

The **GSE** REPORT™

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Financial Crisis Overview

In God we trust, all others pay cash...

- In his 2008 letter to Berkshire Hathaway shareholders, Warren Buffett wrote, "...As [2008] progressed, a series of life-threatening problems within many of the world's great financial institutions was unveiled. This led to a dysfunctional credit market that in important respects soon turned non-functional. The watchword throughout the country became the creed I saw on restaurant walls when I was young: 'In God we trust; all others pay cash.'"
- "By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices, had produced a paralyzing fear that engulfed the country. A freefall in business activity ensued, accelerating at a pace that I have never before witnessed. The U.S.—and much of the world—became trapped in a vicious negative-feedback cycle. Fear led to business contraction, and that in turn led to even greater fear."
- "This debilitating spiral has spurred our government to take massive action. In poker terms, the Treasury and the Fed have gone 'all in.' Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome aftereffects. Their precise nature is anyone's guess, though one likely consequence is an onslaught of inflation."
- "Moreover, major industries have become dependent on Federal assistance, and they will be followed by cities and states bearing mind-boggling requests. Weaning these entities from the public teat will be a political challenge. They won't leave willingly."
- "Whatever the downsides may be, strong and immediate action by government was essential last year if the financial system was to avoid a total breakdown. Had that occurred, the consequences for every area of our economy would have been cataclysmic. Like it or not, the inhabitants of Wall Street, Main Street and the various Side Streets of America were all in the same boat."
- "Amid this bad news, however, never forget that our country has faced far worse travails in the past. In the 20th Century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21.5% prime rate in 1980; and the Great Depression of the 1930s, when unemployment ranged between 15% and 25% for many years. America has had no shortage of challenges."
- "Without fail, however, we've overcome them. In the face of those obstacles—and many others—the real standard of living for Americans improved nearly seven-fold

during the 1900s, while the Dow Jones Industrials rose from 66 to 11,497. Compare the record of this period with the dozens of centuries during which humans secured only tiny gains, if any, in how they lived. Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has, and it will continue to do so. America's best days lie ahead." (*Letter to Shareholders*, Warren Buffett, 02/28/09)

No ordinary recession....

- In a speech in Toronto on the U.S. economic crisis, former Federal Reserve Board chairman Paul Volker said, "...This is not an ordinary recession. I have never, in my lifetime, seen a financial problem of this sort. It has the makings of something much more serious than an ordinary recession where you go down for a while and then you bounce up and it's partly a monetary—but a self-correcting—phenomenon. The ordinary recession does not bring into question the stability and the solidity of the whole financial system. Why is it that this is so much more profound a crisis? I'm not saying it's going to get anywhere as serious as the Great Depression, but that was not an ordinary business cycle either."
- "This phenomenon can be traced back at least five or six years. We had, at that time, a major underlying imbalance in the world economy. The American proclivity to consume was in full force. Our consumption rate was about 5% higher, relative to our GNP or what our production normally is. Our spending—consumption, investment, government—was running about 5% or more above our production, even though we were more or less at full employment."
- "You had the opposite in China and Asia, generally, where the Chinese were consuming maybe 40% of their GNP – we consumed 70% of our GNP. They had a lot of surplus dollars because they had a lot of exports. Their exports were feeding our consumption and they were financing it very nicely with very cheap money. That was a very convenient but unsustainable situation. The money was so easy, funds were so easily available that there was, in effect, a kind of incentive to finding ways to spend it."
- "When we finished with the ordinary ways of spending it – with the help of our new profession of financial engineering – we developed ways of making weaker and weaker mortgages. The biggest investment in the economy was residential housing. And we developed a technique of manufacturing class D mortgages but putting them in packages which the financial engineers said were class A."
- "So there was an enormous incentive to take advantage of this bit of arbitrage – cheap money, poor mortgages but saleable mortgages. A lot of people made money through this process. I won't go over all the details, but you had then a normal business cycle on top of it. It was a period of enthusiasm. Everybody was feeling exuberant. They wanted to invest and spend."

- “You had a bubble first in the stock market and then in the housing market. You had a big increase in housing prices in the United States, held up by these new mortgages. It was true in other countries as well, but particularly in the United States. It was all fine for a while, but of course, eventually, the house prices leveled off and began going down. At some point people began getting nervous and the whole process stopped because they realized these mortgages were no good.”
- “You might ask how it went on as long as it did. The grading agencies didn’t do their job and the banks didn’t do their job and the accountants went haywire. I have my own take on this. There were two things that were particularly contributory and very simple. Compensation practices had gotten totally out of hand and spurred financial people to aim for a lot of short-term money without worrying about the eventual consequences. And then there was this obscure financial engineering that none of them understood, but all their mathematical experts were telling them to trust. These two things carried us over the brink.”
- “...There was so much opaqueness, so many complications and misunderstandings involved in very complex financial engineering by people who, in my opinion, did not know financial markets. They knew mathematics. They thought financial markets obeyed mathematical laws. They have found out differently now. You know, they all said these events only happen once every hundred years. But we have “once every hundred years” events happening every year or two, which tells me something is the matter with the analysis.”
- “So I think we have a problem which is not an ordinary business cycle problem. It is much more difficult to get out of and it has shaken the foundations of our financial institutions. The system is broken. I’m not going to linger over what to do about it. It is very difficult. It is going to take a lot of money and a lot of losses in the banking system. It is not unique to the United States. It is probably worse in the UK and it is just about as bad in Europe and it has infected other economies as well. Canada is relatively less infected, for reasons that are consistent with the direction in which I think the financial markets and financial institutions should go.”
- “So I’ll jump over the short-term process, which is how we get out of the mess, and consider what we should be aiming for when we get out of the mess. That, in turn, might help instruct the kind of action we should be taking in the interim to get out of it.”
- “In the United States, in the UK, as well—and potentially elsewhere—things are partly being held together by totally extraordinary actions by a central bank. In the United States, it’s the Federal Reserve, in London, the Bank of England. They are providing direct credit to markets in massive volume, in a way that contradicts all the traditions and laws that have governed central banking behavior for a hundred years.”

- “So what are we aiming for? I mention this because I recently chaired a report on this. It was part of the so-called Group of 30, which has got some attention. It’s a long and rather turgid report but let me simplify what the conclusion is, which I will state more boldly than the report itself does. In the future, we are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort. Financial systems always fluctuate and go up and down and have crises, but let’s not have a big crisis that undermines the whole economy. And if that’s the kind of financial system we want and should have, it’s going to be different from the financial system that has developed in the last 20 years.”
- “What do I mean by different? I think a primary characteristic of the system ought to be a strong, traditional, commercial banking-type system. Probably we ought to have some very large institutions – or at least that’s the way the market is going – whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit. They ought to be the core of the credit and financial system.”
- “This kind of system was in place in the United States thirty years ago and is still in place in Canada, and may have provided support for the Canadian system during this particularly difficult time. I’m not arguing that you need an oligopoly to the extent you have one in Canada, but you do know by experience that these big commercial banking institutions will be protected by the government, de facto. No government has been willing to permit these institutions, or the creditors and depositors to these institutions, to be damaged. They recognize that the damage to the economy would be too great.”
- “What has happened recently just underscores that. And I think we’re at the point where we can no longer fool ourselves by saying that is not the case. The government will support these institutions, which in turn implies a closer supervision and regulation of those institutions, a more effective regulation than we’ve had, at least in the United States, in the recent past. And that may involve a lot of different agencies and so forth. I won’t get into that.”
- “But I think it does say that those institutions should not engage in highly risky entrepreneurial activity. That’s not their job because it brings into question the stability of the institution. They may make a lot of money and they may have a lot of fun, in the short run. It may encourage pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It’s not consistent at all with avoiding conflict of interest.”
- “These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest. And I think the conflicts of interest contribute to their instability. So I would say let’s get rid of that. Let’s have big and small commercial banks and protect them – it’s the service part of the financial system.”

- “And then we have the other part, which I’ll call the capital market system, which by and large isn’t directly dealing with customers. They’re dealing with each other. They’re trading. They’re about hedge funds and equity funds. And they have a function in providing fluid markets and innovating and providing some flexibility, and I don’t think they need to be so highly regulated. They’re not at the core of the system, unless they get really big. If they get really big then you have to regulate them, too. But I don’t think we need to have close regulation of every peewee hedge fund in the world.”
- “So you have this bifurcated – in a sense – financial system that implies a lot about regulation and national governments. If you’re going to have an open system, you have got to get much more cooperation and coordination from different countries. I think that’s possible, given what we’re going through. You’ve got to do something about the infrastructure of the system and you have to worry about the credit rating agencies.”
- “These banks were relying on credit rating agencies while putting these big packages of securities together and selling them. They had practically – they would never admit this – given up credit departments in their own institutions that were sophisticated and well-developed. That was a cost centre – why do we need it, they thought. Obviously that hasn’t worked out very well.”
- “We have to look at the accounting system. We have to look at the system for dealing with derivatives and how they’re settled. So there are a lot of systemic issues. The main point I’m making is that we want to emerge from this with a more stable system. It will be less exciting for many people, but it will not warrant – I don’t think the present system does, either — \$50 million dollar paydays in that central part of the system. Or even \$25 or \$100 million dollar paydays. If somebody can go out and gamble and make that money, okay. But don’t gamble with the public’s money. And that’s an important distinction.”
- “It’s interesting that what I’m arguing for looks more like the Canadian system than the American system. When we delivered this report in a press conference, people said, ‘Oh you mean, banks won’t be able to have hedge funds? What are you talking about?’ That same day, Citigroup announced, ‘We want to get rid of all that stuff. We now realize it was a mistake. We want to go back to our roots and be a real commercial bank.’ I don’t know whether they’ll do that or not. But the fact that one of the leading proponents of the other system basically said, ‘We give up. It’s not the right system,’ is interesting.’ (*Investors Insight*, John Mauldin, 02/23/09)

The Darwinian flush must occur in the residential real estate market
before housing can recover

- In *House of Cards*, CNBC correspondent David Faber provides an in-depth analysis of the U.S. housing bust which triggered today's financial crisis. In an interview, Kyle Bass, whose hedge fund earned \$1 billion over 18 months by shorting the subprime mortgage market, tells Faber: "...[During the subprime frenzy,] clearly people borrowed too much. Clearly lenders lent them too much. That will not balance itself out until there's a Darwinian flush—until there is a flush of people that can't afford to repay loans and they get wiped out and home values get back to a level where people can afford them." The 90 minute program may be viewed at <http://www.hulu.com/watch/59026/cnbc-originals-house-of-cards>. (*CNBC News Release*, 02/02/09)

How marked-to-market contributed to today's financial crisis

- In a February 26th letter to shareholders, Sears chairman Edward S. Lampert wrote, "...In normal times, market values are volatile and in extraordinary times extremely volatile. For those entities required to sell assets because of their business model or because of their funding circumstances, they are subject to the whims of the market and their business may be severely impacted by wherever market prices may end up on a given date. For many companies, market values can be a guide for purchases and sales of assets, but they don't force actions by the companies."
- "Benjamin Graham said, as Warren Buffett paraphrased, that 'in the short run, the market is a voting machine. In the long run, it's a weighing machine.' Despite this caution, much of our financial system now rests on the shoulders of a 'voting machine' rather than a 'weighing machine.' Don't be fooled by the term 'mark-to-market.' Mark-to-market is a regulatory convention and not a free market convention. As regulated entities, most financial institutions are required to account for their assets by regulatory convention. Similarly, all publicly traded companies are required to conform to GAAP (Generally Accepted Accounting Principles). This helps for comparability and it helps to assure investors that they can rely on the financial statements of publicly traded companies."
- "What has happened is that we have gone from a system which stressed objectivity and verifiability to a system in which the market price of an asset, under conditions of economic stress and financial dislocation, must be derived using a significant amount of judgment. But this is not where it stops. Once you accept the mark-to-market convention, you begin the debate of what is the correct market price. Different people and different firms end up pricing the same asset differently. This has been true for a long time in the derivatives markets, but it also is now true in markets in which asset prices are less liquid. This allows critics and commentators to charge that financial institutions are not marking their assets properly (regardless of whether the

critics have any specific evidence or not). The incessant drumbeat of these charges leads to a loss of confidence among investors as well as concerns from regulators and rating agencies who are fearful of being accused of being lax in overseeing these institutions. The accounting profession, as well, is put into a position of being second-guessed for the financial statements they prepare and certify, so they too become 'conservative.' So much time and money ends up spent ensuring that the financial statements are immune from criticism that it can become much more of a distraction than a useful tool for investors and managers.”

- “That doesn’t mean that mark-to-market has no bearing or that it is wrong. It is important for investors as well as regulators to appreciate the consequences of certain conventions. Imagine you were accounting for an oil company and oil was trading at \$140 when you had to produce financial statements. Three months later, oil is at \$60 and you produce another set of financial statements, marked-to-market. Given the transparency of a single commodity, when the next set of financial statements is produced, the assets of the company are significantly lower. The company explains that with the drop in the price of oil, the value of the assets is significantly lower than three months before. To most investors this would make sense.”
- “Now, take a similar company, but instead of oil as a single commodity, substitute thousands of financial instruments of different types. Each type of asset will have its own price path and level of volatility. When a financial statement is produced three months later showing dramatically lower assets and a significant loss, it is impossible for an outsider to conclude whether the financial statements of three months prior were inaccurate simply because the new financial statements show lower asset values. Sarbanes-Oxley rules were designed to improve the accountability and oversight of public company financial statements to increase investor confidence. Despite these rules, over the past year we have witnessed all kinds of accusations and assertions about company financial statements and management credibility. Instead of recognizing that price volatility, illiquidity, and mark-to-market rules are the primary reason for volatility in financial statements, many have concluded that you can’t trust the ‘bankers’ and that additional regulation and oversight is needed.”
- “The tendency to overreact is very significant. The risk-reward calculation for regulators and rating agencies are heavily weighted towards assuming the worst and acting based on those assumptions. The result of these actions, however, is extremely harmful for the system as a whole. I believe that in a capitalist society we are always faced with the tradeoffs between freedom and tyranny. In a free society and free markets, what people say and what people write have been largely protected by the U.S. Constitution (this is not always true in any capitalist society). This is much less true in the economic domain, where constitutional protections of private property and economic rights have been watered down over time to permit significant levels of regulation and government intervention. Just as with free speech and a free press you will have people saying things that others view as harmful, hateful, or obscene, so too in a free economy you will have individuals and businesses doing things that others will disagree with. Some of those things may lead to great business success and

others to failure or to disgrace. To expect or allow for excessive regulation of business, including financial businesses, is to stifle growth and creativity, which ultimately produce jobs and wealth that are the foundation for any successful and free society.”

- “The two most important books that any student of current events should be reading in this environment are both by Friedrich Hayek, the esteemed Austrian economist. Based on events he witnessed beginning in the early part of the 20th century, Hayek wrote *The Road to Serfdom* as a warning to England and the United States against the damaging impact of socialist policies and *The Fatal Conceit* as a warning against heavy intervention in markets and society at large. Despite the almost universal belief today that more, but better, regulation is needed and that the role of the state needs to be not just temporarily larger, but permanently larger, Hayek’s writings and logic should give everybody pause as to the consequences of these actions.”
- “As a country, we need to rebuild confidence and trust and to understand what happened. Whether by business or by government, the misdiagnosis of situations leads to poor prescriptions for rehabilitation and recovery. When the misdiagnosis is done at the federal government level and involves large parts of a national economy, the consequences can be swift and significant. The unintended consequences are often swifter and even more significant. As the leaders in our nation continue to evaluate and evolve the policies and rules of the game, we would all be wise to heed the cautions raised by Friedrich Hayek. I appreciate that the free market can be a difficult master and that there is an important role for government and regulators, but I hope that as we move forward the rules of the game and the methodology for changing those rules will be more consistent and fair than they have been over the past year. Those who desire to protect civil liberties in times of war appreciate the importance of laws protecting individuals and institutions. In times of economic and financial distress we need to be similarly vigilant in protecting economic and contract rights so that we can continue to have a system that functions properly. Attempts to threaten or eliminate those rights will chase away the capital and investment that our country needs to restore prosperity and to thrive in the future.” (*Letter to Shareholders*, Edward S. Lampert, 02/26/09)

Major Events

President Obama's \$3.6 trillion budget

The administration may put Fannie and Freddie on the federal budget

Wrong policy at the wrong time

Budget Highlights

- The outline of President Obama's FY-2010 budget proposal unveiled the new Administration's policy priorities including universal health care, education, green energy and tax hikes on upper income individuals (taxpayers earning over \$250,000/married and \$200,000/single) which will "kick-in" in 2011. The budget outline closely resembles the campaign proposals made by the Obama Campaign.
- The Administration has announced that it will send a complete (and detailed) budget package to Capitol Hill in early April. Until high level appointees are named at Treasury, the White House will be filling in the details for the budget. Those details will be needed if the Administration expects Congress to advance. The budget outline reflects that parts of the proposal will be controversial, so the Administration will need to fight for its priorities.
- Unlike budgets prepared in past Administrations, the budget uses a "current policy" baseline. This means that many big-ticket items, such as funding for the wars in Iraq and Afghanistan, are included in the budget numbers. It also allows the ongoing issues of AMT tax reform, estate tax reform, and physician fee updates to be budgeted as not costing as much so solving these issues may be more politically viable. This is a major change in budget policy that will need to be adopted by Congress to be effective.
- In addition, the budget outline includes \$750 billion as a "placeholder" for potential additional expenses that may be needed for the bank bailout. The budget outline does not count expenses for the bank bailout on a net basis – projecting estimated costs minus estimated profits by selling any assets it buys.
- With regard to the HUD budget, Obama proposes to boost spending at HUD from \$40.1 billion for FY2009 to \$47.5 billion FY2010. The budget request includes \$4.5 billion of new funds for HUD's Community Block Grant Program; \$1.4 billion to expand the HOPE for Homeowners program; and \$1 billion for the Affordable Housing Trust Fund [which was to have been funded from Fannie Mae and Freddie Mac's profits]. HUD and the FBI will also receive increased funding to help crack down on mortgage fraud.

- Obama also set a goal of slashing the deficit to \$533 billion—or 3% of GDP—by 2013 through a rollback of the Bush tax cuts and a planned drawdown of U.S. troops from Iraq. In his address before Congress, Obama said his administration “already has identified \$2 trillion in savings” to help trim deficit spending, but officials concede that about half of those “savings” are actually tax increases. [After 2013, the budget deficit is projected to begin to climb from there as the Baby Boom generation begins drawing Social Security and Medicare benefits.]
- In a February 26th interview on *Fox News*, Senator Judd Gregg (R-NH) said, “This budget does nothing to get under control what I call the fiscal tsunami which is this huge cost that is coming at our country and specifically at the next generation to support my generation as we retire. And it will basically overwhelm our children and our grand children... Basically, it will bankrupt our country... In my opinion there is excessive spending on the entitlement side, which is where we should have savings rather than new spending. And, of course, there is a lot of new taxes here about 1.4 trillion dollars. ... It is going to bankrupt the country.” (*New York Post*, Geogg Earle, 02/28/09; <http://www.youtube.com/watch?v=HlcrwsOnD5U>; *Wall Street Journal*, Naftali Bendavid and Greg Hitt, 02/27/09; *Wall Street Journal*, Nick Timiraos, 02/27/09; *Bureau of National Affairs*, Aaron Lorenzo, 02/27/09; *Wall Street Journal*, Jonathan Weisman, 02/26/09; *Bloomberg News*, Dawn Kopecki, 02/26/09; *Reuters*, Caren Bohan and Jeff Mason, 02/26/09; *ABC News*, Jake Tapper, 02/26/09; *Wall Street Journal*, 02/27/09; *New York Times*, David Leonhardt, 02/27/09; *Washington Post*, Lori Montgomery, 02/26/09; *Wall Street Journal Online*, Jessica Holzer and Henry J. Pulizzi, 02/26/09)

The administration may put Fannie and Freddie on the federal budget

- OBM director Peter Orszag said Fannie Mae and Freddie Mac’s \$6.6 trillion of liabilities may be added to the federal budget after the administration has time to review the potential consequences. In a Bloomberg Television interview, Orszag said the administration’s budget blueprint didn’t incorporate the GSEs, because his staff hasn’t had enough time to analyze the implications. “I haven’t really changed my mind,” said Orszag, who advocated adding the GSE debt to the budget last year when he ran CBO. “We had five weeks to put together this budget overview. In that context, we tried to deal with the most urgent issues. Consolidating the books of the government-sponsored enterprises, Fannie Mae and Freddie Mac, directly into the federal budget will be something that we’ll be looking at as we have a little more time to process everything.” According to the administration’s budget outline, Fannie and Freddie will need \$173 billion in federal aid through 2011. (*Bloomberg News*, Pimm Fox and Dawn Kopecki, 02/27/09)

Wrong policy at the wrong time

- The banking industry voiced strong opposition to Obama’s proposal to limit the deductibility of mortgage interest by wealthy homeowners, concerned that that

proposal would make homeownership unattractive and exacerbate problems in the residential real estate market. “What we’re worried about is a reduction in the inherent incentive in our tax code to own a home,” said Josh Denney, an associate vice president of public policy at the Mortgage Bankers Association. “We think that today’s economy calls for additional tax stimuli, not a reduction in housing-related tax benefits.” Chris Low, chief economist for FTN Financial Capital Markets, said, “It’s going to provide an incentive for higher-income individuals to pay down their loans. If the pool of total loans shrinks and the good ones are paid off, then the ratio of bad loans is going to be higher, and bad loans are already at the heart of our banking crisis.” Representative Michele Bachmann (R-MN) called the administration’s proposal “very troubling,” and added: “The housing industry ... is in a very difficult position right now, and to phase that out at a time when on one hand [President Obama] is trying to stimulate the market and on the other hand he’s trying to send a poison dart into the market makes no sense. What we are lacking more than anything in financial markets is certainty.” (*American Banker*, Steven Sloan and Emily Flitter, 02/27/09)

- In a February 26th letter to President Obama, Charles McMillan, president of the National Association of Realtors, expressed his group’s opposition to the president’s proposal to modify the Mortgage Interest Deduction (MID) as part of the administration’s 2010 federal budget. McMillan wrote, “...The National Association of REALTORS® believe the MID is the single most important tax provision for our nation and our families. Diminishing or eliminating the MID would hurt all families, the housing market and our national economy. And, at a time when our housing and real estate markets are suffering, we believe it would be irresponsible for the real estate industry and federal policymakers to consider, much less support, any proposal seeking to alter the MID.” (*Correspondence to President Barack Obama*, Charles McMillan, 02/26/09)

Budget Highlights

- Defense: The budget outline assumed a reduction in troops in Iraq, but defense spending actually increases by 4% to \$534 billion in FY 2010. This includes a \$76 billion FY 2009 supplemental spending request plus \$130 billion for the following year.
- Tax Hikes: The budget outline includes –
 - \$636 billion in new revenues from individuals to pay for deficit reduction --
 - By allowing the Bush tax cuts to expire at the end of 2010 –
 - the top individual tax rate will increase to 39.6% from the current 36%
 - applies to taxpayers earning over \$250,000/married and \$200,000/single
 - the top tax rate for dividends and capital gains will increase 20% from the current 15%

- The personal exemption phase-out and limitation on itemized deductions for those taxpayers earning over \$250,000/married and \$200,000/single will be reinstated
 - Several hundred billion for changes in carried interest and other individual taxes
 - Carried interest would be taxed as ordinary income
 - \$645 billion in new revenues from a climate change cap and trade proposal
 - The Cap and Trade system to tax carbon emissions would begin in 2013.
 - \$353 billion in “loophole closers” and other corporate revenue changes including --
 - \$210 billion in additional revenues from multinational businesses by limiting deferral
 - \$31 billion by repealing oil and gas company provisions
 - \$61 billion from repealing LIFO accounting
 - The Economic Substance Doctrine would be codified
 - Information reporting for rental payments would be required
 - The Advance Earned Income Tax Credit would be repealed
- Tax Cuts for Businesses: The budget outline includes several business tax cuts –
 - Expands the Net Operating Loss (NOL) carry back provision that was dropped from the Stimulus Package
 - Makes the R&D credit permanent
 - Eliminates small business capital gains
 - Extends the expiring tax extenders for one more year through 2010
- Tax Cuts for Individuals: The budget outline recommends that –
 - A Making Work Pay Tax Credit be provided
 - The Earned Income Tax Credit be expanded
 - The refundability of the Child Tax Credit be expanded
 - The Saver’s Credit and Automatic Enrollment in IRAs and 401(k)s be expanded
 - American Opportunity Tax Credit be provided
 - The 2009 estate tax rates and exemption (45% and \$3.5 million in 2010 and baseline be extended
- Health Care: The budget outline recommends the establishment of a \$634 billion Health Reserve Fund that would move the system towards universal coverage. This would, in part, be paid for by efficiency gains from Health IT improvements and limitations on deductions for upper-income individuals.

House-passed omnibus includes TILA enforcement authority for state attorney generals
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- On February 25th, the House approved an omnibus bill which contains a provision giving state attorneys general new authority to enforce the Truth in Lending Act (TILA). [Currently, only the Federal Reserve Board and Federal Trade Commission have TILA enforcement authority.] The omnibus provision also gives the Federal Trade Commission a new authority to assess civil penalties of up to \$16,000 per

violation of Regulation Z with regard to unfair, deceptive, or abusive mortgage lending practices. (*Bureau of National Affairs*, Nancy Ognanovich, 02/27/09; *Wall Street Journal*, 02/26/09)

President Obama announced \$275 billion plan to stem mortgage foreclosures

- On February 18th, President Obama announced plans to spend up to \$275 billion on his Homeowner Affordability and Stability Plan (HASP) in an effort to stem home foreclosures. The four point plan will (i) allow an estimated 4 million to 5 million distressed homeowners whose mortgages are owned by Fannie Mae or Freddie Mac to refinance their mortgages; (ii) provide new financial incentives and requirements for mortgage servicers to encourage them to modify mortgage loans at risk of default and foreclosure; (iii) require Treasury to take “major steps” to keep mortgage rates low, which will facilitate refinancing for troubled homeowners; and (iv) adopt a “wide range of reforms designed to help families stay in their homes and avoid foreclosure”—including passage of legislation that would allow bankruptcy judges to reduce mortgages on primary residences to their fair market value and a \$10 billion partial guarantee program to protect investors and servicers against further home price declines for loans that were modified under HASP.
- HASP will bring together a number of financial regulators, along with Fannie Mae and Freddie Mac, to deploy a \$75 billion fund—\$50 billion from the TARP and \$25 billion from Fannie Mae and Freddie Mac—to help at-risk homeowners modify their mortgages. Money from the loan modification fund will be used to help reduce the borrowers’ monthly payments, provided the lender is willing to realize a loss as well. To qualify for the plan, the lender would have to reduce the loan’s monthly mortgage payment to no more than 31% of the borrower’s monthly income. The program, which is available only to owner-occupied properties which have been financed through a first mortgages, would provide mortgage servicers an upfront fee of \$1,000 for each eligible loan and “pay for success” fees of up to \$1,000 each for three years, if the borrower remains current on the loan. Borrowers can receive a principal reduction of \$1,000 a year for up to five years if they stay current with their payments on the modified loan. The government will also provide incentive payments of \$1,500 to mortgage holders and \$500 to servicers for modifications made while a borrower at risk of imminent default is still current. Treasury is working with banking regulatory agencies and following the lead of FDIC in developing guidelines for which mortgages will for HASP. The plan will require all financial institutions which receive funds from the second tranche of TARP to implement the same loan modification guidelines as HASP. The program will go into effect on March 4th, when Treasury publishes detail rules governing the program.
- To help the 30 million homeowners who are current on their mortgages that are owned or guaranteed by Fannie or Freddie, Obama’s plan also would make it easier for those borrowers to refinance at today’s lower rates. While these new loans would not be subsidized, the borrowers would not need to have 20% equity in their homes to

refinance the loan. To help these estimated 4 million to 5 million borrowers, the Obama administration is also prepared to allow Fannie and Freddie's mortgage portfolios to increase from \$850 billion to \$900 billion and waive the rule restricting the GSEs from refinancing mortgages that exceed 80% of the underlying collateral. The limitation to this program is that it would not help "underwater" borrowers, by being available only for mortgages that are no more than 5% above the current market value of the house. Mark Zandi, chief economist for Moody's *Economy.com*, said the plan would help less than one million of the 14 million homeowners who are underwater.

- In addition, Obama's plan also provides an additional \$200 billion for the purchase of preferred stock in Fannie Mae and Freddie Mac, bringing the federal government's financial commitment to the GSEs to \$400 billion. James B. Lockhart, director of the Federal Housing Finance Agency, said, "Resetting those [capital] agreements from \$100 to \$200 billion each should remove any possible concerns debt and mortgage-backed securities investors have about the strong commitment of the U.S. government to support Fannie Mae and Freddie Mac." The GSEs now "are front and center," said John Courson, the president of the Mortgage Bankers Association. "What it does to their future and coming out of conservatorship, only time will tell. But the refinancing portion and loan modification plan are activities they are going to be committed to for years."
- The most controversial aspect of the plan is the administration's plan for Congress to pass "cramdown" legislation, which would allow judicial modifications to home mortgages in the midst of foreclosure, a measure strongly opposed by the financial services industry. The Obama administration said it supports applying cramdown provisions only to loans that can be purchased by Fannie Mae and Freddie Mac. David Kittle, chairman of the Mortgage Bankers Association, said, "Any borrower who cannot stay in their home under [the Obama foreclosure-prevention plan] will certainly not be helped by cram down." The U.S. Chamber of Commerce said that cram-down legislation will "create hundreds of separate mortgage modification policies and will extend uncertainty in the housing market, ultimately raising interest rates."
- Diane Casey-Landry, the American Bankers Association's SVP and COO, issued a statement 'welcoming' the president's announcement of HASP, which she called a "constructive, flexible, and multifaceted initiative likely to have a positive effect on preventing mortgage foreclosures." ABA is committed to working closely with the administration as it completes the remaining details of the plan, she said. The Financial Services Roundtable and the Housing Policy Council, issued a joint statement saying that the groups supported the plan "that includes a uniform modification program with government support to assist American homeowners through the current housing foreclosure crisis" and to working with the administration on fleshing out the remaining details of the plan. While noting that the plan is "thoughtful and comprehensive," Roundtable president and CEO Steve Bartlett opposes the cramdown provisions, adding that such changes should be "as narrowly

tailored as possible and should not undermine other positive components of the president's plan." ICBA president Camden Fine said his organization continues "to oppose legislative efforts that will permit bankruptcy judges to rewrite primary residential mortgages since it will significantly increase the cost of lending to all consumers."

- In a February 19th statement, Senator Richard Shelby said: "The President's [HASP] plan appears to help those who least need it, and doesn't help those that do. The Fannie/Freddie proposal allows underwater homeowners to refinance even if they are not at risk of default. This will encourage lenders to help those who need help the least which will divert resources from families most immediately at risk of losing their home. The biggest outrage is that the President's plan actually will use taxpayer money to pay people to do what they are already supposed to do – pay their mortgage. It also uses taxpayer money to pay banks to do what they should already be doing – modifying mortgages. This is nothing more than a lender bailout where the American taxpayer is once again being asked to foot the bill. Once again, I believe our first priority must be to effectively address the problems in our banking system. Once that is done, we will have built the foundation upon which an economic recovery can be built."
- Wilber Ross, owner of distressed asset investment company WL Ross & Co., estimates that risky lending practices have placed approximately \$2.4 trillion of American homes underwater and potentially at risk of foreclosure. By Ross's analysis, Obama's plan earmarks \$75 billion to cover 9 million homeowners over five years—\$8,000 per borrower [over five years] or \$1,600 annually—to offset the cost of mortgage modification. In an interview on CNBC's *Squawk Box*, Ross said, "Does anyone really think that all that keeps 9 million people from losing their homes is \$1,600 a year? I don't think so." He argued that the HASP doesn't go far enough. "They have to reduce the principal amount of loan, not just nonperforming loans, but also performing ones. Why should a guy who's not paying benefit, while some poor citizen who's struggling to make the payments gets stuck with the mortgage?"
- "This puts the whole moral-hazard issue front and center," said Howard Glaser, a former HUD official in Clinton administration. "This is the equivalent of having the government write a check to both the borrowers and the banks, who both made bad decisions. But if you are going to do something, regardless of the mechanism, you are going to have to cross the Rubicon to direct federal assistance. It's a sign of how very few options are left."
- For all the political hazards of bailing out people who made bad decisions, many economists say the government needs to attack foreclosures if it wants to turn around the economy. In testimony before the House Financial Services Committee, Federal Reserve chairman Ben Bernanke said it imperative to help at struggling homeowners—even if they couldn't afford their home in the first place—because the housing market has crippled the economy. "Some borrowers presumably knew what they were getting into," said Bernanke. "But from a public policy point of view, the

large amount of foreclosures are detrimental not just to the borrower and lender but to the broader system. In many of these situations we have to trade off the moral hazard issue against the greater good.”

- In testimony before the Senate Banking Committee, HUD Secretary Shaun Donovan said the Obama administration expects mortgage servicers to begin implementing its loan modification and refinancing plan immediately after detailed guidelines are released the week of March 2nd. Further, he assured lawmakers that the plan would soon begin showing results, adding: “Certainly in April, we will see a significant decline in foreclosures.” Donovan’s optimism was in stark contrast to recent comments made by MBA president John Courson in a letter Treasury Secretary Timothy Geithner and Secretary Donovan. Courson wrote, “MBA wants the government and borrowers to have realistic expectations on how quickly all of the loans eligible under the program can be identified and processed.” Courson also warned that servicers will need new data systems to process applications and track loan performance, which will require time and resources to acquire and verify borrower information and appraisal data.
- Donovan also addressed the lawmakers’ questions about the bankruptcy cramdown provision, which he acknowledged “is an issue of fairness,” which affects lenders and investors, as well as struggling homeowners who do not file for bankruptcy. “We don’t want to disturb the markets any further,” he said. “There are a couple of provisions we think are important in terms of carefully tailoring this legislation.” The provision should be limited to those loans that have already been originated, which should alleviate concerns about the provision triggering higher interest rates, said Donovan. The bankruptcy option should only be available to homeowners who are unable to obtain loan modifications from their lender and borrowers should be required to certify that they engaged in good-faith efforts to modify their mortgage, he added. “We want to be very clear, this is not a solution to the issues that most homeowners have in struggling with their payments... It is only a last-case resort,” said Donovan. The Secretary hinted to the panel that the administration would be open to other measures to narrow the bankruptcy provision, such as limiting loan write-offs to no more than the current market value of the home.
- Separately, the House of Representatives delayed a vote on cramdown legislation until the week of March 2nd, after certain Democrats voiced opposition to the bankruptcy provisions, arguing that loan modifications should be negotiated between borrowers and their lenders rather than bankruptcy courts. HUD Secretary Donovan has been invited to brief House Democrats in a closed-door meeting on March 2 to discuss how the bill fits with the Obama administration’s broader housing plan. A spokesman for House leadership said the bill will likely come up for a vote on March 3 or 4. The bill is expected to clear the House, but faces an uncertain future in the Senate when the chamber takes up the bill in mid-March. Senate Republican leaders are pushing an alternative bill, which would steer troubled borrowers to low-interest loans from Fannie Mae and Freddie Mac, among other things, in lieu of giving enhanced authority to bankruptcy judges.

- CBO released its estimated costs associated with The Helping Families Save Their Homes Act (H.R. 1106), which contains the mortgage cramdown provision, along with modifications to the Hope for Homeowners program, protection for mortgage servicers from liability stemming from loan modifications, and a permanent increase of FDIC deposit insurance to \$250,000. CBO wrote, “The Act would increase direct spending by about \$8 billion over the 2009-2014 period, and would reduce direct spending by about \$15 billion over the 2009-2019 period. Enacting H.R. 1106 would increase revenues by \$19 million over the 2009-2014 period and by \$23 million over the 2009-2019 period.” Of the one million homeowners who might benefit from the cramdown provisions, CBO estimates, approximately 350,000 homeowners would take advantage of the proposed bankruptcy cramdown legislation over the next ten years—“[a]lthough the number of additional bankruptcy filings that would occur under the bill is ...very uncertain.” Even without the legislation, CBO estimated that Chapter 13 filings will grow 13% in 2009 after growing 14% in 2008. Of those Chapter 13 filers, 96% are homeowners.
- On February 27th, Credit Suisse warned investors that if Congress’s mortgage cram down bill passes without a clause imposing losses based on subordination levels, life insurers could take material losses in triple-A tranches of some mortgage-backed securities. The sector’s shares took another pounding on February 27th due to raised concerns about big losses on the insurer’s investment portfolios and recent downgrades of 10 companies by Standard & Poor’s.
- In a *Wall Street Journal* editorial, George Mason University law professor Todd J. Zywicki wrote, “...Mortgage modifications during bankruptcy will almost certainly increase the losses of mortgage lenders—and this may further freeze credit markets. The reason is that when mortgage-backed securities were created, they provided no allocation of how losses were to be assessed in the event that Congress would do something inconceivable, such as permitting modification of home mortgages in bankruptcy. According to a Standard & Poor’s study, most mortgage-backed securities provide that bankruptcy losses (at least above a certain initial carve-out) should be assessed pro rata across all tranches of securities holders. Given the likelihood of an explosion of bankruptcy filings and mortgage losses through bankruptcy, these pro rata sharing provisions likely will be triggered. Thus, the holders of the most senior, lowest-risk tranches would be assessed losses on the same basis as the most junior, riskiest tranches. The implications of this are obvious and potentially severe: The uncertainty will exacerbate the already existing uncertainty in the financial system, further freezing credit markets.”
- “If Congress wants to deal with the rising number of foreclosures, it should not create a new mess by converting the mortgage crisis into a bankruptcy crisis. Doing so will open the door to a host of unintended consequences that will further freeze credit markets, raise interest rates for new home buyers, and spread the mortgage contagion to other types of consumer credit. Congress needs to reject this plan and look for better solutions.” (*HousingWire*, Paul Jackson, 02/19/09; *New York Times*, Edmund

L. Andrews, 02/17/09; *CNNMoney*, David Goldman, 02/25/09; *American Banker*, Cheyenne Hopkins and Emily Flitter, 02/19/09; *Wall Street Journal*, Laura Meckler, 02/19/09; *Wall Street Journal*, Ruth Simon and Carrick Mollenkamp, 02/19/09; *Bureau of National Affairs*, William H. Carline and Thecla Fabian, 02/19/09; *Wall Street Journal*, James R. Hagerty and Lingling Wei, 02/19/09; *American Banker*, Kate Berry and Harry Terris, 02/19/09; *New York Times*, Sheryl Gay Stolberg and Edmund L. Andrews, 02/19/09; *Washington Post*, Binyamin Appelbaum, 02/19/09; *CQ Today*, Phil Mattingly, 02/18/09; *Bureau of National Affairs*, Mike Ferullo, 02/27/09; *CongressDaily*, Juliana Gruenwald, 02/27/09; *Bloomberg News*, Dawn Kopecki, 02/26/09; *Wall Street Journal*, Todd J. Zywicki, 02/13/09; *Senator Richard Shelby Press Release*, 02/18/09; *Washington Post*, Renae Merle, 02/25/09; *Wall Street Journal*, Gregg Hitt, 02/26/09; *Bloomberg News*, Dawn Kopecki, 02/26/09; *Wall Street Journal*, Leslie Scism, 02/28/09; *Financial Markets Crisis Blog*, Alston & Bird, LLP, 02/27/09; *Correspondence to Representative John M. Spratt, Jr.*, Douglas W. Elmendorf, Director of CBO, 02/25/09)

A dizzying eruption of taxpayer dollars, leading to a \$1 trillion deficit as far as the eye can see

- In a February 27th article, the *Associated Press* wrote, “There has been a dizzying eruption of big numbers from Washington lately, really big ones. Here are some of them:
 - \$3.55 trillion: The total of the spending blueprint President Barack Obama sent to Congress ...for budget year 2010, which begins October 1st. [This budget—which costs each taxpayer \$25,573.48—doubles the national debt in ten years.]
 - \$1.75 trillion: The deficit by which the White House predicted that spending for 2009 will exceed the government’s revenues.
 - \$410 billion: The size of spending legislation passed by the House on [February 25th] to cover government operations of the remainder of the 2009 budget year.
 - \$787 billion: The price tag on a two-year stimulus bill that Obama signed [on February 18th].
 - \$275 billion: The maximum of what Obama pledged last week to combat the record number of home foreclosures.
 - \$700 billion: Financial bailout legislation passed by Congress in October. The Bush administration spent the first half of it, and the Obama administration is in the process of spending the rest.
 - \$17.4 billion: How much automakers General Motors Corp. and Chrysler LLC got from the government in loans in January. They are now seeking an additional

21.6 billion.” (*Associated Press*, 02/27/09; *Telegraph* [UK], Toby Harnden, 02/26/09; *Press Release from Representative John Boehner*, 02/26/09)

- According to a recent study by the Brookings Institute, the United States faces trillion dollar deficits as far as the eye can see. In the study written by Alan J. Auerbach, professor of tax and law at University of California, Berkeley and William G. Gale Brookings vice president and director of the Economic Studies Program, the authors found that even under optimistic assumptions—such as a return to full employment and the expiration of stimulus spending in two years—the deficit will range from \$1 trillion to \$1.3 trillion in current dollars over the next decade. The authors conclude that this is “an increasingly, unsustainable and urgent fiscal problem.” (*Washington Post*, 02/22/09)
- On the *Kudlow Report*, CNBC commentator Rick Santelli said, “In this current political environment with all the credit issues, there’s nothing more permanent than a temporary solution—and I think that should be the mantra that we think about moving forward...” (*CNBC’s Kudlow Report*, 02/823/09)

TARP

Treasury unveils the Capital Assistance Program

Stress tests better be “right”

Obama administration attempts to quell market fears of the nationalization of U.S. banks

Treasury takes big common equity stakes in Citigroup and AIG

Are the insolvent banks worthy of preserving?

- On February 25th, the Treasury Department announced the terms for the Capital Assistance Program (CAP), a new capital assistance program that is a component of the Financial Stability Plan. CAP consists of two core elements—(i) a supervisory assessment of the participant’s economic viability under a one-time stress test, and (ii) access to a government capital investment. U.S. financial institutions (banks) with assets exceeding \$100 billion that are not foreign-controlled, will be required to participate in CAP and smaller banks (with assets under \$100 billion) may voluntarily participate in the program. Applications to participate in the CAP must be submitted by May 25, 2009.
- Under the CAP, the federal banking regulatory agencies (regulators) are conducting forward-looking “stress tests” to evaluate the capital needs of the 19 largest U.S.

banks by analyzing the expected losses under certain conditions and determining the bank's resources available to absorb those losses. Specifically, the regulators have constructed two economic scenarios for banks to use to project expected losses over the next two years. The "baseline" scenario represents a consensus outlook that is based upon the most recent economic forecasts. The "more adverse" scenario incorporates assumptions that reflect a deeper and longer recession than the baseline scenario. In the baseline scenario, the regulators assume (i) a GDP growth rate of -2% in 2009 and 2.1% in 2010; (ii) an unemployment rate of 8.4% for 2009 and 8.8% for 2010; and (iii) a residential home price index change of -14% in 2009 and -4% in 2010. In the more adverse scenario, the regulators assume (i) a GDP growth rate of -3.3% in 2009 and 0.5% in 2010; (ii) an unemployment rate of 8.9% for 2009 and 10.3% for 2010; and (iii) a residential home price change of -22% in 2009 and -7% in 2010. The 19 largest banks will analyze their loan and securities portfolios, off-balance sheet commitments and contingencies, and, for companies with trading assets in excess of \$100 billion, potential trading-related losses, to project expected future losses under each scenario. The banks will also determine the internal resources they have available to absorb losses, including pre-provision net revenue and reserves. They will support their estimates using a standard template and will provide firm-level information to support their estimates.

- The regulator will oversee the banks' stress tests [which must be completed by the end of April] and will determine the amount of regulatory capital necessary for each bank to hold today in order to remain well-capitalized under the more adverse scenario. In making this determination, the regulators will consider the inherent risks of the bank's exposures and business activities, the quality of its balance sheet assets and off-balance sheet commitments, its earning projections, and the composition and quality of its capital.
- Treasury recognizes that some banks may be asked to hold more capital than they might otherwise be required to hold as a result of these stress tests, which it believes this is necessary to restore confidence in the stability of the financial system. Treasury officials stressed that the capital provided under the CAP does not represent a new capital standard and is not expected to be maintained on an ongoing basis. Instead, capital is being made available under the CAP will help banks absorb larger than expected future losses, should they occur, and to support lending to creditworthy borrowers during the economic downturn. If the stress tests indicate that the bank needs additional capital buffer, each company will have six months to raise capital privately or access the capital made available from the Treasury under the CAP.
- With supervisory approval, banks may request capital under the CAP in addition to their existing preferred stock issued under the Capital Purchase Program ("CPP"). The participants may also apply to exchange their existing CPP preferred stock (or existing preferred stock issued under the Targeted Investment Program) for preferred shares newly issued under the CAP. Capital provided under the CAP will be issued as convertible preferred shares (CAP Preferred Shares) that can be converted into common equity at a 10% discount to the price prevailing prior to February 9, 2009,

and carries a 9% dividend yield. Banking organizations may convert the CAP Preferred Shares to common equity at their discretion with the approval of their regulator. Treasury, or any other subsequent holder of the CAP Preferred Shares, has the option to convert the CAP Preferred Shares after certain events, including sales, mergers or changes of control. After seven years, the CAP Preferred Shares automatically convert to common equity, if not redeemed or converted before that date.

- The total amount of CAP Preferred Shares banks generally may issue is between 1% and 2% of their risk-weighted assets plus any amount used to redeem preferred shares issued under the CPP or the TIP. If necessary, banks may issue CAP Preferred Shares in excess of this amount with regulatory approval, based upon Treasury's and the regulator's determination that "exceptional assistance" is deemed necessary. In that event, the bank may be subject to additional terms and conditions, including additional executive compensation restrictions.
- Participants in CAP will be subject to the executive compensation requirements of the Emergency Economic Stabilization Act of 2008, as recently amended by the American Recovery and Reinvestment Act of 2009. [Treasury plans to release rules to implement these amendments in the near future.] Participants also will be subject to restrictions on paying quarterly common stock dividends, repurchasing shares, and pursuing cash acquisitions. Specifically, participating banks may not pay dividends or redeem shares unless they are current with their dividends on the CAP Preferred Shares. As long as a bank has CAP Preferred Shares outstanding, common stock dividends may not exceed \$0.01 per share per quarter without Treasury's consent. The bank must also obtain Treasury's consent for repurchases of equity securities or trust preferred securities for the period in which the CAP Preferred Shares are outstanding.
- As part of the application, banks must submit a plan detailing how they intend to use CAP funds to preserve and strengthen their lending capacity and demonstrate how the company's lending activities will be at higher levels with CAP resources relative to what would have been possible without government support. Banks receiving CAP funds also will be required to submit to Treasury monthly reports on their lending broken out by category. (*Washington Post*, Binyamin Appelbaum, 02/26/09; *Treasury White Paper*, 02/25/09; *Treasury Department Press Release*, 02/25/09; *Financial Markets Crisis Blog*, Alston & Bird, LLP, 02/25/09; *Financial Services Alert*, Goodwin Proctor, 02/25/09; *Bloomberg News*, Rebecca Christie and Robert Schmidt, 02/25/09)

Stress tests better be "right"

- In the *Wall Street Journal*, Peter Eavis wrote, "The bureaucrats had better get their stress tests right, or the banking system risks sinking deeper into a Japan-like quagmire. [On February 25th], banking regulators and the Treasury released details of

the tests they will conduct to assess banks' capital needs. They also issued terms on which the government will acquire convertible securities.”

- “The Treasury appears to be making a bet that most banks can survive the downturn without needing so much convertible equity that the government ends up owning them. The stress tests assume some bearish economic scenarios, but it is clear that final decisions on capital come down to regulators’ judgments. For instance, the plan merely says the government will convert its securities into common equity ‘on an as-needed basis.’ There is no mention of capital thresholds that banks must meet.”
- “The danger is that losses turn out to be substantially higher than regulators predicted. That could see the government drip feed more convertibles into banks over time, keeping some alive that should really be euthanized. And there is political risk. The government has committed to convert into bank shares at close to average prices from early February. That is a giveaway to some sick banks. Citigroup’s shares, for example, were 37% higher back then.” (*Wall Street Journal*, Peter Eavis, 02/26/09)
- In a telephone conference call with reporters, Federal Reserve and OCC officials said that there will be no simple measure for “passing” or “failing” the stress test and only provided vague descriptions of how they would interpret results. A senior government official, speaking on the condition of anonymity, dismissed the idea that the stress tests were a pass/fail exercise, saying: “It is one tool the examiners will use to understand the risks of a firm’s activities, its balance sheets, its commitment[s]. The assessment is going to include risk far greater than what is represented—far greater, meaning more expansive, not deeper, but more expansive than what the template would suggest.” Treasury will not publish the test results, the official added.
- “What is intended here is more political,” said Joe Mason, a professor at Louisiana State University and former economist for the OCC. “This is more like a strategic planning exercise than an actual evaluation exercise.” Paul J. Miller, an analyst with Freidman, Billings Ramsey, said, “It sounds to me like they are designing this to make it sound like the banking system is in great shape.” (*New York Times*, Edmund L. Andrews and Eric Dash, 02/26/09; *Wall Street Journal*, Peter Eavis, 02/26/09; *American Banker*, Cheyenne Hopkins, 02/26/09; *American Banker*, Cheyenne Hopkins, 02/17/09)

Obama administration attempts to quell market fears of the nationalization of U.S. banks

- Treasury’s announcement of the banks’ stress test triggered anxiety in the market with steep sell-offs of financial services stocks. Investors watched in horror, as Bank of America plunged below \$3 and Citigroup broke \$2, resulting in a combined market capitalization for the two banking giants of \$26 billion—well below that of Kraft Foods. Investors panicked, as former Federal Reserve chief Alan Greenspan and Senate Banking Committee chairman Christopher Dodd (D-CT) warned that the only solution to the banking crisis may be nationalization.

- The administration quickly released a “pledge of support” statement by banking regulators. In a joint statement from the Treasury Department, Federal Reserve, FDIC, OCC, and OTS, the regulators said that the government “stands firmly behind the banking system during this period of financial strain to ensure it will be able to perform its key function of providing credit to households and businesses.” During an interview on *The News Hour with Jim Lehrer*, Treasury Secretary Timothy Geithner said nationalization is “the wrong strategy for this country and I don’t think it’s the necessary strategy.” In testimony on Capitol Hill, Federal Reserve chairman Ben Bernanke sent the clearest signal yet to the markets that the federal government plans to support major banks as going concerns in the private markets by taking equity stakes as necessary to shore their capital. When asked by lawmakers if stress tests would lead regulators to take outright control of some banks, Bernanke responded, “No, I don’t think so.” He added, “I do not see any reason to destroy the franchise value or to create the huge legal uncertainties of trying to formally nationalize a bank when it just is not necessary.” Stocks rose in response to the Fed chairman’s comments with Citigroup and Bank of America leading the market, up 21% for the day.
- Christopher Whalen, managing director at Institutional Risk Analytics, said Citigroup and other major banks would almost certainly become insolvent once they absorb the full brunt of losses from the economic downturn. “The stress test is about politics,” said Whalen. “The OCC and the Fed already know the answer. The answer is that we’re going to have to come to a decision: are we going to put in more equity or are we going to resolve the banks through bankruptcy?” (*New York Times*, Edmund L. Andrews and Eric Dash, 02/26/09; *Bloomberg News*, Rebecca Christie and Robert Schmidt, 02/25/09; *Financial Times*, Krishna Guha, 02/25/09; *Fortune*, Shawn Tully, 02/27/09)

Treasury takes a 35% equity stake in Citigroup and 77.9% equity stake in AIG

- A day after the White House spokesman assured investors that the administration didn’t intend to nationalize certain key banks, the Treasury Department reached an agreement with Citigroup in which the federal government will own as much as 35% of the bank’s common shares. Under the agreement, Treasury will strengthen the bank’s capital structure by converting up to \$25 billion of the agency’s preferred stock issued under the Capital Purchase Program into common stock. This exchange is in conjunction with the bank’s conversion of nearly \$27.5 billion in preferred stock sold to investors to common stock, which Treasury will match dollar-for-dollar. The exchange, if fully executed, would give the U.S. government a 35% ownership share of Citi’s common stock, which current shareholders will be left with roughly a 26% stake in the company. Any remaining Treasury and FDIC preferred shares, issued under the Targeted Investment Program and Asset Guarantee Program, would be converted into a trust preferred security with seniority and carry an 8% cash dividend rate. The transaction does not increase the agency’s investment in Citigroup.

- “This securities exchange has one goal—to increase our common capital,” said Citi CEO Vikram Pandi. Separately, the Bank announced that it will record \$10 billion in write-downs in the fourth quarter. Treasury has demanded that the company overhaul its board of directors, which will soon be comprised of a majority of new independent members. Chief executive officer Pandi is expected to keep his job. (*Washington Post*, Binyamin Appelbaum, 02/27/09; *Wall Street Journal*, Kevin Kingsbury and Maya Jackson Randall, 02/27/09; *U.S. Treasury Press Release*, 02/27/09; *HousingWire*, Paul Jackson, 02/23/09)
- On March 2nd, the Treasury Department and Federal Reserve announced a third bailout package for American International Group (AIG) that provides the firm an additional \$30 billion of capital and converts the government’s existing \$40 billion of preferred shares into new preferred shares that more “closely resemble” common stock. Under the agreement, AIG has agreed to issue shares of convertible preferred stock representing a 77.9% equity interest in AIG to the U.S. Treasury. The government’s announcement was made in conjunction with AIG’s disclosure of its \$61.7 billion loss for the fourth quarter.
- As part of this bailout, the Fed will reduce a \$60 billion credit facility in exchange for taking a preferred interest in AIG’s two life insurance holding companies, American Life Insurance Company and American International Assurance Company. The New York Fed also is authorized to make new loans of up to \$8.5 billion to special purpose vehicles (SPVs) established by domestic life insurance subsidiaries of AIG. The SPVs would repay the loans from the net cash flows they receive from designated blocks of existing life insurance policies held by the parent insurance companies. The proceeds of the New York Fed loans would pay down an equivalent amount of outstanding debt under the Revolving Credit Facility. These transactions will reduce the funds available from the Facility from \$60 billion to no less than \$25 billion. The Facility’s interest rate, which is three-month LIBOR plus 300 basis points, will be modified by removing the existing floor (3.5%) on the LIBOR rate. The Facility will continue to be secured by a lien on a substantial portion of AIG’s assets, including the businesses AIG plans to retain.
- Under the agreement, AIG must be in compliance with the executive compensation and corporate governance requirements of Section 111 of the Emergency Economic Stabilization Act, including the most stringent limitations on executive compensation. Additionally, AIG must continue to maintain and enforce newly adopted restrictions put in place by the company’s new management on corporate expenses and lobbying as well as corporate governance requirements. (*Treasury Press Release*, 03/02/09)

Are the insolvent banks worthy of preserving?

- On the *Kudlow Report*, Gerald O’Driscoll, senior fellow at the Cato Institute, said, “I’m really against nationalization. If the politicians get their hooks into a money center bank, they will turn it into a political ATM machine.” (*CNBC’s Kudlow Report*, 02/823/09)
- In a commentary on the banks’ survival, *Fortune* editor-at-large Sawn Tully wrote, “...How the government proceeds ...[with Citigroup] will say a lot about the future of the banking sector. The fear is that Washington will continue to prop up Citi and other wounded banks in their current form. The best course would be to force battered banks to sell enough assets to restore their financial health—if that’s possible—or to dissolve. That would demonstrate that Washington is serious about reviving the industry—the one that is absolutely essential to the nation’s economic recovery. (*Fortune*, Sawn Tully, 02/27/09)
- In a February 24th *Market Commentary*, Hermann Moyses, Jr. wrote, “...[T]he programs put in place so far are merely inflationary. None of the programs has yet addressed the poor management and systems that led to failed underwriting of everything from mortgage loans to CDOs and SIVs, as well as the poor reporting environment and regulatory oversight. If insolvent banks today were car makers, they would be making East-German Trabants. Hence, it is not at all clear the shortfalls we have discovered in today’s financial system are among institutions worthy of preserving and systemic importance of any institutions involved has most likely already long ago been resolved by market forces.” (*Market Commentary*, Hermann Moyses, Jr., 02/24/09)
- In the February 18th *Institutional Risk Analyst*, Richard Christopher Whalen wrote, “...[T]he Q1 2009 numbers at Citigroup [C], Bank of America [BAC] and JPMorgan [JPM] are going to make clear, even to members of the Obama Administration, that talking about injecting new equity into the largest banks without first resolving these institutions is a waste of time and money. Remembering that half of the liabilities of C, BAC and JPM are funded out of the bond markets and not via deposits, it should be clear to one and all that the U.S. taxpayers are not in a position to subsidize the bond holders of these three banks, representing some \$1.5 trillion in debt, if the deposits of these banks are to be protected. Some people, indeed, many people believe that we must avoid another Lehman Brothers type resolution where bondholders take a loss, but to us the only scenario where depositors of C, BAC, JPM do not take a loss is if we haircut the bond holders.”
- “There are no easy answers here, but the guiding principle left by the Founders that bankruptcy be used to quickly and finally resolve insolvency is instructive. In that sense, Lehman Brothers is the ideal example, not something to be avoided. The model of the conduct of the Lehman liquidation by the US Trustee is an excellent archetype that should be carefully studied and considered as the Obama Administration considers the next move. If we are going to consider a restructuring

for General Motors and what remains of Chrysler, then Washington better be in a position to talk with finality about resolving the big banks at the same press conference.”

- “What is required in Washington is an adult conversation, between the U.S. government on the one hand and the holders of the bonds of the largest banks on the other. Many of the bond holders of the large banks are foreign governments, central banks and investment funds and not a few of these sovereign names are in really serious financial difficulties. Since the receiverships for Lehman Brothers and Washington Mutual, where bond holders took a near total loss, these foreign investors have been vocal in demanding that US taxpayers protect them from further harm.”
- “...[T]he US government must be willing to lead by example to show that there really is only one way to restore confidence in zombie banks: use receivership to wipe out the common and preferred shareholders, conserve the deposits and sell the good assets to new investors, and then restructure the remaining operations of the bank to maximize recovery to the bond holders and other creditors.”
- “...We all mostly understand the problem now. The swiftest and surest way to restore market confidence is to create solvent banks and begin the process of rebuilding the global markets for both finance and commerce. That is why we say that the competent and efficient handling of the Lehman Brothers liquidation by the US Trustee, SIPC, other state and federal regulators, and most important the professionals of the US Bankruptcy Court for the Southern District of New York is the model for dealing with the large banks.”
- “...If we delay and pretend that this problem will just go away with time or that the markets of yesterday will miraculously be renewed, then the economic slump will indeed worsen and we shall have all talked ourselves into a bona fide global economic catastrophe. Here’s our two key points again[:]...”
 - **“Finality for the Banks:** The US should announce an open-bank conservatorship for C before the Q1 results drop and be prepared to include BAC, JPM and WFC, in that order of urgency. The deposits of the institutions should be explicitly conserved, but the bond holders and other creditors must be put on notice that their position is a function of the net recovery from the parent holding company a la Lehman Brothers. Keep in mind covering all deposits is a huge concession and may require a subsidy from the FDIC unless the bond holders take the loss. The process of conservatorship for C could go on for years and would ensure that consumers and other customers of the bank are protected.”
 - **“Finality for Markets, Homeowners:** ...[T]he Treasury should begin a systematic process for an at-the-market buy-in [of] all of the extant toxic securitizations, transfer ownership of these assets to the [FDIC] and then use the receiver powers of the FDIC to reorganize the DE trusts that are the issuers of the notes. Start with the paper on repo to the Fed. Once the FDIC gains legal

custody of the collateral, it can then sell these assets through the resolution process now ongoing with financing backed by the Fed. Our preference is to see these loans sold to community banks with branches near the property, a move that would immediately enhance the quality of these credits and also make modification/refinancing more practical. Either tasks requires manpower and the thousands of solvent American community banks in the US are the mechanism to make foreclosure abatement a reality. But any and all buyers should be encouraged.” (*Institutional Risk Analyst*, Richard Christopher Whalen, 02/18/09)

- In the February 23rd issue of *The Nation*, James S. Henry, a former economist at McKinsey & Co. and fellow at Tufts University’s Fletcher School of Law, wrote, “...[W]e have a choice to make: we can spend perhaps \$150 billion to \$200 billion buying out the equity of a handful of leading banks that have gotten themselves in this mess and reform them. This would involve taking them over immediately, installing new managers, giving their creditors a haircut, writing down the toxic assets (which the government-owned bank could do without fear of market reactions) and then preparing them for privatization when the market recovers.”
- “Or we can follow Secretary Geithner’s lead, fiddle around for months, throwing trillions more of government capital, loan guarantees and portfolio insurance at the problem, without any guarantee that the resulting cockamamie approach to creating a ‘public-private’ toxic bank will ever work—while the same old troubled institutions are left standing, no longer encumbered by their dodgy assets perhaps, but still encumbered by dodgy managements. There are lots of technical issues to be weighed in making this choice. But after reviewing all the objections to the kind of short-term, temporary, partial nationalization, I’m convinced that the most important issues are simply political, a choice between our commitment to a failed, hands-off model of bailouts and banking regulation and decisive, FDR-like action.”
- “It is precisely because it is so hard to value these dodgy assets at all that we are even having this discussion. Given the absence of competitive markets for the assets, the uncertain environment and their dependence on taxpayer subsidies and insurance, the prices established are intrinsically political. Either they will be set so low that banks will have to take such massive writedowns that their shareholder equity will disappear entirely anyway, or--more likely--the prices or insurance arrangements will be set so that even more taxpayer wealth is transferred to these very same top-tier banks.”
- “Meanwhile, the whole economy is hostage to this decision. We have no time to waste. We should get on with it, making use of one of the clearest market signals available in this situation—the current value of Citibank and Bank of America shares [which closed at \$1.50 and \$3.95, respectively, on February 27th].”
- “This argument is not at all anti-market, or necessarily even anti-bank. At their best, private markets, entrepreneurship and innovation are absolutely essential. My real objection is to a very specific kind of bank-dominated political economy. To call this ‘capitalism’ is to have Ayn Rand and Friedrich von Hayek turning somersaults in the

crypt. Time and again, this pathological form of pro-bank development has jeopardized the prosperity, stability and innovation of the small businesses, inventors and would-be savers who are the backbone of market economies. Bank-dominated political economies don't really deserve to be called 'capitalism,' since big bankers have never really been entrepreneurs who are content to stick to the capitalist rules of the game. Instead, they periodically demand the divine right to take unlimited risks, privatize the resulting gains and stick the rest of us with any resulting losses."

- "It is time for accountability, we are told by our new president. If so, we should start by holding the world's largest banks, hedge funds, insurance companies, mortgage brokers and private equity firms, together with their many friends in accounting, law, public relations, credit rating, central banking and higher office accountable for this crisis--if in no other way than by refusing to award them this even more massive TARP II bailout, permitting them to rob us, once again, with both hands." (*The Nation*, James S. Henry, 02/23/09; www.google.finance.com)
- On February 26th, *RGE Monitor* wrote, "The deepest, darkest concern of bond professionals is whether bond holders of banks will ever be asked to share the bailout pain. Ever since Lehman the Fed's reluctance to impair bank bonds has been palpable. Finance issues represent more than 60% of 1-5 year maturity bonds. They are ubiquitous in pension funds, insurance company portfolios and, until last fall, money market funds (most money market funds have moved up the capital structure to CDs at this point). So there are 'systemic' reasons to protect them. Large foreign holdings of bank debt may complicate matters further as the U.S. is dependent on foreign financing." (*RGE Monitor*, 02/26/09)
- In the March *Investment Outlook*, PIMCO's Bill Gross wrote, ...[I]f you thought Lehman Brothers was a mistake, just standby and see what nationalizing Citi or BofA would do. Our banks remain at the heart of domestic/global financial transactions and daily clearing... PIMCO would not dispute the need to further capitalize systemically important banks via convertible bonds held by the government, which unfortunately dilute shareholders' interests. To go further, however, and 'haircut' senior debt or even existing preferred stock similar to that issued via the TARP would create an instability policymakers should not want to risk. In turn, forcing creditors to take haircuts would undermine other financial sectors such as insurance companies and credit unions. The goal of future policy should be to recapitalize lending institutions while maintaining the basic infrastructure of credit markets. Outright nationalization and haircutting of creditors will do just the opposite. (*Investment Outlook*, Bill Gross, March 2009)
- In a February 24th article in the *Wall Street Journal*, William Isaac, former chairman of the FDIC wrote, "People who should know better have been speculating publicly that the government might need to nationalize our largest banks. This irresponsible chatter is causing tremendous turmoil in financial markets. The Obama administration needs to make clear immediately that nationalization—government seizing control of ownership and operations of a company—is not a viable option..."

- “So, you might wonder, what’s so bad about nationalization? ...Let’s begin with the fact that today our 10 largest banking companies hold some two-thirds of the nation’s banking assets, and some are enormously complex. ...First, any bank we nationalize will be forced, both by the regulators and the marketplace, to shrink dramatically. We are in the middle of a serious economic downturn where deflation is a realistic concern. Do we really think that dismantling our largest banks would be helpful? I don’t. What’s more, we won’t be able to stop at nationalizing one or two banks. If we start down that path, the short sellers and other speculators that the Securities and Exchange Commission still refuses to re-regulate will target for destruction one after another of our largest banks.”
- “Second, for nationalization to work there needs to be a reasonable exit strategy. ...Today, who has the wherewithal, legal authority, and desire to purchase our largest banks? No one comes to mind, particularly if we rule out foreign groups, which I suspect would not pass muster due to national security concerns about ceding that much power over our economy to foreign powers. Third, who will run these companies when we dismiss the existing senior managers and board members?”
- “...So-called experts frequently cite the success of the Swedish experience with bank nationalization in the last decade. Nothing could be less relevant. Sweden’s population, economy and banking system are roughly the size of Ohio’s. Sweden’s largest bank is roughly 10% the size of each of our three largest banking companies. Moreover, Sweden nationalized only Gota Bank—and that was after it had already collapsed.”
- “The Obama administration should declare that nationalization of any major bank is off the table; that the government stands behind our entire banking system; and that our banks will continue to receive a nonvoting form of equity capital, such as convertible preferred stock, from the government to the extent needed...” (*Wall Street Journal*, William Isaac, 02/24/09)

Legal experts warn institutions about accepting government capital
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- On February 25th, a panel of panel of banking and finance experts warned that government money given to financial institutions under Financial Stability Plan will come with plenty of strings attached—many of which remain unclear two weeks after the unveiling of the program. “All bets are off if you take government capital,” said Robert H. Ledig, a partner in the Fried, Frank, Harris, Shriver & Jacobson LLP law firm. Financial institutions now realize that taking money from the government is “the last thing they should do,” said Ledig. These banks will gain a competitive advantage in the future by choosing to stand on their own, he added.
- There is a “fundamentally conflicting mission” involved in the Treasury’s rescue plan, in which banks must balance their mission of making money for private

shareholders and serving public policy objectives, said Ledig. Last year, former Secretary Paulson, said that Freddie Mac and Fannie Mae were bound to fail because of this conflict. Ledig warned that now, the government seems poised to impose this same conflict on a huge portion of the financial sector, he said.

- To illustrate the conflict, Ledig pointed to Northern Trust Corp, a recipient of \$1.6 billion of TARP funds, which was recently criticized by Democrats for sponsoring a professional golf tournament. In a letter to the Bank's CEO Frederick Waddell, House Financial Services Committee chairman Barney Frank (D-MA) wrote that his company should "immediately return to the federal government the equivalent of what Northern Trust frittered away on these lavish events." Frank added, "Federal taxpayers should not and will not stand for such abuses, and we will insist that any future Treasury support for Northern Trust be conditioned on a thorough reform of your company's policies and practices." The letter was also signed by 17 other Democrats.
- In a letter to Frank, Northern Trust CEO Waddell, wrote, "We understand this is a time of great anxiety and financial distress, and your question regarding our support of an event such as the Northern Trust Open is legitimate. We deeply regret that some of the events associated with the Northern Trust Open have distracted from the positive nature of an event that has raised more than \$50 million for charity since its inception. ... While our client educational and entertainment activities have all been within applicable guidelines under the Capital Purchase Program, we will redouble our efforts to ensure that these activities are appropriate given the current environment." Waddell added that his bank plans to repay the approximately \$1.5 billion of TARP funds "as quickly as prudently possible under" the Treasury guidelines.
- Senator John Kerry (D-MA) said he will sponsor legislation that would restrict banks that received government funds—some 421 companies to date—from hosting, sponsoring or paying for conferences, holiday parties and entertainment events. Any violation of the bill's provisions would result in paying back the party expenses and payment of a \$100,000 fine. "It's an embarrassment that this legislation is necessary, but some companies clearly need a reality check to get their priorities straight so taxpayer money is used to get their house in order and not to pay for lavish parties," said Kerry. "Congress has zero tolerance for this kind of excess."
- Russell J. Bruemmer, a partner at Wilmer Cutler Pickering Hale and Dorr LLP, said the financial rescue plan leaves many questions and concerns unanswered. "Ten percent of the answer is common sense; the rest is whatever the mood of Congress is," said Bruemner. The federal's government's role is going to play out in ways "that will make current and future bankers wonder whether they should be in this business at all," he added.
- Concerns about the changing rules and restrictions for the TARP funds is causing a number of banks to explore repaying the government money early, said Karen

Thomas, director of regulatory affairs for the Independent Community Bankers of America. An administration official, who spoke on the condition of anonymity agreed, saying: “Some banks have already said they want to repay the government ASAP. This could have the unintended consequence of firms choosing not to participate in ways that would be helpful to getting credit flowing, including homeowners, auto loans, and small businesses.”

- Iberiabank Corp, headquartered in Lafayette, LA, is the first banking company in the U.S. to announce that it will redeem the government’s \$90.6 million of preferred shares March 31st [pursuant to the 30 days notice before redemption, as set forth in the Bank’s agreement with Treasury]. In a press release, Iberiabank’s president and CEO Daryl G. Byrd said, “When we decided to accept funds under this program, we believe we were the type of healthy bank that could employ the funds in the manner consistent with the goals initially set out by Congress and the Treasury in supporting the expansion of credit to the markets we serve. We believe recent actions, interpretations, and commentary regarding various aspects of the program places our company at an unacceptable competitive disadvantage. Our board of directors has determined that continued participation in this program is no longer in the best interest of our company and its shareholders.” (*Bureau of National Affairs*, Brittany Schell, 02/26/09; *Congress Daily*, Bill Swindell, 02/25/09; *American Banker*, Stacy Kaper, 02/25/09; *American Banker*, Cheyenne Hopkins, 02/23/09; *American Banker*, Marissa Fajt, 02/27/09)

SEC issues guidance on the say-on-pay provisions of ARRA
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- In a February 20th letter to the SEC, Senate Banking Committee chairman Christopher Dodd (D-CT) asked the Commission to wait until Treasury has issued its guidance on compensation under American Recovery and Reinvestment Act (ARRA), before enforcing a requirement that the chief executive officer and chief financial officer provide written certification that they have complied with the law. “As this certification requirement relates to compliance with executive compensation and corporate governance standards that have yet to be established by the Secretary of the Treasury, it is my view that this requirement is not yet effective,” wrote Dodd. The Senator also asked for some leeway in implementing a proposal that would give shareholders a nonbinding vote on executive pay plans. Dodd wrote that the restrictions should apply to proxy statements filed after February 17th, when ARRA was signed into law. (*American Banker*, Stacy Kaper, 02/24/09)
- On February 24th, the SEC issued interpretations to the say-on-pay provisions of the AARA, in response to Dodd’s letter. Citing the Senator’s correspondence, the SEC advised the 400 companies which have received TARP funds that the say-on-pay provision is immediately effective and applies to preliminary and definitive proxy statements filed with the SEC after February 17th. The guidance did not address, however, the effective date for the CEO and COO to certify compliance with the

ARRA's executive compensation and corporate governance requirements. (*Bureau of National Affairs*, Yin Wilczek, 02/26/09)

Lending by bailout recipients is down

- According to Treasury's survey of the 20 largest banks that received funds from TARP, lending in the last quarter of 2008 was stagnant or down slightly. "Due to decreasing loan demand and tighter underwriting standards, as well as other factors such as charge-offs, or losses written off on loans, banks reported a general trend of modestly declining total loan balances," said Treasury. "In the face of severe economic deterioration during this period ... lending levels largely held steady and would have likely been lower absent capital provided to banks." (*Wall Street Journal*, Michael R. Crittenden and Meena Thiruvengadam, 02/18/09)

Financial Services Regulation Reform

Stop the bailouts and reform of the U.S. financial system

- In March 1st commentary in the *New York Times*, William Poole, former president and CEO of the Federal Reserve Bank of St. Louis wrote, "The fundamental causes of this recession, unique in the experience of the United States, were mortgage defaults and the consequent insolvency of major financial firms. These insolvencies, and especially fear of them, damaged normal credit mechanisms."
- "The self-correcting nature of markets will ultimately prevail. We should not underestimate the power of monetary policy; with the sharp increase in the nation's money stock starting in September, monetary policy is now extraordinarily expansionary. I believe, though without great confidence, that the recession will end in the second half of this year."
- "Federal policy is damaging the economy's prospects. It fails to provide the needed tax incentives for investment in factories and equipment, incentives that were central to efforts to revive the economy during the Kennedy-Johnson era and under Ronald Reagan. But government spending can't lead the way to sustained recovery, because its stimulating effect will be offset by anticipated higher taxes and the need to finance the deficit."
- "Heavy-handed federal intervention into the management of companies from banks to auto makers will also delay recovery. And misguided efforts to help distressed homeowners by permitting courts to rewrite the terms of mortgages will cause banks

to limit mortgage lending, which will prevent housing from contributing to the recovery.”

- “The unrelenting anger across the country over bailouts of corporations and households that made unwise and even irresponsible financial decisions is influencing federal policy. Punitive measures, like forcing companies receiving federal dollars to cancel employee events, will increase uncertainty over where the government will strike next in its effort to deflect public outrage. Instead of more bailouts, we need a clear and consistent path to fundamental reform of our financial system.” (*New York Times*, William Poole, 03/01/09)

President Obama outlines seven key principles governing reform of the nation’s financial regulatory system
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- On February 25th, President Barack Obama met with bipartisan leaders of the House Financial Services Committee and Senate Banking Committee to outline his core principles for reforming the financial regulatory system. Obama called for Congress to establish “clear rules of the road ... to protect consumers and investors and ultimately to keep those financial institutions strong.”
- Obama listed seven principles to guide Congress in planning a new financial regulatory framework. First, financial institutions that pose “systemic risks” to the markets should be subject to “serious oversight” by the government. “When the Federal Reserve steps in as a lender of last resort ... it’s providing an insurance policy underwritten by the American taxpayer.”
- “Second, our regulatory system and each of our major markets must be strong enough to withstand both system-wide stress and the failure of one or more large institutions. And that means modernizing and streamlining our regulatory structure and monitoring both the scale and scope of risks that institutions can take.”
- “[Third,] to rebuild trust in our markets, we must redouble our efforts to promote openness, transparency and plain language throughout our financial system.”
- “Fourth, we need strong and uniform supervision of financial products marketed to investors and consumers. And we should base this oversight not on abstract models created by the institutions themselves, but on actual data on how actual people make financial decisions.”
- “Fifth, we must demand strict accountability, starting at the top. Executives who violate the public trust must be held responsible.”
- “Sixth, we must make sure our system of regulations covers appropriate institutions and markets, and is comprehensive and free of gaps, and prevents those being regulated from cherry-picking among competing regulators.”

- “[Finally,] we must recognize that the challenges we face are not just American challenges. They are global challenges. So as we work to set high regulatory standards here in the United States, we have to challenge other countries around the world to do the same.”
- Although lawmakers have not committed to a firm schedule, White House officials are urging lawmakers to have final plans for the financial overhaul in place by April 2 when leaders of the G-20 nations meet in London. (*Bureau of National Affairs*, Ralph Lindeman, 02/26/09)

Federal insurance charter a “useful idea” says Federal Reserve Chairman Bernanke

- Federal Reserve Board Chairman Ben Bernanke said the creation of a federal charter for insurers would give companies an alternative to the patchwork of state regulations that they currently operate under. “It would be a useful idea to create a federal option for insurance companies, especially for large systemically critical insurance companies,” said Bernanke in testimony before the House Financial Services Committee.
- The American Bankers Insurance Association (ABIA) praised Bernanke’s support of a federal charter. “This long overdue measure would create greater efficiency and modernization for the insurance regulatory system,” said Kevin McKechnie, ABIA’s executive director of the association in a press release. (*American Banker*, Steven Sloan, 02/26/09)

The New Democratic Coalition unveils a 21-point plan to reform the financial services regulation

- The New Democratic Coalition, a group of 60 moderate Democrats, has unveiled a 21-point plan to govern the reform of financial services regulations, which is predicated on modernized regulation, market stability, and consumer protection. The group plans to work with House Financial Services Committee chairman Barney Frank (D-MA), who hopes to have an outline of a reform plan by early April. Instead of proposing specific legislation, the NDC is offering 21 principles to guide the debate, including more oversight of new and unregulated financial instruments, the expansion of the President’s Working Group on Financial Markets to include all federal financial regulators, and the modernization of insurance regulations. A high priority of the group is the creation or designation of a regulatory body to monitor systemic risk. (*Bureau of National Affairs*, R. Christian Bruce, 02/27/09)

- In a February 23rd interview on the Charlie Rose Show, John Mack, chairman and CEO of Morgan Stanley, said, “... [T]here are different times in our history we get wake-up calls. This [financial crisis] has been a wake-up call for the Americans. It has been a wake-up call, I think, for the rest of the world. That global economies—and that’s what we live in, the global economic world that we are in today—cannot be solely managed by the borders of a country. We need to create a systemic risk manager in this country, and we need to coordinate with the rest of the world. We have to work together. Because if you go back 25 years ago or 30 years ago, you could say—well, I remember, when I first got into the business in 1968, you know, you came to work at 9:00 clock in the morning, you took a two-hour lunch, the market closed at 3:30, and you went home. Today you work 24/7. A market is open around the world, 24 hours a day. We are involved in all those markets. Those countries are involved in those markets. So we need to create a regulatory environment and a scheme that helps us manage that process.” (*Charlie Rose Show*, 02/23/09)
- In testimony before the United States Joint Economic Committee, Joseph R. Mason, professor of finance at Louisiana State University and senior fellow at The Wharton School, said, “...This written testimony offers three primary suggestions for short- and long-term strategies to restore the economy and fostering long-term growth. ...[F]inancial crises do not cause recessions, but merely prolong and deepen them. Recessions are therefore possible without a financial crisis, but once an economic is in recession recovery is virtually impossible with a financial crisis ongoing.”
- “...The United States still has the most advanced financial system in the world, but over the last several decades the growth of that system outpaced U.S. regulatory capabilities. Among the key weaknesses that caused the crisis are relatively well-understood shortcomings like too-big-to-fail, insufficient accounting transparency, and asset market overhang. We already have several decades of economic research that we can use to resolve those problems in the short run... Nonetheless, while existing policy attempts to address some of these issues get close, slight changes in approach can achieve success in a much more straightforward and effective manner.”
- “For instance, the House introduced Bond Rating legislation as HR 6482 last summer, but that bill was not put to vote due to the financial market crises of the period. Such legislation will be crucially important to moving the industry forward. But even dogmatic shifts such as focusing on the far more obtainable goal of housing occupancy instead of home ownership can help get our economy moving quickly again with a lower probability of home buyers getting hurt again.”
- “...[R]eform in the long run will be much harder, requiring significant efforts to fix old and build new regulatory structures and set the stage for U.S. economic growth. ...Much additional work is necessary to develop international diplomatic relations around existing unitary principals of oversight to develop standards and procedures

for resolving failed financial institutions, providing bridge financing and oversight and disposing of their assets. Global imbalances in economic growth potential are already spurring the development of trade blocs and agreements worldwide, presenting both opportunities and threats to U.S. markets.

- U.S. financial diplomacy abroad will go a long way toward smoothing some of those sentiments, and U.S. businesses will have to adapt strategically to fast-moving changes in global markets to stay competitive.
- The binding principals of any regulatory reform process—which is a large part of what we have at hand here—are ‘do no harm’ and ‘leave the industry cleaner than when you arrived.’ Hence, we have before us both the opportunity and motivation to improve our economy and our nation. Let us embark on setting a firm foundation for improved financial markets and economic growth potential so that the necessary restructuring becomes known more for its own success than the crisis that motivated the changes.”
- “In conclusion, it is fitting that today’s panel includes the Honorable Paul Volcker, who Chaired the Federal Reserve at a time when we first learned of “natural rates” in economics. We learned then that attempts to push unemployment below natural levels creates perverse economic dynamics, like stagflation. The recent push to drive home ownership rates to one hundred percent and substitute debt for income has had similar perverse effects. As Chairman Volcker showed us back then, the only way out of the perverse dynamics is to move through the downturn. I hope we learn from Chairman Volcker’s example and exhibit the courage to book the losses, learn our lessons, and move back to meaningful and robust economic growth.” (*Testimony before the Congress of the United States Joint Economic Committee*, Joseph R. Mason, 02/26/09)

Fannie Mae and Freddie Mac

Fannie Mae loses \$58.7 billion in FY2008 and requests \$15 billion of financial assistance from the Treasury Department

- Fannie Mae reported a loss of \$58.7 billion for FY2008, compared to its year-earlier loss of \$2.1 billion. In the fourth quarter, the company lost \$25.2 billion, accounting for more than 40% of the year's loss. The company's losses resulted from \$12 billion of credit losses, \$12.3 billion of losses related to the plunging value of its portfolio of guaranteed and privately-held mortgages, and \$4.6 billion of securities impairments. On December 31st, Fannie's non-performing assets totaled \$119.2 billion, up 87% for from September 30th and 338% from year-end 2007.
- According to its 2008 Credit Supplement, Fannie Mae's losses have been heavily concentrated in six states—Arizona (which has experienced a peak-to current *decline* in home prices of 35.7%), California (36.5%), Florida (38.0%), Michigan (24.0%), Nevada (41.6%), and Ohio (8.3%). These six states accounted for more than 65% of Fannie Mae's credit losses in 2008 and more than 49% of the company's real estate owned at year-end (63,538 units). Specifically, Fannie Mae's credit losses were concentrated in California (25.2% of the company's credit losses for its single-family mortgage credit book of business), followed by Michigan (12.5%), Florida (10.9%), Arizona (8.0%), Nevada (4.9%) and Ohio (3.7%). Fannie Mae's REO inventory is heavily concentrated in Michigan (10, 077 units or 15.9% of total REO), followed by California (11.7%), Florida (6.75), Arizona (6.2%), and Ohio (5.3%).
- Fannie Mae expects losses to continue for the foreseeable future. "We expect the market conditions that contributed to our net loss for each quarter of 2008 to continue and possibly worsen in 2009," said Fannie. "We now expect that we will experience a peak-to-trough home price decline of 20 percent to 30 percent, rather than the 15 percent to 19 percent decline we predicted last year."
- Fannie said it would draw more than \$15 billion of assistance from Treasury, following its sixth consecutive quarterly loss, which drove the company's net worth below zero. Previously, Freddie Mac has accessed nearly \$14 billion in assistance from Treasury and recently announced that it may need up to \$35 billion more following the release of its year-end results.
- According to the Obama administration budget blueprint, Fannie and Freddie will need \$173 billion in federal aid through 2011. The administration anticipates investing \$108 billion in preferred stock in the enterprises in FY2009. According to the budget projections, neither company is expected to begin repaying the government's investment during the 10 year cycle. The administration has doubled its emergency capital commitment for Fannie and Freddie to \$200 billion. (*Wall Street Journal*, James R. Hagerty and Damian Paletta, 02/27/09; *Financial Times*,

Saskia Scholtes, Tami Luhby, 02/27/09; *Bloomberg News*, Dawn Kopecki, 02/26/09; http://www.fanniemae.com/media/pdf/newsreleases/2008_10K_credit_summary.pdf; 02/27/09; *CNNMoney.com*)

Freddie Mac announces resignation of CEO David Moffett

- On March 2nd, Freddie Mac announced the resignation of CEO David Moffett effective no later than March 13th. In his resignation letter, Moffett indicated he wants to return to a role in the financial services sector. He wrote, "I have enjoyed my time as CEO of Freddie Mac and I wish all the great employees the very best in the days to come."
- Chairman John Koskinen, said, "We are very sorry to see David go. He made valuable contributions to Freddie Mac as the company transitioned into conservatorship." Koskinen added, "We expect to name an interim CEO before March 13 to assume David's responsibilities once he leaves. The board remains fully committed to ensuring the company continues its critical role in supporting the housing finance system during this difficult economic period."
- James B. Lockhart, director of the Federal Housing Finance Agency said, "We thank David Moffett for his service and leadership during the early days of the Conservatorship. FHFA will work with the Freddie Mac Board and management team to ensure a smooth transition and continuation of their important mission of supporting the housing market." (*Freddie Mac Press Release*, 03/02/09; *Federal Housing Finance Agency Press Release*, 03/02/09)

Fannie and Freddie will play central role in the administration's refinance initiative to help stabilize the mortgage market

- In a February 19th speech to the Association of Government Accountants, Federal Housing Finance Director James B. Lockhart noted that the crux of the problem that is faced in foreclosure prevention is private-label MBS securities, which represent 16% of mortgage but account for more than 62% of serious delinquencies (on September 30, 2008). Lockhart said, "If we are going to stabilize the housing market, we have to address that 62 percent. We believe that Fannie Mae and Freddie Mac must be leaders in improving, promoting, and enforcing industry standards and best practices for all mortgages." (*Prepared Remarks to the Association of Government Accountants*, James B. Lockhart, 02/19/09)
- In conjunction with the president's announcement of the Homeowner Affordability and Stability Plan, FHFA has agreed to the Fannie Mae and Freddie Mac initiatives for refinancing high loan-to-value mortgages. Lawyers at the agency have come up with a "new, liberal" interpretation of a federal law stipulating that the GSEs can't buy or guarantee mortgages exceeding 80% loan-to-value without private mortgage

insurance. The new interpretation allows the enterprises to purchase or guarantee loans of as much as 105% of the current estimated home value. Lockhart said the interpretation applies only to loans that GSEs already own or guarantee and should have a lower default risks because of the borrowers' lower mortgage payments. FTN Financial Capital Markets analyst Jim Vogel described the maneuver as "slippery official behavior at the highest level of government" that should have been explained to the buyers of agency bonds.

- In a letter to Suzanne Hutchinson, EVP of the Mortgage Insurance Companies of America, Lockhart wrote, "The borrower need not obtain additional credit enhancement (such as private mortgage insurance) on a refinanced loan in excess of what is already in place for that loan. ...We intend that the Enterprises would seek to carry forward to the new loan the existing mortgage insurance contract. ...In layman's terms, the refinance initiative is akin to a loan modification for charter purposes as it affects loans for which an Enterprise already holds the credit risk, said Lockhart. "[The refinance initiative] fits within existing charter goals of providing market stability and assisting home ownership while meeting safety and soundness concerns."
- Representative Scott Garrett (R-NJ) believes the initiative may violate the statutory requirements that homeowners put up at least 20 percent of the appraised value of a home or carry mortgage insurance. "I don't see how that stands in face of what the statute says," said Garrett. "It certainly seems as though they need to seek a congressional change, a legislative statutory change." Garrett said he is seeking a copy of the legal opinion prepared by FHFA on this issue.
- "[The GSEs' charters say] in black and white, everything over 80 percent loan-to-value requires mortgage insurance, and you say, 'No, there's wiggle room there,'" said Julian Mann, vice president at First Pacific Advisors LLC in Los Angeles. Such a change in policy will cause some MBS investors to lose money, as borrowers refinance at lower rates and pay down higher-yielding securities, eroding the value of those holdings, said Mann. "If you start playing fast and loose with written rules, you undermine the whole fabric of the capital-market system and you call into question contract law on everything."
- The American Society of Appraisers is considering legal action to block the policy that would cost its members potential business, said Peter Barash, a lobbyist for the group. "We're not there yet because we're not sure what their policy is going to be," said Barash. "Determining loan-to-value is the linchpin of the plan, and in order to get a reliable value it makes sense to rely on professional appraisers."
- Separately, Patrick Lawler, chief economist of the Federal Housing Finance Agency, testified before the House Financial Services Committee that Fannie and Freddie need to relax rules for their streamlined loan modification program that the companies announced in November. "Early indications are that several of the program guidelines should be liberalized to reach a broader population and to create a lower,

more affordable payment,” said Lawler. (*Bloomberg News*, Dawn Kopecki, 02/24/09; *Reuters*, 02/20/09; *Wall Street Journal*, 02/27/09; *American Banker*, 02/23/09; *Correspondence to Suzanne Hutchinson*, James B. Lockhart, 02/20/09)

Activists turn to civil disobedience to help homeowners stay in their foreclosed homes

- Community activists are turning to civil disobedience to help homeowners stay in their foreclosed homes, as federal and local leaders try to intervene on the homeowners behalf. On February 19th, ACORN launched the “Home Defender” in seven cities—Oakland, CA/Contra Costa County, CA, Tucson, AZ, Los Angeles, CA, Orlando, FL, Baltimore, MD, New York, NY, and Houston, TX—in which volunteers armed with cell phones engage in rapid response, community-based civil disobedience to prevent evictions and foreclosures. Volunteers, neighbors, friends, and colleagues will “form a line of defense” to assist those being evicted, said ACORN’s spokesman Charles D. Jackson. (*Bureau of National Affairs*, Joyce E. Cutler, 02/17/09)

Overseas investors want an explicit guarantee on agency debt and MBS

- Over the past six months, overseas investors have voted with their pocketbooks by selling approximately \$170 billion of agency bonds during the second half of 2008. According to Bank of America analysts, Japan and Korea were net sellers of \$6.5 billion in agency bonds in December, while China was a net seller of \$1.2 billion that month. The sell-off reflected a continued lack of confidence among investors, five months after the federal government placed the enterprises into conservatorship. Today, GSE debt effectively competes against debt issued by commercial banks under the FDIC’s Temporary Liquidity Guarantee Program, which is backed by the directly by the government.
- Hideo Shimomura, chief fund investor in Tokyo for Mitsubishi UFJ Asset Management Co., said, “There is still a concern that there is no guarantee” of agency debt and securities, even after the Obama administration has said it will invest up to \$400 billion of funds to backstop the operations of the GSEs, as part of its Homeowner Affordability and Stability Plan. “Looking at the risk, [GSE bonds are] not so attractive,” said Shimomura. “We need a guarantee before we’ll buy.”
- However, extending such a full-faith and credit guarantee to Fannie and Freddie would clearly come with its own dangers, since such a move would instantly nearly double the U.S.’ debt. In April 2008, Standard & Poor’s Ratings Services warned that nationalizing the GSEs could come at the cost of the U.S.’ own sterling sovereign credit rating. S&P wrote, “We believe [the GSEs] pose large contingent fiscal risks that recent policy decisions aimed at supporting the U.S. mortgage market have made even larger. If these risks were to translate into increased government debt, they

could even hurt the U.S.'s credit standing.” (*Bloomberg News*, Dawn Kopecki, 02/20/09; *HousingWire*, Paul Jackson, 02/20/09)

Obama administration stands behind the new RESPA rule

- In legal proceedings against the new RESPA rule, the Obama administration asked the court to dismiss the legal challenge to the rule filed by the National Association of Mortgage Brokers with “prejudice.” Opponents to the rule hope the new administration will reconsider its position, since the main provisions of the final rule do not go into effect until January 10, 2010. (*National Mortgage News’ Mortgage Wire*, 02/23/09)
- In a letter to HUD Secretary Shaun Donovan, eight banking trade groups urged the department to work with the Federal Reserve Board to make mortgage disclosures complement the Fed’s work to avoid consumers’ confusion. In an February 9th letter, the groups wrote, “We urge that HUD and the board to join together, with industry, consumers and other stakeholders, to make the disclosures as effective as possible.” The letter was signed by the American Bankers Association, the Mortgage Bankers Association and five other lender groups. The National Association of Realtors, the Real Estate Services Providers Council, and the American Land Title Association did not sign the letter. (*National Mortgage News*, 02/18/09)

Lenders face GSEs’ multifamily shift

- After years of putting most of their multifamily mortgage originations in their portfolios, Fannie Mae and Freddie Mac are gearing up to securitize these loans. This shift in funding will affect the types of mortgages that can be offered to apartment owners and will require more standardized loan structures. While the loans’ terms will not be as customized, the borrowers should receive lower rates than those offered by portfolio lenders.
- “We don’t want to be dependent solely on Fannie Mae’s retained portfolio as our funding source,” said Phil Weber, Fannie’s senior vice president for multifamily. Fannie once relied heavily on MBS to fund its multifamily business. Returning to that model “is our top priority” in the multifamily business this year, said Weber. It will take a few quarters before Fannie achieves its goal of guaranteeing at least \$500 million of multifamily bond issues a month and serving “the market mainly through MBS issuance,” he added. (*American Banker*, Harry Terris, 02/24/09)

Fannie Mae

Fannie Mae's serious delinquency rate jumps 29 basis points to 2.42% in December

- In December, Fannie Mae's serious delinquency rate for single-family mortgages jumped 29 basis points to 2.42%—more than 250% higher than year-ago delinquency levels. The company's non-credit enhanced portfolio delinquency rate was 1.40% in December, while its credit-enhanced SF delinquency rate was 6.42%. Fannie's delinquency rate on multifamily mortgages increased 5 basis points in December to 0.30% percent, up from 0.10% in January 2008.
- In January, Fannie's retained mortgage portfolio contracted at an annualized rate of 2.6% to \$785.5 billion, while the company's total book of business declined at an annualized rate of 0.9%. The effective duration gap of Fannie Mae's portfolio averaged two months in January, up from one month in December. (*Fannie Mae Monthly Summary*, January 2009)

Freddie Mac

Freddie Mac's delinquencies jumped 26 basis points to 1.98% in January

- In January, Freddie Mac's single-family delinquencies jumped 26 basis points in January to 1.98%—nearly three times the level reported a year earlier. The company said its suspension of foreclosure proceedings contributed to January's rise in mortgage delinquencies. Freddie Mac said, "Additional suspensions of foreclosures during 2009 may also adversely impact delinquency rates going forward."
- In January, Freddie Mac's mortgage portfolio declined at an annualized 8.7% pace in January to \$798.9 billion. In January, Freddie's monthly average duration gap was zero months versus one month in December. (*Reuters*, Al Yoon, 02/25/09)

Freddie Mac retains "Type I" status for three PMI companies recently downgraded by Moody's

- Freddie Mac said there will be no change in its business relationship with MGIC Investment Corp., Radian Group, Inc. and PMI Group Inc., despite the Moody's recent downgrade for the three insurers to below investment-grade on February 13th. The three companies will retain their "Type I" insurer status, said a Freddie Mac

representative. Moody's also downgraded the mortgage insurance units of AIG, Genworth Financial and Old Republic, but maintained the companies' investment grade ratings. (*National Mortgage News*, 02/18/09)

Freddie Mac investigates its \$2 million lobbying campaign

- At the behest of Freddie Mac, Covington & Burling LLP has spent more than a month interviewing current and former company employees and executives about the firm's \$2 million lobbying campaign, which helped quash new GSE regulations before the housing collapse. The inquiry is being led by former Justice Department prosecutor Stephen Anthony, who specializes in internal investigations. The inquiry centers around a \$2 million lobbying campaign conducted in secret by the Republican consulting firm DCI Group to stop proposed GSE regulatory reform legislation in 2005. DCI Group did not file lobbying reports describing the work it performed for Freddie Mac. According to sources, Anthony's inquiry centers around (i) the lobbying work performed by DCI; (ii) Freddie Mac's accounting of six-figure payments to 52 outside lobbying firms and political consultants in 2006, and (iii) accounting for personal use by company executives for company paid-tickets and the company-leased skybox at the Verizon Center. John Koskinen, Freddie Mac's board chairman, confirmed that an inquiry is in process, but declined to make any further comments. (*Associated Press*, Pete Yost, 02/23/09)

Federal Home Loan Banks

Mortgage losses hit eight of the 12 FHLBs

- The scope of mortgage-related problems in the FHLB System became clear with the Banks' release of the financial statements for FY2008, in which two banks reported losses for the year while six other banks said earnings were down because of mortgage losses. The FHLB-Chicago reported a \$119 million loss for last year, which resulted from a \$292 million other-than-temporary impairment charge on the Bank's private-label mortgage-backed securities portfolio and lower net interest income caused by higher funding costs. The FHLB-Boston reported a \$73.2 million loss, after booking a \$339.1 million OTTI charge related to its private label MBS portfolio. [Excluding the charge-off, the Bank would have reported earnings of \$265.9 million for the period—down only 1.5% from its FY2007 earnings.]
- Collectively, the FHLBs of Boston, Chicago, Pittsburgh and San Francisco recorded OTTI charges totaling \$1.5 billion during FY2008. [The Atlanta and Seattle Banks have not yet released their FY2008 results, which aren't officially due until March

31st.] In January, the Seattle and Pittsburgh Banks' warned that OTTI charges could reduce their capital below their regulatory capital requirements. The FHLB-Pittsburgh said its met all of its capital requirements on December 31st, while the FHLB-Seattle has announced it was \$178 million below its risk-based capital requirement at year-end but had a \$149.7 million cushion on January 31st.

- The decline in profits was particularly steep at the Dallas, Pittsburgh, Topeka and San Francisco Banks in 2008. The FHLB-Dallas reported a 100% drop in net income for FY2008, after posting a \$67.6 million loss for the fourth quarter because of losses on derivatives and hedging activities (\$64.4 million). The FHLB-Pittsburgh's earnings fell 91.8%, due largely to a \$236.8 million OTTI charge and a 24.8% decline in net interest income. For FY2008, the FHLB-Topeka reported an 81.1% drop in earnings but provided limited details explaining the decline. [The Bank said that accounting rules contributed to a net loss during the fourth quarter, but did not elaborate on the severity of the loss.] The FHLB-San Francisco's earnings fell 29.3% to \$461 million, following a \$590 million OTTI charge on its private label MBS portfolio.
- Otherwise, the FHLB-Des Moines and FHLB-Indianapolis reported higher earnings in FY2008. The Indianapolis Bank's earnings grew 62% to \$184.5 million, while the Des Moines Bank's earnings grew 25.6% to 127.4 million. (*American Banker*, Steven Sloan, 02/27/09)

Proposed Infrastructure Bank

Obama's 2010 budget appropriates \$25 billion over a five year period for the National Infrastructure Bank
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- In the executive summary of the 2010 budget, the Obama administration wrote, "...The Budget proposes to expand and enhance existing Federal infrastructure investments through a National Infrastructure Bank designed to deliver financial resources to priority infrastructure projects of significant national or regional economic benefit. The mission of this entity will be to not only provide direct Federal investment but also to help foster coordination through State, municipal and private co-investment in our Nation's most challenging infrastructure needs. These projects will directly and indirectly support jobs and stimulate substantial long-term economic growth." The administration's 2010 budget appropriates \$5 billion a year over a five year period (2010-2019) to fund the National Infrastructure Bank. (*A New Era of Responsibility—Renewing America's Promise*, Office of Management and Budget, 02/26/09)

The National Governors Association discuss the need for a National Infrastructure Bank

- At a special session of the February 23rd meeting of the National Governors Association, Felix Rohatyn, an investment banker known for his role in preventing the bankruptcy of New York City in the 1970s, said infrastructure needs to be treated like an investment, not a program, and urged Congress to create a national infrastructure bank to meet the country's infrastructure funding needs. Rohatyn said such a bank, which could become self-financing over time, would require sweeping reorganization of the way infrastructure funding is allocated. However, these changes are necessary to better balance long-term and short-term investments, he said. "I worry that today our budget rules don't distinguish adequately between wealth and income or investment and consumption, leaving us with too little of the former and too much of the latter."
- Governor Edward Rendell (D-PA), chair of NGA and a supporter for the infrastructure bank, said getting Congress to give up their power to determine infrastructure funding and earmark pet projects could be a "difficult" proposition. Rendell also expressed concerns that the time span for action on the creation of the bank is short. Senate Banking Committee chairman Chris Dodd (D-CT), who has introduced a bill to create an infrastructure bank, said the issue would be one of his top priorities for the committee this year.
- Bruce Katz, vice president and director of the Metropolitan Policy Program at the Brookings Institute, said that the infrastructure funding provided in the economic stimulus package is insufficient to fund the transformative, long-term infrastructure projects that America needs, but a national bank could step in to finance those types of projects. Katz argued that a national infrastructure bank could invest in more long-term projects that are needed to bring America's infrastructure up to the level of other developed nations. (*Bureau of National Affairs*, Kate Naseef, 02/24/09)

Ginnie Mae

HUD seeks authority to buy down FHA loan balances

- The Obama administration is seeking new authority to allow FHA to buy down the balances of mortgages the agency insures, said Vance Morris, HUD's director of single family asset management. Morris also said HUD is seeking changes that will expand FHA's authority to help borrowers that have lost their jobs or suffered permanent salary reductions "while considering the impact to program costs." (*Bloomberg News*, Dawn Kopecki, 02/24/09)

Farm Credit System / Farmer Mac

Farm Credit System's credit quality deteriorated in 2008

- In the February issue of *Farm Credit Watch*, Bert Ely wrote, "Credit-quality issues emerged last year in the FCS, according to an FCS news release announcing the FCS's financial results for 2008. Troubled FCS loans more than doubled in 2008, rising to \$4.7 billion at the end of 2008 from \$2.1 billion the year before. Nonaccrual loans, which are included in troubled loans, jumped to \$2.282 billion at December 31, 2008, more than four times the \$512 million in nonaccrual loans at the end of 2007. [According to the FCS news release.] 'This increase was due primarily to the movement into nonaccrual loan status of one large agribusiness loan in the livestock/poultry industry and one large loan to an ethanol producer resulting from higher corn prices that adversely impacted borrowers in these industries.' Most likely, Pilgrim's Pride is the livestock/poultry producer and VeraSun Energy Corporation is the ethanol producer. Both companies, having borrowed heavily from FCS institutions, are now in Chapter 11 bankruptcy. On February 6, VeraSun sought authority to sell substantially all of its assets. Other FCS borrowers in these two industries probably are facing bankruptcy, too."
- "...Despite the quadrupling of its nonaccrual loans, the FCS's allowance for loan losses (ALL) increased just \$155 million in 2008, to \$936 million. Consequently, the FCS's ALL dropped to 41% of nonaccrual loans from 153% at year-end 2007. Measured against troubled loans, the FCS loss reserve was just 20% of those loans at year-end 2008, down from 36% at the end of 2007. Given the economic outlook for 2009 and beyond, the FCS appears to be under-reserved at the end of 2008 for future loan losses. Amazingly, one FCS bank, 'refined its allowance for loan losses methodology and reclassified \$154 million from the allowance for loan losses to [its] reserve for unfunded commitments.' That adjustment was taken by CoBank, which dropped its ALL from \$447 million at the end of 2007 to \$329 million even though its

lending rose by \$1 billion and its non-accrual loans increased 15 times, rising from \$14.8 million at the end of 2007 to \$218 million at the end of 2008. Yet relative to the rest of the FCS, CoBank was relatively well-served on December 31, 2008.”

- “...Overall, FCS profits increased 7.9% [in 2008] to \$2.916 billion, as total assets grew 15.0% to \$214.35 billion, while loans grew 13.0%, to \$161.42 billion. FCS’s equity capital grew only 2.7%, or \$705 million, during 2008 as FCS’s equity-capital ratio dropped to 12.7% from 14.2% at the end of 2007. Capital growth fell far short of earnings largely because the FCS’s accumulated other comprehensive loss (AOCL) jumped \$1.59 billion during 2008, to \$2.13 billion, with much of that increase (\$867 million) occurring in the fourth quarter. FCS’s equity capital actually shrank by nearly as much—\$761 million—during the fourth quarter. An \$838 million increase in unrealized losses on available-for-sale investments and a \$715 million increase in the unfunded status of the FCS’s pension and other benefit plans accounted for most of the 2008 increase in the FCS’s AOCL. The FCS continued to pay a pittance in corporate income taxes, with a 2008 tax provision equal to 5.0% of its pre-tax income, the same as 2007.”
- Ely also noted that FCA has announced its plans to adopt a controversial proposed regulation in July, entitled the Rural Community Investment. He wrote, “...This proposed regulation not only drew strong opposition from bankers ...[and] from four key members of the House Financial Services Committee, including Chairman Barney Frank (D-MA) and Representative Spencer Bachus (R-AL), the top-ranked Republican on the committee. Essentially, they said the FCA had no business authorizing FCS institutions to make debt and equity investments in ‘activities and businesses with few or no ties to the agricultural sector’ of the nation’s economy. They noted that ‘the proposed rule is contrary to Congressional intent’ for the FCS, which intent is the “specific mission of providing credit to our nation’s agricultural sector.””
- “Beyond this general objection, the four House members took strong issue with specific provisions in the proposed rule, such as objecting to FCS investments in venture capital funds. They also expressed concern that this investment authority ‘could be used to facilitate the regulatory transformation of the [FCS] from a farm credit provider to a general credit provider ...[and] the effect of this broad, open-ended provision on the safety and soundness of the [FCS].’ In this letter and in earlier opposition to the HORIZONS Project, these Committee leaders as well as the leaders of the Senate Banking Committee have sent a very powerful message to the FCA—stop trying to broaden the FCS’s off-farm lending powers or we will begin to assert legislative jurisdiction over the FCS. One wonders if the FCA is listening.”
- “The FCA’s regulatory agenda also contains a three-part study, through a Notice of Proposed Rulemaking, of capital adequacy for FCS institutions within the context of the Basel risk-based capital standards. In light of the FCS’s significant decline in its equity-capital ratio last year, one can realistically fear that the FCA will seek to weaken FCS capital requirements.” (*Farm Credit Watch*, Bert Ely, February 2008)

Farm sector may face “less credit and higher interest rates”

- According to the USDA’s *Outlook for U.S. Agriculture Trade*, “Farm operators have continued to get bank loans, despite overall credit rationing, as commercial farm loan delinquencies have been at record low levels. Farm operators may see less credit with higher interest rates as off-farm income drops. Still, farm credit will be less subject to the tight credit rationing seen across the rest of the U.S. economy. (*Outlook for U.S. Agriculture Trade*, United States Department of Agriculture, 02/26/09)

Farm sector is a “loser” in President Obama’s 2010 budget

- According to the *Kansas City Star*, farm payments are slashed \$26 billion in the Obama administration’s 2010 budget. The newspaper wrote, “...Obama would break from the five-year farm bill that Congress enacted last year, with his support. He proposes eliminating what are known as direct payments—subsidies that are paid to farmers regardless of crop prices or how much they grow—for producers with more than \$500,000 in annual sales revenues. The budget also proposes eliminating other agricultural subsidies, putting a cap on the amount of money an individual farmer can receive. President George W. Bush made similar proposals to cut payments for the largest corporate farms in many of his annual budgets, but he was rebuffed by Congress. Southern lawmakers in particular oppose cutting farm subsidies because cotton and rice crops there are more expensive to grow. The farm bill, enacted over Bush’s veto, raised subsidies for some crops.” (*Kansas City Star*,02/26/09)

Postal Service

Congress to hold hearing on PMG's \$800,000 compensation package
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- Congress will hold a hearing on March 25th about why Postmaster General John E. Potter received a nearly 40% increase in compensation since 2006 and was awarded a nearly \$135,000 incentive bonus in 2008, as his agency faced a multi-billion shortfall. For FY2008, Potter's compensation package exceeded \$800,000, according to the USPS. In addition, Deputy Postmaster Patrick Donahoe received \$600,026 in total compensation. Postal officials defend the agency's pay packages, arguing that outside compensation specialists recommended the compensation programs based upon their competitors in the private market. They also pointed out that private company executives earned more than USPS officials—approximately \$10 million in 2008 according to SEC filings. While the Postmaster General's compensation cannot exceed 20% above the salary of the vice president, the Board of Governors can award the PG additional compensation, so long as it is deferred until later years.
- “Last year, the Postal Service took a loss of nearly \$3 billion and recommended that the public take austere cuts in service to allow it to operate, including cutting a day of mail delivery and raising the price of stamps,” said Representative Stephen F. Lynch (D-MA), who serves as chairman of the House Oversight and Government Reform subcommittee that oversees the Postal Service. “All things considered, I think most postal customers feel that the huge increase in pay for Mr. Potter is incongruent with the post office's recent performance. I assure you that our subcommittee will look into this matter at a hearing in March.” Ranking member Jason Chaffetz (R-UT) said, “On the surface it just doesn't smell right. Rewarding people for performance is acceptable, but things kind of seem to be going in the wrong direction. I'm looking forward to that hearing.” (*Washington Times*, Jim McElhatton, 02/23/09)

TVA

TVA lowers rates by 7% effective April 1 st
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- On April 1st, TVA will lower its wholesale electric rates by 7% to reflect the utility's lower fuel costs. In January, the agency lowered rates by 6% after raising rates 20% in October. “In these economically challenging times, we are especially glad lower fuel costs will provide some relief in power costs to the consumers in the Tennessee Valley,” said TVA president and CEO Tom Kilgore. (*Daily Sentinel* [Jackson, MS], Dewayne Patterson, 02/16/09)

NRC authorizes the reinstatement of construction permits
for Unit 1 and 2 reactors at TVA's Bellefonte site

- On February 19th, the Nuclear Regulatory Commission authorized the reinstatement of construction permits for TVA's unfinished Unit 1 and 2 reactors at the utility's 1,600-acre Bellefonte site near Scottsboro, AL. The NRC's action places the units in a construction "terminated" status, until TVA decides if it will complete construction of the units. (*Daily Sentinel* [Jackson, MS], Ken Bonner, 02/20/09)

TVA needs to "rethink coal use" says Senator Alexander

- In the aftermath of a huge coal ash spill in Tennessee, Senator Lamar Alexander (R-TN) said TVA and the public rethink the use of coal to make electricity. "What we need to do, it seems to me, is to make sure that the coal that we burn is burned safely and is burned as cleanly as possible, and that may cost more money and it may mean some changes in procedure," said Alexander during a tour of the Kingston Fossil Plant spill site. "It may mean we need to move more rapidly toward different ways of producing electricity, specifically, nuclear power, a lot more conservation and—where we can—renewable energy." He added that coal must still be a primary source for electricity for the foreseeable future because it is one of the most affordable energy sources and provides many jobs in Tennessee. "It's important to be realistic about the cost of electricity," said Alexander. "TVA rates went up some this last winter, but our rates are still generally lower than most other parts of the country. One of the things we've got to keep in mind is that we not only need clean electricity but we need low rates to keep our jobs and be able to afford our bills."
- TVA is cleaning up the 5.4 million cubic yards of ash that surged into a river and neighborhood near Kingston Fossil Plant in December, which will take many months and cost as much as \$825 million [excluding fines and litigation]. TVA Chairman Bill Sansom has said TVA will not seek help from Washington to help cover the costs of the spill. Alexander said, "If there are options for federal funding I'll be glad to pursue them, but I don't want to just lead ratepayers into thinking there's some magic place in the sky where money comes to help clean up mistakes like this," said Alexander. (*Associated Press*, Beth Rucker, 02/19/09)

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