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Major Events

Mortgage rates fall to lowest rate in 37 years

- The average rate on 30 year fixed-rate mortgages fell for the ninth straight week to 5.10% for the week ending December 31st, marking the lowest rate in the 37-year history of Freddie Mac's mortgage survey. Rates on 15-year fixed rate mortgages averaged 4.83% for the last week December, its lowest level since March 25, 2004. To obtain these rates, borrowers are paying, on average, up-front points of 0.7%. "As a result, the number of refinance applications for conventional mortgages jumped over 500% between the weeks ending on Oct. 31 and Dec. 26," said Frank Nothaft, Freddie Mac's chief economist. According to the Mortgage Bankers Association's weekly survey, overall mortgage applications were up 155% the week of December 22nd with nearly 83% of all mortgage applications made to refinance existing loans.
- The dramatic decline in mortgage rates is attributed to aggressive actions taken by the Federal Reserve, which slashed their targeted federal funds rate to an unprecedented range between zero and 0.25% [on December 16th] and highlighted in its Federal Open Market Committee statement the central bank's plans to purchase \$100 billion of debt and \$500 billion of mortgage-backed securities from the housing GSEs over the next few quarters. A senior official said the Fed "stands ready" to exceed the \$100 billion and \$500 billion thresholds, if further purchases were needed to help lower mortgages rates. The central bank is also exploring whether to buy longer-term Treasury securities but has made no decision on the terms of such a purchase, the official added.
- "The Fed is taking the most extraordinary of actions that they possibly can take," said Joel Naroff, the president and chief economist for Naroff Economic Advisors. "They've basically said that they'll do whatever is needed to be done. They'll spend any amount of money, they'll create any market, [and] they'll expand their balance sheet in any way that is needed in order to keep us from falling into an extended, deep recession." Over the past three months, the Federal Reserve has expanded the use of the asset side of its balance sheet to stimulate activity in credit markets and aid the broader economy through asset purchases and lending arrangements like the Term Auction Facility, the Term Lending Securities Facility, and currency swap lines with foreign central banks. The practical effect on the Fed's actions is a broad expansion of its balance sheet, which totaled \$900 billion as recently as three months ago. Naroff guessed that the Fed's balance sheet would *at least double* from its current size of about \$2.24 trillion.
- "The situation is so dire that everyone was of the same opinion that we need to put out the big fire first and then worry about the rest," said Sung Won Sohn, an economist at California State University. "The risks here are not just of a minor contraction, but possibly a repetition of the lost decade of Japan in the '90s or even

the Great Depression. The consequences are so catastrophic nobody wants to take that chance."

- The Federal Reserve's action will help 30-year mortgages hold steady at around 5% or less over the next few months, said Lawrence Yun, chief economist for the National Association of Realtors. "The Fed is providing an additional buyer for the MBS, increasing demand for them and lowering rates," he said, which should eventually boost the housing market. The full impact of the lower mortgage rates may not be felt for a while, he added. "When rates fall, people respond, but the increase in sales usually follows by three to five months." Observers hope that falling rates coupled with lower home prices, could portend a brisk spring selling season and rejuvenate the home real estate market. However, Yun is cautious in his optimism—"It's hard to dictate the confidence of consumers."
- In a research report, Barclays Capital analysts Derek Chen and Nicholas Strand wrote, "The potential size of the Fed's purchase program can take down most of the 2009 agency MBS net supply" and drive primary mortgage rates down to 4.5% and stimulate further refinancing activity. However, the analysts cautioned that a huge refi boom [last seen in 2003] isn't likely without looser underwriting. Further, the volume of warehouse credit providers has fallen from 30 to 10, raising concerns about the availability of an adequate warehouse capacity to handle a refinance boom. (*CNNMoney*, Les Christie, 12/31/08; *MarketWatch*, Amy Hoak, 12/31/08; *Bureau of National Affairs*, Aaron Lorenzo, 12/17/08; *Washington Post*, Neil Irwin, 12/17/08; *HousingWire*, Paul Jackson, 12/31/08; *HousingWire*, Diana Golobay, 12/22/08)
- Separately, the Federal Reserve announced that it has selected investment managers BlackRock, Inc., Goldman Sachs Asset Management, PIMCO, and Wellington Management Co., to act as government agents for the central bank's purchase of mortgage-backed securities, which is expected to begin in early 2009. (*Bureau of National Affairs*, Mike Ferullo, 12/31/08)
- On December 31, 2008, foreign central bank holdings of agency debt stood at \$814.5 billion, down \$171.4 billion from their record holdings of \$985.9 billion on July 17th. In November, the Federal Reserve stepped in to cover the recent shortfall in demand for agency debt, by launching a program to buy at least \$100 billion of direct obligations issued by Fannie Mae, Freddie Mac, and the FHLB System. (*American Banker*, 01/02/09; *Federal Reserve Statistical Release*, 07/17/08; *Federal Reserve Statistical Release*, 01/02/09; *Thomson Financial News*, 12/29/08)

FHFA and New York AG Cuomo revise the GSEs' appraisal agreement

- On December 23rd, New York Attorney General Andrew Cuomo and the Federal Housing Finance Agency revised their March 2008 agreement, establishing more stringent appraisal standards for mortgages purchased or guaranteed by Fannie Mae and Freddie Mac. The revised agreement requires mortgage lenders to follow a six-

page Home Valuation Code of Conduct (HVCC) for mortgage loans sold to Fannie and Freddie after April 30th.

- Under the HVCC, lenders' employees, directors, officers, and third party representatives are prohibited from influencing or attempting to influence “the development, reporting, result, or review of an appraisal through coercion, extortion, collusion, compensation, instruction, inducement, intimidation, bribery, or in any other manner,” including the threat to withhold future business. Under the code, lenders will be responsible for selecting, retaining, and providing payment for all compensation due to an appraiser and are prohibited from accepting any appraisal reports prepared by an appraiser compensated in any other fashion. Loan production staff members [other than the firm's general counsel and chief compliance officer] are prohibited from selecting, retaining, or influencing the selection of appraisers under the HVCC. Under the HVCC, lenders and appraisal companies must adopt written policies and procedures implementing the code, which will be examined annually by an external auditor or federal or state regulators.
- The revised HVCC allows lenders to use in-house appraisers or affiliated appraisal companies, so long the following conditions are met. Selected appraisers must report to a function of the lender “independent of sales or loan production” and cannot have “substantive communications” with loan officers and other employees involved in originating the loan. The lender or appraisal company cannot “provide the appraiser any estimated or target value of the property or the loan amount applied for” and the appraiser's compensation must not “depend in any way on the value arrived at in any appraisal or upon the closing of the loan for which the appraisal was completed.”
- Under the revised agreement, an Independent Valuation Protection Institute (IVPI) will be created to combat mortgage fraud and mediate mortgage lending disputes. Fannie Mae and Freddie Mac will fund the IVPI, which will man a telephone hotline and receive e-mails for any complaints “from appraisers, individuals, or other entities concerning the improper influencing or attempted improper influencing of appraisers or the appraisal process.” The HVCC exempts small banks with aggregate assets of no more than \$250 million, which Fannie and Freddie have determined will suffer hardships from the appraisal provisions.
- FHFA Director James Lockhart said, “The code strikes a balance of assuring enhanced protections for appraisers while maintaining lender ability to address unprofessional appraisal practices and to perform quality controls on appraisals received.” Cuomo said, “This revised agreement with Fannie Mae and Freddie Mac is a step forward: it preserves the core goals of ensuring appraiser independence and eliminating systemic conflicts of interest. It also incorporates common-sense suggestions of industry participants that increase flexibility and efficiency.”
- In a December 24th article at *HousingWire.com*, Paul Jackson wrote, “...[T]he revised code as it stands now probably won't change much about the day-to-day appraisal process—it no longer looks to force lenders to use outside appraisal management

firms, for example—but it does put new standards in place regarding how the appraisal process is to be managed, both within lenders and at appraisal management firms alike. It's clear that Cuomo, for whatever reason, backed off on much of the earlier fire-and-brimstone sort of talk that he had rained down on the appraisal business earlier this year.”

- The revised HVCC standards are expected to accelerate the use of appraisal-management companies (AMCs) of some kind, whether or not they are owned by the lender. "You're creating a situation where a lender is going to have to order a lot of appraisals from an AMC," said Jonathan Miller, the president and CEO the appraisal firm Miller Samuel Inc. Michael Carrier, an associate vice president at the Mortgage Bankers Association, said, "This will permit lenders and others to use their existing appraiser independence and quality control practices rather than mandate structural reorganization." However, a number of appraisers argued that the revised code would worsen the problem by driving the appraisal process through AMCs. "This would further commoditize appraisers and is counterproductive to solving the problem of collateral valuation," said Richard Maloy, chairman of the government relations committee for the Appraisal Institute. He cautioned that there are "safety issues" when a mortgage lender uses an AMC "as a profit center that is held captive."
- At least one group—the National Association of Mortgage Brokers—is threatening legal action against the revised agreement, which it calls "a de facto regulatory action which avoids the appropriate process." NAMB President Marc Savit argued, "This agreement will increase costs to consumers and remove thousands of small business competitors from the marketplace. This will create a severe disadvantage to small business mortgage brokers, and prevent them from engaging competitively in the mortgage marketplace." (*Reuters*, 12/24/08; *HousingWire*, Paul Jackson, 12/24/08; *American Banker*, Kate Berry, 12/30/08; *Bureau of National Affairs*, Mike Ferullo, 12/30/08; *HousingWire*, Paul Jackson, 12/29/08)

TARP

TARP gets stretched beyond its \$350 billion limit

- With its \$6 billion investment in GMAC, the Treasury Department has allocated \$358.4 billion of TARP funds from the \$350 billion authorized by Congress. According to a senior official, the agency was able to make the GMAC investment because over the short term, the department can redirect money that has been allocated but not yet invested. To date, Treasury has allocated \$250 billion to its capital purchase program; \$40 billion to AIG; \$25 billion to Citigroup; \$20 billion to a Federal Reserve facility to purchase asset-backed securities; \$17.4 billion to General Motors and Chrysler; and \$6 billion to GMAC. On December 31st, Treasury had distributed \$172 billion in capital to banks (69% of the CPP), \$40 billion to AIG, and \$5 billion to GMAC. Citigroup and the automakers expect to receive \$20 billion and \$13.4 billion, respectively, from Treasury “soon.” In February, the Federal Reserve expects to receive \$20 billion from TARP for its facility for asset purchases. The auto manufacturers will not receive the balance of the agency’s commitment—\$4 billion—until the second tranche of the TARP is released. By law, Treasury must request the remaining \$350 billion authorized by Congress and provide lawmakers 15 day to object. Publicly, Treasury Secretary Henry Paulson has called on Congress to release the second installment of the TARP funds, although department officials have not approached congressional leaders to request additional funding
- On December 17th, Paulson said, “In the very short term, the allocated but not yet disbursed Tarp balances, in conjunction with the powers of the Federal Reserve and the FDIC, give me confidence that we have the necessary resources to address a significant financial market event.”
- House Speaker Nancy Pelosi (D-CA) has said that she favors releasing the additional funding with restrictions. Specifically, Pelosi and House Financial Services chairman Barney Frank have said that they will not release the remaining TARP funds until Treasury agrees to use part of the funds for foreclosure mitigation. On December 19th, Frank said, “We should have an agreement among Obama, Paulson and the congressional leadership to release the \$350 billion with conditions on how it’s spent. We need the second \$350 billion, but it can only be done if there’s an agreement as to how to do it.”
- Frank has prodded the Treasury to use TARP funds to reduce foreclosures and hold the participating banks accountable for increasing their lending activities. The chairman said he will introduce legislation in January, which would (i) trigger TARP’s second tranche funding; (ii) require Treasury to adopt the FDIC’s foreclosure prevention plan, which provides a government guarantee for troubled mortgages to encourage loan modifications; (iii) use TARP funds to reduce upfront and annual fees required under the Hope for Homeowners foreclosure relief program and raise the

loan-to-value ratio on participating mortgages to reduce the lenders' losses and increase the number of participating lenders in program; (iv) require banks that participate in TARP's capital purchase plan to report on their new lending activities; and (v) require Treasury to strengthen its restrictions on executive compensation for firms that accept TARP funds. A number of lawmakers have voiced dismay that penalty provisions for excessive compensation in the Emergency Economic Stabilization Act are virtually meaningless, since they apply only to firms selling troubled assets to the government in an auction—an approach originally envisioned by Treasury, which was scrapped in favor of making direct equity investments, making the EESA's executive compensation limits essentially worthless. Subsequently, GAO issued a report, saying it was unclear how Treasury would determine if banks participating in CCP were following the agency's executive compensation rules it had issued. Treasury is working on a policy on how to enforce its compensation rules, but has not indicated when such guidance would be issued or indicated what penalties it might impose.

- Frank said he's also interested in including in the legislation a proposal to Fannie Mae and Freddie Mac to reduce 30-year, fixed rate mortgage loan rates to about 4.5% [from an average of 5.54%] and adopt a plan proposed by Harvard University economist Martin Feldstein, whereby the federal government would substitute a new loan with a lower interest rate for a portion of an existing troubled mortgage.
- There is significant opposition by members of both parties to the release the remaining \$350 billion of TARP funds. Representative Maxine Waters (D-CA) expressed the strongest opposition in a December hearing, saying to Treasury official Neel Kashkari: "Please don't come here and ask for another penny, because if you do, I'm going to work 24 hours a day with the same people that I worked with to support you to make sure that they do not support giving you another dime." In a December letter, House Republican leaders warned Paulson that they would oppose additional funding so long as Treasury continued to stonewall the lawmakers' request for additional information. "Such opaqueness is unacceptable," wrote the 12 Republican lawmakers. To date, the Republican leadership has not yet received a satisfactory response to their letter, said a spokesman for Minority Leader John Boehner (R-OH).
- While some argue that Treasury is being creative to avoid asking Congress for the second tranche, others contend that the agency is taking the necessary steps to address market conditions. "If you need the money ...you just shift the money around and make it available," said Gil Schwartz, a partner in Schwartz & Ballen LLP. "If you have \$20 billion not called upon until February, then you have \$20 billion to play with." Tim McTaggart, a partner with the law firm Pepper Hamilton LLP, dismissed the over-allocation as merely a technical issue. "I don't think it's that big of a deal in terms of money they've committed," said McTaggart, but cautioned it could anger the incoming administration. "[They] would not like to be put in a position of: You have no choice, you have to fund this \$8 billion in order for us to not renege on our commitments. That's not a very desirable position to be in. But the reality is, they

have so many things going on, you can see how they got into this position. They are doing what they can under emergency circumstances."

- "They are pushing the envelope here," said Senator Bernie Sanders (I-VT). "What they are trying to do is create a situation to put pressure on [President-elect Barack] Obama and the Congress to provide the next \$350 billion."
- The number of industries and sectors that are requesting government assistance continues to grow. The commercial real estate industry (CRE) is poised to take a steep dive in 2009 with commercial property defaults projected to triple due to the lack of available funding for maturing loans. Over the next three years, \$530 billion of commercial loans will be due to refinance with \$160 billion coming due over the next 12 months. CRE developers are asking Treasury to be included in the new \$200 billion Term Asset Backed Securities Loan Facility, recently announced a few weeks ago and likely to be up and running by February.
- Another sector that has been rocked by financial and economic turmoil is the municipal bond market, which threatens to dry up state and municipal revenues. According to *Reuters*, "U.S. states and local governments are heading into dangerous territory as a strained municipal market forces them to delay deals while fund managers worry that a lasting recession may lead to defaults." Since states can't print money for their obligations like the US government can, the federal system can either take on critical programs for schools, infrastructure, and social assistance or it can loan states and municipalities money which they are unlikely to be able to pay back for years. That is very different from banks or car companies. A state in receivership is a state which may be unable to educate its population or support the jobless and the homeless. The amount of money Congress will need to salvage the local government system is likely to be in the tens of billions of dollars. And, its money at real risk, which is why no one wants to buy municipal bonds. Governors from five U.S. states have urged the federal government to provide \$1 trillion to the 50 states to pay for education, welfare and infrastructure, as the states struggle to cope with steep budget deficits, now totaling an aggregate of \$100 billion for 43 states.
- The incoming Obama administration is working on transition plans for TARP, which sources say will incorporate a broader approach to address the financial crisis and would likely incorporate multiple remedies. According to a source, the new administration is "is trying to put components together that...will be complementary...while recognizing there's no easy answer." Among the items being discussed is the injection of more capital into banks, the creation of a market for illiquid assets that are clogging the books of financial institutions, and providing troubled borrowers assistance in making their mortgage payments. The team also hopes to avoid the criticism leveled at the Bush administration for not having a consistent strategy to address the financial crisis by developing a cogent explanation of the rationale behind their approach to the process. In contrast to the Bush administration, Obama team sees helping troubled homeowners, who are facing foreclosure, as a critical element of its financial crisis rescue plan. "We are looking at

a number of initiatives that will allow us to move aggressively and responsibly to address the economic and financial crisis both on Wall Street and Main Street, including programs to provide targeted foreclosure relief," said Obama spokeswoman Stephanie Cutter. (*Bloomberg*, Alison Vekshin, 12/19/08; *Wall Street Journal*, Michael R. Crittenden, 12/31/08; *American Banker*, Cheyenne Hopkins, 12/31/08; *Washington Post*, Binyamin Appelbaum, 12/31/08; *Washington Post*, Lori Montgomery and David Cho, 12/16/08; *Washington Post*, Amit R. Paley, 12/15/08; *Bureau of National Affairs*, Brett Ferguson, 12/18/08; *Bureau of National Affairs*, Steven Joyce and R. Christian Bruce, 12/15/08; *Wall Street Journal*, Deborah Solomon, 12/17/08; <http://www.247wallst.com>, Douglas A. McIntyre, 01/02/08; *Reuters*, Jon Hurdle, 01/02/09; *Bureau of National Affairs*, Kate Naseef, 01/02/09)

Good money after bad?

- In a December 31st editorial, the *Wall Street Journal* wrote, "...Within hours of receiving a \$5 billion lifeline from the U.S. Treasury on Monday, GMAC—the financing arm of General Motors—slashed its car-loan rates and lowered its lending standards to help GM sell, sell, sell. As of Tuesday, GMAC was offering 0% financing on several models—hey, if 0% is good enough for Ben Bernanke, it's good enough for you—and said it would extend credit to buyers with credit scores as low as 621—right on the edge of subprime territory. The median credit rating is 723."
- "... Monday's bailout of GMAC, inevitable as it was, shows that the federal government has now waded so far into auto maker business that it's easier to keep marching forward than to pull back. Take GMAC's capital structure. GMAC hasn't said whether it has secured the approval of enough of its bondholders to convert their debt into equity and to satisfy the demands of federal regulators that they do so. As of late last week, it was far from obvious that GMAC would clear this hurdle. But the Federal Reserve blinked anyway and approved its application to convert into a bank holding company."
- "That conversion, in turn, is supposedly necessary to make GMAC eligible for the Troubled Asset Relief Program funds it received Monday night. But if the auto makers are themselves eligible for the TARP, why should Mr. Paulson stand on ceremony when it comes to GM's financing arm? A healthy GMAC is, we are told, essential to a healthy GM, and a viable GM is needed to avert auto Armageddon, so a little thing like reducing GMAC's debt load isn't going to stand in Mr. Paulson's way."
- "This is not to say there aren't other awkward questions for our new public-private automobile complex. For example, Treasury has now twice driven to the rescue of Cerberus, the huge private-equity group that owns 51% of GMAC. Under the terms of the bank conversion, Cerberus will have its ownership diluted and will have to sell

down its stake in GMAC to 33%. GM, which owns the other 49% of its formerly captive financing arm, will have to sell all but 10% of GMAC and give up its seats on the board. But Cerberus's 33% of a bailed-out GMAC is still worth more than 51% of a bankrupt GMAC. As with the Chrysler bailout, taxpayers have a right to ask why Cerberus is being saved without having to contribute more to the rescue.”

- “Meanwhile, some of the vehicles on which GMAC is offering its 0% financing are those nasty, gas-guzzling SUVs that Washington loves to hate. Will Nancy Pelosi stand for this when Congress returns next week? Will those car designers at the Sierra Club insist that the best terms go to the most environmentally conscious vehicles? On second thought, forget we asked.”
- “With taxpayer interests now welded to Detroit at the axle, Mr. Paulson is only doing what every auto dealer in America does six days a week. GMAC says the best incentives end January 5, so don't delay—you'll be paying for those cars one way or another. As the best car salesmen like to say, what can we do to put you in this car today? We'll just check with Hank over in finance...” (*Wall Street Journal*, 12/31/08)
- On www.247wallst.com, Douglas A. McIntyre wrote, “The mathematics of the US car company bailout are simple. At least the car companies say that they are. Expenses get cut. Labor costs go down to what they are for Japanese auto firms operating in the U.S. Creditor costs get chopped as debt is traded for equity. The failure of the GMAC debt swap program shows that not everyone will go along with that. The final piece is that suppliers take a haircut.”
- “On the revenue side, things are even less complex. The U.S. car companies have given Congress a plan that assumes that they will keep their market shares in an industry that will produce at least 12.5 million vehicles sales each year. December sales numbers show that this forecast is completely flawed. According to Edmunds, vehicles sales will fall below 13 million for 2008. That is down 17% from 2007. The rate of the drop-off is expected to be closer to 38% in December, which means the fall-off is accelerating. If last month's numbers are the standard for next year, total vehicles sales could drop below 10 million. While no one wants to believe that is true, no one wanted to believe that the current recession is the worst since WWII. Ford recently told analysts that it expects sales for the industry to drop another 20% to 30% in the first quarter of this year.”
- “The American car industry may be reshaping itself for a world based on wild optimism. If so, the government will be back into the bailout business for much more than the \$37 billion the industry is seeking. If two million vehicle sales disappear next year, \$50 billion in revenue could go out of the domestic market. US companies have about half of that. Chrysler's sales are expected to drop 46% for December. If that holds true for the first quarter of next year, the company is dead. GM and Ford sales are expected to be off by between 30% and 40%. “

- “The new administration needs to put another \$25 billion or more in its auto industry rainy day fund. That is what Detroit will need after it spends the \$37 billion it has already asked for. If 2009 shows no recovery, the figures gets even larger.”
(<http://www.247wallst.com>, Douglas A. McIntyre, 01/02/08)

<p>American Bankers Association endorses use of TARP funds to facilitate FDIC-structured loan modifications</p>

- In a December 11th letter to the FDIC and Treasury Department, the American Bankers Association proposed a two-part approach to modifying mortgage loans, using TARP funds to support loan modifications combined with regulatory exemptions to prevent snags for lenders that work with borrowers. ABA president and CEO Ed Yingling wrote, “We believe that many more borrowers can be helped if the FDIC model were made available nationwide.” Funds from TARP are “both legally and logically the proper source of funding for this program,” Yingling added. ABA also recommended giving lenders a second option for working with loans in default. Under this option, the FDIC would guarantee against default after three months of on-time payments [rather than six months] with “an appropriate and corresponding reduction in the level of the guarantee.” The ABA also suggested that FDIC clarify that it will not have a claim on proceeds from PMI insurance obligations “intended to support lenders and investors, at least in part, during the modifications.”
- Yingling recommended that the FDIC and Federal Reserve Board give bankers explicit exemptions under the Truth in Lending Act to avoid technical violation of TILA provisions governing further extensions of credit. “Lenders may fear TILA class actions unless it is made explicit that modifications under the FDIC program, including those in which missed payments are capitalized, do not require additional TILA disclosures,” wrote Yingling. He also asked the FDIC to address complications posed by second liens and urged the SEC to work with FASB on accounting rules governing loan modifications and their impact on other loans in the portfolio.
- Administration and Federal Reserve officials have raised questions about whether the FDIC loan modification program is the most effective way to help homeowners. In recent testimony before Congress, Federal Reserve chairman Ben S. Bernanke said that the government could end up paying vast amounts for homeowners’ residences whose values have fallen substantially—suggesting that the underlying value of the home must be considered along with the borrower’s income level. Treasury Secretary Henry Paulson has repeatedly argued that the FDIC plan and similar proposals don’t do enough to distinguish between borrowers who could be helped to stay in their homes and those who are destined to default because their incomes and mortgage terms are hopelessly mismatched. Treasury spokeswoman Michele Davis said, “We would not want to put something in place this close to Inauguration Day unless it is something the next administration wants to carry out.” (*Bureau of National Affairs*, R. Christian Bruce, 12/16/08; *Washington Post*, Lori Montgomery and David Cho, 12/16/08)

The net cost of the initial bailout: \$4.6 billion

- In a December 5th report to Congress, the Office of Management and Budget said the government expects to recover almost all of the \$115 billion in initial outlays made by Treasury through November 6th through the agency's capital purchase program in eight major financial institutions under the Emergency Economic Stabilization Act of 2008. On a cash-in, cash-out basis, OMB projected a net cost of \$111.1 billion in 2009 which would mostly be offset in later years, as the stakes were repurchased by the banks or sold by the government. With most of the redemptions taking place in 2012 and 2013, the report projected a net loss of \$4.6 billion—or 4%—over the 2009-2018 period from the initial \$115 billion outlay. In addition, OMB calculated the NPV of Treasury's \$115 billion outlay. Using a government discount rate of 3.84%, OMB determined that the agency's outlay would turn a profit of \$12.6 billion (11% return) over the life of the investment. Using a market risk discount rate of 8.79%, Treasury's initial outlay would post a \$25.5 billion (22%) loss on investment.
- The Congressional Budget Office and some outside budget experts argue that the TARP law requires that cost of the program be calculated using a net present value analysis, because the cash basis artificially inflates the deficit when the initial spending occurs and artificially depresses the deficit when the asset sales occur. Instead, CBO argues that a net present value analysis would attempt to put a price tag on the program, by using estimates of current and future costs and netting them against revenues for a single cost figure for budget purposes. Peter Orszag, the former head of CBO, has been designated by President-elect Obama to head OMB, leading to speculation that the OMB's accounting treatment of TARP may change. (*Bureau of National Affairs*, 12/29/08)
- Separately, House Speaker Nancy Pelosi has announced her intention to appoint Douglas W. Elmendorf as the next director of the Congressional Budget Office. Elmendorf, who is currently the director of the Hamilton Project at the Brookings Institute, has taught at Harvard, worked at CBO, the Federal Reserve, and served as an economist during the Clinton administration at the Council of Economic Advisors and the Treasury Department. (*Bureau of National Affairs*, 01/02/08)

Treasury finds it difficult to monitor the banks' use of capital purchase program funds

- In a December 30th letter to Elizabeth Warren, chairperson of the Congressional Oversight Panel, Neel Kashkari, interim assistant secretary for financial stability, said it was challenging for his agency to track the participating banks' use of the capital purchase program (CCP) funds. "Each individual financial institution's circumstances are different, making comparison's challenging at best, and it is difficult to track where individual dollars flow through an organization," said Kashkari. Despite these challenges, Treasury "is working with the banking regulators

to develop appropriate measurements and Treasury is focused on determining the extent to which the CPP is having its desired effect.”

- Kashkari also defended his agency’s implementation of TARP, responding that “yes, it’s a fair use of taxpayers dollars.” He added, “Treasury has designed its programs, consistent with EESA, to protect the taxpayer.” While TARP has worked immediately to stabilize the financial markets, factors beyond the government's control will prevent the credit situation from rapidly improving. Kaskari said that the program is working—just give it time. He wrote, “The CPP began in October 2008 and the money must work its way into the system before it can have the desired effect. Moreover, we are still at a point of low confidence ...this lending won’t materialize as fast as anyone would like, but it will happen much faster as a result of having used the TARP to stabilize the system and to increase the capital in our banks.”
- Treasury has been harshly criticized by lawmakers and some economists for changing the bailout strategy from an emphasis on purchasing toxic assets to making equity investments in banks. Kashkari said that the shift in strategy was made for two reasons: speed and scope. “Treasury ... determined the fastest, most direct way was to increase capital in the system by buying equity in healthy banks of all sizes. Illiquid asset purchases, in contrast, require much longer to execute.” He added that Treasury’s rescue efforts would be far more expansive in a capital purchase program. "For an asset purchase program to be effective, it must be done in very large scale. Each dollar invested in capital can have a bigger impact on the financial system than a dollar of asset purchase; capital injections provide better 'bang for the buck.' "
- In the minutes of the December 10th meeting of the Financial Stability Oversight Board, the board members conceded difficulties in tracking banks’ use of funds under the CPP. The board meeting also included a discussion of the transitioning of President-elect Obama’s team and officials’ conversations with representatives of the incoming administration on tapping the last half of the TARP funds. Other discussions by the board centered around staffing of the Office of Financial Stability, the housing markets, government’s efforts to stem foreclosures and the use of TARP funds to supplement such actions, and financial market conditions. The board agreed to provide access to its records through the Freedom of Information Act and instructed the Secretary of HUD to rule on appeals to public requests for records. The board also reviewed all TARP activities and discussed the development of a strategy for eventually divesting assets that the government acquired through TARP. The Financial Stability Oversight board members include Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke, SEC Chairman Christopher Cox, HUD Secretary Steve Preston, and FHFA Director James Lockhart. (*Bureau of National Affairs*, 01/02/08; *CNNMoney*, David Goldman, 12/31/08; *HousingWire*, Kelly Curran, 01/02/09)

Senator Sununu named to TARP panel

- Senate Republican Leader Mitch McConnell (R-KY.) has named Sen. John Sununu (R-NH) to the Troubled Asset Relief Program's (TARP) Congressional Oversight Panel. McConnell said, "Senator Sununu has long been a leader on economic and financial market issues and has dedicated his career to ensuring that Congress remains good stewards of taxpayer funds." In November, Sununu lost his Senate seat to Democrat Jeanne Shaheen. (*Bureau of National Affairs*, R. Christian Bruce, 12/18/08)

Treasury hires Thacher, Proffitt & Wood to provide legal counsel for the Term Asset Back Securities Loan Facility

- The Treasury Department hired Thacher, Proffitt & Wood LLP to provide the agency legal advice in connection with investments under the Federal Reserve Board's recently announced \$200 billion Term Asset Backed Securities Loan Facility (TALF) to support consumer loans, including student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. Treasury has pledged \$20 billion of TARP funds to help the Fed guard against credit risk on underlying credit exposures and has agreed to coordinate the TALF. Under its six-month contact with Treasury, Thacher, Proffitt will offer the agency counsel on investments, assist in negotiations, draft investment agreements and other documents, and other matters in connection with the TALF for fees not expected to exceed \$500,000. (*Bureau of National Affairs*, R. Christian Bruce, 12/18/08)

Staring into the dark abyss three times within a 60 day period

- In a interview with *Financial Times*, Treasury Secretary Henry Paulson said he feared that the world financial system faced meltdown on three separate occasions. The first time occurred in August, said Paulson, when he realized that Fannie Mae and Freddie Mac were in very serious trouble. The second time occurred in mid-September, when Lehman Brothers collapsed, bringing a string of other financial institutions to the brink of failure. And, the third incidence occurred at the end of September when the House of Representatives initially voted down his request for a \$700 billion bailout fund to shore up the U.S. financial system. "That was the bottom as far as I was concerned because I had said we were looking at the abyss there if we could not get something done," said Paulson. "This is in my judgment truly historic in terms of the nature of the challenges and the inadequate authorities and capabilities we had to deal with some of these situations"—forcing him to battle the crisis "without all of the authorities that a major nation like the U.S. needs." He added, "If you asked me six months ago... if I was surprised by the magnitude of the challenge the answer is 'yes'. But we have been for some time in the frustrating situation of understanding much more than the public or even the Congress understood in terms of the

magnitude of what we are facing.” The Secretary accepts that mistakes may have been made. “I am sure I am going to look back ...and think of all kinds of things I wish I had done differently,” said Paulson. “[But,] you have to stem this string of failures.” Any inconsistency stemmed from the patchwork nature of legal authorities and tools he had at his disposal, he added.

- As he prepares to step down from office on January 20th, Paulson is full of praise for his successors. “They have got a great team and they don’t need advice,” said Paulson. “I really believe that. There is virtually nothing I have done here that [incoming Treasury Secretary] Tim Geithner doesn’t understand and he’s been part of virtually everything. Larry Summers [the next head of the National Economic Council] understands these issues cold.” All he can pass on, said Paulson, is the importance of co-ordination, communication and the “ability to move quickly, to take action when it is necessary.” (*Financial Times*, Krishna Guha, 12/30/08)

Fannie Mae and Freddie Mac

A daunting agenda for the 111 th Congress: A massive economic stimulus package, foreclosure relief, and restructuring the financial regulatory system
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- The incoming Obama administration and the 111th Congress face daunting challenges in 2009, beginning with a fast-tracked economic stimulus package. Obama’s team is putting the finishing touches on its American Recovery and Reinvestment Plan, an economic recovery package with a price tag of roughly \$675 billion to \$775 billion—the biggest special spending bill in history. The measure is expected to include a mix of tax cuts of \$500 to \$1,000 for “middle-class” individuals and couples and about \$200 billion to support state Medicaid programs and operating costs. A large portion of the funds will go toward infrastructure projects, including bridge repairs, water projects, research and development programs on energy efficiency, and an expansive building of the information technology system for health care. A key pillar of the legislation is the administration’s goal of creating upward of 3 million jobs over the next two years, of which 85% would be created in the private sector. Vice president-elect Joe Biden said the Obama team considers the stimulus plan to be its top priority when Congress convenes in January, calling it “the most urgent order of business for the new administration.” Republican leaders have called for a lengthy vetting of the stimulus proposal to avoid excessive spending. Senate Minority Leader Mitch McConnell (R-KY) said, “We should have a simple test: Will the yet-unwritten, reportedly trillion-dollar spending bill really create jobs and grow the economy—or will it simply create more government spending, more bureaucrats and deeper deficits?” (*Politico*, Mike Allen, 01/03/09; *Wall Street Journal*, Naftali Bendavid, 12/30/08; *Bureau of National Affairs*, Ralph Lindeman, 12/24/08; *Associated Press*, Andrew Taylor, 01/02/09)

- Democratic leaders' next legislative priority will be preventing home foreclosures. Leadership is expected to press legislation providing systematic loan modifications and giving bankruptcy judges the authority to restructure mortgage terms in the bankruptcy process. While there have been similar efforts before, lawmakers said they expect quick action on these issues this year. "President-elect Obama has said that he is very much supportive and interested in getting loan modifications done and indicated that the bailout should have done that," said Representative Maxine Waters. "That is high on my agenda and I think high on the agenda of a lot of legislators who are just caught without being able to help their constituents who are in these home foreclosure problems." Waters said she plans to introduce a bill early in the next Congress which implements the FDIC-loan modification program. Laurence Platt, a partner with K&L Gates, said, "The single biggest issue is going to be loan modifications. They are going to throw the kitchen sink at it." (*American Banker*, Stacy Kaper, 12/30/08)
- Lawmakers are also calling for a massive overhaul of the federal banking regulatory system in the aftermath of the collapse of the financial services sector in 2008. While virtually everyone—lawmakers, regulators, academics, and the financial services industry—views the overhaul vital to the future of the system, reaching a consensus on legislation will be a challenging and longer term goal. "There are a lot of people who have had their come-to-Jesus meeting in the last several months on these points, so philosophically people aren't as locked in to the positions as they once were," said Representative Paul Kanjorski, the chairman of the House capital markets subcommittee. "They see there are failures in the system; they see there are weaknesses in the system; and they see the possibility that some of these things can only be resolved and changed by governmental action." James Barth, a senior finance fellow at the Milken Institute in Santa Monica, CA, said, "Everybody is in agreement that there has to be regulatory reform, but I think nobody is entirely in agreement as to exactly what shape that regulatory reform should take. The lobbying and the politics are going to slow things down quite a bit. It's easy to talk about a stimulus package when unemployment is rising ...but I think regulatory reform is a much more difficult issue to deal with. It involves so many more different players, and the public doesn't fully understand, perhaps, the need for regulatory reform."
- House Financial Services committee chairman Barney Frank (D-MA) outlined his vision for reforming the financial services system in a November speech, saying he is "determined ... to separate out the function of systemic risk protection and investors/consumer protection." Frank added, "Those two things have to be kept in separate institutional areas, because otherwise the investor protections will lose out in some cases to the concerns for systemic risk. Clearly there are going to be capital requirements, and one of the things we are going to say is that you are regulated by your activity, not by your entity." Aside from identifying this issue as a top priority for his panel, Senate Banking Committee chairman Christopher Dodd (D-CT) has said little of note regarding his legislative goals and objectives. President-elect Obama has said he plans to unveil a detailed plan soon, which will bring important

financial companies outside the banking system under the same regulatory umbrella. (*American Banker*, Stacy Kaper, 01/02/09)

- The future role of Fannie Mae and Freddie Mac is another legislative agenda item for the 111th Congress. As policymakers address reforming the financial services sector, the role of government in housing and its prior role of promoting home ownership will be revisited. And, the resolution of that debate will likely impact the future role of the GSEs in the mortgage market. Longtime supporters of the GSEs say that their role must change—but still see a need for government to play a role. “The Fannie and Freddie model has to be approached and the private-public entanglement, I think, will be undone,” said House Financial Services Committee chairman Barney Frank (D-MA). “[GSE reform will likely to include] some subsidy for enhanced affordability and increasing the flow of mortgages.” There is little agreement about how precisely to restructure Fannie and Freddie. While Frank no longer believes the hybrid model is viable, Senate Charles Schumer (D-NY), who chairs the Joint Economic Committee, believes the GSEs’ business model should remain intact. “The hybrid is the best,” said Schumer. “The hybrid nature should remain.” One model gaining attention calls for a breakup of Fannie and Freddie into separate business components in which the investment activities are privatized (without government backing) and the securitization functions being retained by the government with explicit government backing with the Treasury insuring mortgages for a fee. Other options include structuring the GSEs using the utility model or setting the GSEs up as cooperatives. (*Washington Post*, Zachary A. Goldfarb, 12/22/08)

Words of wisdom

- In a December 16th editorial in *Investor Business Daily*, Representative John Campbell (R-CA) wrote, “The credit markets continue to unfreeze. The general economy continues to sink. There are new stock market lows and unemployment highs and we don't know where and how it will all end. But it will end. And we need to start thinking about what regulatory structure will replace the one that failed us so miserably this time. We came perilously close to an abyss... I looked down into that abyss and what I saw was way scarier than any Stephen King movie. Therefore, I think we need dramatic changes to ensure that this sort of calamity does not befall us again. So what do we do to keep it from happening again while still preserving free markets and rewarding enterprise and innovation? Here are a few thoughts:”
- “Banks should be boring entities that you can trust. If you want to double earnings annually, go into another business. We have seen how important our regulated banking sector is to the entire economy. We cannot let them get into high-risk territory.”
- “Gambling should be left to casinos. There is investment and speculation, and then there is gambling. To me, gambling is when there are instruments to bet on something going up or down without any interest in or benefit to the underlying asset.

One example might be naked short selling. If you want to do that, great. But let's call it what it is: gambling, not investment. And let's keep it in casinos or someplace where it cannot infect the markets for those assets.”

- “No more entities that are too big to fail. During the crisis, Treasury Secretary Paulson referred over and over again to entities that were ‘too big or too interconnected to fail.’ They did fail, and the taxpayers had to pick up the pieces. The moral hazard (another often-used term) created by this is unacceptable. Just as Teddy Roosevelt decreed that monopolies should no longer exist, we should decree that entities that are so big or interconnected that their failure will collapse our entire financial system cannot exist either. Break them up.”
- “Credit rating agencies. There are basically two companies that give credit ratings on bonds. There should be more than that, and they should be completely independent of the companies whose debt they are rating.”
- “Stop having multiple regulators regulate the same thing. There was a time when banks were different from savings and loans, which were different from thrifts. They all had separate regulators regulating the same things. That is an archaic model. Similar financial institutions should all have the same standards and one regulator.”
- “Fannie and Freddie. These entities have provided a valuable service for decades, and owning a home is still the linchpin of the American dream. We should continue to support homeownership with some federal backing for the most secure loans. But rather than letting a lightly regulated entity play fast and loose with that government guarantee, let's follow more of a public utility model. In other words, a private entity that administers a government franchise in a tightly controlled way. And let's have more than two of them.”
- “Some insurance is nationwide. Homes don't move, and cars rarely cross state lines. But various financial insurance products (credit default insurance, annuities, life insurance, etc.) have no nexus in any state. Insurance companies that wish to market such products should have a federal regulator that is more focused on these as financial instruments, since they are distinct from traditional home and car insurance.”
- “Don't single out the SEC. There will need to be a complete review of all of the duplicative and complementary regulators in financial markets to streamline the 70-year-old structure we have today.”
- “Accounting matters. As a CPA, I love to point this out. Accounting rules for public entities do matter, as the debate on mark-to-market should indicate. We should transition from quarterly to semiannual financial statements so we can reduce market volatility and shift focus from short-term numbers to long-term viability. We should also move toward the international IFRS accounting standards while shielding companies from abusive shareholder lawsuits.”

- “This is not a comprehensive plan, and there are lots of details I have left out in the interest of brevity. ...The one thing I do know is that I never want to experience what we have experienced this year ever again. I also do not want to stifle innovation and enterprise as we move forward. I do not think these two goals are mutually exclusive.”
- “If investors make a wrong bet, they should lose. But when an investor makes a wrong bet, he or she should not be able to take half the economy down with them. This will not be easy, but it must be done, and soon. Let's get to work.” (*Investor Business Daily*, Representative John Campbell, 12/16/08)

A mortgage industry in tatters

- The financial crisis of 2008 has structurally transformed the mortgage industry, through the closing (or failure) of more than 300 major U.S. lending operations and mergers of distressed companies. According to *National Mortgage News*, roughly 60% of loan production and servicing is now in the hands of four institutions: Bank of America, Wells Fargo, JPMorgan Chase, and Citigroup. All four companies acquired distressed institutions in 2008, creating a “small group of mega-originators who dominate the landscape,” said Scott Stern, CEO of Lenders One. Consolidations are likely to continue in 2009 among smaller entities in an effort to survive the adverse market conditions.
- In 2008, the secondary market became the government’s show—one likely to be remembered by the federal takeover of Fannie Mae and Freddie Mac. FHA and Ginnie Mae, once relics in the mortgage market, became industry kingmakers. FHA lending surged in 2008, filling the gap left by the subprime product. By October, FHA’s mortgage volume more than tripled, bringing its market share from 5.8% in 2005 to 32.9% in October 2008. Similarly, Ginnie Mae issuances tripled to \$29.6 billion in October. “FHA lending was our most important product of 2008,” said Stern with Lenders One. “It was the product where we had the most growth. ... It really was the product that a lot of people say in many ways saved the mortgage industry.” In today’s environment, FHA loans account for 50% to 85% of a lenders volume, said Brian Fitzpatrick, an executive vice president at Lydian Data Services. Barclays PLC analysts predict that 60% of the net supply of agency mortgage bonds will be guaranteed by Ginnie Mae.
- Terry Wakefield, CEO of the mortgage consulting firm Wakefield Co., said without a secondary market for non-agency loans, mortgage lending as practiced by many local and regional banking companies has emerged as “the winning business model out of this crisis.” Wakefield said, “[These companies] are doing a lot of mortgage lending, putting the loans on their balance sheet. These guys who know how to block and tackle and underwrite good-quality loans ...and have a strong deposit base [can] do quite well. [But] balance sheet capacity is always limited.” Operating efficiency is

crucial for agency mortgages, he added. "The market's going to be dominated by products that have less profit margin. The operational infrastructure of the industry continues to be very outdated, and, as a result, ... its ability to produce a commodity product at a profit is very limited. It's not going to be a great year." (*American Banker*, Harry Terris, 12/17/08)

An urgent agenda: Reactivating the financial sector

- In a December 17th white paper, Joshua Rosner, managing director of Graham Fisher, wrote, "The current problems in the real economy are rooted in the excesses of the asset-backed securities (ABS) market. These excesses can be traced to the misaligned incentives institutional investors had to invest in ABS. When interest rates were low institutional investors, whose charters require them to hold only investment grade assets (bank, pension and insurance asset managers), preferred to purchase higher yielding CDOs rather than treasury bonds, municipal bonds, corporate bonds or the underlying residential or commercial mortgage backed securities whose yields were relatively lower and were low on an absolute basis."
- "The ABS market grew dramatically over this time, from \$1 billion in new issues in 1985 to \$997 billion in new issues in 2007. Despite this growth, it suffered from many problems. Specifically, the ABS market never developed a substantive regulatory framework and suffered from inadequate standards of information, inadequate market transparency, and unresolved legal questions. These defects became apparent as investor concerns grew about collateral backing securities and about the robustness of these markets."
- "As a result, 'markets' ceased to function, investor confidence fell, the prices of the securities collapsed, and confidence in financial intermediaries diminished. Formerly acceptable levels of opacity and information asymmetry turned to suspicion and distrust among counterparties. Without regulatory intervention to force disclosure standards in support of information symmetry, capital fled and funding disappeared for real economic activity..."
- "The non-government supported secondary market for loans—the securitization market—has ground to a complete halt, and we must set about to fundamentally repair it. It cannot be merely another iteration of the same flawed market with the same skewed incentives. ... Washington needs to push lobbyists aside and address the abdication of responsibility by Treasury and the SEC. Neither government entity has shown acceptable levels of leadership in addressing the need for substantive and immediate action. While they may claim that they lack clear authority, they have both taken numerous extraordinary emergency actions without such authority."
- "These problems could be properly addressed with narrow legislation that creates an independent oversight board and authorizes Treasury to oversee a new standardized industry securitization 'clearinghouse.' In return for the capital support provided, Treasury has the ability to set the conditions under which recipients could receive

capital and without setting any material conditions—participation in the new standards and new secondary market ‘clearinghouse’ should be a precondition of the largest and most complex institutions.

- “The ‘Clearinghouse’ would serve to develop industry standards, apply those standards in the purchase of collateral from member issuers, and enforce those industry standards... Rather than, necessarily, creating a market or exchange on which these securities would trade, the ‘Clearinghouse’ could, as example:
 - Create collateral definitions (directly tied to loan level characteristic standards) of collateral it would purchase and securitize;
 - Standardize the development of a legally defensible standard of ‘true sale’
 - Create uniform industry Pooling and Servicing and Representation and Warranty contracts
 - Create standardized modification terms and static and flow reporting requirements;
 - Standardize industry definitions, such as Prepayment; Delinquency; Default; Modification;
 - Standardize, register, and publicly disclose all pre-issuance information detailing loan level data (not-including loan identifiers) on the collateral backing securities;
 - Standardize and disseminate consistently formatted, publicly available disclosures of the pricing of pools;
 - Create standardized disclosures of servicer advances;
 - Publicly disclose formatted and standardized monthly servicer/remittance tapes.”
- “This approach would provide a clear and consistent view of publicly available data. As a result, market reliance on rating agencies would be diminished. Moreover, because of the public availability of detailed information, there would be no reason the rating agencies would need to interact with issuers and, like in the single issuer debt market, securities issued by the ‘Clearinghouse’ would be able to be issued and purchased by charter constrained investors without an initial rating. Instead, rating agencies market value would be determined by the predictive worth of their models in the secondary market.”
- “Once set up, the ‘Clearinghouse’ would be able to begin the process of securitizing loans. Securitized pools with guarantees would be less costly to the government than using government while those that were not guaranteed would likely carry risk premiums that reflecting the current economic uncertainty. Over time the pricing

would begin to reflect a rational analysis of the collateral.” (*An Urgent Agenda for Reactivating the Financial Sector*, Joshua Rosner, 12/17/08)

What happens to an economy after a financial crisis?

- In “The Aftermath of Financial Crises,” Carmen M. Reinhart, professor of economics at the University of Maryland, and Kenneth S. Rogoff, professor of economics at Harvard University, analyze previous economic crises to determine what happens in an economy after a financial crisis. The authors wrote, “... Broadly speaking, financial crises are protracted affairs. More often than not, the aftermath of severe financial crises share three characteristics[:]
 - **“First, asset market collapses are deep and prolonged.** Real housing price declines average 35 percent stretched out over six years, while equity price collapses average 55 percent over a downturn of about three and a half years.”
 - **“Second, the aftermath of banking crises is associated with profound declines in output and employment.** The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment.”
 - **“Third, the real value of government debt tends to explode, rising an average of 86 percent in the major post-World War II episodes.** Interestingly, the main cause of debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system. Admittedly, bailout costs are difficult to measure, and there is considerable divergence among estimates from competing studies. But even upper-bound estimates pale next to actual measured rises in public debt. In fact, the big drivers of debt increases are the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions, as well as often ambitious countercyclical fiscal policies aimed at mitigating the downturn.”
- The authors conclude, “...An examination of the aftermath of severe financial crises shows deep and lasting effects on asset prices, output and employment. Unemployment rises and housing price declines extend out for five and six years, respectively. On the encouraging side, output declines last only two years on average. Even recessions sparked by financial crises do eventually end, albeit almost invariably accompanied by massive increases in government debt.”
- “How relevant are historical benchmarks for assessing the trajectory of the current global financial crisis? On the one hand, the authorities today have arguably more flexible monetary policy frameworks, thanks particularly to a less rigid global exchange rate regime. Some central banks have already shown an aggressiveness to

act that was notably absent in the 1930s, or in the latter-day Japanese experience. On the other hand, one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion.”

- “Since the onset of the current crisis, asset prices have tumbled in the United States and elsewhere along the tracks laid down by historical precedent. The analysis of the post-crisis outcomes in this paper for unemployment, output and government debt provide sobering benchmark numbers for how the crisis will continue to unfold. Indeed, these historical comparisons were based on episodes that, with the notable exception of the Great Depression in the United States, were individual or regional in nature. The global nature of the crisis will make it far more difficult for many countries to grow their way out through higher exports, or to smooth the consumption effects through foreign borrowing. In such circumstances, the recent lull in sovereign defaults is likely to come to an end. ...[D]efaults in emerging market economies tend to rise sharply when many countries are simultaneously experiencing domestic banking crises.” A copy of the author’s study is available for reading at <http://ws1.ad.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf>. (*The Aftermath of Financial Crises*, Carmen M. Reinhart and Kenneth S. Rogoff, draft dated 12/19/08)
- In a December 18th speech at the Federal Reserve Bank of Philadelphia, Martin Feldstein, professor of economics at Harvard University and former chairman of the Council of Economic Advisers for the Reagan administration, said the U.S. economy is in the deepest recession in the postwar period, as a result of excessive leverage in financial institutions and a severe, ongoing decline in house prices. Feldstein warned that housing prices may continue to fall for two more years, which could leave a majority of mortgages under water. While he praised the actions of the authorities in establishing facilities to restore liquidity to the credit markets, Feldstein indicated these steps are insufficient to stimulate growth in the economy. From his perspective, none of the phases of the Treasury's TARP has worked. Instead, the economy must be rejuvenated by restoring the sector which triggered the crisis—housing. Feldstein believes that mortgages should be restructured to provide for recourse to the assets of mortgagors. The U.S. is the only industrial country that doesn't provide recourse in its mortgage instrument—a feature which Feldstein believes would allow equity to be restored to many mortgages that would otherwise be underwater. The U.S. recession has deepened to a level that a large, two-year stimulus package will be needed to bridge the gap in demand, caused by the destruction of \$11 trillion of value in the stock market and home prices. While unemployment will likely rise to between 8% and 10%, Feldstein doesn't believe that the damage to the economy is permanent. Feldstein believes that the economy will recover within ten years and resume growing at a “normal” rate. (*Speech by Professor Martin Feldstein*, 12/18/08)

Economic roundup for 2008

- U.S. housing prices in 20 major metropolitan areas fell another 2.2% in October and down an average of 18% from a year ago, according to the S&P Case-Shiller home price index. “The bear market continues; home prices are back to their March 2004 levels,” said David Blitzer, S&P’s chairman of the index committee. (*Bureau of National Affairs*, 12/31/08)
- In 2008, American homeowners lost collectively more than \$2 trillion in home value by year end, according to a report released by Zillow.com. Some 11.7 million homeowners are now “underwater”—owing more on their mortgages than their house is worth. (*CNNMoney.com*, Les Christie, 12/15/08)
- Home sale volumes fell sharply in 2008, with new home sales posting its worst month in 50 years in November and existing home prices falling 3.1% between September and October. Home starts collapsed in November, falling 18.9% to a new record low. Home prices are expected to decline 5% on new homes and 5% to 10% on existing homes, according to a new report issued by Keefe, Bruyette & Woods. (*HousingWire*, Diana Golobay, 12/17/08; *Bureau of National Affairs*, Diana I. Gregg, 12/17/08)
- The U.S. factory sector closed out 2008 on a dour note, marking its weakest period of activity in nearly 30 years. The Institute for Supply Management’s manufacturing sector index came in at 32.4 in December—8.5% lower than analysts’ expectation of 35.4—marking the weakest performance June 1980. The report suggested that the broader economy has fallen into a steep recession, similar to that of the early 1980s. (*Bloomberg News*, Heather Burke, 12/29/08)
- Consumer spending fell 0.6% in November, marking the fifth straight month of decline, according to the Commerce Department. (*HousingWire*, Paul Jackson, 12/24/08)
- Crude oil futures closed at \$44.60 a barrel on December 31st, ending the year down 54%, the biggest yearly loss since oil futures started trading in New York in 1983. (*MarketWatch*, 12/31/08)
- Unemployment which topped 6.7% in November is projected to grow in 2009. According to a survey of economists by the *Bureau of National Affairs*, nonfarm payroll employment will decline by an average of 218,200 jobs per month during the first half of 2009 (1.2 million jobs) and by 41,700 jobs for the second half of the year (240,000 jobs), which would bring total job losses to at least 3.5 million over a two year period. Unemployment is expected to climb to an average of 7.6% during the

first six months of 2009 and to 8.2% during the second half of the year. (*Bureau of National Affairs*, Michael Rose, 01/05/09)

- Following a tortuous trading year on Wall Street, investors lost \$6.9 trillion—marking broad and deep losses in every sector in the S&P 500. The Dow Jones Industrial Average and S&P 500 were down 34% and 38%, respectively, for the year, while the tech-heavy Nasdaq composite was down 41%. (*Washington Post*, Renae Merle, 01/01/09)
- In the December *Investment Outlook*, Pimco’s Bill Gross wrote, “My transgenerational stock market outlook is this: stocks are cheap when valued within the context of a finance-based economy once dominated by leverage, cheap financing, and even lower corporate tax rates. That world, however, is in our past not our future. More regulation, lower leverage, higher taxes, and a lack of entrepreneurial testosterone are what we must get used to—that and a government checkbook that allows for healing, but crowds the private sector into an awkward and less productive corner. Dow 5,000? We don’t have to go there if current domestic and global policies are focused on asset price support and eventual recapitalization of lending institutions. But 14,000 is a stretch as well. One only has to recognize that roughly 20% of bank capital is now owned by the U.S. government and that a near proportionate share of profits will flow in that direction as well.” (*Investment Outlook*, Bill Gross, December 2008)
- Bankruptcy filings topped 1 million for the 12 month period ended September 30th, according to statistics released by the Administrative Office for the U.S. Courts. Filings totaled 1,042,993 for the 12 month period, a jump of more than 30% from filings for FY2007 (ended September 30th). (*Bureau of National Affairs*, 12/16/08)
- U.S. banks’ loan issuance tumbled 55% to \$764 billion, the lowest since 1994. Investment grade loans fell to \$319 billion, down 52% from 2007, while leveraged loan issuance slid to \$294 billion, down 57% from last year. Lending in 2009 will likely remain anemic, with 54% of respondents to a quarterly survey of lenders by Reuters Loan Pricing Corp. saying they will limit their lending to key relationships in 2009. (*Reuters*, 12/30/08)
- In 2008, 25 banks with assets of approximately \$372 billion failed and were taken over by FDIC. The agency expects aggregate losses of \$15.6 billion for 24 of the 25 bank failures, with no estimate provided for Washington Mutual (\$307 billion in assets). The FDIC had 171 institutions (with assets of \$115.6 billion) on its troubled bank list at the end of the third quarter, the latest data available. To prepare for more bank failures in 2009, the FDIC approved an 84% increase in its 2009 budget to \$2.24 billion, largely due to a 567% increase in its receivership budget to \$1 billion, representing nearly half the agency’s operating budget. To cover rising costs, the FDIC board also approved a 7 basis point increase in deposit insurance premiums. (*Wall Street Journal*, Jessica Holzer, *American Banker*, Joe Adler, 12/29/08; *American Banker*, Joe Alder, 12/17/08; *American Banker*, 01/02/09)

Loan modification and foreclosure notes

- Fannie Mae and Freddie Mac slowed the pace of foreclosures on delinquent loans in the third quarter, according to the Federal Housing Finance Agency. Foreclosure proceedings declined to 7.12% of total loans delinquent 60 days or more, from 7.81% in the second quarter. However, the GSEs' delinquent loans, including those in bankruptcy and foreclosure, rose 100 basis points to 2.21% of total loans on September 30th, up 48 basis points from the second quarter. The GSEs also increased the number of short sales during the third quarter with 1,721 in September, versus a year-to-date average of 1,057. (*Reuters*, 12/16/08)
- On December 18th, Fannie Mae and Freddie Mac rolled out their streamlined modification programs (SMP) that were announced on November 11th. The initiative replaces time-consuming steps in the traditional modification process with faster procedures and standard eligibility requirements. The program will allow mortgage and escrow payments to be cut to 38% or less of the borrower's gross monthly income by reducing the mortgage rate, extending the mortgage term to 40 years, or forbearing part of the principal payment amount until the loan matures or is paid off, at which time the borrower will be required to make a balloon payment. Fannie and Freddie are working with the HOPE Now Alliance to implement the SMP to assist at-risk homeowners remain in their homes. (*FHFA Press Release*, 12/18/08; *HousingWire*, Diana Golobay, 12/18/08)
- The HOPE Now Alliance announced it is on track to complete one million loan modifications in 2008. The Alliance also estimates that its efforts helped prevent 2.2 million foreclosures from January through November 2008. "No one did more to prevent foreclosures in 2008 than HOPE Now," said Faith Schwartz, HOPE Now's executive director. "Because there's more to do, in 2009 HOPE Now is going to substantially expand its already successful efforts to make it even easier for at-risk homeowners to avoid foreclosure." The Alliance is participating in the streamlined modification program launched on December 15th by Fannie Mae and Freddie Mac. A number of private mortgage lenders are adopting similar modification programs, which result in increased participation in HOPE Now. Depending upon unemployment trends and deterioration in the general economy, the Alliance anticipates that the number of loan workouts will double to 2 million or more in 2009.
- The Mortgage Metrics Report, issued by OTS and the Office of Controller of the Currency on December 22nd, shows that 55% of troubled loan modifications were 30 days or more delinquent within six months of modification, while 37% of these loan mods were 60 days or more delinquent. "One very troubling point is that, whether measured using 30-day or 60-day delinquencies, redefault rates increased each month and showed no signs of leveling off after six months and even eight months," said Comptroller of the Currency John Dugan. "This trend of increasing delinquencies underscores the need to understand why these modifications have not been more

sustainable.” FDIC chairman Shelia Bair argued that the regulators’ analysis is inconclusive, because report does not provide detailed information on which types of loan modifications were used. She notes that early loan modifications were “short-term fixes” and failed to lower the monthly mortgage payments for troubled borrowers. (*Bureau of National Affairs*, Mike Ferullo, 12/23/08; *Bureau of National Affairs*, Mike Ferullo, 12/18/08)

- Representative Maxine Waters (D-CA) has been personally calling loan servicers, asking them to help her constituents get a lower rate, a longer maturity, or other form of loan modification to help the borrower meet their payments and avoid foreclosure. As the chairwoman of the House Financial Services' housing subcommittee, Waters said she isn't concerned that she's leaning on companies she regulates, potentially creating a conflict of interest and violating House ethics rules. “The Ethics Committee said we are not to get involved—it's a third party and contracts between citizens," Waters said in an interview with *American Banker*. "I don't care. Throw the book at me. Put me in jail. Do whatever you have to do. I am defying them.” To date, Waters and her staff, including an employee who works full time calling servicers to rework loans for constituents, have succeeded in helping seven borrowers avoid foreclosure, and another 30 cases are in the works. Waters said, “One of the reasons why I think we are able to kind of be successful at what we are doing is it's kind of the threat of the member of Congress calling you and working on this.” (*American Banker*, Stacy Kaper, 12/17/08)

Explicit federal guaranty of Fannie and Freddie debt unlikely

- In a CNBC interview, Federal Housing Finance Agency director James Lockhart said that the federal government probably would not be able to substantially lower the borrowing costs of Fannie or Freddie with an explicit guarantee of their debt. “I’m not sure there’s a ‘full faith and credit’ issue,” because MBS guaranteed by the GSEs trade at about the same prices as those backed by federal agency Ginnie Mae, said Lockhart. The director’s comments suggest that Treasury is unlikely to strengthen what Lockhart calls an “effective” guarantee of the GSEs’ debt, as a means of lowering the companies borrowing costs to reduce mortgage rates and stimulate the housing market. The director also said that that FHFA will seek to restrain fees at Fannie and Freddie for their mortgage bond guarantees to lower prices and prevent over-tightening of their standards to stimulate the housing market. “We want to make sure they’re priced for risk, not over-priced,” Lockhart added. He also expects mortgage rates will continue to fall by as much as 100 basis points, based upon historical data. “Certainly one would think another 50 basis points easily and maybe a hundred. "You could see [those] rates are significantly higher than Treasuries, so ...they could come down.” (*Dow Jones*, 12/31/08; *Bloomberg News*, Jody Shenn, 12/30/08)

- In a Congressionally-mandated study, SEC concluded that fair value accounting can be improved to address concerns about the impairment of mortgage securities during the financial crisis, but should not be suspended, as requested by some banking groups. According to the study, the fair value—or marked-to-market—accounting rule used to value hard to price assets underlying the housing crisis “did not appear to play a major role” in bank failures in 2008. “Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence,” said the SEC. “For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.” The SEC recommended that regulators issue more guidance to help banks determine the fair value of an asset, such as mortgage-backed securities, when there is little or no market trading of the asset. The SEC said it supports a FASB proposal that would allow management to use judgment in assessing whether an impairment loss is expected to be temporary, which is scheduled to be finalized on January 8. SEC also expressed support for FASB's project to allow reversal of impairments on debt securities when sufficient evidence demonstrates a recovery. (*Reuters*, 12/30/08; *National Mortgage News*, 12/31/08)

Fannie Mae

Fannie Mae's mortgage portfolio grew 9.3% in November

- In November, Fannie Mae's retained mortgage portfolio grew \$5.8 billion, or 9.3% on an annualized basis, to \$782.9 billion in November. During the month, Fannie Mae provided \$31.7 billion of liquidity for the mortgage market through \$7.9 billion of net retained commitments and \$23.8 billion in mortgage-backed securities issuances. The company's single-family serious delinquency rate increased 17 basis points to 1.89% in October [the latest data available], while its multi-family serious delinquency rate increased 5 basis points to 0.21%. Fannie's effective duration gap averaged zero months in November. (*Reuters*, 12/30/08; *Fannie Mae Monthly Summary*, November, 2008)

IndyMac sold to an investor group with repurchase of Fannie Mae loans "unresolved"

- On January 2nd, the FDIC announced it had reached an agreement with a seven-member group of investors to purchase the failed lender, IndyMac Bank for \$13.9 billion. A holding company, led by Steven Munchin, co-chief executive of private equity firm Dune Capital Management, agreed to buy IndyMac and invest \$1.3 billion of new capital into the bank. Other investors in the partnership include five private equity firms or hedge funds: J.C. Flowers & Co., Stone Point Capital; Paulson & Co., a fund controlled by billionaire George Soros' Fund Management, and a fund controlled by Silar Advisors LP. As part of the deal, the FDIC has agreed to assume losses on a portion of IndyMac's loans.
- An unresolved issue in the transaction is IndyMac's relationship with investors in mortgage-backed securities, including Fannie Mae and Freddie Mac. Shortly after IndyMac went into receivership, Fannie demanded that bank repurchase about \$1 billion in loans owned or guaranteed by the GSE for representation and warranty violations. According to *HousingWire*, FDIC "apparently" offered to settle for \$100 million, but Fannie stood pat on the issue, which became an impediment to merger negotiations. On January 2, Fannie spokesman Chuck Greener said his company "is working constructively with the FDIC and IndyMac to reach a resolution that is in the best interests of all parties involved." (*HousingWire*, Tom Lindmark, 12/31/08; *Associated Press*, Alan Zibel, 01/02/08)

FHFA appoints nine board members for Fannie Mae

- On December 24th, the Federal Housing Finance Agency, acting as conservator for Fannie Mae, appointed nine directors to the company's board, bringing the total number of directors to ten. FHFA made these appointments in consultation with the

company's non-executive chairman, Phil A. Laskawy, who was appointed to the board in September. The new board members include:

- Herb M. Allison, Jr., 65, who has served as president and CEO of Fannie Mae since September 2008.
- Dennis R. Beresford, 70, has served as Ernst & Young Executive Professor of Accounting at the J.M. Tull School of Accounting, Terry College of Business, University of Georgia since 1997. From 1987 to 1997, Mr. Beresford served as Chairman of the Financial Accounting Standards Board (FASB), the designated organization in the private sector for establishing standards of financial accounting and reporting in the U.S. Mr. Beresford is a member of the Board of Directors and Chairman of the Audit Committee of Kimberly-Clark Corporation and Legg Mason, Inc., and has served as a Fannie Mae Director since May 2006.
- William Thomas Forrester, 60, served as Chief Financial Officer of The Progressive Corporation from 1999 until his retirement in March 2007. Mr. Forrester currently serves as a Director of The Navigators Group.
- Brenda J. Gaines, 59, served as President and Chief Executive Officer of Diners Club North America, a subsidiary of Citigroup, from October 2002 until her retirement in April 2004. She also served as Deputy Chief of Staff for the Mayor of the City of Chicago from 1985 to 1987 and as Chicago Commissioner of Housing from 1983 to 1985. In addition, Ms. Gaines serves as a Director of Office Depot, NICOR, Inc. and Tenet Healthcare Corporation and has served as a Fannie Mae Director since September 2006.
- Charlynn Goins, 66, served as Chairman of the Board of Directors of New York City Health and Hospitals Corporation from June 2004 to October 2008. She also serves as a Director of AXA Financial Inc. and its subsidiaries AXA Equitable and MONY Life.
- Frederick B. "Bart" Harvey III, 59, retired in March 2008 from his role as Chairman of the Board of Trustees of Enterprise Community Partners, a provider of development capital and technical expertise to create affordable housing and rebuild communities. Mr. Harvey has served as a Fannie Mae Director since August 2008.
- Egbert L. J. Perry, 53, is the Chairman and Chief Executive Officer of the Integral Group LLC, a real estate advisory, investment management and development company based in Atlanta. Mr. Perry served as a director of the Federal Reserve Bank of Atlanta [for a term that expired on December 31, 2008] and also serves as a Director of Atlanta Life Financial Group and the Advisory Board of the Penn Institute for Urban Research and as a Trustee of the University of Pennsylvania and Children's Healthcare of Atlanta.

- David H. Sidwell, 55, served as Chief Financial Officer of Morgan Stanley from March 2004 to October 2007 and as an Executive Vice President from March 2004 to May 2007. Mr. Sidwell serves as a Trustee of the International Accounting Standards Committee Foundation and also serves as a director of UBS AG.
- Diana L. Taylor, 53, has been a Managing Director for Wolfensohn & Company, a strategic consulting and investment firm, since March 2007. She served as the Superintendent of Banks for the state of New York from 2003 to 2007. Ms. Taylor serves as a trustee of Dartmouth College and as a Director of Allianz Global Investors, Brookfield Properties and Sotheby's.
- Fannie Mae board members will no longer receive stock awards, which previously were award to its members. Instead, directors will receive \$160,000 a year and the chairman will be paid \$290,000. Directors can also receive up to \$25,000 more for chairing board committees.
- The FHFA appointed the members to Fannie's board to comply with the rules governing public companies listed on the New York Stock Exchange. (*Fannie Mae Press Release*, 12/24/08; *Washington Post*, Zachary A. Goldfarb, 12/25/08)

Fannie Mae is finalizing its National Tenant Policy

- In a December 15th statement, Fannie Mae spokesman Brian Faith said, "Fannie Mae is finalizing a new policy that will allow tenants in Fannie Mae-owned foreclosed properties to stay in their homes if they can make their rental payments. For tenants who would prefer not to enter into a lease, we will continue to offer monetary support for the transition to a new residence as an alternative option."
- "Fannie Mae currently has a tenant eviction and foreclosure sale suspension in place through January 9, 2009. The new tenant policy will go into effect prior to the end of the suspension period. The goal of the suspension is to ensure that no renters are put out of their homes during this period. We have notified our attorney and broker networks to cease all eviction-related communications and proceedings during the suspension period. We estimate that 7,000-10,000 families have been able to stay in their homes as a result of the foreclosure and tenant eviction suspension."
- "We've been using the suspension period to fully implement the recently announced Streamlined Modification Program and to review and revise many of our policies and procedures. We've announced a new Trust agreement effective January 1, 2009 and new guidelines for servicers to enable earlier intervention with delinquent and at-risk borrowers. In conjunction with our regulator, FHFA, we will continue working to fully support the market and undertake efforts aimed at keeping people in their homes." (*Fannie Mae Press Release*, 12/15/08)

Fannie Mae institutes a custody fee

- On May 11th, Fannie Mae will begin charging lenders a fee for the custody services on mortgages it buys for its portfolio. In a December 19th letter to lenders, Fannie Mae said it "wanted a document custodian that provides traditional trust services but does not originate, sell, or service mortgage loans." The company also said that it "has negotiated competitive rates for custodian fees that lenders will be required to pay for portfolio mortgages." Fannie said it has hired Bank of New York Mellon Corp to provide these services to lenders for a fee. For loans that are pooled into mortgage-backed securities, lenders will still have the option of purchasing custody services from Fannie Mae or from or another firm that meets the GSE's criteria. (*American Banker*, 12/23/08)

Fannie Mae tightens its underwriting guidelines for condominiums in Florida

- Fannie Mae has tightening its mortgage underwriting criteria for condominiums, particularly in Florida, where excess inventories of unsold units continue to depress real estate values. In a December 16th memo to loan sellers, Fannie Mae said because the number of delinquent mortgages it owns or guarantees secured by condo units in Florida is at an all-time high, the GSE is requiring higher loan-to-value ratios for condo projects in the state. Fannie also increased the minimum share of units in new or newly converted Florida condo projects that must be owner-occupied or under contract from 51% to 70%. (*American Banker*, Allison Bisbey Colter, 12/18/08)

Fannie Mae restricts its future entertainment expenses

- On December 16th, Fannie Mae CEO Herb Allison announced a new policy, restricting all entertainment spending for customers and employees. The new policy was enacted after CBS 11 News in Washington reported on a Fannie Mae golf outing in Grapevine, TX for a cost of \$6,200—just 22 days after the company was placed in receivership.
- In a letter to Representative Hensarling (R-TX), Allison said that in a review of company lobbying, entertainment, sponsorship, events, and charitable activities, the firm-wide review did not identify the Dallas event. Allison wrote, "We regret the oversight, we were highly embarrassed by it, and we took immediate action to prevent a reoccurrence." Allison said that a moratorium has been placed on all entertainment expenses for customers or employees, including meals, sporting events, and holiday parties. On November 26th, the company replaced the moratorium with a new policy which includes new restrictions and supervisory controls on gifts and entertainment, whether provided by or offered to any company employee. "This policy will be strictly enforced," wrote Allison. (*CBS 11 News*, 12/06/08)

Déjà vu

- In a 17-page exposé in the February issue of *Vanity Fair*, Bethany McLean wrote, “...In the end, it was Fannie executives who made a business decision to stake their future on risky [subprime and Alt-A] mortgages that had nothing to do with helping people own homes. The company used its political power to stymie effective regulation, and its extreme aggressiveness and arrogance gave its enemies license to do things they never would have done to a normal company. And, oh, did they ever...” The 10,700 word article is available for reading at <http://www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902>. (*Vanity Fair*, Bethany McLean, February 2009)

Freddie Mac

Freddie Mac’s mortgage portfolio grows 65.6% in November

- Freddie Mac’s retained mortgage portfolio surged by an annual rate of 65.6% in November—or \$41.8 billion—to an all-time high of \$805.4 billion in November. Freddie Mac’s single-family serious delinquency rate increased 18 basis points to 1.52% in November, while its multi-family serious delinquency rate remained unchanged at 0.01%. Freddie’s effective duration gap averaged zero months in November. (*Freddie Mac Monthly Volume Summary*, November 2008; *Bloomberg News*, 12/29/08)

Freddie Mac names its chief credit officer

- Freddie Mac has selected Raymond G. Romano to serve as its chief credit officer. Romano has been serving as acting chief credit officer since September, when the position was created as part of a management reorganization implemented after the company was placed into conservatorship. Romano joined Freddie Mac in 2004 as senior vice president of risk oversight. Previously, he worked for North American Mortgage Co., Dime Savings Bank of New York, and Citigroup. (*American Banker*, Marc Hochstein, 12/30/08)

FHFA appoints ten board members for Freddie Mac

- On December 23rd, the Federal Housing Finance Agency, acting as conservator for Freddie Mac, appointed ten directors to the company's board, bringing the total number of directors to eleven. FHFA made these appointments in consultation with the company's non-executive chairman, John A. Koskinen who was appointed to the board in September. The board members include:
 - Barbara T. Alexander, who has been an independent consultant since 2004 and was previously a senior advisor to UBS Warburg LLC and predecessor firms from 1999 to 2004. She is a member of the board of directors of Centex Corporation and Qualcomm Incorporated and an executive fellow at the Joint Center for Housing Studies at Harvard University. Alexander previously served as a Freddie Mac board member.
 - Linda B. Bammann, who served as executive vice president, deputy chief risk officer for JPMorgan Chase & Co. from 2004 until her retirement in 2005 and held several positions with Bank One Corporation beginning in 2000.
 - Carolyn H. Byrd, who has served as chairman and CEO of GlobalTech Financial, LLC since 2000. She serves as a director of AFC Enterprises, Inc. and a director of Circuit City Stores, Inc. Byrd is also a member of the board of trustees of Fisk University.
 - Robert R. Glauber, who is a lecturer at Harvard's Kennedy School of Government and a visiting professor at the Harvard Law School. Previously, he served as chairman and CEO of the National Association of Securities Dealers ("NASD") from 2001 to 2006, after first serving as its CEO and president and a member of its board. He also is a director of Moody's Corporation, a trustee of the International Accounting Standards Committee Foundation, a lead director of XLCapital Ltd, and a senior advisor at Peter J. Solomon Co., and previously served as a director for Freddie Mac.
 - Laurence E. Hirsch, who has served as chairman of Highlander Partners, L.P., a private equity firm, since 2004. Hirsch also serves as the chairman of the board of directors of Eagle Materials Inc., as a director of A. H. Belo Corporation, and as chairman of the Center for European Policy Analysis in Washington, D.C.
 - John A. Koskinen, who has served as non-executive chairman of Freddie Mac since September 2008. Previously he was president of the United States Soccer Foundation for four years, deputy mayor and city administrator of Washington, DC from 2000 to 2003, assistant to the president and chair of the President's Council on Year 2000 Conversion from 1998 to 2000 and deputy director for management of the Office of Management and Budget from 1994 to 1997.

- Christopher S. Lynch, who is an independent consultant providing a variety of services to financial intermediaries, including risk management, strategy, governance, financial and regulatory reporting and troubled-asset management. Before retiring from KPMG LLP in 2007, Lynch held a variety of positions with KPMG, including National Partner in Charge – Financial Services, the firm's largest industry division.
- David M. Moffett, who joined Freddie Mac as CEO in September 2008. Moffett retired as vice chairman and chief financial officer of U.S. Bancorp in 2007, having served the company in this capacity since 1993. Since his retirement from U.S. Bancorp, Moffett served as a senior advisor at The Carlyle Group. Previously, Moffett was chairman of the CFO Council of the Financial Services Roundtable; a financial services industry advisor of Standard & Poor's Rating Service; a financial services industry advisor of Moody's Rating Service; and a member of the CFO Roundtable, Bank Administration Institute. Moffett also is a director of eBay Inc.
- Nicolas P. Retsinas, who has been director of Harvard University's Joint Center for Housing Studies. He is a lecturer in Housing Studies at the Graduate School of Design and the Kennedy School of Government and in Real Estate at the Harvard Business School. Prior to Harvard, Retsinas served as assistant secretary for housing— federal housing commissioner at HUD from 1993 to 1998 and as director of OTS from 1996 to 1997. He served on the board of the FDIC from 1996 to 1997, the Federal Housing Finance Board from 1993 to 1998 and the Neighborhood Reinvestment Corporation from 1993 to 1998. He also serves on the board of trustees for the National Housing Endowment and for Enterprise Community Partners and on the board of directors of the Center for Responsible Lending and previously served as a Freddie Mac director. Mr. Retsinas also serves on the Obama transition team at HUD.
- Eugene B. Shanks, Jr., who has held a variety of positions with Bankers Trust Company from 1973 to 1978 and from 1980 to 1995, including serving as president and director from 1992 to 1995. Currently, he is a trustee of Vanderbilt University and serves as a director of NewPower Holdings, Inc. and The Posse Foundation.
- Anthony A. Williams, who has been the CEO of Primum Public Realty Trust since 2007. Primum, an indirect, wholly owned subsidiary of Friedman, Billings, Ramsey Group. Williams served as the mayor of Washington, DC from 1999 to 2007 and as its chief financial officer from 1995 to 1998. Williams has also served as vice chair of the Metropolitan Washington Council of Governments and as president of the National League of Cities. He currently is a director of Meruelo Maddux Properties, Inc.
- The Federal Housing Finance Agency, acting as Conservator for Freddie Mac, has determined that the company's board will be comprised of these 11 directors. The

board will have four committees—audit, compensation, nominating and governance, and business and risk. The conservator has delegated to the board basic oversight responsibilities for the company’s operations. The board must consult with the Conservator and obtain his approval, before taking action in certain areas. (*Freddie Mac Press Release*, 12/23/08)

Federal Home Loan Banks

FHLB-Boston increases its retained earnings target by 33%

- In a December 18th letter to members, the FHLB-Boston’s board of directors adopted a revised retained earnings target of \$600 million, up more than 33% from its previous target range of \$375 million to \$400 million. The board also adopted a restriction on quarterly dividend payouts by limiting the quarterly dividends to no more than 50% of quarterly earnings in the event that the retained earnings target exceeds the Bank’s current level of retained earnings. On September 30th, the Bank had retained earnings of \$267.7 million. The FHLB-Boston expects that these new policies will result in lower dividend payouts to members until the new retained earnings target is achieved. Bank president and CEO Michael A. Jesse wrote members, “These actions serve as a prudent response to unprecedented market conditions.” (*FHLB-Boston correspondence to all members*, Michael A. Jesse, 12/18/08)

Former Federal Housing Finance Board chairman being considered for a pardon

- The North Dakota Republican Party is asking the President Bush to pardon John Korsmo, the former chairman of the Federal Housing Finance Board. In March 2004, Korsmo resigned from the Finance Board and later pleaded guilty to lying to Congress. In testimony before the Senate Banking Committee, Korsmo said he didn’t know how organizers of a \$500-a-plate dinner supporting a Republican congressional candidate obtained personal information about Federal Home Loan bank presidents. However, he later acknowledged that his wife had provided the information to the organizers. In 2005, Korsmo was sentenced to 18 months of unsupervised probation and fined \$5,000. In an interview with a North Dakota radio station, Korsmo was gratified by the pardon effort, but was not involved in it. (*American Banker*, Steven Sloan, Emily Flitter, and Cheyenne Hopkins, 12/15/08)

Ginnie Mae

HUD “kills” FHA Secure

- In a December 19th mortgagee letter (2008-41), HUD confirmed that the FHA Secure troubled borrower refinancing program was terminated on December 31st, despite pleas from industry and consumer advocates to keep the program going. In the letter, Federal Housing Commissioner Brian Montgomery wrote that "maintaining the program past the original termination date [of December 31] would have a negative financial impact [on FHA's mortgage insurance fund] that would have to be offset by either substantial across-the-board single-family program premium increases or the suspension of FHA's single-family insurance programs altogether." (*American Banker*, Marc Hochstein, 12/30/08; *HousingWire*, Paul Jackson, 12/29/08)

Fading hope for the Hope for Homeowners Program

- In an interview with the *Washington Post*, HUD Secretary Steve Preston said that the Hope for Homeowners Program (H4H)—the centerpiece of the federal government's effort to help struggling homeowners—has been a failure because of how Congress structured the program. The three-year program, which was supposed to help 400,000 borrowers avoid foreclosure, has attracted only 312 applications since its October launch because it is too expensive and onerous for lenders and borrowers, said Preston. [In contrast, FDIC's loan modification program at IndyMac has restructured 3,500 loans over a two month period.] "What most people don't understand is that this program was designed to the detail by Congress," he said. "Congress dotted the i's and crossed the t's for us, and unfortunately it has made this program tough to use."
- House Financial Services chairman Barney Frank (D-MA), who helped steer the H4H program through Congress, said TARP funds should be used to revamp the program. Acknowledging that the initiative has its problems, Frank blamed the Bush administration, saying: "That's partly their fault. The administration was critical of the program and kept putting pressure on us to make it cheaper and more restrictive. . . . If it hadn't been for the Bush administration's opposition, we would have written it in a better way in the first place."
- The program's success, however, hinges on the lenders' willingness to participate in H4H. Initially, Congress allowed the FHA to insure new loans for only 90% of a home's value. With home prices plunging, borrowers with little or no equity in their homes are able to come up with the remaining 10% equity to qualify only if the lender forgives this balance. And, lenders have balked. In November, Congress granted HUD permission to increase the loan amount that's insured by FHA to 96.5% of the loan amount. Preston praised the change made by Congress, but said its impact

remains unclear. "Getting the lenders to agree ...has been our biggest challenge," said Peyton Herbert, director of foreclosure services at HomeFree USA. "They want dollar for dollar what's owed on that loan or something close to it. That's the fly in the ointment."

- Other impediments for H4H include the program's higher fees and higher interest rates charged to borrowers and the requirement that profits made from the sale of the home be split with the federal government. Moreover, the H4H mortgage payment must not exceed 31% of the borrower's income, which helps few people who have fallen behind on their mortgage payments.
- FHA commissioner Brian Montgomery said lawmakers were hampered by a philosophical divide, when they cobbled the H4H program that made little sense. "There were two philosophies on the Hill: Let's throw the barn door open and help as many people as we can regardless of the reasons. Or we need to make them pay because they should have known what they were doing," said Montgomery. "They found some middle philosophical ground, but that philosophical middle ground made [the program] unworkable." Montgomery also complained that minor adjustments to the program must be passed through an oversight board, which further slows the FHA's response time. Frank called Montgomery's assessment of Congress's handling of the legislation "dishonest." As for oversight, the board is made up of Bush appointees, he noted. "Shame on them if that's the problem," said Frank. FHA's leadership in these trying times has been a "disappointment," said Frank.
- Montgomery responded that Frank's ire at FHA is misdirected. "Barney Frank may have a beef with some of the Republicans, but he shouldn't have a beef with us," said Montgomery.
- In a December 26th editorial, the *Washington Post* wrote, "PASSED BY Congress in July and put into effect on Oct. 1, the federal government's Hope for Homeowners program was billed as strong medicine for the twin ills of rampant foreclosures and sagging home prices. ...Well, the early returns are in, and the program is, at this point, a flop. There have been only 312 applications, according to the Department of Housing and Urban Development. At that rate, the three-year program would help only about 5,400 borrowers."
- "We hate to say we told you so, but—we told you so. Except that we never guessed that the program would perform quite this poorly. The Bush administration and the program's congressional author, House Financial Services Committee Chairman Barney Frank (D-MA), are now engaged in a blame game, with Bush officials saying that the program is a victim of burdensome conditions imposed by Congress and Frank asserting that he only agreed to those conditions as the price of a politically acceptable bill. Each side has a point. Mortgage relief causes genuine ambivalence among Americans of good faith. They feel sorry for their neighbors and want protection against an uncontrolled housing collapse, but they don't think it's fair to spend taxpayers' money bailing out people who took on unaffordable loans and the

bankers who enabled them. Hope for Homeowners tried to keep everyone happy by requiring lenders to sacrifice some of the principal value of homes while requiring borrowers to give up future profits and assume monthly payments of at least 31 percent of their incomes. This may have been the best available deal, politically, but it doesn't make sense, economically, for very many people. Therefore, hardly anyone has chosen it.”

- “After the reports of Hope for Homeowners's dismal start came another good news-bad news story about housing. Hope Now, a government-backed alliance of mortgage lenders, said it is on track to keep 2.2 million homeowners out of foreclosure in 2008—but banking regulators said that about half of the loans modified in the first three months of the year fell back into delinquency within six months. Consumer groups attribute the problem to the modifications' insufficiently generous terms, particularly lenders' refusal to reduce principal amounts or interest rates. There is some truth to this. But declining interest rates have lessened the problem of ‘exploding’ adjustable-rate mortgages. Increasingly, loan delinquencies and foreclosures result from unemployment; people who lose their jobs find it hard to make house payments on time. This suggests that even if loan modifications double in 2009, as Hope Now predicts, they may not keep pace with foreclosures.”
- “There is much discussion now of adding an even bigger anti-foreclosure measure to an economic stimulus plan in the first days of the Obama administration . But recent experience teaches that it is hard to design an anti-foreclosure plan that is both targeted and effective—and that the recession is now driving housing's woes, not the other way around.” (*Washington Post*, 12/26/08)
- In a December 16th newsletter from K&L Gates, Inc., Laurence E. Platt wrote, “In an odd twist to the concept of federal mortgage insurance, the Department of Housing and Urban Development ...is requiring originating lenders to insure the Federal Housing Administration ...against the risk of loss if the shared equity and shared appreciation documents that FHA prepared pursuant to the HOPE for Homeowners Program (the “Program”) are unenforceable under applicable state law. ...The Program’s shared equity and appreciation features raise significant potential issues under federal and state consumer credit laws, which is one of the reasons why lenders have not embraced the Program.... We urge HUD to eliminate the required representation and warranty by an originating lender regarding the model contracts’ compliance with state law. Originating lenders neither designed the parameters or structure of the Program (that was done by Congress), nor prepared the transaction documents in question (that was done by HUD). Moreover, originating lenders are not parties to the SAM and SEM transactions between the mortgagor and HUD, and they do not service these transactions on behalf of HUD. There is no logical reason that private lenders should bear HUD’s legal risk of loss based on both a Program designed by Congress and Program documents drafted by HUD. If the SEM and SAM features prove to be unenforceable under state law, HUD should bear that risk.”

- “Lenders simply are unwilling to take legal risk based solely on the design of the Program by Congress and HUD. Perhaps those in Congress who sponsored the Program under the Act could ask HUD why it is creating needless barriers to the Program's success. After all, it is counterintuitive that the insured would be required to protect the insurer against the legal risk of loss. The Act’s use of the word ‘HOPE’ is reserved for Homeowners, not for HUD.” (*K&L Gates Mortgage Banking and Consumer Credit Alert*, Lawrence E. Platt, 12/16/08)

A recipe for <i>another</i> disaster...

- The FHA is using 24-year-old computer programs and civil servants who handle some loan documents by hand to approve the 40,000 loan applications each month—up from 12,250 applications a month a year ago—as its market share new mortgages soared from 3% in all of 2007 to 40% in the third quarter of 2008.
- The Obama transition team must now consider how much risk the government should take on as one of the nation’s largest insurers of home mortgages. And can FHA handle physically the responsibility it has already been given? Some worry that the agency’s growth has come too fast, particularly as FHA has expanded rapidly into the most risky markets and insures larger loans. In March, Congress increased the FHA-insurance limits to \$729,000 in the most expensive housing markets, an increase of 122% over its previous insurance limit of \$329,000. [In 2009, the FHA insurance limit will fall to \$625,000 in high cost real estate markets—unless Congress reinstates the higher limit.] FHA has expanded its presence in higher cost, higher risk markets, such as California, where 10% of the agency’s mortgages’ collateral properties were located in FY2008, up from just 2% in FY2007.
- While private mortgage insurance companies have tightened their credit standards, FHA has not. The agency now offers loans with minimum down payments of 3.5%—up from 3.0% in 2008. With the PMI companies imposing much tougher standards, the danger is that the riskiest loans will flow to the FHA, said Joe Rogers, an EVP in the home mortgage business of Wells Fargo & Co.
- Congress’s micromanaging of the agency has restricted the FHA's ability to operate as a nimble financial institution. "In many ways, FHA has been inhibited from reaching its potential because of funding shortfalls and overly legislated strictures," said Preston. Congress hasn't approved a risk-based pricing mechanism requested by the agency that would allow the FHA to charge higher premiums to borrowers with poorer credit. These are "portfolio-management measures that any insurance company in the world has," said Preston. (*Wall Street Journal*, Nick Timiraos and James R. Hagerty, 12/26/08)

The Obama administration will likely expand Ginnie Mae's role in the housing market

- Ginnie Mae will likely play a bigger role in the housing market during the Obama administration, according to Joe Murin, the agency's president. "They're specifically looking at Ginnie Mae as to what else we can do" to help stabilize the mortgage market, said Murin. "[Obama's transition team have] said yes, we'd like Ginnie Mae to do more."
- Since Fannie Mae and Freddie Mac were placed into conservatorship on September 6, Ginnie Mae has issued more mortgage bonds than either Fannie or Freddie in the past two months and is likely to do the same for December with between \$27 billion and \$30 billion in volume, said Murin. The agency is expected to package as much as \$325 billion in MBS in 2009, up more than 47% from \$220 billion last year. "We're seeing the flight of the mortgage business into the FHA arena," he added.
- Over the past two years, Ginnie Mae's outstanding mortgage-backed securities have increased 52% to \$662 billion on November 30th and are projected to grow at a similar pace by the end of 2009 to possibly top \$1 trillion. The combined guarantees of Fannie Mae and Freddie Mac have swelled about 25% over the last two years to \$4.4 trillion in October. Murin attributes much of Ginnie Mae's growth to the fees that Fannie, Freddie and private mortgage insurers charge on to their mortgages. "The pricing is just outrageous," said Murin. "Unless you're a 720 FICO score with less than 20% down, you can't price effectively your mortgage with the GSEs. As a consequence you're seeing some very viable borrowers moving into the FHA arena." (*Bloomberg News*, Dawn Kopecki, 12/17/08)

Farm Credit System / Farmer Mac

Chickens coming home to roost

- In the December *Farm Credit Watch*, Bert Ely wrote, "Last month's *FCW* reported that VeraSun, a major ethanol producer and FCS borrower, had filed for Chapter 11 bankruptcy protection. VeraSun's third-quarter 10-Q provided further insight into the depth of the company's problems and the FCS's credit exposure to it. According to the 10-Q, AgStar, one of the largest FCS associations, had a \$459.1 million credit exposure to VeraSun on September 30, 2008—\$237.8 million in construction loans, \$166.6 million in senior secured notes due in 2012, and \$54.8 million in revolving term loans. In a November 4 news release, AgStar announced that it had "agreed to immediately provide \$15 million in Debtor-in-Possession (DIP) financing to VeraSun." Possibly, AgStar has laid off much of its VeraSun credit risk within the

FCS. Headquartered in Mankato, Minnesota, AgStar has been especially aggressive among the FCS associations in expanding its off-farm lending on a nationwide basis.”

- “AgStar asserted in its news release that ‘potential AgStar losses from [the VeraSun] situation are not expected to be material and any losses sustained should not impact AgStar’s overall financial soundness.’ Other parties may bear some of the VeraSun loss. The magnitude of those losses could become evident quite soon, for on November 24 VeraSun announced ‘that it recently received [from an unnamed party] a non-binding unsolicited indication of interest with respect to the purchase of substantially all of its assets.’ However, this offer ‘is subject to significant conditions, and there can be no assurance that it will result in the consummation of a transaction.’”
- “Given current adverse conditions in the ethanol industry, that sale could be at a substantial discount from the book value of VeraSun’s fixed assets. One indication of those adverse conditions—during the third quarter of this year, VeraSun suffered a negative gross profit margin of 20.1%, compared with a positive gross profit of 7.0% during the first half of 2008. That negative margin reflects lower gasoline prices and excess ethanol inventories. Although VeraSun reported a net worth of \$1.07 billion on September 30 underpinning total liabilities of \$1.84 billion, operating losses and a loss on asset sales could wipe out that net worth, bringing losses to VeraSun’s debt holders, including AgStar and other lenders.”
- “Pilgrim’s Pride, the nation’s largest chicken producer, filed for Chapter 11 bankruptcy protection on December 1. As the October FCW reported, over 20 FCS institutions, led by CoBank, had provided 60% of a \$1.17 billion credit facility to Pilgrim. The company has since obtained \$365 million of DIP financing. How much of that financing was provided by the FCS has not been revealed nor the credit losses the FCS may suffer. However, the \$800 million loss Pilgrim’s Pride reported for 2008’s calendar third quarter does not bode well for its creditors.” (*Farm Credit Watch*, Bert Ely, December 2008)

An ethanol bailout?

- In the December 24th editorial, the *Wall Street Journal* wrote, “Along with Russia, Venezuela, Iran and the Dubai property market, add another name to the list of bubble economies hurt by the falling price of oil: the ethanol industry. And naturally, the ethanol lobby is looking for a bailout on top of its regular taxpayer subsidies. The commodity bust has clobbered corn ethanol, whose energy inefficiencies require high oil prices to be competitive. The price of ethanol at the pump has fallen nearly in half in recent months to \$1.60 from \$2.90 per gallon due to lower commodity prices, and that lower price now barely covers production costs even after accounting for federal subsidies. Three major producers are in or near bankruptcy, including giant VeraSun Energy.”

- “So here they go again back to the taxpayer for help. The Renewable Fuels Association, the industry lobby, is seeking \$1 billion in short-term credit from the government to help plants stay in business and up to \$50 billion in loan guarantees to finance expansion. The lobby would also like Congress to ease the 10% limit on how much ethanol can be added to gasoline for conventional cars and trucks—never mind the potential damage to engines from such an unproven mix.”
- “Of course, the ethanol industry wouldn't even exist without the more than \$25 billion in taxpayer handouts over the past 20 years. Congress only recently passed energy and farm bills that further greased ethanol production with a 51 cent a gallon tax credit, corn subsidies, plus increasingly stringent biofuel mandates. We were told, as usual, that profitability was just around the corner.”
- “The uglier realities of corn ethanol are at least becoming more widely recognized, even on the political left. The Environmental Working Group and five other environmental organizations said this week they oppose a bailout because subsidies for corn-based ethanol have produced unintended, yet potentially catastrophic environmental consequences, with little or no return to taxpayers in energy security [or] protection from global warming.”
- “Don't expect Congress to listen. Ethanol may never be profitable in the real world, but in Washington it's a lucrative business that provides jobs and votes. Like Fannie Mae and Freddie Mac, ethanol is a business created by Congress that now has to be bailed out to save Congress from embarrassment.” (*Wall Street Journal*, 12/24/08)

Farm Credit Administration names its director of congressional and public affairs

- The Farm Credit Administration named Michael A. Stokke as its director of the Office of Congressional and Public Affairs. Stokke will lead FCA's congressional liaison, media relations, and public affairs efforts, effective December 8. Previously, he served as Deputy Chief of Staff to former Speaker of the House Dennis Hastert from February 1998 to October 2007, where he formulated political and communication agendas, managed press relations, and managed staff operations in two offices in Illinois and one in Washington, D.C. After leaving that position, he formed Prairie Strategies, a consulting firm based in Illinois, where he advised corporations and nonprofit organizations. (*Farm Credit Administration Press Release*, 12/16/08)

Farmer Mac raises \$50 million of new capital

- Farmer Mac has raised \$50 million of new equity to strengthen its regulatory capital position, through the issuance of \$85 million of new preferred stock and retirement of \$35 million of existing preferred stock. Farmer Mac said \$70 million of the new

capital raise consisted of Series B-3 preferred stock issued to a large institutional investor, which is callable on a quarterly basis beginning Sept. 30, 2009 and initially will pay a 10% annual dividend that will increase by 2% steps annually for the next three years. The remaining \$15 million of preferred stock was issued to the National Rural Utilities Cooperative Finance Corporation (NRUCFC). Farmer Mac has agreed to guarantee and purchase \$500 million of secured debt to be issued by NRUCFU in a deal that will require National Rural to invest in a new series of Farmer Mac preferred stock. (*National Mortgage News*, 12/16/08)

Postal Service

Postal Regulatory Commission issues report on the Postal Service's universal service obligation
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- On December 19th, the Postal Regulatory Commission issued its Report on Universal Postal Service and the Postal Monopoly to the President and Congress. Pursuant to the Postal Accountability and Enhancement Act of 2006, the PRC was directed to identify the scope and standards of universal service and the postal monopoly based on a comprehensive review of their history and development. According to the PRC report, the public is generally satisfied with the current level of universal service provided by the Postal Service. While no changes to either the universal service obligation or the monopoly are recommended at this time, the PRC noted the serious financial crisis currently facing the Postal Service and the general economy and urged Congress to use the Report as a guide, should a rebalancing of postal obligations become necessary to ensure future universal service. The PRC affirmed the current USO of providing mail service to all persons throughout the United States and determined current law requires that the USO apply to both competitive and market dominant postal products. The Commission is initiating a new public inquiry to allow interested persons to express their views on this report. (*Postcom.org*, 12/19/08; *eNAPUS Legislative & Political Bulletin*, 12/24/08)

USPS seeks relief from its financial pressures
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- In a December 23rd letter to House Speaker Nancy Pelosi (D-CA), House Federal Workforce, Postal Service, and the District of Columbia Subcommittee Chairman Danny Davis (D-IL) and Ranking Minority Member John McHugh (R-NY) wrote, "We are writing to request that the text of H.R. 7313, introduced on December 9, 2008, be included in the economic stimulus package currently being developed. This bill would assist the U.S. Postal Service to address its serious financial constraints and would serve to protect existing Postal Service jobs."

- “Challenging economic conditions are reducing mail volume substantially. The Postal Service lost 9 billion pieces of mail in FY2008. In addition, Congress statutorily required the Postal Service to begin pre-funding its retiree health benefits obligation in 2006 and this requirement is also placing a tremendous burden on the Postal Service. The payment schedule statutorily mandated by the Postal Accountability and Enhancement Act of 2006 (PAEA) requires the Postal Service to make an annual payment ranging from \$5.4 to \$5.8 billion from 2007 to 2016. In addition, under PAEA, the Postal Service makes a separate payment to the Office of Personnel Management (OPM) for its annual retiree health benefit premiums until 2016.
- "To address the Postal Service's immediate financial distress, we believe Congress should amend the PAEA to leave the ten-year PAEA payment stream intact, but allow the Postal Service to pay its retiree health premiums out of the Retiree Health Benefit Trust Fund (RHBF), rather than make a separate payment to OPM. This option would simply accelerate a provision in PAEA, which states that after 2016, premium payments would no longer be paid separately, but would be drawn from the RHBF. We would note that at the end of FY2008, the RHBF had a balance of roughly \$32 billion, so the goal of pre-funding retiree health benefits would continue.”
(*Correspondence to the Honorable Nancy Pelosi*, Representatives Danny Davis and John McHugh, 12/23/08)

TVA

TVA dike bursts, releasing more than 5.4 million cubic yards of ash and water

- On December 22, a TVA earthen dam holding back a 40-acre retention pond broke, releasing 5.4 million cubic yards of coal ash and water at the Kingston steam plant. Authorities said that no one was seriously injured or hospitalized as a result of the incident, believed to be caused by heavy rains and freezing temperatures.
- TVA spokesman John Moulton said that the utility’s environmental tests show elevated levels of lead and thallium in water near the breach, but tests elsewhere are within regulatory limits. "Right there at that point is the only place we've had elevated levels," said Moulton, who added that both chemicals should be removed by water treatment systems. Mercury and arsenic have been found in "barely detectable" levels, he added. "All samples received to date indicate that the water entering the Kingston Water Treatment Plant meets public health standards," said Tisha Calabrese-Benton, a spokeswoman for the Tennessee Department of Environment and Conservation.
- TVA estimated that approximately 300 acres were damaged by the spill, which includes half-a-mile square area owned by the TVA plant. “We’ve got surveyors

quantifying how much [of the damage impacts] private [property],” said Ronald Hall, the Kingston plant manager. He also said that the spill wrecked three homes and damaged nine others. Approximately 100 workers are working around the clock to remove the sludge.

- The real estate developer for North Lake Estates has filed a \$165 million lawsuit against TVA, claiming damages from the massive coal sludge spill. The plaintiffs said the spill has caused two real estate sales to fall through and has restricted access to the development by potential buyers. Four more plaintiffs with similar claims will likely be added to the lawsuit at a later date. (*CNN.com*, 12/30/08; *Associated Press*, Duncan Mansfield, 12/22/08; *Knoxville News Sentinel*, 12/27/08;)

TVA earnings rise, as energy demand falls

- Buoyed by electric rate increases in the spring, TVA’s net income nearly doubled for its fiscal year ended September 30, 2008. TVA earned net income of \$817 million for the year, on revenues of nearly \$10.4 billion. In contrast, the utility reported net income of \$423 million on revenues of \$9.3 billion for FY2007. The majority of TVA’s revenue gain came from its 12% rate increase in April and 2.1% increase in July. TVA’s productivity is at an all-time high with the total number of employees falling 11,500—the fourth lowest level in the utility’s history, while electricity production has increased to its highest level, topping 180,000 gigawatt hours. (*Chattanooga Times Free Press*, Dave Flessner, 12/16/08)

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