layer of regulation to more than 45 industries. As the bill is currently written, virtually every business that extends credit to American customers would be affected—"even the local butcher and the credit he extends to his customers," says the Chamber in one of its ads. "The Chamber supports strong consumer protection, but a massive new bureaucracy with sweeping powers that will deprive consumers of affordability and choice is not the answer," said David Hirschmann, president and CEO of the Chamber's Center for Capital Markets. "That is why we're launching a major offensive to inform Americans the CFPA is the wrong answer to consumer protection." In late August, the Chamber conducted a conference call with nearly 200 business organizations to discuss strategies to shut down the legislation that would create the CFPA. The Chamber also has launched a new website, www.StoptheCFPA.com, as a part of its efforts to educate the public. Proponents dismiss the Chamber's arguments, arguing that consumers don't have sufficient protection for credit cards, mortgages, and payday loans, which would be covered by CFPA. (*Bureau of National Affairs*, R. Christian Bruce, 09/09/09; *CongressDaily*, 09/08/09; *CQ Today*, Benton Ives and Phil Mattingly, 09/08/09)

- In a September 14th statement, the Shadow Financial Regulatory Committee outlined the following concerns about the proposed Consumer Protection Agency:

    - "The proposal would require providers of financial products always to make available a 'plain vanilla' (simple and easy to understand) financial product alongside anything more complex. Only if the market doesn't provide such a product should the CFPA require that it be provided."

- "The initial proposal would require the CFPA to prescribe rules or take enforcement actions with respect to 'unfair, deceptive and abusive' acts or practices. The language relating to 'unfair and deceptive' practices is borrowed from the Act that created the FTC and is well understood under current law. The term 'abusive' is not defined and is given no bounds. There is no need to add it to the list of offensive practices."

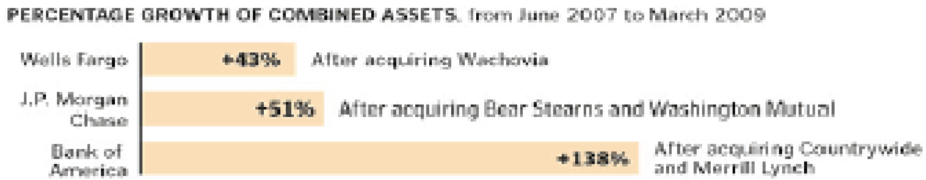
- "The Committee sees no logic in vesting authority with the CFPA to enforce the CRA. Whether and how an institution is meeting the credit needs of the communities it serves is not actually a consumer product. Moreover, the CRA is enforced by giving bank regulators authority to deny a merger involving a bank not in compliance with the CRA. This authority should not fall within the purview of a consumer regulator."

- "Finally, the Committee believes that the CFPA's rule writing authority (but not enforcement activities) should preempt those of state regulators. Otherwise, there is a risk of having 51 different state consumer protection rules alongside the federal regime. This could significantly impair the ability of financial institutions to develop and market financial products on a national basis." *(Statement of the Shadow Financial Regulatory Committee on A New Consumer Financial Protection Agency*, Shadow Financial Regulatory Committee 09/14/09)

- The House Financial Services Committee is expected to release a new draft of the legislation to create the Consumer Financial Protection Agency (H.R. 3126) in coming days. The Committee has scheduled at hearing on September 30th at 10:00 a.m. to review the legislation and has tentatively scheduled markup of the bill for October 18th. (*House Financial Services Press Release*, 09/15/09)

"Our goal must be to end too big to fail," said FDIC chairman Bair

- A year after the near-collapse of the financial system, top regulators are alarmed that banks that were already too big to fail have grown even larger and more interconnected. As of June 30th, the top five banks were Bank of America ($2.25 trillion in assets), JPMorgan Chase ($2.02 trillion); Citigroup ($1.85 trillion); Wells Fargo ($1.28 trillion); and Goldman Sachs ($0.89 trillion). Collectively, these five institutions represent 62 % of all insured members' assets on June 30th, according to FDIC. The following chart reflects the asset growth of Wells Fargo, JPMorgan Chase, and Bank of America, which was achieved in part through distressed acquisitions during the financial crisis.



- The nation's top banks have extended their tentacles to Wall Street. The top five firms on Wall Street—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley made $23 billion in profits for the first six months of 2009, compared to a $6.7 billion loss a year earlier. The investment banks' biggest profit engines remain their trading arms, which place short-term wagers using much of the firms' own money on stocks, bonds, commodities, currencies and other financial products and markets. In the first half of 2009, these firms generated $56 billion in trading revenue, more than double that of the first half of 2008 ($22 billion). Overall, these top firms are assuming greater trading risks than they did a year ago. According to regulatory filings, the $1 billion that the top five banks stood to lose on an average day in the second quarter represents an 18% increase from a year earlier an is up 75% from the first six months of 2007.

- "It's at the top of the list of things that need to be fixed," said FDIC chairman Shelia Bair. "It fed the crisis, and it has gotten worse because of the crisis." Mark Zandi, chief economist of Moody's *Economy.com*, said, "There's been a significant consolidation among the big banks, and it's kind of hollowing out the banking system. You'll be left with very large institutions and small ones that fill in the cracks. But it'll be difficult for the mid-tier institutions to thrive. The oligopoly has tightened."

- The growth of the oligopoly is illustrated by the Fed's facilitation of Wachovia's merger with Wells Fargo. According to documents, the central bank identified six metropolitan regions in which the combined companies would exceed the Justice Department's antitrust guidelines or hold more than 33% of an area's deposits. Nevertheless, the Fed deemed that local competition in each of those places was sufficient to allow the merger to go through. Camden Fine, president of the Independent Community Bankers of America, said the Fed's action reveals the government's preferential treatment of big banks. Fine doubts that the Fed would have approved of the merger of community banks, if the combined company ended up controlling more a third of the market. "To favor one class of financial institutions over another class skews the market," said Fine. "You don't have a free market; you have a government-favored market." (*Washington Post*, David Cho, 08/28/09; *Statistics at a Glance*, FDIC, 06/30/09; *Wall Street Journal*, Peter Eavis, 09/11/09; *Wall Street Journal*, David Enrich and Damian Paletta, 09/09/09)

- At the recent meeting of the G20 finance ministers, the attendees called for too big to fail [TBTF] banks to raise more capital and become less leveraged "once recovery is assured." *Newsweek* reporter Niall Ferguson points out that the compensation issue is a red herring. Ferguson wrote, “Politicians like to focus on bankers’ bonuses because everyone is shocked [by their compensation levels]… But that’s a symptom, not a cause of the deep rooted problem. The TBTFs are able to pay crazy money because they reap all the rewards of risk-taking without the cost: the cost of going bust…” (*Newsweek*, Niall Ferguson, 09/11/09)

- In a September 18th speech in Washington, FDIC chairman Shelia Bair said, “I want to talk this morning about how to create a more resilient, transparent, and better regulated financial system – one that combines stronger and more effective regulation with market discipline. **Ultimately, our goal must be to end too big to fail.** [Emphasis added.] To do this, we need to fix weaknesses in our regulatory system, and to work with our international partners to reform the resolution processes in other countries when large firms become non-viable. With these steps we can foster real market discipline and make international cooperation more successful.”

- “It’s very clear that one of the causes of the economic crisis is significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, and consumer protection, and the almost complete lack of regulation of over-the-counter derivatives, allowed rampant regulatory arbitrage. Reforms are urgently needed to close these gaps.”

- “At the same time, keep in mind that much of the risk in the system involved firms that were already subject to extensive financial regulation. One of the lessons of the past few years is that regulation alone is not enough to control imprudent risk-taking within our dynamic and complex financial system. You need robust and credible mechanisms to ensure that market players will actively monitor and keep a handle on risk-taking. In short, we need to enforce market discipline for systemically important institutions.”

- “In a properly functioning market economy there will always be winners and losers. So when firms, through their own mismanagement and excessive risk-taking, are no longer viable, they ought to fail. Preventing companies from failing ultimately distorts market discipline, including the incentive to monitor competing firms and to allocate resources to the most efficient ones.”

- “Unfortunately, measures taken during the past year – while necessary --have only reinforced the idea that some financial firms are simply too big to fail. Today, we now have fewer players in critical areas of our markets. The market is even more concentrated and interconnected than before. And unless we adopt needed reforms, our system will be more, not less, fragile after this crisis.”

- “This too-big-to-fail doctrine creates a vicious cycle that needs to be broken. Large firms can borrow more cheaply and on more favorable terms because the market assumes the government will not let them fail. Equity investors also have relied on an implicit government guarantee – with an unlimited upside, but a very limited downside. In effect, the largest firms socialized their risks and costs – by not paying for equity and credit based on their true risk – while keeping the enormous profits during good times."

- "This creates equally enormous risks for the system. Big firms leverage their operations to make still greater profits, while investors and creditors become more complacent and more likely to extend credit and funds without fear of losses."

- "For senior managers, the incentives are even more skewed. Paid in large part through stock options, senior managers have an even bigger economic stake in going for broke, because their upside is so much bigger than any possible loss. And, once again, with too big to fail, the government takes the downside risk."

- "…To end too big to fail, we need an orderly and highly credible mechanism that's akin to the process we use to resolve FDIC-insured banks. When the FDIC closes a bank, what typically happens is shareholders are wiped out ... creditors take a substantial haircut, management is replaced, and the remaining assets of the failed institution are sold off."

- "The process is harsh. It's painful. But it works. It quickly puts assets back into the private sector, and into the hands of better management. And it limits the cost of the takeover to the FDIC's insurance fund. It also sends a strong message that investors and creditors face losses when an institution fails. So-called "open-bank" assistance for large complex firms should be prohibited. This assistance puts the interests of shareholders and creditors before that of the public."

- "…We have an effective process to close banks – but we do not have such a process to close large holding companies or other large firms, like Lehman. We need an orderly process for winding down these large, systemically important financial firms without imposing costs on taxpayers."

- "Unlike what we have now, a new resolution regime would focus on maintaining a failed institution's liquidity and key activities so it can be resolved without the near panic we saw a year ago. Losses would be borne by the stockholders and bondholders of a holding company, and senior managers would be replaced."

- "…In addition, firms that pose systemic risks should be subject to regulatory and economic incentives that require them to hold larger capital and liquidity cushions. Restrictions on leverage, and risk-based premiums on institutions and their activities, would be disincentives for growth and complexity that raise systemic concerns."

- "In addition, large financial holding companies should be subject to tougher prompt corrective action standards under U.S. law. And they should be subject to holding company capital requirements that are no less stringent than those for insured banks. As for off-balance-sheet assets and conduits, which were a major headache in the current crisis, these should be counted as on-balance-sheet risks."

- "…We're also in need of a regulatory framework that's proactive, and identifies issues and trends that pose risks to the broader financial system. The new structure, featuring a strong oversight council, would monitor the financial system, from insurance companies to banks. By looking broadly across all of the financial sectors, the council will be able to adopt a "macro-prudential" approach."

- "The point of looking more broadly at the financial system is that reasonable business decisions by individual financial firms may, in the aggregate, pose a systemic risk. This is a classic "fallacy of composition" problem that cannot be solved by simply making every financial product or practice safe. Instead, rules issued by the council would be uniform for all parts of the regulatory system. The council would monitor how the rules are working and would have the power to take corrective action, if necessary."

- "…Another huge gap that desperately needs plugging is the lack of regulation of over-the-counter derivatives, like the credit default swaps that crippled insurer AIG. We support Treasury's proposal to require standardized derivatives to trade on exchanges and settle through central counterparty systems because this will reduce the risk that a single market participant can trigger destabilizing contagion in the markets. However, we must go further to make sure market participants have strong incentives to move to standardized products – through capital, margin, and other incentives."

- "… [T]ransparency is absolutely critical. We must have more transparency in our capital markets – from securitization to derivatives – to give us a more efficient, resilient market. This requires regulatory diligence and it requires market mechanisms that support transparency. Never again can we permit the growth of totally opaque structures, like SIVs and CDOs, that mask the underlying assets, game the capital rules, and arbitrage ratings and regulatory requirements."

- "I support most of the Financial Accounting Standards Board's changes to bring more assets on balance sheet, to limit the opportunities for hiding assets in special purpose entities, and to require more balanced accounting treatment. These favor transparency. Some proposals, however, do not appear to advance the ball."

- "In some cases, marking banking assets to market prices doesn't make sense. When a bank is holding a deposit, a loan or a similar banking asset for the long-term, it shouldn't have to mark them to market values that may vary widely over time. Extending MTM accounting to all banking assets takes a good approach for market-based assets, like securities, but extends it to areas where it doesn't accurately reflect the business of banking."

- "We don't need to deepen crises by inaccurately reporting so-called market values for loans and other banking assets. This introduces a level of pro-cyclicality that can have dire consequences when the accounting is divorced from reality. During good times, such an approach could inflate the true value of bank assets and capital strength. And during periods of market stress, losses could be exaggerated."

- "… [G]iven the idiosyncratic nature of the credit characteristics of individual loans, trying to determine a "market price" for many of them would be more art than science ... and of questionable utility to investors compared to cost accounting. In fact, the apparent "transparency" may be illusory because fair valuing assets and liabilities without any clear "market" prices may simply increase valuation discretion."

- "I would note that in a recent letter to the President, the oversight body for the International Accounting Standards Board recognizes that cost-based accounting is appropriate for certain financial instruments and that the IASB is not proposing that the loan book of banks be held at fair value."

- "…All of these reforms have a vital international component because our largest financial institutions operate on a global scale. They can operate through foreign branches, foreign subsidiary banks and trading operations, as do many of our largest banking organizations. So it's vital that we have a stronger, more durable world financial system."

- "…Let me focus on one major issue. I've long advocated for more and better quality capital to reduce the fragility of major banks. A key part of this is an internationally recognized leverage ratio – which provided a vital backstop to the U.S. capital framework during the crisis. It meant that U.S. banks came into the crisis with more capital than their foreign counterparts. ...This is critical. Global firms need more and better quality capital. And the U.S. must work with its friends to achieve a safer financial system."

- "Another part of a safer global system is a more effective way to close failing cross-border financial firms. Today there are no international laws or agreements for managing a financial crisis or a failure of a major cross-border bank. If one of these large banks fails, a variety of different national laws would apply. This makes it very hard to predict what will happen. But very likely that cooperation between different countries where the bank operates will break down. Just as in our domestic system, you must have an effective way to close failed cross-border firms. Countries must reform their legal frameworks so that big financial groups can fail in an orderly fashion, and not simply be bailed out."

- "…The next step is to keep the focus on reforming national laws. While many recognize the current need for reform, we must avoid complacency and forgetting the lessons of the crisis. The G-20 and the Financial Stability Board will be key players in keeping these issues before our trading partners."

- "…I hope Wall Street has learned some …lessons. I hope financial institutions have learned that long-term, sustained profitability can only come from products and services that have real value for businesses and consumers. And to be sure, regulators need to be more vigilant and vigorous. There's a difference between 'free markets' and 'free-for-all markets.' The government needs to set and enforce the basic rules." (*FDIC Chairman's Remarks*, Shelia Bair, 09/18/09)

National Economic Council Director Summers says administration open to having other bank regulators join the Fed in regulating systemic risk

- In face of stiff opposition to the administration's proposal to having the Fed regulate systemic risk, National Economic Council Director Lawrence Summers suggested that other banking regulators could join the Central Bank in performing that function. While the Fed remains the "natural place" to regulate systemic risk, Summers said, "[S]ystemic-risk regulation has a number of elements [which] goes to the regulation of individual institutions, a number of threats to future stability. It goes to key features of the financial landscape. Just how the Fed will interact with other regulators, just precisely what the configuration will be, is obviously going to be a subject of discussion." Administration officials acknowledge they face strong opposition from lawmakers to the Fed playing a central role in systemic-risk regulation, but say the president isn't "softening" his position and preserving the Fed's major role in systemic-risk regulation is still the outcome the White House is advocating in negotiations with Congress. (*Wall Street Journal*, Jonathan Weisman, 09/12/09)

- House Financial Services Committee chairman Barney Frank said his panel will empower a council of regulators to monitor systemic risk, bucking the White House's plan to provide that power to the Federal Reserve. In a *Bloomberg* interview, Frank said the central bank's case for serving as the systemic regulator was "weakened" when the Fed agreed to let AIG pay $165 million in bonuses after the insurer received bailout funds. "The Fed took a hit when the AIG bonuses came and it was connected to them," said Frank. "I think the Fed has learned its lesson, but as a result of that and some other things there will be a council." (*Bloomberg News*, Alison Vekshin and Peter Cook, 09/14/09)

- A bill taking shape in the Senate Banking Committee could give the Fed far less authority than the administration's proposal unveiled in June. Senators from both sides of the isle have expressed a lack of confidence in the Federal Reserve, criticizing everything from the central bank's transparency to its ability to protect consumers. "We really do take what the administration did as advisory. We have our own ideas," said a Democratic staff member familiar with the legislation. "We've been thinking about this a long time." Frank has also said that he will "tweak" language in the bill, allowing an audit of the Federal Reserve, to ameliorate concerns that such action would weaken the central bank's independence and might destabilize the financial markets. The revised language would allow the GAO to audit and make public what assets the Fed purchases, but would delay release of that information so it could not be used to manipulate markets. "There ought to be a time delay where [what] you buy and sell isn't instantly disclosed," said Frank. "There out to be market integrity there." Frank added that the GAO will not be able to investigate the central bank's monetary policy, which would preserve the Fed's independence and ensure that it can fulfill the Fed's mandate of price and economic stability. (*CongressDaily*, Bill Swindell, 09/10/09)

- The Senate bill may also seek to further consolidate banking regulation into fewer agencies than proposed by the administration. Committee members from both parties have expressed a preference in putting all banking regulation under one agency. In an article in the *Financial Times*, Senator Mark Warner (D-VA) wrote, "[A single bank regulator] "creates a more powerful and effective federal bank regulator while preserving the dual banking system with both state and federal chartering and allowing Federal Reserve and FDIC to focus on their core responsibilities for monetary policy and deposit insurance, respectively." (*Washington Post*, Brady Dennis, 09/10/09)

- The Federal Reserve Board has rejected a request by Treasury Secretary Timothy Geithner for a public review of the central bank's structure and governance, according to three sources familiar with discussions. On June 17th, the Obama administration proposed a financial- regulatory overhaul, which included a "comprehensive review" of the central bank's "ability to accomplish its existing and proposed functions" and the role of the Fed's regional banks. Treasury said it would consider making recommendations from the review and "propose any changes to the Fed's governance and structure." The administration proposed that the Fed lead the study and utilize the help of Treasury and "a wide range of external experts." According to two sources, some top central bank officials, who initially agreed to the review, saw a potential threat to Fed independence from the study. Although the study hasn't been formally scrapped, no work has been done on the project, which is due October 1st. Instead, the Fed is performing internal reviews to consider possible operational changes in the aftermath of the financial crisis. In addition, Fed Governor Elizabeth Duke is leading an internal study of the roles of the directors, who serve on each of the boards at regional Fed banks. (*Bloomberg News*, Craig Torres and Robert Schmidt, 09/251/09)

Congressional debate continues over regulating OTC derivatives and providing exemptions to "some" end users

- At a September 17th hearing on the regulation of derivative products by the House Agriculture Committee, witnesses urged lawmakers to retain a proposed exemption from mandatory clearing of OTC products for certain market participants, arguing that they—and possibly consumers—would be financially harmed if the exemption were dropped from the reform legislation. Witnesses argued that many end users of derivative products utilize derivatives solely to hedge business risks and cannot afford the added costs associated with margin under the clearing mandate.

- Under Treasury's proposed legislation, "standard" derivatives contracts would be traded on a regulated exchange and would have to be cleared centrally. However, Treasury's proposal exempts transactions in which one side was not a dealer or "major swaps participant"—the end-users' wish. Under Treasury's bill, custom contracts, while escaping the clearing mandate, would be subject to even higher capital costs as a way of discouraging their use.

- End users, such as Glenn English, CEO of the National Rural Electric Cooperative Association, Dave Schryver, executive vice president of the American Public Gas Association, and Ben Hirst, Delta Airlines' general counsel who testified on behalf of the Air Transport Association, said a mandatory clearing requirement would be cost prohibitive for their industries. Representative Collin Peterson (D-MN), chairman of the Agriculture Committee, said he "do[es] have some outstanding concerns [regarding Treasury's proposal] such as the fair treatment of end-users."

- In addition, representatives from the industries involved in derivatives trading also testified. Dan Budofsky, a lawyer Davis Polk & Wardwell LLP, who testifying on behalf of the Securities Industry and Financial Markets Association, said the trade group supported an exemption for corporate end-users of derivatives from mandatory clearing. Budofsky said the funds required to cover margin costs "would no longer be available for productive investment in the corporate end user's business. He added, "A clearing requirement would create a significant disincentive to use swaps to manage risk." John Damgard, president of the Futures Industry Association, said that mandatory clearing of standard contracts would lead to risk-management trading going overseas, where lower costs and other burdens would be more attractive. To avert such an outcome, Damgard suggested that a clearing mandate be replaced by "incentives" to trade on an exchange and clear centrally.

- Robert Pickel, executive director and CEO of the International Swaps and Derivatives Association, testified that not all standardized contracts can be cleared, because illiquid contracts, for example, are hard to price daily and related margins cannot be quantified. For that reason, clearing of standard derivatives should not be mandatory, said Pickel. Further, even major swap participants should not be subject to clearing requirements, he argued. "End-users are not systemically significant and regulations intended to improve stability and decrease systemic risk should not apply to them."

- On September 22nd, the committee will hold a second hearing on Treasury's proposed legislation and hear testimony form SEC chairman Mary Schapiro and Commodity Futures Trading Commission chairman Gary Gensler. (*Bureau of National Affairs*, Richard Hill, 09/18/09)

- Treasury's 115-page legislative proposal to reform OTC derivatives will likely play a key role in developing a House bill, said Representative Scott Garrett (R-NJ), a ranking member of the House Financial Services Committee subcommittee. "The Treasury proposal is going to be, as far as we can tell, the …base document," said Garrett. Treasury's proposal contains a number of deficiencies as basic as how financial instruments are defined and is too complex and overly prescriptive, he added. Further, the proposal's language uses a "sledgehammer approach" to deal with OTC derivative for non-US transactions or participants, he added. Garrett hopes Republicans are able to stall reform efforts until members of Congress have time to learn more about OTC derivatives, particularly "inaccuracies" about the supposed role of derivatives in the financial crisis. (*Bureau of National Affairs*, Stephen Joyce, 09/16/09)

- Senator Blanch Lincoln (D-AR), who succeeds Tom Harkin (D-IA) as chairman of the Senate Agriculture Committee, said she supports a small exception to a proposed rule to bring OTC derivatives onto central clearing platforms and exchanges. In an interview with *Reuters*, Lincoln said "I think there is a small, narrow place for the over-the-counter [derivatives trading]" and the committee is mulling over how to define it. She added that there should be more regulation of derivatives. "It is going to be critical and important for us to provide greater oversight, greater transparency [to reduce the risk of manipulation or market disruptions]," said Lincoln. "The CFTC (the Commodity Futures Trading Commission) is the appropriate place." Previously, Harkin had filed a bill to ban OTC trading. Lincoln's views of regulatory reform are more in line with the administration's goals and has a good working relationship with Senate Banking Committee chairman Christopher Dodd (D-CT) and minority leader Richard Shelby (R-AL). (*Reuters*, 09/09/09; *American Banker*, Emily Flitter, 09/11/09)

- On September 14th, Commodity Futures Trading Commission Chairman Gary Gensler said the regulatory reform bill for the financial services industry must cover all over-the-counter derivatives products, not just those that caused last year's the financial crisis. "This must cover all of the different products, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps, as well as the derivative products that we have not yet thought of," said Gensler, who noted he's equally adamant that dealers be regulated. "Tens of thousands of end users will benefit from the transparency brought by moving standardized swaps onto exchanges or regulated trading platforms." Transparency should give end users better pricing on standard products and customized products, since customized products would be priced in relation to the standard products traded on exchanges, he added. (*CongressDaily*, Jerry Hagsrom, 09/14/09)

House announces tentative schedule for regulatory reform

- On September 15th, House Financial Services Committee chairman Barney Frank released a tentative schedule for the consideration of regulatory reform legislation for the financial services industry, which includes a final round of hearings in September (five) and the first two weeks of October (six). The Committee will hold hearings on systemic risk, oversight and audit issues proposed at the Federal Reserve, the Consumer Financial Protection Agency, capital market issues, and prudent banking reform issues. Markups on legislation are expected to be held immediately after the hearings conclude.

- To date, the Senate Banking Committee has not released a hearing schedule for these matters. Chairman Christopher Dodd (D-CT) stated that he still intends to pass financial regulatory reform this fall. In consultation with Senate leaders and the administration, Dodd decided to remain chairman of the Senate Banking Committee, where he could offer the best chance of legislative success in passing financial regulatory reform legislation. Keeping the Senate Banking Committee gavel, while maintaining an active role in the healthcare debate, may also provide Dodd his best chance of political survival in his difficult re-election fight in 2010. "The major reform efforts of financial regulation are in front of us," said Dodd. "I want to get that done. This is important work. People are losing their homes [and] the economy is still struggling."

- To date, the committee staffs for Dodd and minority leader Richard Shelby (R-AL) have done preliminary work, including looking for areas of agreement, say lobbyists. However, heavy lifting remains, including whether to grant the Federal Reserve broad powers to monitor systemic risks to the economy—which Shelby has opposed—and winning moderates' support to set up a Consumer Financial Regulatory Agency. The *New York Times* reports that Dodd is preparing a bill that will be introduced in coming weeks, which is more ambitious and politically risky than the administration's proposals. Dodd's bill will likely propose the merger of the Federal Reserve, the Office of Thrift Supervision, the FDIC and the Comptroller of the Currency into one "super regulator" for financial institutions. Dodd's plan would diminish the role of the Federal Reserve as the regulator of banks and its ability to regulate mortgages and credit cards. Dodd also rejected the administration's proposal that the central bank serves as the systemic risk regulator—a role he plans to assign to a council of regulators. Similar to the administration's proposal, Dodd supports the creation of a Consumer Financial Protection, which would write and enforce new rules to protect consumers from abuse or deceptive terms. The bill would make it easier for the government to seize large troubled companies and would provide shareholders a non-binding vote on executives' pay.

- "There's lots going in regulatory reform behind the scenes, lots of meetings, lots of discussions, thrashing it out," said Senator Charles E. Schumer (D-NY), a senior member on the Senate Banking Committee. "And unlike health care, regulatory reform—the basic paradigm of what should be done—is more or less accepted." Schumer has been pushing for consolidation among bank regulators which goes further than what the administration has proposed. (*InforBytes*, Buckley Sandler, LLP, 09/18/09; *CongressDaily*, Bill Swindell, 09/14/09; *CQ Today*, Benton Ives, 09/09/09; *CQ Today*, Benton Ives and Phil Mattingly, 09/08/09; *New York Times*, Stephen Labaton, 09/20/09)

Is increasing banks' capital requirement the answer?

- On September 3rd, the U.S. Treasury Department called for a comprehensive global agreement of stronger capital and liquidity standards for banking firms to safeguard the financial system from mounting loan losses and the danger of future risk. Treasury said the agreement should be reached by the end of 2010 and implemented nationwide by year-end 2012. (*HousingWire*, Jon Prior, 09/04/09; *Treasury Department Press Release*, 09/03/09)

- In the September 16th issue, the *Institutional Risk Analyst* wrote, "Bottom line is that deflation is still the chief threat to the U.S. economy, driven by a relentless contraction in bank and nonbank credit. Until we see a restoration of the market for nonbank finance and a sustained turn in the [exposure at default—the ratio of unused lines of credit to total loans outstanding] of the large bank peer group, which accounts for almost 70% of the entire US industry balance sheet, we do not believe that any economic recovery will be meaningful in terms of jobs or asset prices. Indeed, we have to wonder whether the FDIC should even try to impose another assessment on the banking industry to fund failed bank resolutions when the effect of this action is to remove capital from the system and thereby accelerate the shrinkage of the collective balance sheet of US banks."

- "Before Secretary Geithner and the G-20 talk further about raising bank capital levels, we first need to find a way—and fast—to stabilize the existing capital base of the banking industry. Failure to do so, in our view, could be catastrophic for the global economy and could also further radicalize the political situation in the US, where many Americans are starting to realize that the party is well and truly over. … [T]alking about raising bank capital at the present time is the functional equivalent of the imposition of the Smoot-Hawley Tariff Act of 1930. We desperately need a different approach. (*Institutional Risk Analyst*, 09/16/09)

- "I think this financial panic and Great Recession is an inflection point for the financial system and the economy," said Mark Zandi, chief economist for *Moody's Economy.com*. "It means much less risk-taking, at least for a number of years to come—a decade or two. That will be evident in less credit and more costly credit. If you are a household or a business, it will cost you more, and it will be more difficult to get that credit." (*McClatchy Newspapers*, Kevin G. Hall, 09/08/09)

The Financial Crisis Commission begins its assessment of the financial crisis

- In a September 16th interview on Bloomberg News, Phil Angelides, chairman of the Financial Crisis Commission, said his panel will compile "an unbiased historical accounting" of what led to the financial crisis and ferret out the facts and lay them before the American people. The panel's goal is to tell a "cautionary tale" about what caused the financial crisis, so that it never happens again. The panel will follow a number of "threads" in examining the crisis, ranging from the mortgage market—

everything from exotic products and fraud on the ground—to credit derivative swaps to the role of credit rating agencies to what the regulators did and didn't do, which impacted this crisis. While the panel has subpoena power, Angelides hopes that bank executives and regulators will cooperate with the Commission in the interest of the country. "[Otherwise,] we have subpoena power and we will use it," said Angelides. (www.bloomberg.com/avp/avp.htm?clipSRC=mms://media2.bloomberg.com/cache/vA9r4dul7xI8.asf; *Washington Post*, Brady Dennis, 09/16/09)

- Thomas Green, a 25-year veteran of the California Attorney General's Office, will serve the Commission's executive director. Previously, Green coordinated the multi-state remedies trial against Microsoft, led a team that prosecuted civil cases against Enron and negotiated a $1.5 billion settlement for California with El Paso Natural Gas. (*CongressDaily*, 09/15/09)

Congress failed to save Fannie Mae and Freddie Mac

- In a September 8th interview on CNBC's *Squawk Box*, former Federal Housing Finance Agency director James Lockhart said, "The problem was that Congress allowed [Fannie Mae and Freddie Mac] to be leveraged well over 100 to 1. We were asking—since the day I took the job 3½ years ago—for legislation to fix them. And it didn't happen until a little over a year ago. By then, it was only about 40 days before conservatorship."

- "Often times what happens…, Congress creates an agency, doesn't give it all the tools it needs, eventually it gets into trouble, and we have to re-fix it. …Again, the real problem was they were allowed the leverage themselves so dramatically and no financial institution in this kind of market could have survived." (*Squawk Box*, James Lockhart, 09/08/09)

A confluence of financial models and public housing policy

- In testimony before the House Committee on Science & Technology, Subcommittee on Investigations and Oversight, Christopher Whalen, co-founder of *Institutional Risk Analyst*, said "… [W]hen the world of finance marries the world of outcome driven economics—the world of 'what if' and 'I want'—models cease to be mechanistic tools for validating current outcomes with hard data and assessing a reasonable range of possible future events. Instead models become enablers for speculation, for the use of skillful canards and legal subterfuge that ultimately cheat investors and cause hundreds of billions of dollars in losses to private investors and insured depository institutions."

- "Take the world of mortgage backed securities or MBS. For decades the investment community had been using relatively simple models to predict the cash flow of MBS in various interest rate scenarios. These predictions have been relatively simple and are validated against the monthly mortgage servicer data available to the analyst community. The MBS securitization process was simple as well. A bank would sell conforming loans to GNMA and FNMA, and sell inferior collateral to a handful of investment banks on Wall Street to turn in the loans into private MBS issues."

- "At the beginning of the 1990's, however, Wall Street's private MBS secret sauce escaped. A firm named Drexel, Burnham, Lambert went bankrupt and the bankruptcy court sold copies of Drexel's structured finance software to anyone and everyone. It eventually wound up in the hands of the mortgage issuers themselves. These banks and non-banks naturally began to issue private MBS by themselves and discovered they could use the mathematics of modeling to grow their mortgage conduit businesses into massive cash flow machines. When brought to market, these private MBS were frequently under-collateralized and could therefore be described as a fraud."

- "Wall Street, in turn, created even more complex modeling systems to squeeze even more profits from the original MBS template. The expanding bubble of financial innovation caught the eye of policy makers in the Congress, who then created political models envisioning the possibility that 'innovation' could be used to make housing accessible to more Americans."

- "Spurred on to chase the 'policy outcome' of affordable housing, an entire range of deliberately opaque and highly leveraged financial instruments were born with the full support of Washington, the GSEs and the Congress. Their purpose now was to use the alchemy of financial modeling to create the appearance of mathematical safety out of dangerous toxic ingredients. Wall Street firms paid the major rating agencies to award 'AAA' ratings to derivative assets that were ultimately based on subprime mortgage debt. And the stage was set for a future economic disaster."

- "In the case of subprime toxic waste, the models became so complex that all transparency was lost. The dealers of unregulated, unregistered complex structured assets used proprietary models to price and sell deals, but since the 'underlying' for these derivative securities was invisible, none of the investment or independent ratings community could model the security. There was no validation, no market discipline. Buy Side customers were dependent upon the dealer who sold them the toxic waste for valuation. The dealers that controlled the model often times would not even make a market in the security."

- "Clearly we have now many examples where a model or the pretense of a model was used as a vehicle for creating risk and hiding it. More important, however, is the role of financial models for creating opportunities for deliberate acts of securities fraud. These acts of fraud have caused hundreds of billions of dollars in losses to depository institutions and investors."

- “Whether you talk about toxic mortgage assets or credit default swaps, the one common element that the misuse of models seems to contain is a lack of a visible underlying market against which to judge or ‘mark’ the model. Indeed, the use of models in a subjective context seems to include the simulation of a nonexistent market as the primary role for the financial model.”

- “In single-name credit default swaps or ‘CDS’ for example, there is often insufficient trading in the supposed underlying corporate debt security to provide true price discovery. In the case of CDS on complex structured assets, there is no underlying market to observe at all. The subjective model becomes the market in terms of pricing the security. In the spring of 2007, however, the fantasy land consensus that allowed people to believe that a model is a market came undone. We have been dealing with the consequences of the decisions that originally built the house of cards since that time.”

- “The term ‘model’ as it applies to finance can be a simulation of reality in terms of predicting future financial outcomes. The author Nassim Taleb, who is appearing at this hearing, says the term ‘VaR’ or value at risk describes a statistical estimate of “the expected maximum loss (or worst loss) over a target horizon within a given confidence interval.”

- “VaR models and similar statistical methods pretend to estimate the largest possible loss that an investor might experience over a given period of time to a given degree of certainty. The use of VaR type models, including the version imbedded in the Basel II agreement, involves a number of assumptions about risk and outcomes that are speculative. More important, the widespread use of these statistical models for risk management suggest that financial institutions are subject to occasional ‘Black Swans’ in the form of risk events that cannot be anticipated.”

- “We take a different view. We don’t actually believe there is such a thing as ‘Black Swan.’ Our observations tell us that a more likely explanation is that leaders in finance and politics simply made the mistake of, again, believing in what were in fact flawed models and blinded themselves to what should have been plainly calculable innovation risks destined to be unsustainable. Or worse, our leaders in Washington and on Wall Street decided to be short sighted and not care about the inevitable debacle.”

- “We suggest that going forward our national interest needs to demand a higher standard of tangible proof from “outcome designers” of public policies. If financial markets and the models used to describe them are limited to those instruments that can be verified objectively, then we no longer need to fear from the ravages of Black Swans or systemic risk. The source of systemic risk in the financial markets is fear born from the complexity of opaque securities for which there is no underlying basis. The pretext for issuing these ersatz securities depends on subjectivity injected into a flawed model.”

- "If we accept that the sudden change in market conditions or the 'Black Swan' event that Taleb and other theorists have so elegantly described arises from a breakdown in prudential regulation and basic common sense, and not from some unknowable market mechanism, then we no longer need to fear surprises or systemic risk. We need to simply ensure that all of the financial instruments in our marketplace have an objective basis, including a visible, cash basis market that is visible to all market participants. If investors cannot price a security without reference to subjective models, then the security should be banned from the US markets as a matter of law and regulation. To do otherwise is to adopt deception as the public policy goal of the US when it comes to financial markets regulation."

- "As Graham and Dodd wrote nearly a century ago, the more speculative the inputs the less the analysis matters. Models only have real value to society when their workings are disciplined by the real world. When investors, legislators and regulators all mistook models for markets, and even accepted such speculations as a basis for regulating banks and governing over-the-counter or OTC markets for all types of securities, we as a nation were gambling with our patrimony. If the Committee and the Congress want to bring an end to the financial crisis, we must demand higher standards from our citizens who work in and regulate our financial markets."

- "As we discussed in a commentary last month, 'Systemic Risk: Is it Black Swans or Market Innovations?,' published in The Institutional Risk Analyst , "were the failures of Bear Stearns, Lehman Brothers, Washington Mutual or the other 'rare' events really anomalous? Or are we just making excuses for our collective failure to identify and manage risk? A copy of our commentary follows this testimony. I look forward to your questions." (Statement by Christopher Whalen, House Committee on Science & Technology Subcommittee on Investigations and Oversight , 9/10/09)

Fannie Mae and Freddie Mac

The mortgage market: A year after Lehman's failure and the implosion of the financial markets

- A year after the failure of Lehman Brothers and the ensuing financing crisis, the only mortgage lender of any consequence remains the federal government, the nation's mortgage banker. "Absent government intervention, there would be no lending," said Nicolas P. Retsinas, director of Harvard University's Center for Housing Studies.

- Over the past 12 months, the federal government funded or guaranteed nearly 90% of all mortgages. As conservators of Fannie Mae and Freddie Mac, the federal government—and taxpayers—are "on the hook" for the $5 trillion of mortgages owned or guaranteed by the GSEs, which represents 66% of the debt the U.S. owes. Over the past twelve months, Fannie and Freddie have tapped approximately $96 billion of government assistance to date and are projected to need anywhere from $160 billion to $200 billion before the mortgage crisis ebbs. In addition, Fannie and Freddie have received nearly 10 times that amount in additional support through the Federal Reserve's and Treasury's purchase of agency debt and mortgage-backed securities, bring total government support to the GSEs as of August 20th to approximately $1.1 trillion, according to the Congressional Research Service.

Table 1. Government Financial Support for Fannie Mae and Freddie Mac
($ Billions)

Government Action	Fannie Mae	Freddie Mac	Total
Treasury Purchases of Senior Preferred Stock	$44.9	$50.7	$95.60
Treasury Purchases of MBS	$89.0	$82.8	$171.80
Federal Reserve Purchases of MBS	$445.3	$259.4	$704.70
Federal Reserve Purchase of GSE Debt	$45.1	$41.3	$86.40
Total Government Support	$624.3	$434.20	$1058.50

Source: Federal Housing Finance Agency, *Current Data on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*, Aug. 20, 2009, http://www.fhfa.gov/webfiles/14778/TSYFed082009.pdf.

- The government now decides who qualifies or doesn't qualify for a mortgage. As a result of tightening in lending standards, nearly 33% of the borrowers who obtained mortgages during the boom years of 2005 and 2006 wouldn't qualify for loan today.

- The government's tentacles in the mortgage market are extensive. FHA has dramatically increased the market share of mortgages it insures from 1.8% to 18% year-to-date, while its delinquent mortgages have ballooned to nearly 8% at the end of June. By year-end, FHA expects to insure approximately $400 billion, as insurance losses drive the agency's reserves below its statutory requirement. In aggregate, the federal government insures 86% of all new home loans up from 30% four years ago.

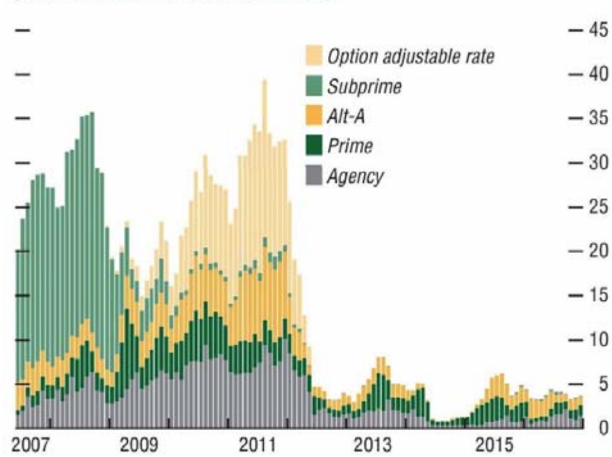
- Moreover, today's residential mortgage origination and servicing market is dominated by just three large banks—Wells Fargo, Bank of America, and JPMorganChase—who originated and sold in aggregate 52% of all mortgages during the first six months of 2009, more than double their market share in 2005. With the mortgage market on government life support, Treasury-backed GSEs—Fannie Mae, Freddie Mac, and FHA—have guaranteed about 85% of new mortgage originations, while the Federal Reserve has purchased approximately 80% of new agency MBS issuances. Meanwhile, Wells, BofA, and JPMorgan have doubled their market share for mortgage servicing from 22% in 2005 to 49% in 2009. During this crisis, it appears that the government has reinforced a system in which it provides subsidies [via artificially low mortgage interest rates] to the mortgage market, which periodically goes through highly leveraged speculative booms rather than trying to implement changes.

- "Having the government this heavily into the mortgage market is inherently a dangerous thing for taxpayers," said Anthony Sanders, a finance professor at George Mason University. "We've already gone through one big bubble and burst, and right now the tax payers are on the hook for a substantial amount of money."

- While government officials generally agree that it would be better for private lenders to resume their traditional role of providing mortgage loans, policymakers face tough choices on how to reduce the government's support of the mortgage market while avoiding its collapse. "The problem has been a long time brewing, and the problems in our mortgage finance system will take a long time to repair," said Michael Barr, Treasury's assistant secretary for financial institutions.

- Resolving the problems in the mortgage finance system will be driven, in part, by the economy, in general, and employment, specifically. While real estate values appeared to have stabilized in some markets, what appears to be a jobless recovery casts a shadow on the potential for a long-term recovery. With the unemployment rate expected to top 10% in 2009, the prospects for rising mortgage delinquencies appear likely, as the mortgage resets for Alt-A and option adjustable rate loans continue through 2011. While Alt-A borrowers

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

are more likely to refinance out of their adjusting loans, declining home prices and tighter loan underwriting standards could prohibit some borrowers from refinancing and result in growing foreclosures through 2011. Furthermore, approximately $587 billion of mortgages, which serve as collateral private-label securities, were in either non-performing or re-performing status on August 31st.

- Moody's Investor Services said residential mortgage-backed securities performance will continue to deteriorate into 2010 as house prices fall—"despite some recent signs that the decline is slowing." Moody's does not expect investor interest to generate a recovery for at least 12 to 18 months. (*Washington Post*, Zachary A. Goldfarb and Dina ElBoghday, 09/07/09; *Wall Street Journal*, Peter Eavis, 09/18/09; *Associated Press*, Alan Zibel, 09/07/09; *The PLS Universe Report*, Amherst Securities Group LP, August 2009; *HousingWire*, Diana Golobay, 09/09/09)

The future for Fannie Mae and Freddie Mac?

- On the one year anniversary of the take-over of Fannie Mae and Freddie Mac, virtually no one with any authority over the GSEs wanted to talk about the enterprises' future. At a press briefing, a Treasury official said that the GSE's future is "more of next year's business than this year's." Likewise, Fannie Mae CEO Mike Williams demurred as well. "Down the road, if asked, we would be glad to share what we know, what we've learned about the housing and mortgage finance markets, especially during this crisis," said Williams in a speech at the Exchequer Club. "At the moment, though, our focus is really on the front lines of the housing crisis — helping to get housing back on track, and doing our part for the economic recovery of the nation."

- In an August report, Moody's Investor Services concluded that the likelihood that Fannie and Freddie would be replaced with a new entity "continues to increase as their losses mount." Moody's predicted that it could take at least a decade of government ownership of the GSEs before the enterprises could become viable, stand-alone entities.

- In an August 19th letter to the GAO, former Federal Housing Finance Agency director James B. Lockhart urged policymakers to consider the broader issue of how housing should be financed before tackling Fannie Mae and Freddie Mac. Lockhart wrote, "That includes determining the most appropriate roles for private- and public-sector entities, competition and competitiveness, risks and risk management." (*Bureau of National Affairs*, Thecla Fabian, 09/14/09; *Fannie Mae and Freddie Mac: An Analysis of Options for Revising the Housing Enterprises' Long-term Structures*; GAO, September 2009; *Wall Street Journal*, Nick Timiraos, 09/02/09)

<u>By default, the GAO appears to favor structuring the GSEs as federal agencies</u>

- In a September 10th study of the future options for Fannie Mae and Freddie Mac, the GAO outlined a "continuum of some overlap in [three] key areas." The main categories identified included:

    - (i) Reconstituting the enterprises as for-profit corporations with government sponsorship, but placing additional restrictions on them, such as eliminating or reducing mortgage portfolios, establishing executive compensation limits, or converting the enterprises from shareholder-owned corporations to associations owned by lenders;

    - (ii) Establishing the enterprises as government corporations or agencies, which would focus on purchasing qualifying mortgages and issuing mortgage backed securities and would eliminate their mortgage portfolios. [The FHA could assume additional responsibilities for promoting homeownership for targeted groups.]; and

    - (iii) Privatizing or abolishing the GSEs in their current form and dispersing mortgage lending and risk management throughout the private sector.

- While the agency did not take a formal position on how lawmakers should structure the GSEs in the future, GAO essentially declared two options—fully privatizing the enterprises or structuring them as public utilities—as unworkable. GAO cautioned that privatization of the GSEs would represent a radical shift to one market—one with potentially harmful consequences in which "lenders would be less willing to originate 30-year fixed-rate mortgages" due to interest rate risk. Further, GAO warned that such a structure could result in an increase in mortgage rates because private sector lenders might not have the funding advantages the GSEs have enjoyed through federal sponsorship. GAO also noted, "It is not clear that the public utility model is an appropriate regulatory structure because, unlike natural monopolies such as electric utilities, the enterprises have faced significant competition from other providers of mortgage credit over the years." Additionally, the utility model has been criticized as inefficient, which has led many states to deregulate their public utilities, said GAO.

- GAO noted several advantages of operating the GSEs as government agencies. "A government entity may be able to continue to fund its activities through government debt issuances," said GAO. "In contrast, for-profit entities face conflicts in supporting mortgage finance during stressful economic periods because they also must be concerned about maintaining shareholder value, which may mean substantially reducing their activities or withdrawing from markets entirely." However, GAO noted the downside of operating the GSEs as a government agency is the possibility that the entities fail to rein in risks, which could result in a "significant loss" to taxpayers.

- Prior to their conservatorship, Fannie Mae and Freddie Mac had a "mixed record" in meeting their housing goals and the deficiencies in the GSEs' capital and risk management deficiencies "compromised [the enterprises'] safety and soundness," concluded GAO. While the GSEs secondary marketing activities helped create a liquid national mortgage market and lowered rates somewhat, GAO concluded that the enterprises' capacity to support housing finance during periods of economic stress "has not been established." Fannie's and Freddie's structure as GSEs "undermined market discipline and provided them incentives to engage in potentially profitable business practices that were risky and not necessarily supportive of their public missions," said GAO. "Further, the enterprises' substantial investments in assets collateralized by subprime and other questionable mortgages in recent years generated losses that likely precipitated conservatorship."

- GAO's report on options for restructuring Fannie Mae and Freddie Mac is available at http://www.scribd.com/doc/19939456/GAO-Report-on-GSEs. (*Bureau of National Affairs*, Thecla Fabian, 09/14/09; *Fannie Mae and Freddie Mac: An Analysis of Options for Revising the Housing Enterprises' Long-term Structures*; GAO, September 2009; *Bloomberg News*, Jody Shenn, 09/10/09; *American Banker*, Steven Sloan, 09/11/09)

- In a September 9th CRS Report to Congress, N. Eric Weiss outlines the options to restructure Fannie Mae and Freddie Mac in Table 2. Weiss suggests that Congress might "wish to consider the future of the third housing GSE, the Federal Home Loan Bank System, as it determines the fate of Fannie and Freddie. This CRS report is available at http://www.scribd.com/doc/19939372/CRS-Options-to-Restructure-Fannie-Mae-and-Freddie-Mac-Sept-9. (*Wall Street Journal*, Nick Timiraos, 09/02/09)

Table 2. Summary of GSE Restructuring Options

Category	Option	Summary
Maintaining GSE status	Return control to stockholders	Return GSEs to status prior to being placed in conservatorship with no changes to oversight
	Retain GSE status with additional regulation	Return GSEs to status prior to being placed in conservatorship with additional oversight
	Explicit guarantee	Federal government would explicitly guarantee MBS. (The explicit guarantee probably would eliminate the GSE status of Fannie Mae and Freddie Mac. See 2 U.S.C. 622(8))
	Utility model	Return GSEs to status prior to being placed in conservatorship, but regulate their profits
	Split GSEs	Return GSEs to status prior to being placed in conservatorship, but divide the two GSEs into many GSEs
	Combine with FHLBanks	Fannie Mae and Freddie Mac would be merged with the FHLBanks, which is the third housing GSE
Eliminate GSE status	Government agency	Merge the GSEs with FHA and Ginnie Mae, which are parts of HUD, or convert the GSEs into a new government agency
	Privatization	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters
	Privatization with Co-Op Insurance	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters, and organize a co-operative to provide first line insurance for MBS.
Supplementary	Reinsurance	Provide explicit federal backup insurance for MBS
	Covered bonds	Encourage the issuance of overcollaterized MBS

Source: CRS.

Mortgage trade groups address the future of Fannie Mae and Freddie Mac

- The Mortgage Bankers Association has called upon Congress to transform Fannie Mae and Freddie Mac into several smaller privately-held companies, which would issue mortgage-backed securities carrying an explicit government guarantee. Under MBA's proposed framework, these privately-held companies would have the authority to create securities backed by certain types of mortgage and guarantee the securities against defaults on the underlying mortgages.

- Under MBA's proposal, the new companies would pay fees into a federal insurance fund, which would guarantee interest and principal payments to bondholders, if the companies were unable to make the payments in the event of a catastrophic loss. Such an insurance fund would provide the explicit federal backing. John Courson, the MBA's CEO, said, "If we're going to restore and maintain investor confidence and …consistent liquidity, that is going to require an explicit backstop [e.g., a government guarantee]." The MBA's proposal calls for government agencies, rather than the successors to Fannie and Freddie, to assume the mission of promoting affordable housing. The MBA report is available at http://www.scribd.com/doc/19939442/MBA-70212-Recommendations-for-the-

Future-Government-Role-in-the-Core-Secondary-Mortgage-Market. (*Wall Street Journal*, Nick Timiraos, 09/02/09)

- In April testimony provided to the House Financial Services Committee and in a comment letter filed to the Federal Housing Finance Agency, the Consumer Mortgage Coalition outlined a proposal to re-engineer the mortgage finance system, including a new role for Fannie Mae and Freddie Mac. CMC proposed that a new mortgage finance structure be created to facilitate a transparent, standardized securitization process, which would restore investor confidence in the mortgage market. Under CMC's proposal, the secondary market would be closed for many of the risky loan products which shouldn't have been made in recent years. This structure, which must be flexible so as not to stifle innovation, would return to "basics" of mortgage lending.

- CMC proposes the creation of an at-cost cooperative entity, the "Mortgage Clearinghouse," which would standardize, centralize and enhance the residential mortgage securitization process. The Mortgage Clearinghouse would be an analogous to the Depository Trust & Clearing Corporation, which provides an efficient and safe way for buyers and sellers of securities to make their exchange, and thus "clear and settle" transactions. The Mortgage Clearinghouse would act as a "gateway" for securitized mortgage product, which would restore liquidity to the securitization market now and maintain the integrity of the market in the future. It would accomplish this by establishing basic underwriting rules, requiring data transparency, and provide financial guaranty reinsurance coverage, backed by appropriate levels of capital, on the securitizations. CMC proposed that the Mortgage Clearinghouse be owned 50% by well-capitalized private lenders and financial services companies and 50% by a government entity, with members of the Board appointed from all parties. CMC recommended that the government entity be a single Government Sponsored Enterprise (GSE), resulting from the merger of Fannie Mae and Freddie Mac. CMC proposed that the new GSE's future role be that of a public utility, which adds value but does not displace available public sector capital and resources. CMC's written testimony is available at http://www.scribd.com/doc/20024355/CMC-Written-Testimony-to-Frank-and-Bachus-42309-2. (*Testimony before the Committee on Financial Services,* Consumer Mortgage Coalition, 04/23/09)

Congressional hearing ramps up the pressure on servicers to help distressed borrowers, and Chairman Frank threatens again to pass cramdown bill

Treasury to encourage short sales

HAMP should be adjusted slightly to provide a backstop loss guarantee for properly re-underwritten and re-appraised properties to draw institution investors back into the mortgage space

Loan modification programs that support short sales can be effective in mitigating losses

The loan modification process: "One of the biggest issues facing American capitalism"

<u>Congressional hearing ramps up the pressure on servicers to help distressed borrowers, and Chairman Frank threatens again to pass cramdown bill</u>

- At a September 9th hearing of the House Financial Services Subcommittee on Housing and Community Opportunity, witnesses from Treasury and HUD touted the achievements of the Making Homes Affordable (MHA) program. "MHA has achieved clear success in a relative short time period and there are some indications that the housing market is stabilizing with home price declines slowing," testified FHA Commissioner David Stevens. Today, 45 mortgage servicers, representing 85% of the market, participate in the MHA program. To date, the servicers have extended more than 570,000 loan modifications of which 360,000 borrowers have entered into the 90-day trial period, said Stevens. Michael Barr, Treasury assistant secretary for financial institutions, told lawmakers that the MHA program is on track to reach nearly 4 million borrowers over the next four years.

- During the hearing, a major issue emerged concerning how MHA can produce a meaningful number of mortgage modifications without addressing the needs of the unemployed, who don't qualify for the program. Some questioned the need for the MHA Program, including Representative Spencer Bachus (R-AL), the ranking member on the House committee, who called MHA unnecessary. "As long as people are losing jobs, they're going to lose their homes," said Bachus. "We need to let the private sector create those jobs, and that's how we're going to save those homes." Bachus added, "I know the terrible cost of foreclosure, but I still think …the government has simply got to end its substitution of public debt for private debt that continues to drag the economy down and pile up unpayable debt."

- House Financial Services Committee chairman Barney Frank (D-MA) reiterated his interest in reviving cramdown legislation, which would empower bankruptcy courts to restructure mortgages on primary residences. Specifically, Franks said he would attach the cramdown measure to legislation to revamp the nation's financial regulatory system, because he believes that the administration's MHA program is moving too slowly. "I'm disappointed at the pace of this program," said Frank. "We do believe that the possibly of bankruptcy will be an important incentive to getting things done." Barr testified that the bankruptcy proposal would have no negative effect on the administration's MHA program, designed to stem the tide of foreclosures which are projected by Credit Suisse to top 8 million over the next four years. When Bachus expressed concern that such a measure would increase the cost of mortgage credit, Frank denounced Republican lawmakers for refusing to do anything in response to the financial crisis. (*HousingWire*, Jon Prior, 09/09/09; *Hearing on Progress of the Making Home Affordable Program*, House Financial Services Subcommittee on Housing and Community Opportunity, 09/09/09; *HousingWire*, Jon Prior, 09/10/09; *CongressDaily*, Bill Swindell, 09/09/09; *American Banker*, Cheyenne Hopkins, 09/10/09)

Treasury to encourage short sales

- In September, Treasury plans to issue details on a new program designed to encourage short sales and deeds-in-lieu of foreclosure. In testimony before a House Financial Services subcommittee, FHA Commissioner David Stevens told lawmakers that the program is being finalized and would be announced as soon as possible. In written testimony, Stevens said, "Because we know that the MHA program will not reach every at-risk homeowner or prevent all foreclosures, on May 14th the Administration announced the Foreclosure Alternatives program that will provide incentives for, and encourage, servicers and borrowers to pursue short sales and deeds-in-lieu of foreclosure in cases where the borrower is generally eligible for a MHA modification but does not qualify or is unable to complete the process." Stevens said the FA program will simplify the process of short sales and deeds-in-lieu of foreclosure and will standardize the process, documentation and shorten performance timeframes. This program will eliminate the need for a lengthy and expensive foreclosure proceeding, preserve the physical condition and value of the collateral property, and afford the homeowners a "transition with dignity to more affordable housing," said Stevens. (*HousingWire*, Diana Golobay, 09/10/09; *American Banker*, Kate Berry, 09/09/09)

Loan modification programs that support short sales can be effective in mitigating losses

- According to a September 10th report by Amherst Securities Group (ASG), programs that support short sales could be the most effective loss mitigation approach, because they minimize loss severity. The Hope-for-Homeowners (H4H) program could be a "powerful alternative" to the Home Affordable Modification Program (HAMP), since H4H's ability to mimic the impact of short sales, such as a one-time loss on the loan, provides a softer loss severity than foreclosure sales, concluded ASG. "In all cases, the loss severity on the short sale is 15-20% less than on the foreclosure sale," wrote ASG.

- Borrowers, who complete the H4H program, become re-equified and refinanced into a new FHA-insured mortgage, while HAMP only provides capped incentives to servicers to modify mortgages at risk of foreclosure. Treasury then adjusts the HAMP incentive caps based on the level of actual participation. Within the next two months, plans for the "new and improved" H4H program could be released which resolve enough issues to maximize the net present value of loans in bank portfolios. However, it is "unlikely" that the H4H program would be used for loans in private label securitizations. "This is a superior alternative to either the HAMP modification or foreclosure," concluded ASG. While borrowers would make the same payment [31% of income] under both programs, ASG expects higher success rates with H4H because (i) the borrower is re-equified and re-underwritten to ensure that he/she qualifies for the loan; and (ii) H4H extinguishes the second mortgage.

- Servicers and investors agree that HAMP is particularly less useful to pay-option adjustable-rate mortgages (ARMs) borrowers because of the difficulty of reducing payments from their current levels. HAMP's 40-year term extension doesn't help many of the option ARM mortgages that are already at a 40-year term. Also, these borrowers have mortgages that are less affordable, on average, than any other product type, according to the report. "Once the new H4H program is implemented, we expect portfolio lenders to make considerable use of the program," wrote ASG. (*Amherst Mortgage Insight*, Laurie Goodman, 09/10/09; *HousingWire*, Jon Prior, 09/11/09)

<u>HAMP should be adjusted to provide a backstop loss guarantee for properly re-underwritten and re-appraised properties to draw institutional investors back into the mortgage space</u>

- In a 32-page report issued by Magnetar Capital, a multi-strategy asset manager, argues that a mortgage recovery backstop that guarantees a minimum recovery could play a key role in restoring a functional market. In lieu of the incentive fees paid under the HPDP section in the administration's HAMP, Magnetar proposes that the government guarantee a minimum recovery of 75% of the newly underwritten value of a home for loans being modified in exchange for a 10 basis points fee paid by the investor. Under this proposal, the government would also create a mechanism to ensure servicers are disposing of properties efficiently, similar to how the GSEs monitor servicers of the mortgages they guarantee.

- Without such a backstop or monitoring process, Michael Henriques, a principal at Magnetar, wrote, "The investors are the ones who are going to lose money. We have no idea whether servicers are making the right decisions in modifying loans." Magnetar principal David Wecker added that the proposal should stabilize ratings for private-label securities by providing a guarantee on a significant, but not the entire, portion of the principal balance of most senior securities. In turn, this stabilization should reduce forced selling by banks and insurers.

- With no floor for home price declines, mortgage assets are trading at steep declines because investors are factoring in a "substantial uncertainty premium" under worst case scenarios, said Laurie Goodman, a senior managing director at Amherst Securities Group. "Investors are really worried about the loan mods that fail." (*Mortgage Recovery Backstop: The Path to a Functional Market for Legacy Non-Agency Mortgages and Mortgage-Backed Securities*, Magnetar Capital, June 2009; *American Banker*, Kate Berry, 09/15/09)

<u>The loan modification process: "One of the biggest issues facing American capitalism"</u>

- BlackRock Inc. chairman Laurence Fink said the Obama administration's programs to help homeowners avoid foreclosure may hinder the recovery of the mortgage market, while benefiting banks that own second loans on the properties. "I am just very worried," said Fink. "How do we get a vibrant securitization market back when we are doing these things in the short run that are good for the banking system and good for the homeowner but not as good as it should be?"

- Fink said the administration's foreclosure policies are flawed because they don't require home-equity loans to be extinguished before the mortgage is modified. Instead, second loan's terms may also be revised, spreading the financial loss among lenders and running counter to the intentions of mortgage contracts, he said. This structure puts at risk the recovery of the mortgage-backed securities market, including nearly $1.7 trillion in residential-mortgage bonds not backed by the U.S., said Fink.

- "This to me is one of the biggest issues facing American capitalism," Fink said. "There is modification going on protecting our banks, protecting their balance sheets. …If you really want to protect the homeowner, wipe out the second lien, modify [reduce the principal balance] the first lien. …[T]he homeowner is better off, America is better off, and you could say the first lien holder is better off."

- Fink is the highest-profile investor to call attention to potential conflicts for banks that service mortgages and also handle loan modifications. Specifically, Fink is concerned that many servicers also hold home-equity loans that would lose all value in a foreclosure. The four largest servicers—JPMorgan Chase & Co., Bank of America Corp., Wells Fargo & Co. and Citigroup Inc.—own approximately $450 billion of home-equity loans, according to Amherst Securities Group in New York.

- "I am glad that a firm such as BlackRock believes these conflicts are serious and the lack of resolution has profound implications on the financial markets and our country," Bill Frey, head of Greenwich Financial Services LLC. "We have been working with a number of very large financial institutions and many hold the view." Frey is suing Bank of America over modifications the bank agreed to make to settle charges of fraudulent lending against Countrywide Financial by state attorneys general. Frey said his investors want "to devise strategies to enforce their contractual rights," but declined to identify the firms or their potential tactics.

Support in the Senate appears to be growing for an extension of the homebuyer tax-credit

- Senator John Isakson (R-GA) said support in the Senate is gaining for a bill he is sponsoring which would extend and expand the homebuyer tax credit set to sunset on November 30th. To date, the bill has at least 15 co-sponsors, including Senate Banking Committee Chairman Christopher Dodd (D-CT) and Senators Patty Murray (D-WA) and Joe Lieberman (I-CT). Specifically, the bill would extend the homebuyer tax credit program through the end of 2010, nearly double the credit from $8,000 to $15,000 and remove restrictions that prohibit individuals who already own homes or earn $75,000 [$150,000 for couples] from getting the tax break. In June, the bill failed in the Senate by a vote of 47-50.

- Separately, Senator Benjamin Cardin (D-MD) has introduced S.1678, which would extend the $8,000 first-time homebuyer tax credit for six months beyond its current November 30 expiration date. The bill is co-sponsored by Senators John Ensign (R-NV), Johnny Isakson (R-GA.), Harry Reid (D-NV) and Debbie Stabenow (D-Mi). Cardin said, “A six-month extension is a fiscally responsible way to provide adequate time to nudge even more prospective home buyers off the sidelines and closer to owning their part of the American Dream.”

- White House spokesman Robert Gibbs said the administration’s economic team is looking at the proposed tax credit and “evaluating the impact” it might have on home sales. “Through that evaluation, we’ll come to something to give the president a recommendation,” said Gibbs.

- Realtors, bankers and homebuilders have begun a campaign to promote the bill, carrying a tag line “Don’t Let America’s Real Estate Recovery Expire.” Lawrence Yun, NAR’s chief economist, said, “[The tax credit] is having an impact in lifting sales and reducing inventory, which will help stabilize home prices—the key to the economic recovery…” Yun estimates that about 350,000 home sales through August were directly attributable to the tax credit, which was utilized in 1.2 million home purchases this year. Fannie Mae CEO Michael Williams and Hyperion Partners CEO Lewis Ranieri have attributed recent improvements in home sales and real estate prices to the tax credit. Isakson has expressed concerns that the market may suffer without the tax credit, if it is allowed to end.

- Mark Zandi, chief economist for *Moody’s Economy.com*, favors the expansion of the tax credit for homebuyers into next summer. “The risks of not doing something like this are too great,” said Zandi. “I don’t think the coast is clear.” James Glassman, economist for JPMorgan Chase, echoed Zandi’s comments, but added that he favored continuing to restrict the tax credit to first time homebuyers.

- “Things could get ugly,” said Thomas Lawler. Lawler, an independent consultant in Leesburg, Virginia, who was an economist for Fannie Mae for 22 years. “We could be facing a triple whammy at the end of the year: the expiration of the tax credit, the end of the Fed mortgage-buying program and rising foreclosures." (*Bloomberg News*, Dawn Kopecki, 09/16/09; *New York Times*, David Streitfeld, 09/16/09; *HousingWire*, Austin Kilgore, 09/18/09*; Bloomberg News*, Kathleen M. Howley and Rich Miller, 09/21/09)

Center for American Prosperity urges SIG-TARP to review the lending practices and CRA compliance of the large banks receiving TARP funds Activists lobby for the expansion of CRA to include non-bank depositories, affiliate companies and credit unions

Center for American Prosperity urges SIG-TARP to review the lending practices and CRA compliance of the large banks receiving TARP funds

- The Center for American Progress has called on the special inspector general for TARP to review the lending practices of the 14 systemically significant banks that have received bailout funds, after determining in a study of HMDA data that these institutions participated in discriminatory lending practices toward minorities. According to CAP's analysis of 2006 HMDA data, 41.5% of African-Americans were offered higher priced home loans versus 31% of Hispanic borrowers, 17.8% of high-income white borrowers and 11.5% of Asian borrowers. Of the 14 banks reviewed, Regions Financial Corp. offered the most high-priced loans to high-income minorities with 84% of Hispanics and 73.5% of African-Americans.

- CAP concluded that no further repayments of TARP funds should be allowed by these banks until SIG-TARP could determine if their lending practices are fair. "TARP as a whole has already been criticized for privatizing profits and socializing losses," wrote CAP. "If we allow public money to go toward steering people into high-cost mortgages and other violations of fair lending laws, we will allow the large banks to reap the profits of those activities while leaving taxpayers to suffer the costs as those loans fail and more homes flood the market."

- CAP also suggests that the creation of the Consumer Financial Protection Agency (CFPA) would do more than existing regulators to protect consumers from unfair lending. Observers acknowledge that the financial crisis will result in an even wider discrepancy in loans to minorities, giving consumer advocates more ammunition to push for the creation of CFPA. Andrew Sandler, co-chairman of Buckley Sandler LLC, noted, "As a result of the recent tightening of credit, denial disparity rates will significantly increase. The HMDA data will enhance the level of concern and discussion about fair lending, and necessarily, then, will focus attention on the role of the new agency in fair lending and the need for the new agency in terms of enhanced fair-lending protection." (*American Banker*, Emily Flitter, 09/09/09)

Activists lobby for the expansion of CRA to include non-bank depositories, affiliate companies and credit unions

- At a September 16th hearing of the House Financial Services Committee, CRA advocates, who have long pushed for an update to the 32-year old law, urged lawmakers to modernize the Community Reinvestment Act and broaden its application to nonbank lenders, affiliate companies and credit unions. Representative Eddie Bernice Johnson (D-TX), the sponsor of the Community Reinvestment Modernization Act (H.R. 1479), testified that his bill would increase the responsiveness and accountability of banks to all communities, rural as well as urban. The bill would require CRA exams in the geographical areas that banks serve, including markets where the institutions make loans through brokers. The legislation also would address racial disparities in lending by requiring CRA exams to explicitly consider lending and services to minorities in addition to low- and moderate-income communities. It would require the reporting of race and gender of borrowers of small business loans and would require data collection of deposit and savings accounts. Under the bill, the Federal Reserve Board would be required to create a database on foreclosures and loan modifications, which would be linked to Home Mortgage Disclosure Act (HMDA) data.

- Banks would be required to submit public improvement plans, which would be subject to public comment, when the institutions earn low ratings in any of their service areas. Under the bill, federal regulatory agencies would be required to hold more meetings and public hearings when banks merge or seek to close branches. The CRA Modernization Act also would establish CRA requirements for all affiliates and subsidiaries of banks, independent mortgage companies, "mainstream" credit unions, insurance companies, and securities firms.

- The administration has proposed that the Consumer Protection Agency assume the responsibility for HDMA data, which would be expanded to include credit scores in the data mix. The House bill includes much of the administration's language on CPA. A similar bill has not been introduced in the Senate. Consumer advocates argue that the proposed CPA with its broad mandate to protect consumers would be suited to assume responsibility for HFMA and handle the new data.

- Although critics of CRA argue it helped fuel financial crisis, "most" observers believe the odds are growing in favor of the passage of some kind of modernization of CRA as part of the regulatory reform legislation for the financial services industry. (*Testimony of Representative Eddie Bernice Johnson before the House Financial Services Committee*, 09/16/09; *American Banker*, Emily Flitter, 09/09/09; *Bureau of National Affairs*, Jewel Edwards, 09/16/09; *HousingWire*, Austin Kilgore, 09/16/09)

Fannie Mae and Freddie Mac seek significant revisions in FHFA's new product rules

- In a joint comment letter to the Federal Housing Finance Agency, Fannie Mae and Freddie Mac sought significant revisions to a July 2nd interim rule that forces the enterprises to submit all new products and activities for review, arguing that the rule is too restrictive and goes against congressional intent. The companies argued that the rule was unnecessarily burdensome and ineffective, and might make it difficult for the GSEs to help during a crisis.

- Timothy J. Mayopoulos, Fannie's general counsel, and Robert E. Bostrom, Freddie's general counsel, wrote, "The enterprises encourage FHFA to implement the statutory requirements in a manner that reflects the intention of Congress that this approach to new products should allow the enterprises to respond appropriately and in a timely manner to market needs and not unduly burden the enterprises at a time when innovation and flexibility are very important to borrowers and the secondary mortgage market." The general counsels added, "Congress clearly intended that new products would be subject to a greater degree of pre-launch scrutiny than new activities, and that new activities would require a lower level of pre-launch review. In order to be workable and predictable, the final rule should provide clear definitions." Under the proposed rule, FHFA did not define the difference between a new product and a new activity, leaving it to the discretion of the agency's director to distinguish between the two.

- Joseph Mason, an associate professor of finance at Louisiana State University noted, "This is an extremely important challenge to the nascent regulator."

- Separately, the Mortgage Bankers Association voiced strong support for FHFA's interim rule governing new product and activity approval for the GSEs. "We believe effective GSE oversight requires constant supervision throughout the business cycle of a product or activity, not just at the initiation or approval stage," wrote the MBA.

- In a comment letter to FHFA, the Consumer Mortgage Coalition said if the GSEs were ever returned to their previous, semi-private status, the FHFA should monitor them even more strictly than the interim rule stipulates. CMC also suggested changes to the rule to reduce the exemptions it currently contains for select products that the GSEs currently offer. (*American Banker*, Steven Sloan, 08/31/09; *American Banker*, Rob Blackwell and Emily Flitter, 09/03/09)

The Federal Reserve Board and HUD pledge to coordinate on mortgage disclosure under RESPA and TILA

- On September 15th, officials from the Federal Reserve Board and HUD said they are examining ways to combine or streamline disclosure forms required under RESPA and TILA. Kathleen Ryan, senior counsel at the Fed Division of Consumer and Community Affairs, said her agency is aware of the problem and is exploring ways to eliminate unnecessary and duplicative reporting requirements with the goal of possibly developing a single disclosure form for lenders to use which satisfies both laws. “We have had discussions with HUD about working together to try to find a way to either combine the disclosures or to ultimately have two forms that are streamlined and harmonized to provide the right information for consumers,” said Ryan. Ivy Jackson, director of HUD’s Office of RESPA and Interstate Land Sales, said HUD is fully behind the streamlining effort. “We want to make sure what we are doing is helpful to the consumer,” said Jackson. “And we do try not to be overburdensome to the industry.” However, Jackson said there is no timetable for completing the streamlining project. (*Bureau of National Affairs*, Mike Ferullo, 09/16/09)

Capitol Hill notes

- Senator Judd Gregg (R-NH) will be the newest member of the Senate Banking Committee, replacing former Senator Mel Martinez (R-FL), who left Congress on September 9th.(*CQ Today*, Phil Mattingly, 09/17/09)

- *The Hill* reports that House Financial Services Committee chairman Barney Frank (D-MA) is interested in “capping” his political career by serving as the Secretary of HUD for the Obama administration. But first, Frank says, he wants to pass more legislation on affordable housing. “I want at least two years with President Obama and a solidly Democratic Senate so that we can get the federal government back in the housing business.” (*The Hill*, Bob Cusack, 09/07/09)

- On September 15th, House Financial Services Committee chairman Barney Frank (D-MA) issued a memo, barring Michael Paese, the head of Goldman Sachs Group’s Washington lobbying office, from communicating with the Democratic majority on the panel. Paese was a top staffer on the committee until last September. He was hired by Goldman in April. Under House rules, Paese was prohibited from lobbying the panel for one year after his employment there, which would have expired on September 11th. To avoid the appearance of any conflict of interest, Frank extended Paese’s recusal time until the end of the congressional term next year. “Neither I, nor full committee nor subcommittee staff, will meet, or otherwise communicate with, Michael on any issues related to committee business or jurisdiction,” wrote Frank. “I ask that subcommittee chairs abide by this same rule.” (*Bloomberg News*, Robert Schmidt, 09/16/09)

- In *National Mortgage News Online*, Paul Muolo wrote, “…Now we know why Wilbur Ross hired former Federal Housing Finance Agency James Lockhart. It appears Mr. Ross is kicking the tires over at United Guaranty, the MI company that belongs to American International Group. Mr. Lockhart should be well versed on the MI industry and why Fannie Mae and Freddie Mac need them so badly. If there are successor GSEs to FanFred the MIs will be essential—now more than ever. If Mr. Ross does in fact wind up with UGI (or another such firm) he will own a servicer, a bank and an MI...” (*National Mortgage News Online*, Paul Muolo, September 12-13, 2009)

Consumer protection non-profit is launched to evaluate the fairness and safety of mortgage products

- The Fair Mortgage Collaborative (FMC), a Washington, DC-based, consumer protection non-profit, has entered into a partnership with software developer Mortgage Grader to launch a software tool to evaluate whether lenders’ products are “fair and safe.” FMC aims to provide consumers information and protection through the mortgage process by giving consumer an independent source of rating and evaluating lenders. The organization’s chairman is Janis Bowdler with the National Council of La Raza. FMC obtained financial backing from the Ford Foundation, among other groups. The group currently has eight members, including online broker Mortgage Grader and Neighborhood Housing Services, and expects to have at least 35 members by year end. FMC has not yet gained the participation of the four major lenders, JPMorgan Chase, Bank of America, Wells Fargo and Citigroup, but says its organizers are holding preliminary discussions with these banks. (*New York Times*, Bob Tedeschi, 08/02/09; *HousingWire*, 09/11/09)

Federal Reserve Governor Duke questions proposed accounting models for valuing financial instruments

- In a September 14th speech, Federal Reserve Board Governor Elizabeth Duke voiced concerns about the relevance and reliability of the accounting models for financial instruments being developed by FASB and its international counter part, International Accounting Standards Board. Specifically, Duke questioned FASB’s and IASB’s approaches to the models which would stray from reflecting the traditional banking “business model” and “constitute a significant departure from current practice.”

- “Reflecting market value fluctuations of all assets through the income statement would significantly increase the volatility of reported bank earnings, likely leading to changes in risk management practices,” said Duke. “At the extreme, this approach could incent all financial intermediaries to adopt a trading or investment banking model.” Duke said that would amount to moving away from commercial bank’s traditional “originate and hold” lending model. “Given my background as a community banker, I feel it is crucial that an accounting regime directly link reported financial condition and performance with the business model and economic purpose of the firm,” said Duke. “It is difficult for me to comprehend the value of an accounting regime that doesn’t make that link.”

- Duke added, "As a regulator, I focus on the viability of individual financial institutions and the financial system as a whole. To be frank, it has been frustrating to try to assess that viability when the value of an asset is based on the nature of its acquisition rather than the way in which it is managed or the way in which its economic value is likely to be realized" In terms of relevance, the measurement principle in GAAP for financial instruments should reflect the manner in which entities actually use the instruments, she said. "In this regard, the business model and risk management approach—as well as the way in which the value of the instrument itself is likely to be realized—should be factored into the measurement determination. … Admittedly, some have used the business model argument to manipulate accounting results. But the actions of those entities do not diminish the relevance of the business model to the measurement principle."

- At a September 15th IASB-FASB roundtable on financial instruments, ISAB member James Leisenring said he views the business model argument "as a euphemism for free choice." He added, "I think the business model is not relevant to the objective." (*Bureau of National Affairs*, Steve Burkholder, 09/16/09)

- On September 10th, the American Bankers Association warned that efforts of the IASB to revamp financial instrument accounting by yearend 2009 "would undermine the G-20's efforts to strengthen the financial system." In a letter to Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernanke, the ABA endorsed the September 5 communiqué of the Group of 20 finance ministers and central bank governors on banking, in which they reaffirmed their earlier commitment to move forward with global convergence on "a single set of high-quality, global, independent accounting standards on financial instruments, loan-loss provisions, off-balance sheet exposures and the impairment and valuation of financial assets"

- However, the ABA warned that the actions of the IASB and FASB on reforming financial instrument accounting that appear to address the G-20 recommendations are actually at odds with those recommendations. Specifically, the accounting boards' moves to expand the use of fair value accounting for more types of financial instruments threatens to increase the pro-cyclical impact of accounting standards, undermine the relevance of the banking business model, disrupt international convergence efforts, and institute wholesale changes where more targeted changes are being neglected, said ABA. (*Bureau of National Affairs*, 09/11/09)

Shadow Financial Regulatory Committee proposes ways to reduce interference with accounting standards

- In a September 14th statement the Shadow Regulatory Committee said, "Throughout the financial crisis, the two major accounting standard setters—the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)—have been under strong pressure to account for and accommodate concerns of financial regulators about financial stability and procyclicality in the design of the accounting rules. The Committee is concerned about these pressures as they lead to increasing interference with independent accounting standard setting and the purpose of financial reporting. In the Committee's view, it is preferable to separate accounting standard setting and financial reporting from measuring regulatory capital for financial institutions. Accounting standards and regulatory standards have different objectives and goals. Accounting standards serve the informational and contractual needs of investors in all public companies. Regulatory standards apply to financial institutions and are aimed at ensuring the safety and soundness of the financial system. At times, these two objectives may be in conflict. This conflict is most evident in the measurement of a firm's capital in a crisis. During these times, financial regulators may be inclined to be more lenient with loan loss provisions or write-offs while investors may prefer timely loss recognition."

- "…Separating accounting standards and regulatory capital requirements would have several principal advantages. First, it does not compromise financial accounting for investors. Second, it makes regulators' deviations from GAAP transparent and hence regulators accountable for explaining these deviations for regulatory capital purposes. Third, it permits regulators in individual countries to tailor their definitions of regulatory capital and capital adequacy to the needs of their financial system without interfering with accounting standard setting. This in turn would make the convergence of international accounting standards less political and contentious."

- "These aforementioned principles are particularly important in light of the fact that the G20, the Financial Stability Board and various prudential regulators have made capital requirements the centerpiece of their blueprints for regulatory reform. The effectiveness of capital requirements depends crucially on the proper valuation of assets and liabilities, including timely impairments. But reliable valuations are hard to come by when markets are in turmoil". (*Statement No. 277 of the Shadow Financial Regulatory Committee*, 09/14/09)

Fannie Mae

Fannie Mae's mortgage portfolio grew 18% in July

- In July, Fannie Mae's retained mortgage portfolio fell at an annualized rate of 18%, dropping $13.2 billion to $779.4 billion. The company continued to expand its mortgage guarantee business in July, increasing the volume of mortgage-backed securities that it backs at a 6.5% annualized rate to $2.8 trillion. The company's loan which were delinquent 90 days or more rose 26 basis points to 3.94% in June, the latest data available. (*Bloomberg News*, Dawn Kopecki, 08/28/09)

Terry Edwards named Fannie's EVP, Credit Portfolio Management

- Fannie Mae CEO Mike Williams has appointed Terry Edwards to serve as the company's new EVP, Credit Portfolio Management, responsible for the company's foreclosure prevention and loss mitigation activities for its single-family book of business. His duties will include executing the Making Home Affordable program, managing Fannie's real estate owned and loss mitigation activities, ensuring collection and preservation of credit enhancements, and overseeing the GSE's servicing guidelines and policies. Formerly, Edwards was the president and CEO of PHH Corporation. (*Fannie Mae Press Release*, 09/16/09)

Fannie Mae to offer "quicker" cash for MBS purchases

- In an effort to support the housing market, Fannie Mae will expedite its help to warehouse lenders that provide funding to small lenders, said Fannie Mae CEO Michael Williams. "We're providing faster funding to lenders so that they get cash immediately at closing to continue funding loans." (*HousingWire*, Austin Kilgore, 09/11/09)

Curious…

- Four days after Bank of America's shareholders voted to approve the merger with Merrill Lynch, Timothy J. Mayopoulos, the bank's general counsel, was told by the chief risk officer that he was no longer needed at the company. As general counsel, Mayopoulos was responsible for advising the bank on its disclosure decisions. Mayopoulos was terminated the day that BofA's management informed its board of directors that Merrill's losses increased at an unexpected pace. Upon notification of his termination, Mayopoulos was immediately escorted out of the bank's building and not allowed to return to his office. Mayopoulos now serves as Fannie Mae's general counsel. In a February 2nd recommendation letter, Bank of America said he had served “with distinction throughout his tenure with the company.” (*New York Times*, Louise Story, 09/096/09)

Sweetest deal ever

- According to the Federal Housing Finance Agency, lawyers defending former CEO Franklin Raines, CFO J. Timothy Howard, and comptroller Leanne Spencer have received $6.3 million for defending the three executives in lawsuits since the company was placed in conservatorship on September 5th through July 21st. Specifically, the taxpayers have spent $2.43 million to defend Raines, $1.35 million to defend Howard, and $2.52 million to defend Spencer. The agency has paid an additional $16.8 million over the period to cover legal expenses of OFHEO’s workers associated with defending the regulator in litigation against the former Fannie executives.

- The information on FHFA’s legal expenses was requested by Representative Alan Grayson (D-FL), who questioned if there are any legal options under the conservatorship to stop paying the former executives’ legal fees. “When did Uncle Sam become Uncle Sap?” asked Grayson. In a situation where billions of losses have already occurred, is it really asking too much that people pay their own legal bills? …It is wrong in a very deep sense. The essence of our society is that people who do good things are rewarded and people who do bad things are punished. Where is the punishment for Raines, Howard and Spencer? There is none.” (*New York Times*, Gretchen Morgenson, 09/06/09)

- On CNBC’s September 8th *Squawk Box*, host Joe Kernen said, “We now know the greatest job in the world was Franklin Raines’ job [as Fannie’s chairman and CEO]… To leverage 100 to 1, too big to fail, a part of the government, make your compensation a percentage of some of what you’re able to drive, cook the books on top of it all, and be covered by the U.S. taxpayers. That was the sweetest deal ever.” (*Squawk Box*, Joe Kernen, 09/08/09)

Freddie Mac

What a difference a year makes

- *Fortune Magazine* notes, “The top returning Fortune 500 stock over the past year is, ironically enough, Freddie Mac. The irony lies in the fact that the government’s seizure last September of the mortgage purchaser and its big sister Fannie Mae kicked off the most turbulent month in the financial markets since the Great Depression. Taking over the companies didn’t just tip Fannie and Freddie shares into free fall. It also sent shock waves through the financial system, as dozens of banks and insurance companies were left with big losses on preferred shares of Fannie and Freddie they had viewed as safe.”

- “When Lehman failed a week later, Fannie and Freddie shares had a head start in the race to the bottom that many other giant financial firms, from AIG to Wachovia and Washington Mutual, would soon join. Since then, shares of Freddie are up 367%. Fannie Mae was No. 3, returning 167% over the year ended September 15, 2009.”

- “Yet even after those gains—much of the increase coming during the manic cheap-stock rallies this summer—shares of Freddie were trading recently for only $1.87 each and those of Fannie were fetching just $1.60. Given the tens of billions of dollars of federal aid the companies have received, *many analysts doubt the shares will hold even that value for long.”* FBR Capital Markets recently issued a report saying there is “no fundamental value remaining” in Fannie Mae’s and Freddie Mac’s shares. *(Fortune* Magazine, Colin Barr, 09/18/09; *Wall Street Journal*, Nick Timiraos, 09/02/09)

- As a result of the GSEs’ recent price appreciation, Fannie Mae’s and Freddie Mac’s shares averaged above $1 for the month of August, meeting the NYSE’s minimum listing requirements and avoided being delisted. (*Bloomberg News*, Dawn Kopecki, 09/05/09)

Ginnie Mae

House passes resolution to modernize the FHA and promote warehouse lending

- On September 15th, the House of Representatives passed a House Resolution 3146 which would make legislative changes to make technical correction to Housing and Economic Recovery Act and facilitate increased warehouse capacity for qualified warehouse lenders. Specifically, the resolution provides FHA the authority and funding needed to hire and train qualified staff and would require the HUD to continue to review new mortgages that become 60 or more days delinquent within the first 90 days of origination. The bill also calls on HUD, Treasury and the Federal Housing Finance Agency to provide financial support and assistance through recent economic recovery legislation to support the flow of credit and lending by warehouse lenders to mortgage lenders. (*Housing Wire*, Austin Kilgore, 09/15/09)

Ginnie Mae sets record in reverse mortgage MBS issuance in August

- In August, Ginnie Mae set a record of $1.9 billion in its issuance of mortgage-backed securities backed by reverse mortgages, up from $853 million in July. Ginnie Mae securitizations of Home Equity Conversion Mortgages increased, after Fannie Mae, the biggest investor in FHA insured HECMs, increased its margins in March by 50 to 75 basis points.

- In aggregate, Ginnie Mae issued a total of $44.7 billion in mortgage-backed securities in August, down 3.3% from its record of $46.2 billion in July. "The importance of Ginnie Mae in the current economic environment cannot be underestimated," said Ginnie Mae's acting EVP Thomas Weakland. "The stability provided by a government-backed security program is critical to bring liquidity to our nation's housing market." (*National Mortgage News*, 09/11/09; *HousingWire*, Austin Kilgore, 09/14/09)

- On June 30th, roughly 8,500 insured banks and thrifts held $113.5 billion of Ginnie Mae mortgage-backed securities, up 176% from $41 billion a year earlier. Under the banks' regulatory capital rules, Ginnie Mae securities have a risk weighting of 0% versus 20% for MBS backed by Fannie Mae and Freddie Mac and 50% for privately-issued MBS. "With the pressure for capital, that's really made the Ginnie Maes more attractive," said John C. Clark, CEO of First State Bank in Union, TN. Eddie Creamer, CEO of Prosperity Bank [St. Augustine, FL], said, "There's no more risk in Fannie and Freddie securities than in a Ginnie Mae security [despite the capital difference]. It has a broader implication on the availability of those mortgages and the costs of those mortgages." (*Wall Street Journal*, David Enrich, 09/10/09)

Proposed National Infrastructure Bank

Obama administration urges Congress to create an Infrastructure Bank

- In a Statement of Administration Policy, the Obama administration wrote, "The administration encourages the Congress to support the creation of a National Infrastructure Bank and not substitute in its place a national infrastructure grant program in conjunction with increases for transportation infrastructure credit. Once established, a Bank will help forge a new path forward in infrastructure sponsorship and cross-jurisdictional partnership. The Administration looks forward to working with the Congress as soon as possible to authorize a National Infrastructure Bank, which could blend grant and credit financing. The Bank will play a key role in supporting regionally and nationally significant, high-value, multi-modal projects selected on the basis of merit." (*Statement of Administration Policy for H.R. 3288—Transportation, Housing and Urban Development and Related Appropriations Act, 2010*, September 10, 2009).

Farm Credit System / Farmer Mac

As U.S. farms' profits fall, regulators appear to brace for more failures of ag-focused banks

- The Department of Agriculture projects that net farm income for 2009 will decline 38% from last year to $54 billion, largely because of falling commodity prices. On balance, dairy farmers are losing money on every gallon of milk produced, cattle and hog farmers are breaking even, and the exuberance for ethanol has tempered, as export demand has declined. The sector's lower income may also signal a second straight year of lower farmland values, which declined 3.2% in 2008, following 21 years of gains.

- Regulators appear to be bracing for more failures of ag-focused institutions, following the April 10th failure of New Frontier Bank in Greely, Co, one of the nation's largest lenders to dairy farmers. John Blanchfield, SVP of the American Banker's Center for Agriculture and Rural Banking, said the FDIC is in talks with his trade group to help train examiners on structuring farm workout loans. Without a broad economic rebound, bankers and farmers are concerned that demand for agricultural products will continue to weaken and prices will continue to fall, which will result higher delinquencies. The retrenchment in the agriculture sector is already discernable, with demand for direct operating loans from the Farm Service Agency—"the lender of last resort"—increasing 81% for the first eight months of FY2009 relative to the same period last year, according to the Congressional Oversight Panel for TARP. Over the same period, demand for direct ownership loans from FSA has increased 132%. (*American Banker*, Anthony Malakian, 09/10/09; *Bloomberg News*, Alan Bjerga, 08/27/09)

U.S. biofuel boom appears to be running on empty—but taxpayer subsidies continue

- With 66% of the U.S. biodiesel production capacity sitting unused, the biofuel revolution that promised to reduce the country's reliance on foreign oil appears to be fizzling out. The global credit crisis, coupled with a glut of capacity, lower oil prices, and delayed changes in the government rules on fuel mixes, are threatening the viability of biodiesel and the next generation of fuels derived from food stocks. Critics of the biofuel industry point to government support, which helped create the current situation. In 2007, biofuels [including ethanol] received $3.25 billion in subsidies and support—more than nuclear, solar or any other energy source. With new stimulus funding, the New Energy Finance Ltd. estimates that blending mandates alone will provide over $33 billion in tax credits to the biofuel industry through 2013. (*Wall Street Journal*, Ann Davis and Russell Gold, 08/27/09)

- In a September 12th letter to the editor of the *Wall Street Journal*, C. Larry Pope, president and CEO of Smithfield Foods, Inc., wrote, "Using a food source like corn to make fuel doesn't make economic or environmental sense. Yet American ethanol is still made primarily from corn, a staple in our food supply and the main ingredient in feed for livestock, even though nonfood alternatives are available."

- "The federal policy that drives more than 30% of our corn into ethanol led to a nearly 200% increase last summer in the price of corn. This is driving the livestock farmers who are raising the cattle, chickens and pigs that are vital to our food supply out of business. This situation will become more severe if the Environmental Protection Agency spurs greater use of corn for fuel by boosting the allowed level of ethanol in gasoline blends to 15% from the present 10%. This would be in addition to the distortions to the market caused by a 54-cent-per-gallon tariff on importation of foreign ethanol made from non-corn feedstock, and a 45-cent-per gallon tax credit for ethanol blenders."

- "I favor biofuels as part of an overall energy strategy. However, as the CEO of one of our country's largest providers of meat, I have a front-row seat to the problems, especially the havoc caused by our outdated, ill-considered, politics-driven policies that are propping up a corn-ethanol industry that can't economically sustain itself. The result of these actions? More small farmers will fail, the price of corn will remain artificially high and consumers will face higher food costs for the meat on their table, their breakfast cereal and the Coke they drink. These policies have failed to protect the environment or reduce our reliance on foreign energy sources." (*Wall Street Journal*, C. Larry Pope, 09/12/09)

- In a September 18th letter to the editor of the *Wall Street Journal*, Bob Dicky, president of the National Corn Growers Association, wrote, "…As CEO of a giant agribusiness, Mr. Pope should know that ethanol is good for farmers because 95% of the U.S. corn supply grows on family-run farms that depend on prosperous and stable markets for their crops. At a time when modern food companies such as Smithfield face so many challenges and critics, Mr. Pope and his company should partner with their farm colleagues instead of launching senseless attacks. "(*Wall Street Journal*, Bob Dicky, 09/18/09)

Postal Service

House passes measure that would lower USPS payments for future health care benefits by $4 billion for FY2009

- In a speech to the mailing industry, Postmaster General John E. Potter, said, "[The USPS is] working closely with Congress and the administration on initiatives that are critical to the future of our business. We are seeking legislation in three key areas. The first would reduce the immediate financial strain resulting from a law that increased our costs by more than $5 billion a year beginning in 2007 to prefund retiree health benefits. With more than 450,000 retirees, the Postal Service has already set aside a reserve that's essentially sufficient to fund these benefits for each of their lifetimes. I am optimistic that Congress will act on this issue—which does not require the appropriation of any funds— particularly after the House overwhelmingly passed H.R. 22 yesterday **[**which would lower the payment the USPS must make to a trust fund intended to pay for future retiree health benefits to $1.4 billion from $5.4 billion for FY2009]. We will now work with the Senate and Administration on this short-term action and then with the House, Senate and Administration on payments in future years."

- "Our next priority is legislation that would allow us to adjust the capacity of our system to bring it in line with reduced mail use....The law that created a self-supporting Postal Service some 39 years ago didn't come with all of the restrictions that are making it so hard to succeed today....[T]he status quo is unacceptable. The Postal Service must have the ability to manage its business, to adapt quickly to the needs of our customers and the marketplace. And our business model must change to reflect the reality of a volatile economy and a communications marketplace that's been undergoing a transformation as profound as anything that has ever happened before." (*USPS Press Release*, 09/16/09; *CQ Today*, Greg Vadala, 09/15/09)

Idle postal workers costing the USPS $50 million a year

- With mail volumes down more than 12% this year, the USPS is spending more than $1 million a week to pay more than 11,000 workers to sit in empty rooms and do nothing. The practice—called standby time—is averaging about 45,000 hours each week at a cost of more than $50 million per year. Under APWU union rules, the postal service's management is not allowed to lay off excess workers. In fact, union contracts prohibit the agency from even reassigning these employees to other facilities that have work for them.

- This year, more than 15,000 employees have spent time on standby—some for a few hours and others for entire shifts in conference rooms, break rooms and, occasionally, in 12 foot by 8 foot storage closets. "It's just a small, empty room," said one postal service employee. "It's awful. Most of us bring books, word puzzles. Sometimes, we just sleep." APWU president William Burrus said, "[The Postal Service] just instructs employees to report to these holding areas. The employees resent it. They can't work, they can't read, they just sit there." Burrus added, "[Standby time] is clear evidence that we have a surplus of employees. I hope our people accept the [postal service's] buyouts."

- Postal Service spokesman Mark Saunders said, "Thirty thousand employees—that's how much we're overstaffed. That's the big reason behind our incentives. …The majority of employees who are asking to leave right now, the work in our [mail processing plants which are having problems with standby time]. (*Federal Times*, Gregg Carlstrom, 09/07/09)

"Free" the mails—*and* the taxpayers

- In the August 28th issue of *The American Spectator,* Cato economists Chris Edwards and Tad Dehaven wrote, "Yet another giant company has plunging sales, soaring debt, and is weighed down by massive labor costs. Will taxpayers have to pay for another federal bailout? Alas, it's already in the cards because this company is the U.S. Postal Service, which has estimated losses of $7 billion this year."

- "With email grabbing ever more market share from snail mail, USPS's finances are steadily deteriorating. What should federal policymakers do? They can't give USPS the General Motors treatment and nationalize it, because it's already government-owned. And they can't reform postal markets with a 'public option' because that's what the USPS already is."

- "Instead, Congress and President Obama should deregulate postal markets and privatize the USPS. It's true that such pro-market reforms are not in vogue these days, but Obama claims that on economics, he doesn't want to 'get bottled up in a lot of ideology…my interest is finding something that works.' For postal reform, that means injecting competition by allowing 'private options' in the marketplace."

- "We know that postal deregulation works because it's already in place abroad. Postal services have been opened to competition in Britain, Finland, New Zealand, and Sweden. In those countries, private operators are starting to challenge former monopoly mail providers, particularly on business mail delivery. In Germany and the Netherlands, the main postal companies (Deutsche Post and TNT Post respectively) have been privatized, allowing them to expand into foreign markets and diversify their services. These two countries haven't yet leveled the playing field for competitor firms, but that reform should be coming soon. That's because the 27 member nations of the European Union have agreed to end their mail monopolies by either 2011 or 2013. Some countries are dragging their feet, but it appears that the wheels are in motion for the Europeans to soon have a much more dynamic postal sector than the United States."

- "An analysis by the Consumer Postal Council found that U.S. postal markets are the third most regulated among 19 countries examined. The main regulatory shackle is the USPS's legal monopoly over first-class mail. That restriction makes no sense in today's economy. It simply deprives consumers of the innovations and cost savings that could be brought to the mail business by entrepreneurs. The good news is that the choke-hold that the USPS has long had over personal and business correspondence has ended. USPS's mail volume peaked in 2006 and will probably never recover. These days, people communicate via email, text messages, and other electronic tools. The share of bills that U.S. households pay online is already 38 percent and rising fast."

- "The bad news is that we've still got a 700,000-worker behemoth to deal with. We can let entrepreneurs into the market to bring new efficiencies to letter delivery, but we still need to downsize the USPS. In most industries, businesses facing declining markets can radically cut costs and innovate to survive. But the USPS can't do that effectively because it is beholden to members of Congress and their parochial concerns."

- "Plans to close down some of USPS's 37,000 retail locations across the country are usually met with resistance on Capitol Hill as members defend the facilities in their states. [The Postal Service's proposal to close 700 mail facilities has been whittled to 413 by Congress over recent months.] And recently, the USPS floated the idea of cutting mail delivery to five days, but members haven't embraced that cost-cutting idea either."

- "At the same time, USPS managers try to avoid tough financial decisions. Right now, for example, the USPS is asking Congress to suspend a legal requirement that it pre-fund its huge unfunded health care liability. However, that would just dig a deeper financial hole for the organization down the road."

- "And then there is USPS's difficulty in cutting its massive labor costs. The average USPS worker earns $83,000 per year in compensation, as union deals have delivered regular wage and benefit increases over the years. The [GAO] recently noted that 'compensation and benefits constitute close to 80 percent of USPS's costs—a percentage that has remained similar over the years despite major advances in technology and the automation of postal operations.'"

- "A privatized USPS would have the incentive and freedom to tackle such long-standing inefficiencies. At the same time, competitor firms would give households and businesses alternatives to the USPS's regular postal rate increases. It's time to end America's last great monopoly and free the mails." (*American Spectator*, Chris Edwards and Tad Dehaven, 08/28/09; *Raleigh News and Observer*, Matt Ehlers, 09/03/09)

TVA

President Obama nominates Dr. Barbara Haskew and Neil McBride to serve on TVA's board of directors

- President Barack Obama has nominated Dr. Barbara S. Haskew, professor of economics at Middle Tennessee State University, and Neil McBride, the general counsel for the Legal Aid Society of Middle Tennessee, to serve on TVA's board of directors. Haskew, who has taught at MTSU for 20 years, was formerly with TVA for eight years, serving as a manager of wholesale and retail rates. McBride, who served on TVA's first long-term planning advisory panel in the 1990s, previously worked for Ralph Nader as a public interest advocate in Washington. If confirmed by the Senate, the nominees would fill two of the four vacancies on the nine-member board. (*Chattanooga Times-Free Press*, Dave Flessner, 09/10/09; *Knoxville News-Sentinel*, Michael Collins, 09/11/09; *The Tennessean*, Anne Paine and Bill Theobald, 09/11/09)

- In an Associated Press interview, Neil G. McBride said he has been surprised by how little has changed at TVA since the 1970s, when the utility's problems included poor decision-making practices, environmental issues arising from the use of coal, and modest programs to reduce electricity demand. "The whole question of TVA culture, how they look at long-range environmental issues and the appropriate way of dealing with energy efficiency at the residential level—those are clearly [problems that] are clearly unresolved," said McBride. (*Associated Press*, Erik Schelzig, 09/12/09)

IG determines that Representative Shuler *did* contact TVA about obtaining a permit for his lakefront development project

- A TVA employee *falsely* told the agency's inspector general that Representative Heath Shuler (D-NC) had not contacted the utility about a lakefront development permit for The Cove at Blackberry Ridge, in which Shuler was an investor. "[The employee] denied knowing Shuler held an ownership in Blackberry despite evidence he was fully aware of the ownership status," said the IG. "[The employee also] denied Congressman Shuler had contacted TVA about Blackberry's [dock] application. However, an internal e-mail shows [the employee] knew or should have known otherwise." Shuler, who invested in the Blackberry development before he was elected to Congress in 2006, was appointed to the House Transportation Committee's Subcommittee on Water Resource and the Environment, which has oversight of the TVA.

- For the first time, the IG's report says that Shuler had some contact with TVA about a lakefront marina permit application submitted by a company that he partly owned. "I believe the inspector general's own words show that Mr. Shuler did have contact during the land swap process, disproving what [Representative] Shuler has said," said

Robert Danos, Henderson County's Republican Party chairman. "[Representative] Shuler did get involved and he owes an immediate explanation to the voters."

- The allegation that the employee provided false information to the IG was the subject of a subsequent inquiry by the IG, according to a report released to the *Knoxville News Sentinel* under the Freedom of Information Act—one of two reports the newspaper has sought. The second IG report, which has been sent to the House Ethics Committee, has not been released. Danos predicts the second IG report will demonstrate Shuler was more involved in the application process. "The report from the inspector general proves he did wrong," Danos said. "And we will learn he did more wrong if and when the ethics report is released."

- On September 16th, Shuler's office released a statement saying he "stands by his previous position that he has never used or intended to use his position in the U.S. House of Representatives to improperly influence anyone for personal gain." Shuler's statement appears to contradict the conclusion in a report released by TVA's inspector general and "further clouds a complex and politically charged issue" wrote the *Knoxville News-Sentinel*.

- TVA is postponed making any decision on the Cove at Blackberry Ridge's application until after the House Ethics Committee finishes reviewing the documents and makes a decision. TVA's senior vice president of communications, David Mould, told the *Knoxville News Sentinel* that the employee who was the subject of the inquiry had resigned. He said he could not say whether the resignation arose from the IG's report. (*Times-News* [Hendersonville, NC], James Shea, 09/16/09; *Knoxville News-Sentinel*, Bill Theobald, 09/17/09; *Associated Press*, Duncan Mansfield, 09/16/09)

TVA pledges $40 million to help clean up Roane County, site of the coal ash spill

- As TVA continues its removal of coal ash sludge, the utility has pledged $40 million in funding for projects to help clean up Roane County's image as an environmentally tarnished community. "Our image was broken," said Harriman Mayor Chris Mason, "and this is one way to start moving forward." The TVA and county leaders have announced the formation of the Roane County Economic Development Foundation to administer the funds, which consist of four TVA representatives and four elected officials. (*Knoxville News*, Ed Marcum, 09/15/09)