

The **GSE** REPORT™

www.gsereport.com

<u>Contents of GSE Report™</u>	
Major Events	4
• FASB issues final staff positions on fair value and security impairments	4
• Treasury launches Public-Private Investment Fund to purchase toxic assets.....	7
• Treasury Secretary Geithner unveils map for new era of regulation.....	11
• Senator Dodd and Representative Frank pledge to create a “new framework for 21 st century regulation”.....	12
• Obama administration’s regulatory reform proposal will create GSEs in every sector of the financial system	13
TARP.....	15
• Fannie Mae CEO Allison expected to head TARP.....	15
• Is TARP running on fumes?	15
• CBO revises estimate of cost of TARP up 88% to \$356 billion.....	15
• Congressional Oversight Panel questions success of TARP	16
• Obama administration seeks to circumvent Congressional restrictions on TARP recipients as a means of attracting firms to participate in bailout programs	17
• TARP recipients must participate in the government’s mortgage modification program.....	18
• “First do no harm”	18
• Mum’s the word on the banks’ stress tests	19
• Treasury to offer TARP assistance to life insurers.....	20
• Two wholesale credit unions fail the stress test and are seized by NCUA.....	21
• Housing industry trade groups urge Treasury to provide capital to PMI industry	21
• Treasury issues term sheet for mutual holding companies participation in the Capital Purchase Program	22
• TALF facility expanded to cover servicing advances.....	22
• An alternative view of the housing crisis.....	23
• Economic conditions and trends	24
Financial Services Regulation Reform.....	28
• JPMorgan Chase CEO Dimon’s addresses regulatory reform for the financial services industry.....	28
• Policymakers should be mindful of the long-term consequences of their actions.....	34
• Congress begins its efforts to reform the regulation of the financial services industry:	34
• Regulatory modernization bill is introduced in the House and Senate.....	35

• Markup of the Chairman Frank’s mortgage reform and predatory lending bill will be scheduled after the Easter recess.....	35
• Possible compromise on mortgage cram-down emerges in the Senate	36
• H.R. 1479 introduced to “modernize” the Community Reinvestment Act.....	37
• Representatives Bean and Royce propose bill to create an optional federal regulatory structure for insurance industry	37
Fannie Mae and Freddie Mac.....	39
• Fannie Mae and Freddie Mac have posed the most negative shock to the financial system	39
• Fannie Mae and Freddie Mac—“the largest regulatory failure of all time”	40
• The “current [GSE] model is broke” says Chairman Frank	40
• Treasury’s Senior Preferred Stock facility provides Fannie and Freddie an <i>effective guarantee</i> , says FHFA director Lockhart	41
• President Obama urges homeowners to refinance their mortgages	43
• Federal Reserve pledges another \$1.2 trillion to support the housing market.....	44
• Fed study finds loan modifications not as effective as direct aid to homeowners.....	44
• Federal agencies organize “aggressive action” to fight mortgage fraud.....	45
• Fannie’s and Freddie’s retention bonus program comes under fire.....	45
• FHFA considers new role for Fannie Mae and Freddie Mac.....	47
• President Obama announces nominees for Treasury and HUD positions	47
Fannie Mae	48
• Fannie Mae’s retained mortgage portfolio declined 1.3% in February	48
• Fannie Mae and KPMG are engaged in battle over attorney-client privilege	48
• Javid Jaberri joins Fannie Mae to oversee the company’s “mega servicers”.....	49
• New wave of mortgage buybacks coming from the HomeSave Advance program... ..	49
• Fannie Mae releases a new version of its Desktop Underwriter and new web portal ..	49
Freddie Mac	51
• Freddie Mac’s retained mortgage portfolio reaches an all-time high of \$822 billion in February	51
• Freddie Mac’s public and private roles conflict—again.....	51
• Freddie Mac’s strategy for handling its rising REO inventory.....	52
• Freddie Mac introduces the Reverse REMIC program to improve the liquidity of the residential mortgage market.....	53
• Former Freddie CEO nominated to serve on PHH Corp.’s board of directors.....	54
Federal Home Loan Banks	54
• Boston FHLB books OTTI charge of \$381.7 million.....	54
• FHLB-Seattle reports material weaknesses in how the Bank values its MBS portfolio	54
• FHLB-Seattle suspends dividend payments and excess stock repurchases.....	55
• Charles Bowsher resigns from the FHLBanks Office of Finance Board.....	55

Ginnie Mae	56
• FHA delinquency rate increases 21% to 7.46% in February, raising concerns about the agency may be “another powder keg about to explode”	56
• HUD may allow principal reductions of up to 30% for FHA-insured mortgages	57
• FHA plans to test pilot fully electronic mortgages by yearend	57
• Ginnie Mae MBS issuance tops \$34.5 billion in March.....	58
• Ginnie Mae stands ready to help ease the pain of mortgage warehouse constrictions	58
Farm Credit System / Farmer Mac	59
• Farm Credit System’s nonperforming loans increase more than 400% in 2008	59
• Two FCS associations “busted” for paying illegal rebates.....	59
• CEO compensation at the FCS banks goes “jumbo”	60
• Farmer Mac reports \$154.1 million loss for 2008	61
Postal Service	61
• Postmaster General Potter tells Congress that the USPS is running out of money	61
TVA	62
• Obama administration expected to announce soon their appointments to the TVA board	62
• TVA purchases 70 properties impacted by ash spill at a cost of \$20 million.....	64

Major Events

FASB issues final staff positions on fair value and security impairments
--

- Under intense pressure by Congress to issue crisis-driven rule changes for fair value accounting, the Financial Accounting Standards Board has approved the issuance of controversial FASB staff position (FSP) on fair value and impairment of debt securities which are widely seen as easing accounting for troubled assets held by financial institutions and other companies. On April 9th, the FASB finalized the issuance of final guidance for FSPs on three proposals intended to meet the need for greater transparency by banks. FASB Chairman Robert Herz said, “Taken together, these three new [proposals] significantly expanded and enhanced disclosures.” Specifically, the FSPs address (i) the determination of fair value when the volume and level of activity for the assets or liability have been significantly decreased and identifying transactions that are not orderly under FAS 157-4; (ii) interim disclosures about fair value of financial instruments under FAS 107-1 and APB 28-1; and (iii) recognition and presentation of other-than-temporary impairments under FAS 115-2 and FAS 124-2. FASB said the FSPs are effective for interim and annual periods ending after June 15, 2009, but entities may early adopt the guidance for the interim and annual periods ending after March 15, 2009. FASB said the three FSPs should be considered in context of the larger ongoing joint project with the International Accounting Standards Board to reconsider accounting for financial instruments, which is expected later this year.
- Under the FSP for FAS 157-4, companies are required to examine factors and use judgment to ascertain if a [formerly] active market has become inactive. After determining that the market is inactive, entities trying to estimate fair value of such assets are required to consider if the observed prices or broker quotes obtained represent “distressed transactions.” Under such circumstances, a company may use other techniques such as a management estimate of the expected cash flows, said FASB. Even if a company analysis is used to estimate the asset’s fair value, it must meet the objective of estimating the orderly selling price of the asset under current market conditions. Some financial institutions released public statements indicating that they do not expect this FSP to significantly affect their financial statements, said FASB.
- Under the FSP for FAS 107-1 and APB 28-1, commercial banks will be required to provide disclosures on a quarterly basis, which provide qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. Previously, fair values for these assets and liabilities were only disclosed annually.
- Under the FSP for FAS 115-2 and FAS 124-2 on other-than-temporary impairments (OTTI), entities are required to continue using fair value to measure impairment in

comprehensive income. The FSP requires increased and more timely disclosures regarding expected cash flows, credit losses, and an aging of securities with unrealized losses. The goal of this FSP is to provide greater consistency to the timing of impairment recognition and greater clarity to investors about credit and noncredit components of impaired debt securities that are not expected to be sold.

- Congressman Spencer Bachus (R-AL), the minority leader of the House Financial Services Committee, said, “Today’s announcement that the FASB will be adjusting mark to market rules is long overdue. Financial institutions and community banks have been adversely affected by the rigid application of these rules during this financial crisis, causing further instability in the banking system. I look forward to hearing more from the FASB later this month when they appear before the Financial Services Committee.”
- Wallace Enman, a vice president and senior accounting analyst at Moody’s Investors Service, said the impairment FSP “will lower the hurdle for firms to avoid OTTI charges on securities that have not experienced credit deterioration.” The FSP’s slight change in wording on the circumstances that lead to such charges “could substantially reduce the number of impairment charges,” he added. The disclosure FSP will result in enhanced footnote reporting requirements for (i) information about valuation techniques; (ii) more granular, or disaggregated, disclosures by type of security; and (iii) a roll-forward of OTTI-related charges. Enman said, “These disclosures are essential, since giving firms the ability to disregard observed transactions in determining fair value, and to avoid OTTI charges, without improved disclosure would increase financial statement opacity and would hinder investor confidence. The incremental information required by the new rules will improve transparency and be of significant help to investors.”
- Reaction to the FASB fair value guidance by security analysts and investor groups has been generally positive, but concerns and criticisms remain over FASB’s OTTI changes. The American Bankers Association commended FASB “for finally offering new guidance on mark-to-market accounting and impairment.” However, ABA expressed concern that FASB “has not done enough to fully repair the accounting for securities classified as held-to-maturity [under FAS 115].” The Financial Services Roundtable concluded that FASB took “progressive steps” on the security impairment rules, but “regressed” on the fair value measurement guidance. Patrick Finnegan of CFA Institute, who has been a harsh critic of the fair value and OTTI proposals, said, “We were pleased with the board’s decision to reverse the direction [in the FSP on fair value]. That was a good outcome [that FASB] retained the definition of exit value [which is central to board-defined principles of fair value and discarded a presumption of a distressed transaction in an inactive market].”
- However, Finnegan and other investment analysts and accountants are unhappy with the FSP on OTTI and its reliance on judgment. Critics argue that the FSP will lead to the use of a new level of discretion by the banks’ and other companies’ managers. Ultimately, this discretion will help postpone what some argue are inevitable losses

on held-to-maturity securities, argue the critics. Other critics question how the FSPs proposal to split the credit/noncredit split on loss treatment will work “operationally.” Under the guidance, the new rules’ scheme will split accounting treatments according to whether other-temporary impairment losses stem from credit losses—which run through the income statement—versus losses related to other factors—such as non-credit related OTTIs which are recorded in “other comprehensive income” as a charged to equity and doesn’t affect earnings. “Putting some of the loss on the balance sheet until the security matures inappropriately delays recognition of a loss that is inevitable,” said Rick Martin with Pluris Valuation Advisors. “Putting today’s loss in tomorrow’s financial statements can be misleading to investors.”

- Other critics warned that the political pressure that led to FASB’s adoption of the FSPs might endanger the wider market. In a letter to Representative Paul Kanjorksi (D-PA), a group of investment officials and analysts wrote, “We are concerned that having seen Congress act in this case, special interests will pursue this avenue in the future to advance narrow agendas at the expense of the broader market. We believe that political interference will only serve to further destabilize confidence in the system.”
- Instead of relaxing accounting standards for fair value accounting, the International Accounting Standards Board (IASB) said that it will move ahead with a full, faster review of how it accounts for financial instruments, which it expects to complete within six months. “It is far better to undertake a fundamental reassessment than adopting a piecemeal approach to a standard that is widely recognized as being outdated,” said Gerrit Zalm, chairman of the IASB.
- On April 9th, the *Financial Times’ Lex Blog* wrote, “If the world’s accounting bodies were deliberately trying to destroy confidence in bank financial statements, they could not have done a better job. The Financial Accounting Standards Board, the US standards setter, last week bowed to pressure to relax mark-to-market rules. Its international counterpart would prefer a comprehensive, six-month review to avoid piecemeal tweaks.”
- “But another change to accountancy rules is more controversial and even harder to harmonize between the two regimes. Changes to how banks account for “other than temporary” impairments to debt securities will feed directly through to their capital ratios. Two members of the five strong FASB board voted against this measure, compared with unanimous support for other changes. Banks will now be able to split declines in the value of debt securities into two buckets. Only the portion related to a fundamental deterioration in credit will hit income. Any fall in value due to “liquidity” is separated out. The dissenters sensibly argue that the total value should still flow through the profit and loss account.”
- “Then there is the link to capital. When moving to the new rules, each bank will also divide previous impairments made to assets still on its books. This will not boost income. It will, however, shift past losses between two lines on the balance sheet,

increasing “retained earnings” and decreasing “accumulated other comprehensive income.” Regulators essentially disregard changes to the latter in calculating tier one, a core measure of bank capital. The result? Accounting jiggery pokery will increase a bank’s supposed strength, as measured by its regulatory capital.”

- “Of course, this is nonsense. It is little wonder investors have focused on capital ratios based on tangible common equity, which is less prone to tinkering. The FASB is trying to be responsive in a crisis. Loss of faith in public accounts is too high a cost.”
- Corinne Russell, spokeswoman for the Federal Housing Finance Agency, said FASB’s new rules have “the potential to have a positive effect on both earnings and shareholders’ equity, which would decrease future draws [by Fannie Mae and Freddie Mac.” FHLB executives are hopeful that the new accounting rules may finally end the “assault” on their mortgage holdings, against which nearly \$2 billion in OTTI charges were booked in 2008. The FHLB System had lobbied to apply the rule change to the fourth quarter, which would have relieved as much as \$1.77 billion of OTTI charges. However, the FSPs do not allow companies to apply the change to 2008. (*Bureau of National Affairs*, Denise Lugo, 04/10/09; *Wall Street Journal*, Kara Scannell, 04/03/09; *Financial Services Committee GOP Press Release*, 04/02/09; *Bureau of National Affairs*, Steve Burkholder, 04/10/09; *Financial Times*, Jennifer Hughes, 04/03/09; *Bureau of National Affairs*, Steve Burkholder, 04/03/09; *Financial Times’ Lex Blog*. 04/09/09; *Bloomberg News*, Dawn Kopecki, 04/02/09)

Treasury launches Public-Private Investment Fund to purchase toxic assets

- On March 23rd, Treasury Secretary Timothy Geithner introduced the Public-Private Investment Program (PPIP) designed to partner with private investors in pricing and removing toxic assets from banks’ balance sheets. Under PPIP, Treasury will use up to \$100 billion of TARP funds to co-invest with private investors, the FDIC and the Federal Reserve in the purchase of \$500 billion of toxic assets (“legacy assets”). Eventually, the PPIF may invest in up to \$1 trillion of legacy assets. The program’s goal is to use the private market to establish prices for assets that have stopped trading or whose values have plummeted in the on-going financial crisis. Geithner argued that the public-private partnership is the best vehicle to protect the tax payers and address the root cause of the financial crisis. “Private investors will share the risk alongside with the taxpayer and the taxpayer will share returns,” said the Treasury Secretary.
- PPIP will have separate programs for legacy loans and legacy securities. Under PPIP’s Legacy Loan Program, FDIC will establish public-private investment funds (PPIFs) which will purchase and hold specific loan pools put up for sale by banks. The transaction price for the loan pools will be determined by the highest bid at an auction run by the FDIC, in which a wide array of institutional investors and individuals with a long-term orientation are encouraged to participate. The liabilities

of the PPIFs will consist of an equity stake—50% provided by the auction winner and 50% from Treasury, using TARP funds—and collateralized debt issued by the investment fund and guaranteed by the FDIC to finance the remainder of the purchase price (with FDIC receiving a guarantee fee its role in the transaction). Before the auction, the FDIC will specify the pool-specific debt-to-equity ratio it is willing to guarantee, subject to a maximum 6-to-1 leverage ratio. The private investor would then manage the servicing of the asset pool, using asset managers approved and supervised by the FDIC, until the PPIF is liquidated or matures. FDIC will oversee the formation, funding, and operation of PPIFs, along with the management of its debt guarantees and also will play an ongoing reporting, oversight and accounting function on behalf of Treasury. Treasury and FDIC will establish governance procedures for the management, servicing agreement, reporting requirements, exit timing and alternatives for each asset pool. The selling bank will service the assets, unless otherwise defined and the PPIF will retain control of servicing, subject to relevant agreements. FDIC and Treasury will establish servicing parameters. The PPIF will pay ongoing administrative fees for oversight functions, along with an annual debt guarantee fee, a portion of which will be allocated to FDIC's deposit insurance fund. Treasury and FDIC will enter into an agreement on allocating costs and responsibilities, which provides FDIC reimbursement for its expenses.

- Under PPIP's Legacy Securities Program, separate public-private investment funds (PPIFs) will be formed to purchase and hold non-agency CMBS and RMBS, which were issued prior to 2009 and were originally rated AAA by two or more NSROs without ratings enhancements. Treasury may consider adding other asset classes to this program at a later date. To qualify for the program, the securities must be directly secured by actual mortgage loans—not by securities, other than certain swap positions which Treasury may determine—and the underlying loans must be predominately in the U.S. [which Treasury may clarify later]. Eligible assets must be purchased solely from a financial institution—including banks, credit unions, security brokers or dealers, or insurance companies—established and regulated under U.S. law in any U.S. state, territory, or possession, with significant operations in the U.S. No central banks or institutions owned by any foreign government will qualify for this program. Fund managers must be headquartered in the U.S.; have a demonstrable track record with a minimum of \$10 billion of assets under management; and demonstrate the capacity to raise at least \$500 million in private capital. Initially, Treasury expects to select five fund managers. Fund managers will manage Public Private Investment Funds (PPIFs) that will have two investors only—the Treasury and a vehicle controlled by the Fund Manager through which private investors can invest. Fund managers will have the option of subscribing to secured, non-recourse Treasury senior debt for PPIFs, up to 50% of the PPIF's equity; Treasury loans may be up to 100% of the funds total equity, subject to restrictions on asset level coverage, withdrawal rights, disposal priorities, and other factors. Fund managers will control the PPIF and determine the process of selecting and pricing assets, and selling and trading assets—except that they will follow a predominately long-term buy and hold strategy. Fund managers will submit reports monthly on the PPIF to Treasury and provide access to its books and records to Treasury, TARP's Special Inspector

General, and GAO. Fund managers will have the discretion to set fees for private investors, which will be considered by Treasury in evaluating applications for prospective fund managers.

- Despite public outcry about executive bonuses, Treasury Secretary Geithner said [on March 23] that investors and pension funds which manage up to \$1 trillion in toxic assets through PPIP will not have to comply with limitations placed on executive compensation for TARP participants, because the program is designed to unfreeze the credit markets [as opposed to stabilizing their institution]. “If you are already an institution that has received TARP assistance then you will be covered ... [by the restrictions on compensation],” said Geithner.
- On April 7th, Treasury released updated guidelines “to better accommodate increased participation” in PPIP through the potential for more proposal approvals and more business and fund manager participation. Specifically, Treasury announced that the failure to meet any one eligibility criteria for Fund Managers will not necessarily disqualify an application. The agency clarified that the legacy securities portion of the PPIP is separate from the Federal Reserve’s TALF, noting that while they will work together, “they will remain separate.” Treasury also indicated that it is considering a broader class of assets for use in the legacy securities program. At the encouragement of the Congressional Black Caucus, Treasury also encouraged small, minority-, veteran-, and women-owned businesses to participate through partnerships with fund managers. Treasury also extended the PPIP application deadline to April 24th with notification of “preliminary” qualification set for May 25th. Representative Maxine Waters (D-CA) said she was encouraged by Treasury’s steps to include small businesses in PPIP, she “remains concerned that even under updated guidelines, the burden remains on minority- and women-owned business to find willing partners ... who do not have a particular incentive to welcome their assistance.”
- The PPIF essentially utilizes more leverage and securitization through PPIP to price and sell illiquid assets and enable banks to make new loans and raise new capital. In substance, PPIP aims to conscript private money into public service—and will work only if investors believe that the expected financial rewards will outweigh the potential legal risks. Under this program, investors will use leverage rather than prices to potentially earn a higher rate of return on an asset than they might otherwise. However, the legal risks are more complicated, given the fundamentally different purposes, obligations and constituencies that a fund manager has versus those of government agencies. A fund manager faces four basic legal concerns with PPIP: (i) the consistency and reliability of the government as an investor partner; (ii) concern that gains earned on PPIP investments may be ultimately be subject to punitive taxes [particularly in the wake of the AIG bonus flap]; (iii) the prospect of “rigorous oversight” of the PPIPs by FDIC; and (iv) tax considerations.
- Given Treasury’s efforts on April 6th to expand participation in PPIP, some speculate that interest in the program has been “muted.” Bridgewater Associates, the world’s largest hedge fund manager, has reversed course from earlier plans to participate in

PPIP . Ray Dalio, Bridgewater’s founder, blasted the securities portion of the program, calling it a conflict of interest and one that offers very little leverage. Dalio said, “The managers are clearly in a conflict-of-interest position because they have both the government and the investors to please and because they will get their fees regardless of how these investments turn out. We would not want to have our clients commit to invest, or even ask them to trust us being in this conflicted position.”

- In an April 7th commentary, Herman Moyses, professor of finance at Louisiana State University, cautioned that the politicization of bank resolutions is “dangerous,” as last witnessed during the thrift crisis of the 1980s, when the Resolution Trust Corporation was run through on the Congressional budget, similar to Treasury programs today. Moyses wrote, “My own academic work on optimal liquidation in a least-cost resolution environment shows the FDIC performed admirably in the Thrift Crisis era. The RTC, on the other hand, performed dismally due to the repeated funding delays [by Congress]... Hence, it makes sense to structure resolutions around an independent bank-funded institution rather than a politically-driven Congressionally-funded institution. Let’s stop the politicization of the program until we at least have a well-defined program and – whether that program is a conservatorship regime that recapitalizes and right-sizes institutions or something else – keep resolution authority in the hands of an independently-funded and capable FDIC, where it belongs.”
- In a March 24th Letter to the Editor of the *Financial Times*, AEI resident fellow Alex J. Pollock wrote, “Structured investment vehicles to invest in tranching mortgage-backed securities with plenty of leverage have been duly condemned for the huge problems and losses they caused. So to solve the problems the United States Treasury now brings us structured investment vehicles to invest in tranching mortgage-backed securities with plenty of leverage provided by the taxpayers. Hair of the dog?” (*HousingWire*, Diana Golobay, 04/07/09; *CQ Today*, Benton Ives and Phil Mattingly, 03/23/09; *HousingWire*, Paul Jackson, 04/03/09; *Legacy Securities Public-Private Investment Funds Summary of Proposed Terms*, U.S. Treasury Department, 04/06/09; *Legacy Loans Public-Private Investment Funds Summary of Proposed Terms*, U.S. Treasury Department, 03/23/09; *Wall Street Journal*, Michael Pereira, 04/10/09; *CQ Today*, Phil Mattingly, 04/06/09; *CongressionalDaily*, 03/23/09; *Wall Street Journal*, Maya Jackson Randall, 04/06/09; *Bureau of National Affairs*, R. Christian Bruce, 04/07/09; *CQ Today Online News*, Phil Mattingly, 04/07/09; *Empiris Market Commentary*, Hermann Moyses, Jr., 04/07/09; *Financial Times*, Alex J. Pollock, 03/24/09)

Treasury Secretary Geithner unveils map for new era of regulation

Senator Dodd and Representative Frank pledge to
create a “new framework for 21st century regulation”

Obama administration’s regulatory reform proposal will create GSEs
in every sector of the financial system

- In a March 26th House Financial Services Committee hearing, Treasury Secretary Timothy Geithner called on Congress to enact the most comprehensive changes in the regulation and structure of the U.S. financial system since the New Deal. Geithner’s proposal outlined changes in four key areas---(i) limiting risks that could threaten the broader economy; (ii) enhancing protections for investors and consumers; (iii) closing the gaps in regulatory oversight; and (iv) coordinating any actions globally. In his testimony before the panel, the Treasury Secretary focused on measures to limit systemic risk, which included the creation of an “independent” agency to monitor major institutions or payment systems whose failure could destabilize the national economy. He outlined six priorities for regulating systemic risk, which include (i) establishing of a single entity with responsibility for systemic stability over the major institutions that pose potential risk to the stability of the financial system; (ii) creating more conservative capital requirements for those institutions; (iii) requiring leveraged private investment funds, including hedge funds, private equity funds, and venture capital companies with assets over a certain threshold, to register with the SEC; (iv) establishing oversight for the OTC derivatives market; (v) developing strong requirements by the SEC for money market funds; and (vi) establishing a stronger resolution mechanism. [Additional details on these recommendations are available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf.] Key to Geithner’s proposal is the proposal to empower the federal government to seize and deconstruct a large failing financial company that can’t currently be taken over by the FDIC. The federal government needs these powers immediately, said Geithner, and asked Congress to pass legislation in this area “as quickly as you can.”
- Geithner argued that his plan would help restore market confidence and could constrain companies whose size and complexity could threaten the stability of the U.S. financial system. The Obama administration hopes to replace or revamp the existing rules in nearly every corner of the U.S. financial system—from mortgages to money market mutual funds to “too-big-to-fail banks” to the “shadow financial system.” During the hearing, Chairman Barney Frank (D-MA) said, “The days of ‘light touch’ regulation are over.” Administration officials believe that they have a unique opportunity to capitalize on public anger at the banking sector to push through major changes to the regulation of the financial system.

- Geithner intentionally left many of the details to his plan blank, saying he wants to work with lawmakers on these issues in coming weeks. Republican lawmakers expressed concerns with Treasury’s proposals, particularly regarding the agency’s proposal to take over failing private companies. Representative Don Manzullo (R-IL) asked Geithner, “You’re talking about seizing private businesses. You don’t consider that to be radical?” Minority leader Spencer Bachus (R-AL) said, “This is an unprecedented grab of power, and before that occurs, there ought to be a real debate on whether we should give that authority to the Treasury Secretary.” Representative Scott Garrett (R-NJ) expressed concern that government backing of systemically significant financial institutions would give rise to a new set of “too big to fail” GSEs. Representative Ed Royce (R-CA) voiced similar concern. Royce also pointed out that giving resolution authority unlimited TARP funding would create a new class of companies with implicit federal backing that could borrow cheaply and crowd out competitors.
- Some experts warn that the administration’s proposed systemic risk regulator could unleash new hazards when certain companies are deemed to big to fail. Firms may be incentivized to grow rapidly so they can “win” the government’s guarantee against failure. Once under government protection, the company will likely be able to borrow at below market rates because of the government guarantee. These risks are illustrated by Fannie Mae and Freddie Mac, which enjoyed inexpensive financing as government-sponsored entities and grew rapidly before ultimately failing and being placed into government conservatorship. “If these entities are now perceived to be too big to fail within the protective net, then they get an advantage vis-à-vis other institutions that are not so perceived,” said Lawrence White, a New York University economics professor. “The creditors to these guys become even less inclined to monitoring and more inclined to say, ‘Hey, let the government do it.’” (*Wall Street Journal*, Damian Paletta, 03/27/09; *Testimony of Treasury Secretary Timothy Geithner*, 03/26/09; *Transcript of the House Financial Services Committee Hearing on Comprehensive Regulatory Reform*, 03/26/09; *Reuters*, 03/24/09; *Washington Post*, Zachary A. Goldfarb, 04/07/09)

Senator Dodd and Representative Frank pledge to create a “new framework for 21st century regulation”

- In a March 30th letter, Senator Chris Dodd (D-CT), chairman of the Senate Banking Committee, and Representative Barney Frank (D-MA), chairman of the House Financial Services Committee, pledged to work together with the Obama administration to modernize the country’s financial regulatory system. The chairmen committed to work expeditiously, carefully and deliberately to create a framework for 21st century regulation that will enhance financial stability and protect consumers and investors. Specifically the lawmakers wrote, “We agree on the core principles for modernizing the financial regulatory system that you and Secretary Geithner have articulated, including providing for systemic risk regulation, strengthening consumer and investor protection, streamlining prudential supervision, and addressing gaps in

regulation. We also recognize that the mobility of capital means that, while the ultimate decision as to what rules to adopt is a sovereign decision of each individual nation, success in this effort requires us to consult closely with other major financial centers with the goal of achieving appropriate coordination and minimizing any opportunities for regulatory arbitrage.”

- “In addition, we agree that we must redouble our efforts to promote openness, transparency and plain language throughout our financial system. Such openness and transparency will benefit consumers, investors, the markets, and the entire financial sector. We also support comprehensive reform of the corporate governance and executive compensation of financial institutions. We will continue to work together with your administration to ensure a new corporate governance framework which demands strict accountability of executives and promotes long-term value and growth for shareholders, companies, workers, and the economy at large.”
- Separately, Dodd said, “As we prepare to write legislation that will modernize our financial regulatory system for the 21st century, the Banking Committee has strong partners both across the Capitol and in the White House. I will also continue to work closely with Ranking Member Shelby and my other Republican colleagues to build upon our bipartisan record. We have already begun an intensive series of hearings, briefings and meetings on this subject which, combined with the important work of the House Financial Services Committee, will help us pave the way for this significant undertaking. I am confident that through this process we will be able to design a system to better protect consumers and restore confidence in our banking system.” (*Correspondence to President Barack Obama, Senator Christopher Dodd and Representative Barney Frank, 03/30/09*)

Obama administration’s regulatory reform proposal will create GSEs in every sector of the financial system

- In a March/April issue of *Financial Services Outlook*, AEI fellow Peter J. Wallison wrote, “In late March ...the Obama administration revealed its plan for regulating and restructuring the U.S. financial system. There were no surprises; its approach, presented by Treasury Secretary Timothy Geithner, endorsed both a single powerful systemic regulator, with authority to designate and regulate ‘systemically important’ institutions in every financial sector, and a system for liquidating or bailing out financial firms that might cause a systemic breakdown if they failed. Although presented as a way to prevent a repeat of the current financial crisis, the proposals will, if implemented, seriously impair competitive conditions in all U.S. financial markets—enhancing the power of large companies that are designated as systemically important and threatening the survival of those that do not receive that endorsement. Underlying the plan is the erroneous belief—shattered by the catastrophic condition of the heavily regulated banking sector—that regulation can prevent risk-taking and failure. Although the plan could get through Congress if the financial industry

remains inert and apathetic, the weakness of the administration's case suggests that it is vulnerable to determined opposition.”

- “The Obama administration and Congress are now filling in the details of a long-anticipated plan for reorganizing and restructuring financial regulation. It is no exaggeration to say that the proposal will create what are essentially government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac in every sector of the financial economy. ...To be sure, there are differences between the implicit government backing that Fannie and Freddie exploited and a designation as a ‘systemically important’ firm, but in competitive terms, these differences are minor. Designation as a systemically important firm is, in effect, a certification by the government that a firm is too big to fail—its failure, in theory, will create systemic risk—and this status will be seen in the markets as lowering its risk as a borrower. Lower risk will translate into lower funding costs, exactly the advantage that allowed Fannie and Freddie to drive all competition from their market. Indeed, it may well be that the systemically important firms will be more formidable competitors than Fannie and Freddie, which were restricted by their charters from expanding beyond their secondary market role. There is no indication that systemically important firms will be similarly restricted.”
- “In light of the competitive danger that the administration’s proposal creates for smaller firms, the lack of any adverse reaction thus far in the financial services sector is surprising. It is also surprising that the administration would back a plan that will inevitably create more firms—rather than fewer—that are too big to fail. It is not hard to understand why the largest firms might not see the plan as a threat; they might believe that the government support they receive will be more helpful than harmful in the future. But it is harder to understand why there seems to be so little vocal opposition at this point from the many smaller firms—insurance companies, securities firms, hedge funds, and finance companies—that will be forced to face government-aided competition. Perhaps they believe that these changes are inevitable. There is little else to explain the support for the idea from such organizations as the U.S. Chamber of Commerce and the Securities Industry and Financial Markets Association—two organizations that are normally skeptical about excessive regulation and object to the government picking winners and losers.”
- Wallison’s *Outlook*, which reviews the administration’s plan in detail, also outlines why and how scheme will make major changes in the structure of and competitive conditions in the financial sector of the economy. The full article is available at <http://www.scribd.com/doc/14223074/Reinventing-GSEs-by-Wallison>, (*Financial Services Outlook*, Peter J. Wallison, March/April 2009)

TARP

Fannie Mae CEO Allison expected to head TARP

- According to the *Wall Street Journal*, President Barack Obama is expected to name Fannie Mae CEO Herb Allison as assistant secretary for the Office of Stability, in charge of TARP. Allison would be stepping in to head TARP at a critical juncture, as Treasury completes its assessment of the banks' stress test analysis and ramps up its public-private investment program to remove toxic assets from the banks' balance sheets. Last September, the Federal Housing Finance Agency tapped Allison, the former chairman of TIAA-CREF and Merrill Lynch executive, to serve as chief executive of Fannie Mae. Michael Williams, Fannie's COO would likely be named the company's interim CEO, said a person familiar with internal discussion at Fannie. Allison's appointment move would leave the administration searching for new chief executives for Fannie and Freddie, which were placed into conservatorship last fall. To date, Obama officials have had a difficult time locating executives who are willing to serve as directors and executives of the GSEs, given the economic and political climate of the enterprises. (*Wall Street Journal*, Deborah Solomon, 04/14/09; *Bloomberg News*, Dawn Kopecki, 04/14/09)

Is TARP running on fumes?

- A March 2009 CBO report concluded that the remaining funds in the \$700 billion TARP may be as low as \$32.6 billion, under the maximum allowance model which assumed the Capital Purchase Plan at \$250 billion and the Term Asset-Backed Securities Loan Facility at \$100 billion. A GAO analysis of TARP's "projected use of funds," which assumed lower levels for CPP (\$218 billion) and TALF (\$55 billion), concluded that \$109.6 billion remains available for use by Treasury. Although the Obama administration had requested an additional \$250 billion for TARP in its FY2010 budget, the House and Senate versions of the budget exclude the TARP funding request. (*HousingWire*, Diana Golobay, 03/09/09)

CBO revises estimate of cost of TARP up 88% to \$356 billion

- CBO "quietly" revised its estimate of the ultimate cost to taxpayers of the \$700 billion TARP fund from \$189 billion in January to \$256 billion in March—an increase of 88%. The agency said the estimates reflect, among other things, Treasury's recent allocation of TARP funds to help avoid foreclosures, the revised aid package to AIG, and the deteriorating financial condition of banks that have received TARP funds. Additionally, CBO estimates that the bailout costs for Fannie Mae and Freddie Mac

will total \$52 billion in 2009 and an additional \$28 billion from 2010 to 2019. (*Wall Street Journal*, David Wessel, 04/03/09)

- The taxpayers have \$2.9 trillion at risk in the financial bailout package which federal government has extended, over four fold that of the original TARP commitment made by Congress of \$700 billion, said Neil Barofsky, the special inspector general assign to oversee TARP. The program's initial seed funding does not include the additional financing and associated programs run by the Federal Reserve and FDIC, said Barofsky. "History teaches us that an outlay of so much money in such a short period of time will inevitably attract those seeking to profit criminally," he added. Senate Finance Committee chairman Max Baucus (D-MT) said, "\$2.9 trillion is just short of the amount the entire federal government spent in fiscal year 2008." (*The Hill*, Silla Brush, 03/31/09)
- "We're in a government-dependent financial system," said Paul Volcker, who heads the President's Economic Recovery Advisory Board. "I never thought I'd see the day." (*Wall Street Journal*, Peter Eavis, 04/08/09)

Congressional Oversight Panel questions success of TARP

- In an April Oversight Report, the Congressional Oversight Panel (COP) for TARP reported that Treasury has spent or committed \$590.4 billion of TARP funds and relied heavily on the expansion of the Federal Reserve's balance sheet, which expanded by more than \$1.5 trillion [excluding TALF loans], over the past six months. The panel said the total value of all direct lending, loans, and guarantees by the government to date in conjunction with the financial stability efforts now exceeds \$4 trillion. "Six months into the existence of TARP, evidence of success or failure is mixed," said the panel. "It is possible that the Treasury's approach fails to acknowledge the depth of the current downturn and the degree to which the low valuation of troubled assets accurately reflects their worth." The two Republican members of the panel issued an alternate report, saying that Treasury's strategy is "reasonable and viable."
- In an interview with the *New York Post*, the Oversight Panel's chairman, Elizabeth Warren, said the top executives at struggling financial institutions must be fired, if the economy is to have any chance of recovering. "The management of the institutions receiving subsidies from the government must be replaced," said Warren, a Harvard law professor, pointing to failure to do so in past financial crises, particularly Japan in the 1990s, slowed the recovery dramatically. "It is crucial for these things to happen," she added. "Japan tried to avoid them and just offered subsidy with little or no consequences for management or equity investors, and this is why Japan suffered a lost decade." In a public outreach to the U.S taxpayers, Warren also appears in an eight-minute Youtube video, to introduce the COP's April report. The video is available at <http://www.youtube.com/watch?v=7bRerUGAOAw>. (*Bureau of*

National Affairs, 04/08/09; *CQ Today*, Phil Mattingly, 04/07/09; *The Big Picture Blog*, Barry Ritholtz, 04/08/09; *New York Post*, James Doran, 04/05/09)

Obama administration seeks to circumvent Congressional restrictions on TARP recipients as a means of attracting firms to participate in bailout programs

- The Obama administration is engineering bailout initiatives in a way that it believes will allow firms benefiting from the programs to avoid restrictions imposed by Congress, including restrictions on executive pay. Administration officials believe this approach is vital for persuading firms to participate in programs funded by the \$700 billion financial rescue package. To sidestep Congressional restrictions on TARP participants, Treasury has set up special entities to serve as middlemen, channeling the bailout funds to the firms and, via this two step process, stripping away the requirement that the restrictions be imposed, according to officials. Officials said this structure gives them latitude to determine whether firms should be subject to the congressional restrictions, which would require recipients to turn over ownership stakes to the government, as well as curb executive pay.
- Administration officials have concluded that the conditions should not apply in at least three of the five initiatives funded by TARP. In a program designed to restart small business lending, the administration is planning to set up a special purpose vehicle or another type of entity to evade the congressional mandates, said sources familiar with the structure. In a program seeks to stimulate consumer lending, a special entity has been created to getting around legal limits on the Federal Reserve, which is helping fund this initiative. While the Fed doesn't provide support for the markets that finance credit cards, auto loans and student loans, the central bank will be able to channel the funds through a middleman to facilitate the consumer lending initiative.
- The administration also plans to exempt financial firms that participate in Public-Private Investment Program (PPIP) designed to use private capital to buy distressed assets from banks. But Treasury officials are still examining the legal basis for doing so. Congress has exempted the Treasury from applying the restrictions in a program that aids lenders who modify mortgages for struggling homeowners.
- In defense of the agency's actions, Treasury spokesman Andrew Williams said, "These programs are designed to both comply with the law and ensure taxpayers' funds are used most effectively to bring about economic recovery."
- Representative Edolphus Towns (D-NY), chairman of the House Oversight and Government Reform Committee, who said the restrictions set forth by Congress should apply to any firm benefiting from bailout funds, plans to review the administration's decisions and may seek to reverse them. "We have to make certain that if they are using government money in any sort of way, there should be restrictions," said Towns. In a letter to Treasury, Towns outlined six questions for the

agency to answer, dealing with its enforcement of executive compensation restrictions and requested a response by April 16th.

- Legal experts argue that Treasury’s plan to bypass the restrictions may be unlawful. “They are basically trying to launder the money to avoid complying with the plain language of the law,” said David Zaring, a former Justice Department attorney. “They are trying to create a loophole to ignore Congress, and I think the courts will think that it’s ridiculous.”
- In an April 4th appearance on CBS’s Face the Nation, Treasury Secretary Timothy Geithner denied that his agency is trying to circumvent restrictions placed on TARP recipients. Geithner said “Our obligation is to apply the laws that Congress just passed on executive compensation and we’re going to do that.” (*Washington Post*, Amit R. Paley and David Cho, 04/04/09; *CQ Today Online*, Phil Mattingly, 04/07/09)

TARP recipients must participate in the government’s mortgage modification program

- All participants in TARP are “going to be required as a condition of participating [in the program] going forward [to] participate in [the Obama administration’s Making Home Affordable plan],” said HUD Secretary Shaun Donovan during an interview on Bloomberg News. HUD spokeswoman Melanie Roussell said that these restrictions would apply only to banks taking new TARP money in the future—not those who have previously received TARP funds. (*Bloomberg News*, Dawn Kopecki and Peter Cook, 04/09/09)

“First do no harm”

- On April 14th, President Barack Obama reiterated that he doesn’t support the nationalization of the country’s financial institutions. Although he isn’t philosophically opposed to nationalization, Obama said he is concerned that government takeovers would be too costly. “The reason we have not taken this step has nothing to do with any ideological or political judgment we’ve made about government involvement in banks, and it’s certainly not because of any concern we have for the management and shareholders whose actions have helped cause this mess,” he said. “Rather, it is because we believe that preemptive government takeovers are likely to end up costing taxpayers even more in the end, and because it is more likely to undermine than to create confidence. Governments should practice the same principle as doctors: First do no harm.” (*American Banker*, Cheyenne Hopkins, 04/15/09)

- The Federal Reserve has instructed banks not to discuss the results or the process of the stress tests, which have recently been completed on the 19 largest banks and are being reviewed by bank regulators. Sources at Treasury say the agency plans to delay the release of any test results until after the banks' release their first quarter earnings to avoid complicating the stock market's reaction. Administration officials also are discussing how the results of the tests will be released. According to a source, officials are considering a summary of the results, which is not institution-specific, but no final decisions have been reached. Administration officials are also considering making public some stress test results, clearly separating the healthy institutions from the weaklings. However, officials are concerned about how the market will react to stress test results which show there is no clear recovery path for a bank deemed to have a large capital need, which might set off a panic, according to the source. "There will be definitely be some information that will be provided at the end of it, but exactly what that will be, and when it will be provided, will come forth later," said Comptroller of the Currency John Dugan. The administration expects to release the results of the stress tests—in some form—by the end of April.
- After the stress tests are finalized and capital needs have been identified, the banks will have six months to raise the required capital; if they are unable to raise the needed capital, Treasury said taxpayer money—in the form of preferred stock under the Capital Assistance Program or a conversion of CAP preferred shares into common stock—will be available to meet the banks' needs. Concurrently, administration plans to pressure the banks to sell their toxic assets to the Private Public Investment Program. In its 2010 budget, the Obama administration signaled that it would be requesting as much as \$250 billion for TARP for use in the financial crisis. Treasury officials are expected to use the stress test results to demonstrate the need to Congress for the addition TARP funds. (*New York Times*, Eric Dash, 04/09/09; *Reuters*, 04/14/09; *Reuters*, 04/07/09; *HousingWire*, Paul Jackson, 04/10/09; *Wall Street Journal*, Deborah Solomon and Michael R. Crittenden, 04/15/09)
- In an appearance of CBS's *Face the Nation*, Treasury Secretary Timothy Geithner said he is prepared to oust senior executives and directors at banks which require "exceptional assistance" from the U.S. government. Geithner said, "If in the future, banks need exceptional assistance in order to get through this, then we will make sure that assistance comes [and protect the taxpayers]. Where that requires a change in management and the board, then we will do that." There is increasing anxiety in the banking industry that the administration could use the stress tests to insist on management changes, as it did with General Motors when administration officials forced the resignation of the auto maker's chief executive. (*Bloomberg News*, Jesse Westbrook, 04/06/09; *New York Times*, Stephen Labaton and Edmund L. Andrews, 04/11/09)

- Moody's Investor Service downgraded the financial strength rating of Bank of America from a B- to a D and Wells Fargo from a B to a D+. The rating agency said it expects both banks to need further "systemic support" from the U.S. government. Keefe, Bruyette & Woods, an investment banking firm that specializes in bank stocks, expects Wells Fargo to report \$120 billion in "stress test losses," under a worst case scenario. The projected loss represents more than 266% of its year-end capital of \$45 billion and nearly 24% of the bank's assets which totaled \$481 billion. (*HousingWire*, Paul Jackson, 03/26/09; *Naked Capitalism blog*, 04/14/09)
- Following its release of strong first quarter earnings (\$1.81 billion or \$3.39 a share), Goldman Sachs successfully completed a \$5 billion offering of common stock offering, which its plans to use toward the repayment of the \$10 billion of TARP funds the company received last fall. Goldman would join six other institutions which have repaid a combined \$442 million to the government through stock repurchases. A senior Treasury official said the government will accept repayment of TARP funds from any institution whose regulator concludes is healthy enough to operate without government capital. (*Reuters*, 03/24/09; *American Banker*, Bonnie McGreer, 04/09/09; *HousingWire*, Diana Golobay, 04/13/09; *Wall Street Journal*, Deborah Solomon and Michael R. Crittenden, 04/15/09)

Treasury to offer TARP assistance to life insurers
--

- The U.S. Treasury has decided to extend bailout funds to a number of distressed life insurance companies, according to sources close to the negotiations. In 2008, life insurers reported a \$32 billion decline in statutory capital, as investment values plummeted. Subsequently, the shares of life insurance companies have fallen more than 40% in 2009. Hartford Financial Services, Genworth Financial and Lincoln National reached agreements to buy thrift institutions in 2008, as a vehicle to qualify for government funds. [On April 10th, Genworth was told that it failed to meet the requirements to receive TARP funds.] On April 13th, MetLife announced that it will not participate in the TARP program.
- With insurers own 18% of all corporate bonds outstanding, investors are closely monitoring trading patterns in some securities for sign of wholesale liquidations by distressed companies. While TARP funds won't necessarily resolve the industry's problems, it would provide distressed insurers breathing room to help the companies avoid further credit-rating downgrades and the need to raise capital under onerous terms. Treasury officials said the criteria for insurers to participate in TARP are still being developed and it would probably be at least two weeks or more [April 23rd or later] before any of the insurers "got their answers." (*Washington Post*, David S. Hilzenrath, 04/10/09; *New York Times*, Mary Williams Walsh, 04/09/09; *Wall Street Journal*, Scott Patterson and Gregg Hitt, 04/09/09; *Bureau of National Affairs*, R. Christian Bruce, 04/14/09)

Two wholesale credit unions fail the stress test and are seized by NCUA

- In an unprecedented move, the National Credit Union Administration has seized control of U.S. Central Federal Credit Union (\$34 billion of assets) and Western Corporate Federal Credit Union (\$23 billion of assets) because of their vast exposure to risky subprime, Alt-A and payment option ARM mortgage securities. On March 20th, NCUA seized the corporate credit unions due to growing losses on their private label mortgage-backed securities, hours after U.S. Central released its February results showing that the unrealized losses on its MBS rose by \$1.2 billion, to \$10.5 billion [with virtually all of the new losses accruing to private-label MBS]. NCUA placed the credit unions into receivership, after receiving an independent review by Pimco Investors of the investments in U.S. Central, WesCorp and 25 other corporates.
- In a 4,500 page report, Pimco concluded that the corporates' current mortgage holdings could result in losses in excess of \$16 billion, which would wipe out the capital of every corporate CU. Pimco wrote, "The vast majority of U.S. Central's risk and projected losses are from such securities (MBS) originated in 2006 and 2007. Of the 2006 and 2007 originated securities, the risk is concentrated in securities backed by subprime, Alt-A, and Option ARM (negative amortization) loans. Actual loan losses and increased loss projections, relative to subordination, have affected the subordinate, mezzanine, and senior securities within U.S. Central's portfolio. Contemporary NRSRO ratings and external vendor loss projections support the portfolio risk assessment." At WesCorp, 86.5% of its portfolio was AAA rated at purchase, and 13.5% AA. By February 23, 2009, only 36.3% was AAA, and 10.9% AA, with 1.6% A rated. On balance, 46.5% the portfolio had been downgraded to non investment grade, with 4.7% at BBB. NCUA said, "Over one third of the securities owned by WesCorp are mezzanine securities backed by Alt-A and Option ARM loans" with the vast majority of the securities backed by loans originated in 2006 and 2007.
- NCUA officials are considering a plan to combine the distressed corporate investments into a single "bad bank" and preserve the remnants of the corporate credit union system, which provides critical investment and payment system services to more than 8,000 retail credit unions. (*National Mortgage News*, 04/13/09; *Associated Press*, Marcy Gordon, 03/20/09; *National Mortgage News*, 03/20/09; *Bureau of National Affairs*, Thecla Fabian, 04/13/09)

Housing industry trade groups urge Treasury to provide capital to PMI industry

- In a letter to Treasury secretary Timothy Geithner, The Financial Services Roundtable, Mortgage Bankers Association, National Association of Home Builders, National Association of Hispanic Real Estate Professionals and Asian Real Estate Association of America urged the Obama administration to provide capital support for private mortgage insurers so financing will be available for homeowners who

cannot afford a 20% downpayment for their homes. The groups noted that a \$1 billion capital infusion into the PMI industry could generate \$80 billion of mortgages, which Fannie Mae and Freddie Mac could securitize. This increased level of financing is critical to meet the demands of potential homeowners, restore growth in the market and reduce the excess supply of homes,” wrote the five trade groups. They also cautioned that that “a vibrant housing market will not be possible unless new homeowners enter the market.” Federal Housing Finance director James Lockhart also has called on Treasury to provide support for the PMI industry. (*National Mortgage News*, 04/08/09)

Treasury issues term sheet for mutual holding companies participation in the Capital Purchase Program

- Thrift mutual holding companies may apply to participate in Treasury’s Capital Purchase Program, under a term sheet released April 7th. Applications must be received by May 9th. Treasury released three term sheets for different types of mutual holding companies—privately held subsidiary holding companies, mutual holding companies that do not have subsidiary holding companies, and publicly-traded subsidiary holding companies. All three programs will be subject to dividend restrictions, warrant issuance, and executive compensation limits. (*American Banker*, Cheyenne Hopkins, 04/08/09)

TALF facility expanded to cover servicing advances

- In April, the Federal Reserve’s Term Asset-Backed Securities Loan Facility (TALF) will start accepting servicing advances as collateral in its asset-backed securities program. The Fed Board expanded the TALF lending facility to help cash strapped mortgage servicers that pay advances to MBS investors to cover missed payments by delinquent homeowners. (*National Mortgage News*, 03/20/09)
- According to *Time Magazine*, there has been a “spectacular” lack of interest in the latest round of TALF lending. In March, the \$200 billion facility loaned just \$4.7 billion and \$1.7 billion during the first nine days of April. Why the “shortfall” of demand? First, dealers and investors have disagreed over the terms of the product; the New York Fed has engaged both sides in several of these disputes and believes it can resolve the problems, said a Fed official. Secondly, “there’s nervousness about the possibility of retroactive action by Congress,” said a government official. It appears that there’s been a fundamental shift in the appetite for nonbank securitized loans, which previously represented some 40% of U.S. consumer lending. “The Fed and Treasury have said we’re prepared to lend up to \$200 billion for small business, auto, student and other kinds of loans, but what is the market for them?” asked the Fed official. “You still have to figure out what the demand is at this point, because of the state of the economy and whether people are comfortable doing these [securitized nonbank loans].” (*Time Magazine*, Massimo Calabresi, 04/09/09)

- Mason University law professor Todd Zywicki argues that there are three distinct types of housing markets in the U.S. and only one of the three shows real signs of distress. Even then, that distress is only in a limited number of geographic areas. The first type of market is the traditional market, in which smooth adjustments are made between supply and demand. For example, in markets such as Dallas and Charlotte, prices rose and builders constructed new houses. When prices softened, building has slowed. “Prices in these markets rose gradually, and now they’re settling back to earth,” said Zywicki. “There hasn’t been any tragedy.”
- The second type of market, such as the New York, Boston, San Francisco and Washington, D.C. markets, has a long history of price volatility. “The housing stock in these markets is constrained, either by geography—San Francisco is surrounded on three sides by water, for example—or land use controls,” said Zywicki. When demand in such a market increases, prices soar. When demand weakens, prices plummet. “But the people who live in these markets expect big price swings,” Zywicki says. “They’ve learned to live with them. They’re holding onto their homes because they’re confident prices will eventually recover. Again, there hasn’t been any tragedy.”
- The third type of market has both the ability to expand the supply of houses, characterized by the first type of market, and the price swings, which is characterized by the second type of market. “Type three markets are concentrated in the Sun Belt,” said Zywicki. “Ordinary investors seem to have calculated that a lot of people would either retire or buy second homes in these places. And when prices went up, speculators moved in. Pure bubbles developed.” In these markets, hundreds of thousands of new homes were built and the oversupply will now keep prices low for years. “Las Vegas, Phoenix, Tampa--those are the places you’ll find the tragedies,” said Zywicki.
- Instead of frightening people by talking about the end of the American dream, politicians should offer reassurance, stressing the specific, limited nature of the foreclosure problem, argues Zywicki. “Heck, 41 out of the 50 states have foreclosure rates below the national mean,” he added.
- The administration should think long and hard about just who it wishes to bail out and why, argues Zywicki. “If we bail out anybody, they should only be people who want to stay in their homes but can’t make the payments, not people who could make the payments but want to walk. ...[A]nd if you put no money down and don’t have any equity in your house, you’re not a homeowner.”
- Zywicki argues that the most important step the administration could take is to resist intervening in the housing market as a whole. “Assistance for the relatively small

number of people who are facing really tragic circumstances makes sense, but if the administration tries to push overall housing prices back up, it will only be asking for trouble,” he said. “We overbuilt. That’s the reality. And not even Obama can change it.” Stand back—stand back and let the markets clear,” Zywicki urges. (*Forbes*, Peter Robinson, 04/10/09)

Economic conditions and trends

- In March, the unemployment rate rose to 8.5%, a 25 year high. Year-to-date, the economy has lost over 2 million jobs and 5.1 million jobs since the recession began in December 2007. (*RGE Monitor*, 04/06/09)
- In March, 130,793 bankruptcy petitions were filed, up 9% from February and up 38% compared with a year earlier, according to Automated Access to Court Electronic Records. “We have a lot of people out of work, but that alone is not driving the spike in bankruptcy filings,” said Robert M. Lawless, a professor at the University of Illinois College of Law. “Along with job loss is the tightening of consumer credit. Compared to 18 months ago, the American consumer does not have the same ability to borrow in an attempt to stave off the day of reckoning. With no income and no credit, it is not surprising that the middle class is looking to the bankruptcy courts for relief.” Lawless expects total bankruptcy filings to reach 1.45 million to 1.5 million in 2009, up more than 30% from the nearly 1.1 million filings in 2008. (*New York Times*, Tara Siegel Bernard, 04/04/09)
- In January 2009, average home prices in the U.S. were at similar levels to that in late 2003. From the housing price peak in the second quarter of 2006, the S&P/Case-Shiller 10-City and 20-City Home Price Index Composites were down 30.2% and 29.1%, respectively. (*Standard & Poor’s Press Release*, 03/31/09)
- Analysts contend that there is a “shadow inventory” of foreclosed homes, which have not yet reached the market and impacted the real estate values. “We believe there are in the neighborhood of 600,000 properties nationwide that banks have repossessed but not put on the market,” said Rick Sharga, vice president of RealtyTrac. “California probably represents 80,000 of those homes. It could be disastrous if the banks suddenly flooded the market with those distressed properties. You’d have further depreciation and carnage.” A RealtyTrac survey found that only 30% of foreclosures were listed for sale in real estate listings like the MLS. A San Francisco Chronicle article concludes that a number of factors have created the shadow inventory of REO. First, there are so many homes being foreclosed that it’s hard to get them onto the market and sold. Typically, about 160,000 homes a year are sold through foreclosure sales. Today, foreclosure sales are averaging 80,000 a month, or six times normal levels, and rising. Second, lenders may be deferring sales to delay the recognition of the extent of their losses. Finally, banks may be simply managing their assets as a means of not flooding the market with REO, driving real estate prices

down even more, in order to recover the most capital they can. (*Frontline Weekly Newsletter*, John Mauldin, 04/10/09)

- In February, 7% of homeowners with mortgages were at least 30 days late on their loans, an increase of more than 50% from a year earlier, according to U.S. Information Systems for Equifax Inc. Among subprime borrowers, 39.8% of these homeowners were at least 30 days behind on their payments, up 68% from a year earlier. (*Reuters*, Helen Chernikoff, 04/07/09)
- In an April 7th interview on CNBC, analyst Meredith Whitney said she expects home prices to fall another 30%, which, if correct, means that U.S. banks and mortgage lenders may yet have their worst work ahead of them. “Home prices cannot bottom while liquidity is still contracting from the economy,” Whitney said. She predicted that peak-to-trough home price declines will average 50% percent nationally before the nation’s housing crisis is over. (*HousingWire*, Paul Jackson, 04/07/09)
- Less than 90 percent of all mortgages were considered “performing” at the end of 2008, compared with 93 percent at the end of September 2008, said the OCC and OTS in a joint quarterly mortgage performance report. Although subprime mortgages showed the highest level of serious delinquencies, prime mortgages posted the largest percentage jump—more than double from 1.1% recorded at the end of March 2008, to 2.4 percent at year-end. Recidivism rates among modified mortgages continues to represent a problem for the industry. The agencies reported that 41% of loans modified in the second quarter had fallen at least 60 days behind payments after eight months, a trend that “appeared to continue for loans modified during the third quarter.” The agencies wrote, “The reasons for high re-default rates are not clear. As noted in the previous quarter’s report, high re-defaults could be the result of a worsening economy, excessive borrower leverage, or poor initial underwriting.” (*HousingWire*, Diana Golobay, 04/04/09)
- The Department of Justice is “moving closer” to forming a national mortgage fraud task force to investigate and prosecute mortgage related crimes, government officials familiar with the matter have told *National Mortgage News*. David Fleck, who recently stepped down as deputy District Attorney in charge of real estate fraud for Los Angeles, said he has talked to DOJ about setting up a task force, but the agency has yet to make a final decision. After the Senate confirms Lanny Breuer to head DOJ’s criminal division, the agency is expected to make a final decision on the task force. Fleck noted that Los Angeles has 20 detectives currently working on real estate fraud related investigations, which “just [scratches] the surface.” (*National Mortgage News*, 04/08/09)
- On April 9th, Standard & Poor’s downgraded the entire mortgage insurance industry, saying the sector would continue posting operating losses through 2010 because of falling home prices, rising unemployment and increasing loan delinquencies. However, S&P said it is “comfortable” that insurers have adequate resources to cover their claims and other obligations, despite the industry’s exposure to an additional

\$34 billion to \$54 billion in losses. S&P maintained the investment grade ratings for Genworth Mortgage Insurance Corp., Republic Mortgage Insurance Corp. and United Guaranty Residential Insurance Corp, based upon the companies' lower risk profiles and stronger diversified parent companies; however, S&P dropped the ratings of Mortgage Guaranty Insurance Corp., PMI Mortgage Insurance Co. and Radian Guaranty Inc. to slightly below investment grade. (*National Mortgage News*, 04/09/09)

- The American Banking Association reported that the delinquency rate for its composite index of eight different types of consumer loans jumped to a record high of 3.22%. (*Frontline Weekly Newsletter*, John Mauldin, 04/10/09)
- During the first quarter of 2009, the nation's vacancy rate in the apartment market jumped an average of 7.2%--a full percentage point increase over the past two quarters and the highest level since the first quarter of 2004, according to Reis Inc. Vacancies soared, despite the 0.6% fall in asking rents—the largest fall since Reis began tracking rents in 1999. Effective rents—the rents that landlords actually collect—fell 1.1% in the first quarter to \$984. In the commercial mortgage-backed securities sector, the multifamily MBS posted the highest delinquency rate in February, reaching \$3.2 billion—or 3.3%, up 30 basis points from January, reported Standard & Poor's. In the fourth quarter of 2008, Fannie Mae's delinquency rate for multifamily loans rose 88% to 0.3%. (*Wall Street Journal*, Nick Timiraos, 04/08/09)
- S&P has warned that they may cut ratings on \$97 billion in commercial-mortgage asset-backed debt. In aggregate, the country's 10 biggest banks hold approximately \$327.6 billion in commercial mortgages, according to regulatory filings. A projected tripling in the default rate would result in losses of about 7% of total unpaid balances, according to estimates prepared by Reis Inc. analysts (*Bloomberg News*, Sarah Mulholland, 04/07/09; *Frontline Weekly Newsletter*, John Mauldin, 04/10/09)
- Moody's Investors Services has assigned a negative outlook to the creditworthiness of all local governments in the U.S., the first such blanket report ever issued on municipalities by the credit rating agency. In a special report issued on April 7th, Moody's cited the municipalities' falling revenues and the problems they are facing from their purchase of complex financial products. Moody's warned investors of the conflicts that lay ahead between taxpayers struggling to keep their own households afloat and elected officials responsible for meeting the municipalities' payrolls, balancing their budgets, and protecting their credit ratings. "Taxpayers, worried about their own financial condition, are more resistant than ever to increasing property or other local taxes," wrote Moody's. (*New York Times*, Mary Williams Walsh, 04/08/09)
- In an April 8th statement, House Financial Services Committee Chairman Barney Frank (D-MA) said he was "troubled" by Moody's broad downgrade of municipalities and expressed concern that the rating agency's negative outlook for the sector could lead to unjustified increases in municipal borrowing costs. Jeffrey Esser,

CEO of the Government Finance Officers Association, said Moody's was "just being lazy by assigning a negative outlook to all municipalities. ...Moody's is failing to recognize the difference between [various] state and local governments. There are those that are healthy and those affected by the economic downturn." (*House Financial Services Press Release, Chairman Barney Frank, 04/08/09; Bureau of National Affairs, Stephen Joyce, 04/09/09*)

- The U.S. posted a record \$956.8 billion budget deficit for the first half of fiscal 2009, more than triple the year-ago shortfall, reflecting the government's increased spending on financial and economic rescue programs, said the Treasury Department. In March, the government recorded a deficit of \$192.27 billion, a record for the month and nearly four times the year-ago gap of \$48.21 billion. (*Reuters, 04/10/09*)
- The CBO is forecasting a record \$1.8 trillion deficit for FY2009, which ends on September 30th, representing 13.1% of GDP. In FY2010, CBO projects that the deficit will "ebb" to \$1.4 trillion or 9.6% of GDP. "Although the economy is likely to continue to deteriorate for some time," the CBO said, "[the \$787 billion stimulus package] and very aggressive actions by the Federal Reserve and the Treasury are projected to help end the recession in the fall of 2009." CBO is projecting the national economy will contract 3% in 2009, before growing 2.9% in 2010 and 4.0% in 2011. The agency also revised its forecast for the government's accumulated deficits over the next ten years, projecting an aggregate deficit of \$9.3 trillion from 2010 to 2019. (*Reuters, Jeremy Pelosky, 03/20/09*)

Financial Services Regulation Reform

JPMorgan Chase CEO Dimon's addresses regulatory reform
for the financial services industry

- In a March 23rd Letter to Shareholders, Jamie Dimon, chairman and chief executive of JPMorgan Chase, wrote, "...The causes of the financial crisis will be written about, analyzed and subject to historical revisions for decades. Any view that I express at this moment will likely be proved incomplete or possibly incorrect over time. However, I still feel compelled to attempt to do so because regulation will be written soon, in the next year or so, that will have an enormous impact on our country and our company. If we are to deal properly with this crisis moving forward, we must be brutally honest and have a full understanding of what caused it in the first place. The strength of the United States lies not in its ability to avoid problems but in our ability to face problems, to reform and to change. So it is in that spirit that I share my views."
- "Albert Einstein once said, 'Make everything as simple as possible, but not simpler.' Simplistic answers or blanket accusations will lead us astray. Any plan for the future must be based on a clear and comprehensive understanding of the key underlying causes of—and multiple contributors to—the crisis, which include (i) the burst of a major housing bubble; (ii) excessive leverage pervaded the system; (iii) the dramatic growth of structural risks and the unanticipated damage they caused; (iv) regulatory lapses and mistakes; (v) the pro-cyclical nature of virtually all policies, actions and events; and (vi) the impact of huge trade and financing imbalances on interest rates, consumption and speculation Each main cause had multiple contributing factors..."
- "...The extent of the damage and the magnitude of the systemic problems make it clear that our rules and regulations must be completely overhauled. Such changes to the regulatory system could have huge implications on the long-term health, and strategies, of our business. While unprecedented actions have been taken by both the Federal Reserve and the Treasury, my hope is that new policies are grounded in a thorough analysis of what happened and what we need to do about it. Political agendas or simplistic views will not serve us well."
- "Often we hear the debate around the need for more or less regulation. What we need is better and more forward-looking regulation. Someone has famously said that a crisis should not go to waste. But what is also true is that it shouldn't take a crisis to solve our problems. During a crisis, people panic. This can make it harder, not easier, to do the right thing. From our perspective, certain improvements would make a big difference. We would like to share with you some of our suggestions."
- **"A. The need for a systemic regulator with much broader authority.** We agree with our leaders in government that we should move ahead quickly to establish a

systemic regulator. In the short term, this would allow us to focus attention on correcting some underlying weaknesses in our system and filling the gaps in regulation that contributed to the current situation. It also is clear that U.S. policy must be coordinated with the proper set of international regulators. When the crisis emerged, the actions of individual countries had a critical impact on numerous other countries. International coordination is essential in resolving this kind of crisis.”

- “*There should be procedures in place to deal with systemically important institutions – failure is fine as long as it’s orderly and controlled and doesn’t cause systemic failure. Size is not the issue; rather, it is when institutions are too interconnected that an uncontrolled failure has the potential to bring the whole system down. What we need is a resolution process that allows failure without causing damage to the whole system. In the case of Bear Stearns or Lehman – both investment banks – regulators did not have this protocol. They do have it, however, for commercial banks. Even more important, regulators are going to need a resolution process for large, global corporations that operate in many jurisdictions around the world.*”
- “The first goal should be to regulate financial institutions so they don’t fail. If they do fail, a proper resolution process would ensure that action is swift, appropriate and consistent. The lack of consistency alone caused great confusion in the marketplace. For example, when some of the recent failures took place, there was inconsistent treatment among capital-holders (preferred stock and debt holders were treated very differently in different circumstances). It would have been better if the regulators had a resolution process that defined, a priori, what forms of aid companies would get and what the impact would be on capital-holders. The FDIC resolution process for banks provides a very good example of how a well-functioning process works.”
- “Various liquidity and ‘lender of last resort’ facilities, like some of those put into place during this crisis, also could be in place on an a priori basis. These controls would reduce risk and maximize confidence.”
- “*Regulation needs to be administered by product and economic substance, not by legal entity. We have experienced the unintended consequences of redundant regulation; i.e., different agencies regulating the same product in the mortgage business, in the derivatives business and in lending overall. If, on the other hand, similar products were overseen by a single regulator, that regulator would have much deeper knowledge of the products and full information that extends across institutions. The ‘regulatory competition’ that could have caused a race to the bottom would be eliminated.*”
- “*Hedge funds, private equity funds and off-balance sheet vehicles must be included in our regulatory apparatus without compromising their freedoms and positive attributes. Certain vehicles like hedge funds and private equity funds need to be regulated but only to protect the system against risk. These vehicles do not need to be heavily regulated like a deposit-gathering bank. We should consider requiring hedge funds over a certain size (say, \$1 billion of equity) to register, provide quarterly*

audited reports, disclose total leverage and certain risk attributes – like volatility and investment categories—and outline operational procedures. They also could be required to show their regulators (not their competitors) any concentrated ‘trades’ that could cause excessive systemic risk. This all could be done without compromising flexibility or disclosing confidential positions while allowing these vehicles to move capital – as freely and aggressively – as they see fit.”

- *“The systemic regulator needs the ability to anticipate risk and do something about it if necessary. There, undoubtedly, are financial products in the market today that – if unchecked – could have a destabilizing effect. A systemic regulator, had it been closely watching the mortgage industry, might have identified the unregulated mortgage business as a critical point of failure. This regulator also might have been able to limit the leverage of Fannie and Freddie once they were deemed to pose major systemic risks. Such a regulator might have been in the position to recognize the one-sided credit derivative exposures of AIG and the monoline insurers and do something about it.”*
- *“A systemic regulator also should be on the lookout for new or potential structural risks in our capital markets, such as the structural flaw that grew in money market funds.”*
- **“B. The need to simplify our regulatory system.** Everyone agrees that the existing system is fragmented and overly complex. We have too many regulators and too many regulatory gaps. No one agency has access to all the relevant information. Responsibility often is highly diffused. This problem could be relatively easy to fix but only if we have the political will to fix it.”
- **“C. The need to regulate the mortgage business—including commercial mortgages — in its entirety.** Many of the same gaps in regulation that helped lead us into this mess still exist today – for example, in the mortgage business. Mortgages are the largest financial product in the United States, and while we do not want to squelch innovation, the entire mortgage business clearly needs to be regulated. This is not the first time that mortgages and real estate have led this country and many of its financial institutions into deep trouble. Proper regulation would go a long way toward standardizing products, testing new ones, improving customer disclosure and clarifying responsibility.”
- **“D. The need to fix securitization.** We believe that securitization still is a highly effective way to finance assets. But some securitizations, particularly mortgage securitizations, had an enormous flaw built into them: No one was responsible for the actual quality of the underwriting. Even mortgage servicing contracts were not standardized such that if something went wrong, the customer would get consistent resolution.”
- *“We cannot rely on market discipline (i.e., eliminating bad practices) alone to fix this problem. We have heard several reasonable suggestions on how the originator,*

packager and seller of securitizations could be appropriately incentivized to ensure good underwriting. For example, requiring the relevant parties to keep part of the securitizations, much like we do with syndicated loans today, would help manage resolution if something were to go wrong and could go a long way to re-establish market confidence and proper accountability.”

- **“E. The need to fix Basel II — leading to higher capital ratios but a more stable system.** ...Basel II has many flaws – it has taken too long to implement, it responds slowly to market changes and it is applied unevenly across global borders. Perhaps its worst failing is that, in its current construct, Basel II does not include liquidity, which allowed commercial and investment banks to buy liquid or illiquid assets and fund them short. While this practice did not appear quite so dangerous in benign times, it created huge issues for many financial institutions during the market crisis. Basel II also has relied too heavily on rating agencies and, by its nature, has been highly pro-cyclical in its capital requirements for assets. It would be easy to make these capital requirements less pro-cyclical and require Basel II to recognize the risk of short-term funding, particularly that of wholesale funding. Finally, Basel II should be applied consistently, reviewed continuously and updated regularly. The world changes quickly.”
- **“F. The need to get accounting under control.** We at JPMorgan Chase are strong believers in good, conservative accounting. Accounting should always reflect true underlying economics, which actually is how we run the company. However, accounting practices are not widely understood, are changed too frequently and are too susceptible to interpretation and manipulation. Sometimes, they even inadvertently determine U.S. government policy.”
- *“We generally like fair value accounting.* For assets that are bought and sold, fair value accounting creates the best discipline. Fair value accounting (often referred to as mark-to-market accounting) already provides for some flexibility if recent prices are under highly distressed conditions. In such cases, good judgment and sound fundamental cash flow-type evaluations can be employed to value certain assets. However, in our opinion, the application of fair value accounting for certain categories needs to be reconsidered.”
- “For example:
 - “We now have to mark to market our private equity investments by using potentially artificial benchmarks. These investments, by their nature, are very illiquid and are intentionally held for several years. To mark them to market, proxies made up of comparable companies are used, and appropriate discounts and judgments are applied. Essentially, we write these investments up when markets are good and write them down when markets are bad. But I am fairly confident that this approach is not always right. In many instances, cost is the best proxy for fair value. We would rather describe our investments to our shareholders, tell them when we think these investments might be worth more

- and, certainly, write them down on our financial statements when they have become impaired.”
- “A new mark-to-market rule addresses ‘debit valuation adjustments.’ Essentially, we now have to mark to market credit spreads on certain JPMorgan Chase bonds that we issue. For example, when bond spreads widen on JPMorgan Chase debt, we actually can book a gain. Of course, when these spreads narrow, we book a loss. The theory is interesting, but, in practice, it is absurd. Taken to the extreme, if a company is on its way to bankruptcy, it will be booking huge profits on its own outstanding debt, right up until it actually declares bankruptcy – at which point it doesn’t matter.”
 - “It is becoming increasingly more difficult to compare mark-to-market values of certain instruments across different companies. While it’s too involved to go into detail here, different companies may account for similar mark-to-market assets differently. This needs to be addressed by ensuring that companies adhere to consistent valuation principles while applying the rules.”
 - “Fair value accounting does not and should not apply to all assets. Investments or certain illiquid assets that are intended to be held for the longer term (like real estate or plant and equipment) or loans and certain assets that are shorter term (like receivables or inventory) all could actually be marked to market. There are, in fact, markets for some of these assets, and others could be calculated based on reasonable assumptions; for example, a farm would be worth more when corn prices go up, and a semiconductor plant would be worth less when semiconductor prices go down. However, if we marked these assets in this way, they would have wildly different prices depending on the health of the economy or the swings in prices for their output. While accounting should recognize the real impairment in the value of assets, marking the aforementioned assets to market every day would be a waste of time. Under this scenario, it would be quite hard for companies to invest in anything illiquid or to make long-term investments.”
 - *“New accounting rules that have the potential to inadvertently affect how the capital markets function or change fundamental long-term U.S. government policies should be made thoughtfully, deliberately and with broad input.”*
 - “For example, we all believe that companies should have fully funded pension plans; i.e., the actual assets in the plan should be enough to meet a fair estimate of the liabilities. Years ago, if this wasn’t the case, companies were allowed to maintain a “deficit” and fund it over several years. That deficit was not recorded on the financial statement of the company.”
 - “A change in accounting rules dictated that the deficit should not just be a footnote in the financial statements but that it should be reflected directly in the equity account of the corporation. Clearly, in very bad markets, these deficits grow dramatically, thus depleting the increasingly precious capital that companies have. (This is just another

example of a pro-cyclical force). When companies realized they were getting enormous volatility in their capital account, they began to curtail or eliminate their pension plans in favor of 401(k) plans (where the individual bears all the investment risk). This was a rational, precautionary step. But it, in effect, transferred the risk from the company to the individual. No longer did the large corporations assume the risk of providing a steady income stream to retired employees. Instead, the risk was passed to the individuals – many of whom could not afford it.”

- “This is a perfect example of how accounting inadvertently sets policy. And, in my opinion, this was probably the wrong policy for the country. There would have been many ways to be true to the economic purpose of accounting without making a detrimental policy change. There are countless other examples, and we hope regulators and accountants will eventually find better ways to apply accounting principles.”
- **“G. The need for appropriate counter-cyclical policies.** During this crisis, it became evident that our system created enormous pro-cyclical tendencies. In fact, I can’t think of one counter-cyclical policy at all (other than emergency actions taken by the government).”
- “Accounting policies such as mark-to-market and loan loss reserving are pro-cyclical. Basel II capital requirements are pro-cyclical. Regulatory and legal requirements are pro-cyclical. Repo and short-term financing are pro-cyclical. The one pro-cyclical tendency we probably can never correct is that of the market itself (i.e., the cost of capital goes way up in a downturn or investors refuse to finance less liquid assets). I have heard many good ideas about how to create some counter-cyclical policies and will focus on three here.”
- *“Loan loss reserving can easily be made counter-cyclical.* I find it absurd that loan loss reserves tend to be at their lowest point precisely when things are about to get worse. As things get worse and charge-offs rise dramatically, one must dramatically increase loan loss reserves, thus depleting capital rapidly. This problem would be solved if banks were allowed to estimate credit losses over the life of their loan portfolios. Reserves should be maintained to absorb those losses. This would enable banks to increase reserves when losses are low and utilize reserves when losses are high. Transparency would be fully preserved because investors and regulators would still see actual charge-offs and nonperformers. This would require a rational explanation about the appropriateness of the lifetime loss estimates. It also would have the positive effect of constantly reminding CEOs, management teams and investors that bad times, in fact, do happen – and that they should be prepared for such events.”
- *“Repo and short-term financing can easily be made counter-cyclical.* All banks now have access to the standard financing facilities for securities and loans via the Federal Reserve (i.e., the Fed will lend a specific amount of money against specific assets). A suggestion is this: If an institution provides financing to clients in excess of what the

Fed would lend to the bank for the same securities, it would have to be disclosed to risk committees and the company's Board of Directors. The Fed then would have two major tools to reduce leverage and in a way that is counter-cyclical – it could charge higher capital costs to a bank when the bank is lending more than the Fed would lend or the Fed could reduce the amount it would lend to the banks. Market players would still be free to provide credit and leverage as they see fit.”

- “*Banks should have the ability to implement countercyclical capital raising with rapid rights offerings.* Banks and possibly other companies would be aided by having the ability to effect rights offerings at a moment's notice. Regulations should facilitate such offerings – with the proper disclosure – in a matter of days rather than weeks. This would allow a company to raise capital and repair a balance sheet that might have been stretched by unanticipated market events and to do so in a manner that is fair and does not dilute the company's existing shareholder base.”
- “...We can't fall into the trap of institutional sclerosis—now is the time to act. In the past, this nation has shown the fortitude to work together to accomplish great things, and we need to do that again. For our part, we at JPMorgan Chase are doing everything we can to be helpful to our leaders on all these issues.” (*Letter to JPMorgan Chase Shareholders, Jamie Dimon, 03/23/09*)

Policymakers should be mindful of the long-term consequences of their actions

- In a speech at the Council of Institutional Investors' 2009 Spring Meeting, Federal Reserve Board Governor Kevin Marsh said, “...[P]olicymakers across the government must be ever mindful of the long-term consequences of their actions. Fluctuations in economic output and employment are unavoidable. As a result, policymakers' objective should be more humble: Maximize sustainable economic growth while reducing the incidence, severity, and economic fallout of future shocks. And we must ensure that the long-heralded strengths of the U.S. economy—the resiliency and dynamism in our labor markets, product markets, and, yes, our financial markets—are allowed to flourish. In so doing, trust will continue to displace panic in our markets, and our economy will ultimately rebound with great vigor and even greater promise.” (*Prepared Remarks by Federal Reserve Governor Kevin Marsh, 04/06/09*)

Congress begins its efforts to reform the regulation of the financial services industry:

Regulatory modernization bill is introduced in the House and Senate

Markup of the House's mortgage reform and predatory lending bill
will be scheduled after the Easter recess

Possible compromise on mortgage cram-down provision emerges in the Senate

Chairman Frank prepares bill to revamp Fannie Mae and Freddie Mac

H.R. 1479 introduced to “modernize” the Community Reinvestment Act

Legislation introduced to create a federal regulatory structure for insurance industry

Regulatory modernization bill is introduced in the House and Senate

- On March 23rd, Senator Susan Collins (R-ME) and Representative Mike Castle (R-DE) introduced the Financial System Stabilization and Reform Act (S. 664, H.R. 1754) to overhaul the financial system and create an independent Financial Stability Council to serve as a “systemic risk monitor.” The Council, comprised of representatives from existing federal regulators, also would strengthen oversight and accountability of the financial system and strengthen the public’s trust through modernized financial regulation and improved transparency. The Council would oversee all systemic risks in the financial system and have the power to prevent or mitigate those risks. In addition, the Council would have the authority to close regulatory “black holes” that pose a systemic risk for products or activities which fall outside the current authority of federal financial regulators.
- The Council would be authorized to adopt rules to ensure financial institutions do not grow “too big to fail” which (i) impose capital requirements, (ii) raise risk premiums, or (iii) require a larger percentage of debt be held as long-term debt. The legislation also would require oversight of credit default swaps and impose safety-and-soundness requirements on new investment banks by requiring them to organize under the Bank Holding Company Act. The bills would merge the OTS and the OCC.
- House Financial Service Committee chairman Barney Frank (D-MA) plans to offer regulatory reform bill, which will contain recommendations from the Obama administration. (*American Banker*, 04/09/09)

Markup of the Chairman Frank’s mortgage reform and predatory lending bill will be scheduled after the Easter recess

- On March 26th, House Financial Services Chairman Barney Frank (D-MA) introduced the Mortgage Reform and Anti-Predatory Act (H.R. 1728), which would ban lenders from making loans to borrowers which they cannot afford or did not provide the borrower a net tangible benefit. The 151-page bill, which is similar to a version passed by the House in the last Congress, has tougher standards and stricter liabilities. The measure would ban brokers or loan officers originating a loan from receiving yield-spread premiums or other forms of compensation for steering borrowers into higher-cost mortgages. Originators would be required to assess the

borrower's ability to repay, based upon the loan's fully indexed and amortized rate using verified and fully documented borrower information. To encourage traditional lending, the bill would provide protection from liability for lenders making "qualified" 30-year fixed rate mortgages, which are fully documented, have no negative amortization or interest-only features, and whose rates do not exceed average rates by more than 150 basis points for a first lien or 350 basis points for a subordinate lien. Qualified loans would be presumed to meet the ability to repay and net tangible benefit standards, but would not be protected from legal challenges. H.R. 1728 would create liability for all participants in the mortgage chain—short of the end investor or trust. The originating lender would have to retain at least 5% of the mortgage's risk when selling the loan for securitization. Any originator who violates the law would be liable for the greater of actual damages or three times the broker fees plus costs. H.R. 1728 also contains a host of mortgage protections, which would limit prepayment penalties, ban creditors from financing single-premium credit insurance, require specific disclosures for negative amortization features, ban practices that increase the risk of foreclosure, beef up appraisal independence, set up a licensing and registration system for mortgage originators, and adds servicing requirements. The measure would also cover a wider scope of the Home Ownership and Equity Protection Act's high-cost loan triggers and enhance borrowers' protections. Frank postponed markup of H.R. 1728 until after the Easter recess.

- In its current form, H.R. 1728 would fundamentally alter the mortgage market, likely pushing some major players out of the sector and leaving borrowers with little choice but the 30-year mortgage product. "Everything in here is going to have a profound change on the way in which the mortgage lending business is carried out," said Steve Zeisel, VP and senior counsel at the Consumer Bankers Association. "There is nothing small about this." Scott Talbott, SVP for the Financial Services Roundtable, said, "This would return mortgage lending back to the 1950s and has a limiting effect on mortgage products." Specifically, Talbot argues that the lenders' safe harbor is too narrow in the bill and would effectively force lenders to stop offering adjustable rate mortgages or even 15-year fixed loans for fear of liability. "The goal should be to find safe-harbor provisions for mortgage products like the 15-year and the 20-year or even adjustable-rate mortgages," Talbott added. (*CQ Today*, Phil Mattingly, 03/27/09; *American Banker*, 04/09/09; *American Banker*, Stacy Kaper, 03/31/09)

Possible compromise on mortgage cram-down emerges in the Senate

- Senate Banking Committee chairman Christopher Dodd (D-CT) has given housing advocates two weeks to reach a compromise on cram-down legislation which could attract the 60 votes needed in the Senate for legislation permitting bankruptcy judges to restructure mortgages. According to *CongressDaily*, a compromise may have emerged over the cramdown provision, in which the homeowner would be ineligible to modify their loan through bankruptcy if he had been offered a modification through the Obama plan or a program included in last year's housing bill. *CongressDaily* reports, "The possible deal has other provisions. At-risk low-income

borrowers and those who pay less than 31[%] of their income for mortgage payments would be ineligible for principal reduction, but they could have their rates reduced or their loans amortized over a longer time. If a homeowner opted for a modification under the Obama plan and wound up paying a quarter of income or less for the mortgage, he or she would be ineligible for any bankruptcy modification. If the principal is reduced by a judge, the possible compromise would allow the lender and borrower to evenly split any profit up to the original amount of the loan if it is sold while the homeowner is still in bankruptcy. Only loans that originated before 2009 and amount to less than \$729,750 could be modified in bankruptcy. The program would end in 2014. All sides cautioned that no final deal has been struck and that negotiations could easily fall apart...” (*CongressDaily*, Bill Swindell, 04/15/09; *Politico*, Victoria McGrane, 04/07/09)

H.R. 1479 introduced to “modernize” the Community Reinvestment Act

- On March 12th, Representative Eddie Bernice Johnson (D-TX) introduced the Community Reinvestment Modernization Act of 2009, which would expand the CRA provisions to insurance companies, securities firms and credit unions. The bill also would also expand reporting requirements under the HMDA to include credit scores, debt-to-income ratios, loan-to-value ratios by firms covered by this legislation. The text of bill can be found at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-1479>. (<http://www.scanph.org/node/816>)

Representatives Bean and Royce propose bill to create an optional federal regulatory structure for insurance industry

- Representatives Melissa Bean (D-IL) and Ed Royce (R-CA) have introduced H.R. 1880, the National Insurance Consumer Protection Act (NICPA), which would establish a “parallel national system of regulation and supervision” for the insurance industry, including financial guarantors in the muni market. Citing the failure of AIG and the broader financial crisis, Bean and Royce said that their legislation would establish a robust federal regulator for insurance to act as an alternative to the “antiquated, non-uniform system of state insurance regulators.” Under this legislation, insurance companies would have the option of operating under a charter issued by a federal regulator, which would oversee insurance companies, their holding companies and any of their subsidiaries—rather than state regulators. “The events of 2008 show us that insurance reg reform can no longer be postponed—it is needed now,” said Bean. “This bill will provide consumer protection and choice while eliminating barriers to industry competitiveness in the global market.” Royce added, “Never before has the federal government been so invested in an industry it has no regulatory authority over. Leaving the business of insurance regulation solely to the various state insurance commissioners while the federal government provides taxpayer-funded assistance is simply irresponsible.”

- NICPA would establish an office of national insurance within Treasury, which would be headed by a commissioner appointed by the president and confirmed by the Senate to a five year term. The legislation also would establish a “coordinating national council for financial regulators” to monitor issues related to the health and competitiveness of the financial services industry. The council would be chaired by the Treasury secretary, and be comprised of the commissioner of national insurance, the heads of the Federal Reserve, SEC, Commodity Futures Trading Commission, OTS, FDIC, the Comptroller the Currency, and three state regulators appointed by the president. Under the bill’s provisions, the national regulator must be in place no later than two years after enactment. Insurance companies which participate in the federal system would contribute to a national guarantee fund to pay for the collapse of insurers and would also have to continue to pay into any state guarantee funds to prevent instability within those funds. [Bill is available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.1880:>.]
- The American Bankers Association and American Bankers Insurance Association endorsed NICPA, saying the bill would address “inefficiencies built into the current state-by-state regulatory structure [that] prevent many companies and agents from fully meeting consumers’ financial needs by allowing insurers, reinsurers and agents to obtain a federal charter to better serve consumers.” (*Bond Buyer*, Andrew Ackerman, 04/03/09)

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac have posed the most negative shock to the financial system

- In a speech at the Council of Institutional Investors' 2009 Spring Meeting, Federal Reserve Board Governor Kevin Marsh said, "...In my judgment, the story of Fannie Mae and Freddie Mac exposes perhaps the most consequential negative shock to the financial system during this [financial crisis]. For about a generation, the GSEs issued debt that was thought by virtually all market participants to be backed de facto by the U.S. government. The GSEs traveled the world, selling debt at rates and terms and funding schedules that were largely comparable to Treasury securities. Some loud protestations aside, government policy—broadly defined—tended to countenance investor expectations. At year-end 2007, the outstanding public debt of Fannie Mae and Freddie Mac totaled about \$5.0 trillion, roughly comparable with the publicly held Treasury debt of \$5.1 trillion, and spreads to Treasuries on their senior debt amounted to about 30 to 50 basis points, even though the institutions were thinly capitalized relative to their asset composition and risk characteristics.”
- “In the fall of 2008, however, GSE senior debt spreads widened significantly to more than 500 basis points. Market participants grew increasingly skeptical of the GSEs’ financial and operational wherewithal and were uncertain of the depth of government support. When markets decided to test policymakers, as markets are especially wont to do during panics, the Treasury was forced to intercede, effectively taking control of the entities. Congress authorized successive Administrations to take forceful actions, including appropriations of up to \$200 billion to-date, to assure investors and counterparties that the institutions would remain solvent. These efforts, while necessary and well intended, have not completely resolved the uncertainty around the GSEs to market participants. Indeed, even after extraordinary actions most recently by the Federal Reserve to improve liquidity and market functioning in the agency debt markets, confidence in the GSEs is less than markets were long accustomed to before this period began.”
- “When presumptively risk-free, highly liquid assets backed by the highest-grade sovereign are subject to large swings in value, the risk-return profile of virtually all other assets becomes highly uncertain. The resulting portfolio reallocation boosts demand for Treasury securities, and reduces demand for assets that are genuinely riskier, placing upward pressure on risk premiums across a wide range of markets. In addition, financial firms that had assumed that their holdings of GSE debt were as good as cash were forced to reassess the adequacy of their liquidity positions, adding to balance sheet pressures and leading to even greater safe-haven demands for Treasury securities. Across a broad range of financial institutions and financial markets, an unhealthy mix of recession dynamics and panic conditions appear at work. But, in my view, it is predominantly the latter—the uncertainty with respect to financial intermediation and the corresponding breach of articles of faith—that have

exacerbated the downturn.” (*Prepared Remarks by Federal Reserve Governor Kevin Marsh, 04/06/09*)

Fannie Mae and Freddie Mac—“the largest regulatory failure of all time”

- In a March 23rd Letter to Shareholders, Jamie Dimon, chairman and chief executive of JPMorgan Chase wrote, “...Perhaps the largest regulatory failure of all time was the inadequate regulation of Fannie Mae and Freddie Mac. The extraordinary growth and high leverage of Fannie Mae and Freddie Mac were well-known. Many talked about these issues, including their use of derivatives. Surprisingly, they had their own regulator, which clearly was not up to the task. These government-sponsored entities had grown to become larger than the Federal Reserve. Both had dramatically increased their leverage over the last 20 years. And, amazingly, a situation was allowed to exist where the very fundamental premise of their credit was implicit, not explicit. This should never happen again. Their collapse caused damage to the mortgage markets and the financial system. And, had the Treasury not stepped in, it would have caused damage to the credit of the United States itself...” (*Letter to Shareholders, Jamie Dimon, 04/23/09*)

The “current [GSE] model is broke” says Chairman Frank

- House Financial Services Committee chairman Barney Frank (D-MA) said he plans to introduce legislation later this year to restructure Fannie Mae and Freddie Mac. “The current model is broke,” said Frank. Among the options under consideration would be the creation of separate companies to serve two purposes—one entity to address the profit mission of ensuring adequate funding for the home mortgage market and a separate entity to address the public mission of providing government subsidies for housing for low income people. At a speech before the Center for American Progress, Frank urged housing-related organizations to send him ideas for restructuring Fannie Mae and Freddie Mac. (*Wall Street Journal, James R. Hagerty and Michael M. Phillips, 03/18/09*)
- Representative Spencer Bachus (R-AL), the minority leader on the House Financial Services Committee, said the solution is to “break them up.” He added, “One possibility that I’ve looked at is letting the Federal Home Loan Banks take over some of their obligations and operations.”
- Fannie and Freddie are under increasing pressure from lawmaker to revamp their operations, as operating losses force the enterprises to tap government money to fund their operations. Internally, Fannie Mae executives have discussed the possibility of acquiring Freddie Mac—but a formal approach isn’t imminent, said people familiar with the private discussions. A merger of the two enterprises would be the quickest way for the Federal Housing Finance Agency, acting as conservator, to reduce the GSEs’ costs by shedding duplicative functions and reducing the companies’

combined 11,000 employees. “[A merger has]s got to happen,” said Christopher Whalen, co-founder of Institutional Risk Analytics. “We’re not going to put them back the way they were. The only way we’re going to be able to manage them is if we squeeze every last ounce of savings out of the administrative side and just focus on trying to keep the loss number under control.” (*Wall Street Journal*, James R. Hagerty and Michael M. Phillips, 03/18/09; *Bloomberg News*, Dawn Kopecki and Alison Vekshin, 03/15/09)

- In a speech at the Federalist Conference on The Financial Services Bailout, AEI fellow Alex J. Pollock outlined his recommendations on how Fannie and Freddie should be restructured. Pollock said, “...[T]he ongoing bailout of Fannie and Freddie is a government intervention to save a failed previous intervention. In the last year, Fannie and Freddie have gone from being a government-sponsored duopoly to being a government-owned duopoly. They have changed from being GSEs to being government housing banks. They are therefore available to be directed by the government to participate in mortgage financing based on political policy, not profit...”
- “This government housing bank status should have a firm sunset. Then a long-term restructuring should divide Fannie and Freddie into three parts: (i) prime mortgage securitization; (ii) mortgage portfolio investing; and (iii) government activities. The prime loan securitization business, which is a business, should be fully privatized into private companies to compete like anybody else, sink or swim, flourish or fail. The business of owning a leveraged portfolio of mortgage loans and MBS should be moved into a banking charter or real estate investment trust with a fresh start as part of the private market, again, sink or swim. The final element of the former Fannie and Freddie consists of those activities which belong in the government, such as providing subsidies in one form or another and providing non-market financing of risky loans. These should stay in the government, being merged into the structures of the Department of Housing and Urban Development-FHA-Ginnie Mae. Their funding would and should then have to be appropriated by the Congress in a transparent way, instead of escaping the appropriations discipline by being hidden in the GSEs. The total result would be that no GSEs could reemerge: a consummation devoutly to be wished.” (*Prepared Remarks at the Federalist Society Conference*, Alex J. Pollock, 03/19/09)

Treasury’s Senior Preferred Stock facility provides Fannie and Freddie an *effective guarantee*, says FHFA director Lockhart

- In a March 18th speech to the Women in Housing and Finance Symposium, Federal Housing Finance Agency director James B. Lockhart said Fannie Mae, Freddie Mac and the FHLBs play a critical role in stabilizing the housing through four key strategies: (i) supporting the mortgage market in a safe and sound manner by providing liquidity and stability with a special interest on affordable housing; (ii) working with the GSEs’ government partners to get mortgage interest rates down;

(iii) setting best practices for the mortgage market; and (iv) working on foreclosure prevention to help at-risk homeowners obtain affordable modifications and refinancings.

- Lockhart said, "...Treasury's Senior Preferred Stock facility, originally \$100 billion each but now set at up to \$200 billion each, as part of the President's Homeowner Affordability Plan, provides *an effective guarantee* [emphasis provided] of the Enterprises' debt and mortgage-backed securities by ensuring the Enterprises have a positive net worth. This facility protects not only present senior and subordinated debt holders and MBS holders but also *any future* [emphasis provided] debt and MBS holders, with no expiration date."
- Lockhart said his agency has taken strong actions to ensure that the Enterprises exert maximum effort to modify loans to prevent foreclosures and play a leading role in the private label securities (PLS) market. Together, Fannie, Freddie and the FHLBs are the largest owners of PLS with approximately \$250 billion of once-AAA rated PLS. Today, approximately 55% of Fannie Mae's and Freddie Mac's PLS holdings--\$178 billion—have been downgraded to junk levels and the average price of these securities continue to fall. These price declines and OTTI impairments have been a major "destroyer" of the Enterprises' capital. Together, Fannie and Freddie own or guarantee approximately 31 million of the 55 million mortgages outstanding—or about 56% of all single-family mortgages; however, the GSEs' mortgages comprise only 20% of serious delinquencies. In contrast, private label securities comprise 15% of the mortgages outstanding, but comprise 50% of serious delinquencies. Lockhart noted, "If we are going to stabilize the housing market, we have to address that PLS 50 percent."
- Through the \$75 billion Home Affordable Refinance Initiative, Fannie and Freddie are working directly with more than 3,000 loan servicers to help at-risk borrowers restructure their mortgages. Lockhart added, "Modifications need to be paired with the ...[FHA's] expanded and improved Hope for Homeowners program and the aggressive Troubled Assets Relief Program efforts to purchase second mortgages." [Separately, a senior Treasury official said that the agency will soon issue guidance to mortgage servicers for extinguishing or reducing second lien loans under the administration's mortgage modification plan.] As agents of the Treasury, Fannie will serve as administrator and Freddie as "compliance enforcer" in the implementation and ongoing oversight of the modification program, said Lockhart. The Finance Director urged all members of the industry to "get behind Making Houses Affordable and aggressively work at reducing foreclosures." (*Prepared comments for the Women in Housing and Finance Symposium on Meeting the Challenges of the Financial Crisis*, James B. Lockhart, III, 03/18/09; *Bureau of National Affairs*, Mike Ferullo and Aaron Lorenzo, 04/09/09)
- On March 17th, the FHFA announced that Fannie Mae and Freddie Mac increased the number of loan modifications made by 76% from the third to fourth quarters of 2008. "These data reflect that the post-conservatorship programs are starting to work to

prevent foreclosures, even before the implementation of the streamlined modification program (SMP) in January,” said Lockhart. “I believe that the Making Home Affordable loan modification and refinance programs, building upon Fannie Mae and Freddie Mac’s SMP should cause loan modifications to accelerate. These more aggressive modifications should help lessen redefaults and better stabilize the housing market and neighborhoods.” (*Federal Housing Finance Agency Press Release*, 03/17/09)

- In an interview with *National Mortgage News*, FHFA director James Lockhart said servicer guidance along with the net present value (NPV) test for the Obama administration’s new loan modification program will be issued “very soon.” He added, “I’m hopeful we can get this kicked up very fast.” While Fannie and Freddie have already issued servicer guidance for modifying loans they own or guarantee, the new NPV test will be used to determine which non-agency loans qualify for a loan modification. “That is being finalized,” said Lockhart. (*National Mortgage News*, 04/14/09)
- Separately, HOPE Now is ramping up its efforts to reach at-risk homeowners through “Reach Out,” a targeted state-by-state campaign that pairs at-risk homeowners with HUD-certified counseling agencies to “determine options that will best serve their needs.” The program will begin in Wisconsin, for homeowners who are 90 days or more delinquent. The mortgage alliance plans to expand the program to other states with the highest 90-day plus-delinquencies, including New Jersey, Texas, South Carolina, and Florida. (*HousingWire*, Diana Golobay, 04/09/09)
- Fannie Mae announced that its refinancing volume nearly doubled in March to \$77 billion—after nearly tripling to \$41 billion in February from January’s refinancing volume. The company also noted that more than 100,000 borrowers have accessed its online mailbox to inquire about their eligibility for the administration’s refinancing plan and 50,000 borrowers have made inquiries on the company’s hotline about the program. (*Fannie Mae Press Release*, 04/03/09; *Fannie Mae Press Release*, 03/18/09)
- The Mortgage Bankers Association now forecasts mortgage originations to total \$2.78 trillion in 2009, the fourth highest originations year on record [behind only 2002, 2003 and 2005]. MBA said, “This boost is due entirely to the expected increase in mortgage refinancing activity motivated by the drop in interest rates following last week’s Federal Reserve’s announcement on the Treasury bond and mortgage-backed securities purchases programs and the Fannie Mae and Freddie Mac refinance programs.” (*HousingWire*, Paul Jackson, 03/24/09)

President Obama urges homeowners to refinance their mortgages

- Speaking at a White House roundtable on housing finance, President Barack Obama estimated that 7 million to 9 million homeowners can now save up to \$2,000 a year

by modifying their mortgages at historically low mortgage rates. “We are at a time where people can really take advantage of this,” said Obama, who encouraged troubled borrowers to see if they’re eligible to participate in the government’s foreclosure prevention plan. The president noted that overall refinancing activity has increased 88% since his administration’s foreclosure plan was announced. In a conference call with reporters, HUD Secretary Shaun Donovan said, “There are obviously a number of details [about the foreclosure plan] which need to be worked through and finalized, but we have continued to hear positive responses from servicers and we are moving forward. They expect to do large numbers of modifications under the program.” (*Bureau of National Affairs*, Mike Ferullo, 04/10/09; *Wall Street Journal*, John D. McKinnon, 04/09/09; *Marketwatch*, Robert Schroeder, 04/09/09)

Federal Reserve pledges another \$1.2 trillion to support the housing market

- On March 18, the Federal Reserve Board’s policy making committee took an aggressive action to lower mortgage rates to purchase an additional \$750 billion of agency MBS in coming months. The Fed said, “To provide greater support to mortgage lending and housing markets, the [Federal Open Market] Committee decided ...to increase the size of the Federal Reserve’s balance sheet further by purchasing up to an additional \$750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to \$1.25 trillion this year, and to increase its purchases of agency debt this year by up to \$100 billion to a total of up to \$200 billion.” (*HousingWire*, Diana Golobay, 03/18/09)

Fed study finds loan modifications not as effective as direct aid to homeowners

- A recent study by Federal Reserve economists concluded that programs aimed to ease home-loan terms for troubled borrowers may not be as effective in stemming foreclosures as more-direct aid. The Fed study found that job losses and falling home prices are having a bigger impact on delinquencies than mortgage terms. Moreover, the economists concluded that loan modifications are not necessarily a better deal for investors than foreclosures, the authors argued. Instead, the government should consider offering unemployed homeowners bridge loans for up to two years or helping borrowers become renters. The study was authored by Christopher Foote and Paul Willen, senior economists with the Boston Fed, Kristopher Gerardi, a research economist with the Atlanta Fed, and Lorenzo Goette, a former economist with the Boston Fed. (*Bloomberg News*, Scott Lanman, 04/10/09)

Federal agencies organize “aggressive action” to fight mortgage fraud

- On April 7th, Treasury unveiled a coordinated plan, in conjunction with the FTC, HUD, the Justice Department, and state agencies, to crack down on mortgage and foreclosure scams. The agencies will work with state and local law official combat these scams and protect homeowners. Separately, HUD is developing a separate program to increase the oversight of major lenders and loan servicers who plan to participate in the administration’s loan modification program. Donovan said, “A key part of the Making Home Affordable plan is the oversight that we’re going to be doing to make sure that as we’re applying this plan to the portfolios of the largest servicers—they make up 65% of all the mortgage servicing in the country today—we will have very strict procedures in place to review their modifications and do quality assurance, make sure they’re actually providing modifications that are having a positive effect and as part of that we mean catching instances of fraud.” (*Bureau of National Affairs*, Aaron Lorenzo, 04/07/09; *American Banker*, Emily Flitter, 04/07/09)

Fannie’s and Freddie’s retention bonus program comes under fire

- Fannie Mae and Freddie Mac plan to pay more than \$210 million in bonuses through the end of 2010 to provide more than 7,600 employees the incentive to remain in their jobs. According to a letter to Senator Charles Grassley (R-IA), the Federal Housing Finance Agency said that the enterprises paid bonuses of nearly \$51 million in 2008, and are scheduled to award bonuses totaling \$146 million in 2009 and \$13 million in 2010. Fannie Mae has granted a \$1.1 million retention award and \$160,000 cash bonus to CFO David Hisley; a \$1 million retention award to Kevin Bacon, EVP of housing and community development, and Thomas Lunch, EVP of single-family mortgage unit; and a \$1.3 million retention award to COO Michael Williams. [These awards will be paid in four installments through February 2010.] Fannie Mae CEO Herb Allison decided to forego all compensation and bonuses and to reimburse Fannie for his car and driver in 2008. Allison’s compensation package for 2009 hasn’t yet been established. Freddie Mac has not yet disclosed the details on its bonus payments.
- In the letter to Grassley, FHFA director James B. Lockhart defended the retention bonuses, arguing that keeping the GSEs “operating at full speed was best for the housing markets and best for the economy.” He added, “That would only be possible if we retained the Fannie and Freddie teams.” Lockhart also noted that the collapse of the enterprises’ stock prices “destroyed years of saving for many” of the GSEs’ workers. Lockhart denied the Senator’s request that his agency disclose the names of employees receiving at least \$100,000 in bonuses, citing “personal privacy and safety reasons.”

- In a letter to Lockhart, House Financial Services Committee chairman Barney Frank wrote, “I am writing to urge strongly that you rescind bonus programs at Fannie Mae and Freddie Mac, prohibit any further payment of bonuses to executives under that program, and pursue repayment of any already paid bonuses.” Frank added, “The public, having provided significant support for the purpose of restoring trust and confidence in our country’s financial system, rightfully insists that large bonuses such as these awarded by institutions receiving public funds at a time of a serious economic downturn cannot continue.”
- In response to Frank’s letter, Lockhart wrote that he instituted the retention programs at Fannie Mae and Freddie Mac in consultation with Treasury officials. Lockhart wrote, “It was very important to work with the current management teams and employees to encourage them to stay and to continue to make important improvements. In response, most have stayed. Indeed, I can attest that many employees at all levels at each company have been working far more hours, with far less compensation than they did prior [to the government’s takeover].” Lockhart added, “These [bonuses] are going to employees at all levels, not just top executives. In this uncertain compensation environment, it is very difficult to hire people to fill vacancies of which there are a larger number of senior ones at both companies, including the CEO, COO and CFO positions at Freddie Mac.” Lockhart added, “We believe that FHFA would be violating its duties as conservator to end the retention plans and allow Fannie Mae and Freddie Mac to be hollowed out. There are no other financial institutions that can replace them in this critical time for the nation’s economy.” On balance, Fannie Mae’s retention program involves 3,545 employees (or 61% of its workforce), while Freddie Mac’s program involves 4,057 employees (80%).
- However, many lawmakers had little sympathy for Lockhart’s arguments, in the aftermath of public outcry over AIG’s bonuses of \$165 million. Lawmakers have had second thoughts about legislation passed by the House, which would have taxed excessive bonuses “away,” in reaction to the furor over AIG. The House subsequently passed a bill that would allow the payment of bonuses if Treasury and the financial regulators determine that they are not “unreasonable and excessive.”
- In an internal email to employees, Fannie Mae CEO Herbert M. Allison, Jr. wrote, “While it’s unclear what shape the legislation eventually will take, like many of you I am deeply concerned. I fervently hope Congress and the administration will reconsider and leave our retention plan intact—not only for your sake, but also for the sake of our collective efforts to aid the housing recovery.” (*Wall Street Journal*, James R. Hagerty, 04/04/09; *Dow Jones Newswire*, Jessica Holzer, 03/20/09; *CQ Today*, Benton Ives, 03/20/09; *Bloomberg News*, Dawn Kopecki, 03/20/09; *Washington Post*, Zachary A. Goldfarb, 03/21/09; *Associated Press*, Alan Zibel, 03/03/09; *Minyanville.com*, Scott Reeves, 03/06/09)

FHFA considers new role for Fannie Mae and Freddie Mac

- The Federal Housing Finance Agency is looking at ways that Fannie Mae and Freddie Mac can help revive the warehouse loan market by allowing the GSEs to help finance small mortgage banks. FHFA has asked representatives of the National Mortgage Bankers Association to develop a detailed plan for how Fannie and Freddie could provide mortgage banks obtain credit. One option being considered is using the enterprises to guarantee debt issued by warehouse lenders. MBA president John Courson said he believes that FHFA can provide Fannie and Freddie temporary authority to help fund warehouse loans, which wouldn't require congressional approval for this expansion of the enterprises' role. "We just don't have the luxury of time for going through the legislative meat grinder," said Courson. (*Wall Street Journal*, James R. Hagerty, 03/30/09)

President Obama announces nominees for Treasury and HUD positions

- President Barack Obama has announced the following nominations to serve in key roles under Treasury Secretary Tim Geithner:
 - Neal Wolin has been nominated to serve as deputy secretary. Wolin previously served as the general counsel for Treasury during the Clinton administration. He is the former president and COO for the property and casualty operations at The Hartford Financial Services Group.
 - Lael Brainard has been nominated to serve as under secretary of the Treasury for international affairs. Brainard currently serves as vice president and founding director of the global economy and development program for the Brookings Institute. Previously, she served as deputy national economic advisor and deputy assistant for international economics in the Clinton administration.
 - Stuart Levey was nominated to serve as under secretary for terrorism and financial intelligence. Levey previously served as a principal associate deputy general at the Department of Justice.
 - Helen Elizabeth Garrett has been nominated to serve as assistant secretary of tax policy. Garrett is vice president for academic planning and budget for the University of Southern California and was a member of President George W. Bush's Advisory Panel on Federal Tax Reform. She also serves on the national governing board of Common Cause.
 - Michael S. Barr has been nominated to serve as the assistant secretary for financial institutions. Barr currently teaches courses on financial institutions, international finance, transnational law, and jurisdiction and choice of law at the University of Michigan law school. He served as a deputy assistant Treasury secretary in the Clinton administration.

- George W. Madion has been nominated to serve as general counsel. Madison is the former EVP and general counsel of TIAA-CREF. (*HousingWire*, Diana Golobay, 03/24/09; *Wall Street Journal*, 03/28/09; *National Mortgage News*, 03/24/09)
- President Obama has named David Stevens to serve as Assistant Secretary for Housing and FHA Commissioner and Carol Galante to serve as deputy assistant secretary in charge of HUD's multifamily program. Stevens currently serves as president and COO of the Long & Foster Companies, which owns Long & Foster Real Estate and its affiliated mortgage, title insurance, and home service business units. Previously, Stevens was EVP, National Wholesale Manager for Wells Fargo Home Mortgage's wholesale channel and VP of single-family business for Freddie Mac. Galante previously was president of the Bridge Housing Corp, a nonprofit multifamily builder which specializes in affordable homes in California. (*National Mortgage News*, 03/24/09; *HUD Press Release*, 03/23/09)

Fannie Mae

Fannie Mae's retained mortgage portfolio declined 1.3% in February
--

- Fannie Mae's retained mortgage portfolio declined at a compound annual rate of 1.3% to \$784.7 billion, while its MBS and other guarantees increased at an annualized rate of 1.3% driven largely by mortgage refinances. The company's conventional single-family serious delinquency rate rose 35 basis points to 2.77% in January (the latest data available), while the company's serious delinquency rate for multifamily properties declined 3 basis points to 0.27%. Fannie Mae's effective duration GAP averaged positive three months in February, up from two months in January. (*Fannie Mae Monthly Summary*, February 2008; *Reuters*, 03/30/08)

Fannie Mae and KPMG are engaged in battle over attorney-client privilege
--

- KPMG is battling to obtain access to nearly 8,000 documents related to Paul, Weiss, Rifkind, Wharton & Garrison's independent investigation of Fannie Mae's corporate practices. While Fannie has provided copies of most of the material from the investigation, the company has contended that a few thousand documents—the exact number has not yet been determined—are protected by the attorney-client privilege. KPMG claims that Paul Weiss did not represent the mortgage dealer in any traditional sense, in part because OFHEO mandated the investigation and has looked at most of the paperwork it produced. KPMG also argues that Fannie waived any rights to the privilege when it published the final report. “Paul Weiss was not hired to represent Fannie Mae in proceedings against OFHEO or another third party. Instead, Paul

Weiss was explicitly required to independently [conduct a review] of Fannie Mae,” wrote Gibson, Dunn & Crutcher lawyers, who represent KPMG.

- Fannie Mae and Paul Weiss have filed opposition motions, arguing that KPMG has asked for documents that OFHEO never saw. Despite the fact that Paul Weiss was performing an investigation, the parties argue that for all intents and purposes, it was an attorney-client relationship. “While Paul, Weiss was ‘independent’ in the sense that the firm had not worked previously for Fannie Mae or its board, independence in this regard does not mean that Paul, Weiss did not or could not act as legal counsel,” wrote lawyers for Paul Weiss. “Indeed, [Fannie Mae] sought Paul, Weiss’s legal advice on many issues, including, for example, how best to conduct a credible internal investigation that would withstand the scrutiny of the regulators.” (*BLT—Blog of the Legal Times*, 04/07/09)

Javid Jaberri joins Fannie Mae to oversee the company’s “mega servicers”

- Javid Jaberri, the former senior vice president of servicing in charge of loss mitigation for Residential Capital Corp., has joined Fannie Mae. According to an associate, Jaberri will oversee “mega servicers,” such as ResCap, which sell loans to, and services them for Fannie. In late 2008, Jaberri left ResCap, which is 51% owned by Cerberus Capital. (*National Mortgage News*, 04/09/09)

New wave of mortgage buybacks coming from the HomeSave Advance program

- Fannie Mae has warned servicers that they face a new wave of mortgage buyback requests, citing six errors that are frequently made on unsecured loans [of up to \$15,000] that were extended to delinquent borrowers under the HomeSave Advance program. The mistakes range from clerical errors, such as completing the wrong form, to more “severe” errors, such as extending the loan to ineligible borrowers. The company has issued new guidelines for program, which apply retroactively to the 71,000 advances that have been made under the HomeSave Advance since its launch last year. “Everybody gets the sense that there’s going to be a big ‘gotcha’ because delinquencies are rising and they want to put the risk on somebody else,” said Cheryl Lang, the president of Integrated Mortgage Solutions. “It’s like having the rules changed in the middle of the game,” said Lang. Fannie should have “spelled out the rules of engagement” when it unveiled the program a year ago, she added. (*American Banker*, Kate Berry, 04/03/09)

Fannie Mae releases a new version of its Desktop Underwriter and new web portal

- On April 4th, Fannie Mae released Version 7/1 of the Desktop Underwriter®, which implements, among other things, the company’s DU Refi Plus™ program, designed

to provide lenders with increased efficiencies for the origination and underwriting of loan refinance loan applications. Fannie Mae's Refi Plus options—DU and manual—are designed to help responsible borrowers take advantage of today's historically low rates to reduce their monthly principal and interest payments, or to move from a more risky loan structure (such as interest-only or short-term ARM) to a more stable product. This enhancement leverages DU to expand eligibility criteria and reduce documentation requirements on certain limited cash-out refinance loan casefiles where the borrower's existing loan is identified by DU as a Fannie Mae loan and the borrower has an acceptable payment history (as determined by DU).

- In addition, the updated DU 7/1 includes updated property fieldwork requirements for foreclosure or REO Properties; multiple financed property policies and reserve requirements; and modified messages reflecting changes to Fannie's Selling Guide, specifically related to detached condominiums and certain state-specific requirements.
- Fannie Mae also has launched the web portal (<http://www.hmpadmin.com/>) to provide mortgage servicers information & tools needed to participate in Treasury's Home Affordable Modification Program, including (i) the Service Participation Agreement; (ii) information about how to become an approved servicer; (iii) additional guidance to implement the program for non-GSE mortgages; and (iv) a net present value overview. (*Fannie Mae Email*, 04/06/09)

Freddie Mac

Freddie Mac's retained mortgage portfolio reaches an all-time high of \$822 billion in February

- Freddie Mac's retained mortgage portfolio increased at an annualized rate of 34.7% [\$23.1 billion] to a record high of \$822 billion. Company spokesman Michael Cosgrove said the mortgage growth was a "sign of Freddie will continue to support the mortgage market"—which has been made possible by the increased capital provided through conservatorship. Freddie Mac's single-family delinquency rate increased 15 basis points in February to 2.13%, while its multifamily delinquency rate increased 5 basis points to 0.08%. The company duration gap averaged one month in February. (*Freddie Mac's Monthly Volume Summary*, February 2008; *Washington Business Journal*, 03/25/09)

Freddie Mac's public and private roles conflict—again

- In March, Freddie Mac executives concluded that they had to disclose to shareholders that the government's management of the company was undermining profitability and would cost the company tens of billions of dollars. However, the GSE's conservator, Federal Housing Finance Agency, urged management not to make this disclosure, raising tension among the parties said several sources familiar with discussions. However, Freddie's executives refused to bend and threatened to go to the SEC to obtain a ruling the FHFA's ruling was out of line. Freddie Mac executives insisted that they had to make the disclosure under federal securities law. Ultimately, the regulator backed down.
- FHFA didn't want Freddie Mac to make a disclosure which gave taxpayers the impression that the government was causing big losses at the GSE which would require more taxpayer funds to support the company's operations, said one source. In addition, FHFA officials thought fair value accounting rules would change soon, making the disclosure unnecessary, said another source familiar with the dispute.
- In a March 11th filing with the SEC, Freddie Mac made the following disclosure to shareholders: "We have made changes to certain business practices that are designed to provide support for the mortgage market in a manner that serves public policy and other non-financial objectives but that may not contribute to profitability. Some of these changes have increased our expenses or caused us to forgo revenue opportunities." Specifically, Freddie Mac said it would incur "an initial pretax charge" of \$30 billion—based on year-end 2008 figures—from the company's participation in the Obama administration's Homeowner Affordable and Stability Plan, which requires the GSE to modify at-risk mortgages and "mark them down to

current price.” Freddie cautioned, “These initiatives are likely to have a significant adverse effect on our financial results or condition.”

- In March, the company’s CEO, David Moffett [who joined Freddie in September at the government’s behest], submitted his resignation. Freddie Mac is now looking for a new president, COO, and CFO and appears to be having trouble finding qualified candidates, who will accept the jobs. Internally, the company’s management team is trying to determine if their highest priority should be fulfilling the mandates of the Obama administration or striving to restore the company’s profitability. (*Washington Post*, Zachary A. Goldfarb, 03/27/09)

Freddie Mac’s strategy for handling its rising REO inventory
--

- In a speech at Source Media’s 3rd Annual Mortgage Servicing conference, Ingrid Beckles, Freddie Mac’s SVP of Default Asset Management, discussed her company’s outlook for the U.S. housing market and plans for handling rising foreclosures. According to Beckles’ slide presentation, there are 3.46 million homeowners who are seriously delinquent, defined at 90+ days delinquent, whose mortgages are held in private label securities (51%), Freddie Mac and Fannie Mae MBS (7% and 13%, respectively), banks and thrifts (11%), GMAC and FHA (11%), and other (8%). Prime and Alt-A mortgage delinquencies are also on the rise in the “sand states,” including California (5.56%), Nevada (7.55%), Nevada (5.04%), and Florida (8.90%), she added.
- Beckles said, “People are leaving [their homes] sooner than ever before. There is some fraud, but it’s not that big compared to overall delinquent mortgage market.” Freddie Mac’s “90+ day loan disputes” were comprised of REO (19%), vacant (32%), short sales (2%), loan modifications (19%), repayment plans (15%) reinstatements (9%) and other (4%), she said. Intervening earlier is better because there are more options available, but it’s difficult to know what type of borrower sits in the early default population, because there’s more “noise” in the 30-day delinquency pool than before, said Beckles. Historically, 75% of borrowers late by 30 days did not move into a later state of foreclosure. Today only 25-50% of these borrowers do not advance toward foreclosure.
- To target borrowers for loan modifications, Beckles proposed the simple “dialing for dollars” method - setting up phone banks and simply contacting borrowers by brute force, as this would enable communication between borrowers and lenders and help to facilitate a resolution that otherwise may not have been reached. Freddie Mac is utilizing a “Mortgage Risk Scoring Method,” which works much like a FICO score, to target at risk borrowers. Borrowers are rated on a scale of 0-800, with the lower the value assigned, the higher the risk of default. At a score of < 300, borrowers have a 60% propensity to move into default. At a score of < 250, borrowers are 80% more likely to default. Historically, 78% of borrowers with loan modifications have performed over five years with 22% of the borrowers re-defaulting. Today, however,

loan modifications have a re-default of 27% after three months, 42% after six months and 47% after nine months.

- To expedite the loan modification process for at-risk borrowers, Freddie Mac phone servicers are now authorized to take actionable steps to avoid bureaucratic approvals, under the guidance that NPV > 0 for the modified loan, including (i) extend loans to a 40-year term; (ii) introduce principal forbearance (not principal forgiveness); and (iii) reduce interest rates payments by up to 2%. In general, borrowers are seeking affordable cash flows rather than principal forgiveness, said Beckles. She contended that the mortgage servicing process is almost identical to the mortgage origination process. It's a matter of setting up a servicing shop at the back end as you would a front-end origination shop, she argued. "It's a product flow through a process," adding "we can do this." It's a matter of delegation and standardizing the process that provides phone servicers the ability to make decisions and reach the "low-hanging fruit" on the phone, said Beckles.
- Freddie Mac projects that 136,000 of the company's new REOs will hit the market in the fourth quarter of 2009, an increase of 350% from the fourth quarter of 2008. To address this growing problem, Beckles said Freddie (i) introduced a month-to-month rental program for former borrowers; (ii) aggressively begun to promote loan modifications for at-risk borrowers, and (iii) "will potentially reinstate the mortgage where possible." (*Seeking Alpha*, Scott Sambucci, 08/09/09)

Freddie Mac introduces the Reverse REMIC program to improve the liquidity of the residential mortgage market
--

- Beginning with its March 30th REMIC settlements, Freddie Mac said it will begin offering 15-, 20-, and 30-year Reverse REMIC Giant PC securities, a new mortgage-related security intended to provide liquidity to the U.S. residential mortgage market and new options for investors. Under the program, Freddie Mac will offer investors a pro-rata portion of all outstanding Freddie Mac REMIC security classes from a previously issued REMIC group — which, in aggregate, constitute a pass-through from the mortgage collateral backing the original REMIC group — to be recombined into a Pass-Through ReREMIC class. This pass-through Re-REMIC class in turn becomes the collateral backing a new Freddie Mac Giant PC security that is eligible collateral for all Freddie Mac resecuritization programs. If the collateral backing the original REMIC met Securities Industry and Financial Markets Association TBA market good-delivery guidelines at origination, the new Giant security also will meet those same good-delivery guidelines.
- "Freddie Mac Reverse REMIC Giant PC securities are designed to provide a new, additional dimension of liquidity to the residential mortgage-backed securities market," said Mark Hanson, vice president for mortgage funding. "Historically, remaining tranches in REMIC securities lacked the liquidity sought by investors. Freddie Mac Reverse REMIC securities provide a new alternative investment vehicle

by converting them into Freddie Mac Giant PC securities.” (*Freddie Mac Press Release*, 03/26/09)

Former Freddie CEO nominated to serve on PHH Corp.’s board of directors

- Pennant Capital Management, a hedge fund and largest shareholder of PHH Corp [the nation’s tenth largest residential servicer], is seeking to install former Freddie Mac CEO Greg Parseghian to the lender’s board of directors at the shareholder’s meeting in June. Parseghian left Freddie Mac in 2003 in the midst of the GSE’s accounting scandal. (*National Mortgage News*, 03/31/09)

Federal Home Loan Banks

Boston FHLB books OTTI charge of \$381.7 million

- The FHLB-Boston booked an OTTI charge of \$381.7 million on its \$652.9 million of private-label mortgage-backed securities, which resulted in a net loss of \$115.8 million for 2008. “The net loss eliminated retained earnings, resulting in an accumulated deficit of \$19.7 million” but the Bank continues to meet its minimum net worth requirement, said Michael Jessee, president of the Boston Bank. However, recent changes to accounting “will restore a significant portion of the retained earnings that were lost in 2008 when implemented in the first or second quarter of 2009,” said Jessee. (*National Mortgage News*, 04/13/09)

FHLB-Seattle reports material weaknesses in how the Bank values its MBS portfolio

- In independent auditors for the FHLB-Seattle have discovered “material weaknesses” in how the bank’s management accounted for losses on mortgage bond investments, which may take up to six months to correct. According to the Bank’s SEC filing, the FHLB-Seattle failed to adequately oversee “significant accounting estimates and assumptions” used to quantify losses on its MBS portfolio. Bank spokesperson Connie Waks said “rapidly changing market conditions” led to the deficiencies in valuations and accounting controls. She added, “We are working to ensure that our methodologies, processes and procedures are appropriate and effective in this type of dynamic environment.” Charles Mulford, accounting professor at the Georgia Institute of Technology said, “That’s a problem. There is a risk that financial items will be improperly valued [without strong internal controls]. What the auditors will do is audit around the problem and find ways of assuring themselves that the numbers themselves are correct.”

- For the fourth quarter of 2008, the FHLB-Seattle posted a \$241.2 million loss, which resulted in a \$199.4 million net loss for the full year. The Bank's fourth quarter losses largely stemmed from an unrealized \$304.2 million other than temporary write-down of the value on its \$546.4 million in Alt A private label mortgage bonds (PLS). The FHLB-Seattle has written down the value of all its PLS 35% from \$5.6 billion to \$3.6 billion as of December 31st. The bank's statements fairly represents its financial condition and "were prepared" in accordance with GAAP, said Waks. (*Bloomberg News*, Dawn Kopecki, 04/01/09)

FHLB-Seattle suspends dividend payments and excess stock repurchases
--

- The FHLB-San Francisco announced it will not pay a dividend for the first quarter or repurchase excess stock held by its members on April 30th. In a letter to members, Bank president Dean Schultz wrote, "Ongoing stresses in the credit markets, substantial declines in real estate values, and weakness in the U.S. economy are continuing to affect the loan collateral underlying the bank's non-agency [mortgages]. As a result, it is likely that the bank will incur credit losses on some of these securities at some future time and will record impairment charges." Schultz added that the Bank is "currently evaluating" FASB's new guidance, which might ease the impact of OTTI charges. (*American Banker*, Steven Sloan, 04/14/09)

Charles Bowsher resigns from the FHLBanks Office of Finance Board

- The FHLBanks Office of Finance, the debt issuance facility of the FHLBs, has announced that Charles A. Bowsher has resigned as the private citizen member of the Office of Finance Board of Directors. In April 2007, Bowsher was appointed to the Finance Board, where he served as chairman. Previously, Bowsher had a career in both the public and private sectors including 15 years as the Comptroller General of the United States, and service on the advisory board of the Public Company Accounting Oversight Board. "Mr. Bowsher's experience and effective leadership made him a valuable asset to the Board and his contributions will be missed," stated John Fisk, CEO of the Office of Finance. (*FHLBanks Office of Finance*, 03/24/09)
- When asked by a *Bloomberg* reporter about his resignation, Bowsher said, "I was not comfortable as an audit committee member in signing off on the financial statements after I became aware of the standards and processes for valuing the mortgage-backed securities. ... Now if you think about it, the FASB might be changing the whole thing, and everybody might mark their assets up. Who wants to be part of that?" *Bloomberg's* interview occurred when FASB was voting to relax its marked-to-market accounting rules. (*American Banker*, Allison Bisbey Colter, 03/09/09)

Ginnie Mae

FHA delinquency rate increases 21% to 7.46% in February, raising concerns about the agency may be “another powder keg about to explode”

- FHA-insured home mortgages originations over the past two years are falling into delinquency at a faster rate, adding to risks to the insurance fund and increasing the likelihood that taxpayer funds will be needed to bailout the agency. During the first quarter of 2008, nearly 10.2% of borrowers who took out FHA-insured loans were at least two consecutive monthly payments behind within the first 10 months, up from 9.4% in 2007. About 12.3% of the FHA-insured loans made in 2007 were seriously delinquent [90 days or more late] in February 2009, including 4% that were in foreclosure or bankruptcy, which helped boost the overall delinquency rate on FHA-backed loans in February 2009 to 7.46%—up 21% from 6.16% a year earlier.
- FHA defaults have also jumped in certain markets in which Congress increased the agency’s loan limits last year. For example, Florida accounted for 14 of the 50 markets with the highest FHA default rates at the end of 2008, up from two in 2007. In West Palm Beach, defaults nearly doubled to 10.7% in December, up 95% from the 5.5% default rate a year earlier.
- In testimony before Congress in April, top HUD officials told lawmakers that the FHA, a self-funded government agency, is weighing whether it will need to ask for taxpayer money for the first time in its 75-year history. Job losses and broader economic deterioration have made borrowers more vulnerable and are primarily responsible for the rising defaults, said administration officials. In addition, loans with seller-funded down payments, which have higher default rates, were “clearly adding to the overall losses”—which accounted for 30% of FHA’s foreclosures, but comprised only 12% of all loans—said William Apgar, a senior adviser to HUD Secretary Shaun Donovan.
- In testimony before the Senate Budget Committee panel on housing, HUD inspector general Kenneth Donohue warned lawmakers that the FHA mortgage-insurance programs are at risk as record U.S. home-loan defaults have eroded the agency’s reserves by nearly half to \$12.9 billion from \$21 billion. If more pessimistic assumptions are factored in, the agency’s reserves could dip below 2% in succeeding years, requiring an increase in premiums or congressional appropriation intervention to make up the shortfall,” Donohue told lawmakers. FHA has never been under more strain as other sources for lenders to finance and insure their mortgages have dried up over the past 18 months and as policy makers create new FHA programs for riskier borrowers, said Donohue. Moreover, the agency may not have the systems and infrastructure to “adequately perform” its duties, or take on new functions imposed by Congress, including insuring larger “jumbo” loans of as much as \$729,750, he added. FHA-insured mortgages accounted for about 70% “of the [mortgage] market” in the

first quarter of 2009, up from 21% a year earlier, said Donohue. Senator Kit Bond (R-MO), said, “If Congress and the administration place more risk on FHA before the problems are solved, this powder keg could explode and taxpayers will be on the hook.”

- To handle its exploding loan demand, FHA has relaxed mortgage-broker licensing requirements, which exposes the agency’s system to potential fraud, said Donohue. In FY2008, FHA approved 3,300 lenders, up more than four-fold from 692 in 2006, he said “The integrity and reliability of this crop of loan originators is, in our view, unproven and in light of the aggressive recent history of this industry, may pose a risk to the program,” said Donohue. The risks and capacity strain at FHA could have “collateral implications for the integrity” of mortgage bonds backed by government agency Ginnie Mae,” which Donohue noted also “has stretched and limited resources to adequately address this increase.” (*Wall Street Journal*, Nick Timiraos, 04/11/09; *Bloomberg News*, Dawn Kopecki, 04/02/09)
- The omnibus appropriations bill recently passed by Congress increased the FHA commitment authority to \$315 billion for FY2009, up 70% from \$185 billion for FY2008. Ginnie Mae also received a 50% increase in its commitment level from \$200 billion in FY2008 to \$300 billion in FY009. Appropriators also allocated \$120 million to the HUD inspector general with \$13 million designated to monitor closely the FHA single-family program. Appropriators also instructed GAO to determine if the IG’s office had adequate resources to audit FHA’s “expanded role” in refinancing high risk mortgages. (*National Mortgage News*, Brian Collins, 03/21/09)

HUD may allow principal reductions of up to 30% for FHA-insured mortgages

- HUD is seeking to expand its mitigation loss authority by allowing FHA-insured mortgage balances to be reduced by up to 30% to avoid foreclosure. Under this proposal, FHA would pay the partial claim to the mortgage servicer or investor, which would cover the principal reduction and bring the loan current. Ultimately, the borrower would have to repay the forgiven principal amount [but without interest]. HUD senior advisor William Apgar said, “It would save the FHA money” and such an aggressive approach would be “consistent” with President Obama’s loan modification plan. (*National Mortgage News*, 03/31/09)

FHA plans to test pilot fully electronic mortgages by yearend

- The FHA officials the agency plans to publish electronic mortgage specifications this year and test pilot of fully-electronic mortgages with an FHA approved lender. To date, the agency has circulated a seven-page draft of its electronic signature specifications.

- “We know we need to work in a paperless environment,” said Jo Ann Kuczma, the director of FHA’s home mortgage insurance division. “Our goal is to receive all mortgage documents electronically and update FHA systems with all required information so that manual input of information by lenders is not required.” Kim Weaver, the vice president of product management for Fiserv Inc.’s electronic lending platform, said, “This says that we’ve passed the tipping point on adoption. Considering that Fannie and Freddie control most of the industry and FHA controls the rest, [the agency’s] willingness to work on documents across the life cycle of the whole mortgage and not just the note is huge.”
- FHA’s focus on standardizing all mortgage documents has observers questioning if the specifications ultimately will be too complicated to stimulate adoption. “There seems to be a lack of clarity on what standards are applied to what document,” said Ken Moyle, the chief legal officer at DocuSign Inc. and a member of the Electronic Signature and Records Association (ESRA). “For example, they’re clear they want the note to be a Smart Doc [a securable, manageable, archivable, retrievable and transferable document] but not the other documents.”
- Moyle said. “[ERSA’s goals is] keeping technology neutral. If the FHA were to adopt a position that is simply compliant [with the Electronic Signatures in Global and National Commerce Act of 2000] and the lender can assure that it obeys those structures, that’s great. But the more FHA defines standards instead of just having the lender certify to what’s out there, the more complicated it will become to adopt. ...I’m certain the Obama administration doesn’t want to be a barrier to e-commerce, but they run the risk of doing that if the standards are too specific.”
- However, Weaver said she doesn’t expect anything FHA does will be too difficult for lenders to adopt. “FHA is interested in coming up with standards that can be used,” she said. “I think they’ll encourage feedback from lenders and other industry participants. ... Remember, they’re keen on getting this adopted.” (*American Banker*, Anthony Garritano, 04/08/09)

Ginnie Mae MBS issuance tops \$34.5 billion in March
--

- In March, Ginnie Mae’s mortgage-backed securities issuance reached a record monthly high of \$34.5 billion, largely comprise of single-family issuance (\$34.1 billion) which included \$28.2 billion of Ginnie I s and \$5.9 billion of Ginnie II s. (*National Mortgage News*, 04/06/09)

Ginnie Mae stands ready to help ease the pain of mortgage warehouse constrictions

- Ginnie Mae president Joseph Murin said his agency stands ready to help ease constrictions caused by a dramatic pullback in mortgage warehouse lending, should

the Obama administration elect to pursue such an easing. The contraction in warehouse lending is a serious issue and I think we need to do things as quickly as possible,” said Murin. “Any nondepository mortgage banking operation is headed for extinction if we don’t figure this out.” Moreover, disruptions not only lengthen the time it takes for consumers to get a mortgage, but they also increase borrowing costs, he added. “Certainly Treasury understands that it’s an issue [as do federal lawmakers],” said Murin. (*American Banker*, Harry Terris and Kate Berry, 03/20/09)

Farm Credit System / Farmer Mac

Farm Credit System’s nonperforming loans increase more than 400% in 2008

- In 2008, the Farm Credit System’s nonperforming loans grew from \$621 million (0.43% of gross loans) to \$2.416 billion (1.50%). At yearend 2008, the FCS reported total assets of \$214.4 billion, gross loans of \$161.4 billion, an allowance for loan loss reserves of \$936 million (0.58% of gross loans), and total capital of \$27.124 billion (12.65% of total assets). The System reported net income of \$546 million, which represented a 1.41% return on assets and 10.70% return on equity. (www.fca.gov/reports/fcsindicators.html)
- The Farm Credit System’s nonperforming loans will likely grow, as the cascade of ethanol bankruptcies continues. In April, Pacific Ethanol joined the growing list of biofuel producers, hurt by lower gasoline prices, higher corn and energy costs and the global credit crunch, which faces bankruptcy if it can’t renegotiate or find additional financing. Pacific Ethanol, which has three weeks to find financing, is expected to file for bankruptcy—on the heels of Nova Biosource Fuels’ bankruptcy filing on March 30. According to the Biofuel Deathwatch List, 31 ethanol plants have been closed or construction has been suspended as of April 3rd. [Map of the closures is at <http://maps.google.com/maps/ms?ie=UTF8&hl=en&oe=UTF8&msa=0&msid=100024416568883817560.00044249b4bd966e2adf0&source=embed&ll=38.410558,-102.128906&spn=24.035972,41.484375.>] (*BNet.com*, Kirsten Korosec, 04/07/09)

Two FCS associations “busted” for paying illegal rebates

- In the March issue of *Farm Credit Watch*, Bert Ely wrote, “1st Farm Credit Services, one of the two FCS associations serving Illinois, was directed last month by the State of Illinois’s Division of Insurance to ‘discontinue its Dividend Patronage Program’ under which it illegally paid rebates to farmers who purchased Federal crop insurance from the association. 1st Farm Credit Services has been just one of many FCS associations which have been paying illegal rebates on the Federal crop insurance

they sell. As the December 2007 *FCW* reported, the USDA's Risk Management Agency (RMA), which administers the Federal crop insurance program, and 27 state insurance commissioners launched a joint attack on the illegal rebating of crop-insurance premiums."

- "An RMA memorandum to all crop-insurance providers highlighted this new federal-state cooperative effort to stamp out illegal premium rebates by stating that 'some of these schemes violate not only the Federal prohibition against rebating, but also certain State statutes regarding, for instance, the types of entities allowed to sell insurance. Consequently, RMA will cooperate with the State insurance commissioners and share information relating to potential rebating violations. Quite possibly, this action by the Illinois Division of Insurance is a product of that federal-state cooperation. It also signals the type of state action which must be taken against the other FCS crop-insurance rebaters. Bankers, other *FCW* readers, and even the Farm Credit Administration ...should alert the other state insurance departments about this Illinois action.'" (*Farm Credit Watch*, Bert Ely, March 2009)

CEO compensation at the FCS banks goes "jumbo"
--

- In 2008, the compensation [excluding the change in pension value] for the CEOs of the five FCS banks ranged from \$2.941 million for Robert Engel, CoBank's CEO to \$756,000 for William York, CEO of AgriBank. From 2006 to 2008, increases in compensation also varied significantly, with Engel receiving an 85.8% increase versus York's more modest 24% increase. Compensation for Jamie Stewart, who runs the Funding Corporation, increased 31.4%—from \$836,000 in 2005 to \$1.098 million in 2008.
- In *Farm Credit Watch*, Bert Ely noted, "The greatest variation among the CEOs was in the change in their pension value. Striking it rich was Larry Doyle, CEO of the Texas Farm Credit Bank. In return for agreeing to no longer participate in the bank's supplemental pension plan, Doyle is receiving \$13 million, with \$8.5 million of that paid in January of this year and \$4.5 million next January, offset by a \$5.81 million pension benefit he surrendered, for a net gain of \$7.19 million. Darryl Rhodes, U.S. AgBank's CEO, was the second-lowest paid CEO last year, at \$843,000, but his change in pension value was \$2.425 million in 2008, following a \$1.238 million pension value change in 2007. Consequently, after factoring in the changes in pension values, Rhodes finished third in the 2008 CEO compensation contest, with total compensation of \$3.268 million, finishing behind Doyle's \$4.130 million and Engel's \$4.077 million. York finished last, at \$801,000." (*Farm Credit Watch*, Bert Ely, March 2009)

Farmer Mac reports \$154.1 million loss for 2008

- Farmer Mac reported a \$154.1 million loss or \$15.40 per share for calendar year 2008. During the fourth quarter, the agency's losses totaled \$61.1 million, which was largely driven by losses on financial derivatives and loss provisions related to credits granted in the ethanol sector. Farmer Mac cut its dividend in half for the first quarter to \$0.05 a share. (*National Mortgage News*, 03/17/09)

Postal Service

Postmaster General Potter tells Congress that the USPS is running out of money

- In testimony before Congress, USPS Postmaster General John Potter told lawmakers that his agency will run out of money this year unless it gets taxpayers' help. Potter told the House oversight postal office subcommittee, "We are facing losses of historic proportion. Our situation is critical." In FY2008, the Postal Service lost \$2.8 billion and expects much larger losses this year, said the Postmaster General. Even if the agency succeeds in cutting its cost by \$5.9 billion, the USPS could still incur a \$6 billion deficit in FY2010, said Potter. "Without a change we will exhaust our cash resources," he said. "We can no longer afford business as usual."
- If Congress allowed his agency to cut mail delivery from six to five days a week, the USPS could save \$3.5 billion annually, he added. Potter also urged Congress to make changes in how the Postal Service pre-pays for retiree health care, which would reduce the agency's annual costs by \$2 billion. If the Postal Service were to run out of money, Potter said there are questions about which bills will be paid and which will not. Workers' salaries would be paid first, but other bills may have to wait, he said.
- The Postal Service has announced plans to offer early retirement to 150,000 workers, to eliminate 1,400 management positions, and to close six of its 80 district offices in cost-cutting efforts. Potter said his agency expects 10,000 to 15,000 workers to accept the early retirement offer. When asked if layoffs would occur, Potter said it is possible, but hopes it can be avoided.
- Lawmakers asked Potter about recent news reports, claiming the Postmaster General is paid as much as \$800,000 a year. Potter responded that the news reports are not accurate. Potter said his salary, set by Congress, is \$263,575. The news articles were including in his compensation his retirement fund, the cost of his security detail, and a \$135,000 bonus to be paid over a 10 year period after he retires. The bonus was

based upon on improved delivery rates and customer satisfaction, he added. Under the current financial conditions, Potter will not be eligible for a bonus this year.

- Dan Blair, chairman head of the independent Postal Regulatory Commission, has suggested closing small and rural post offices for additional cost savings—an idea Congress has resisted in the past. Blair argues these closing may be necessary to increase the limit on the amount of debt the USPS can carry. Blair also suggested that Congress consider appropriating money to help the post office weather the current economic downturn, which contributed to a mail volume drop of 5.2 billion pieces, compared to the same period last year. If there is no economic recovery in 2009, postal officials project the agency’s mail volume will be down by 12 billion to 15 billion pieces of mail.
- In testimony before the panel, William Young, president of the National Association of Letter Carriers, stressed that the agency is not seeking a taxpayer bailout, “but we are here to ask the Congress for help.” He added, “At this moment, the survival of the Postal Service—a venerable institution that is literally older than our country—hangs in the balance.”
- “With the Postal Service facing budget shortfalls, the subcommittee will consider a number of options to restore financial stability and examine ways for the Postal Service to continue to operate without cutting services,” said subcommittee chairman Stephen F. Lynch, (D-MA). “[The financial stability of the USPS] is critical to the American expectation of affordable six-day mail delivery.” (*Associated Press*, 03/25/09)

TVA

Obama administration expected to announce soon their appointments to the TVA board
--

- TVA chairman Bill Sansom’s term expires on May 18th, along with fellow director Don DePriest of Columbus, MS. In an interview with the Associated Press, Sansom said that he and DePriest would likely stay on the board until their replacements arrive or the end of the current session of Congress later this year. “Don and I have talked about it,” said Sansom. “We will probably stick around if nothing is done. I care a lot about the place. I think we need all the wisdom on this board that we can get.” (*Associated Press*, 04/06/09)
- TVA board member Don DePriest has resigned effective May 8th, on the same day the *Knoxville News Sentinel* contacted his office about his business and personal finances. In a four sentence letter to President Barack Obama, DePriest wrote, “I count it as one of the honors of my life to have served on the Board of Directors of the Tennessee Valley Authority.” DePriest, who was appointed to the board by

President George W. Bush and confirmed by the Senate to a term ending May 18, 2009, served as chairman of TVA's Community Relations and Energy Efficiency Committee and a member of the Finance, Strategy, Rates and Administration Committee. (*Knoxville News Sentinel*, Scott Barker, 04/11/09)

- In an April 9th editorial, the *Chattanooga Times Free Press* wrote, “President Barack Obama’s authority to appoint board members for the Tennessee Valley Authority was probably not on the minds of many Tennessee voters last fall, but it’s one of those presidential powers that now looms large for this region’s energy future. TVA’s board will have four vacancies in May, and two more next year—all subject to Mr. Obama’s appointment power and the elected officials who have his ear. The competency and energy policy views of these pending appointees could dramatically affect TVA’s approach to energy supplies, rates and energy-use patterns in what may well be some benchmark years just ahead for this region and the nation.”
- “...A troublesome issue on the near horizon is the goal of some in Congress to transform the nation’s independent, utility-owned power grids into the equivalent of an energy super-highway infrastructure for moving electricity around the country. That’s a problematic goal, one in which TVA customers have an enormous equity stake. The cost and technical hurdles are huge, given the finite load-carrying capacity of interconnected regional utility grids, the perishable character of electricity transferred over hundreds of miles, the assumption of grid maintenance costs, and the problem of peak-hour brown-outs and black-outs from sagging, overloaded lines. TVA must defend its interests and investment in the integrity and cost of its grid.”
- “National advocates, and some in TVA, also want to expand the nuclear industry. Ideas range from more cost-effective standard design packages to nuclear fuel reprocessing, all without regard to the unmet problems of ore extraction and waste-disposal. Board members must understand the stakes. And there certainly will be a push to make tangible the advertising myth of clean coal and the unproved potential of deep-well carbon sequestration of coal-burning power-plant pollution. Even if that effort stalls, TVA and the industry at large will be under the gun to meet rising energy demand with cleaner processes — from reductions in its massive air pollution output to its fly ash disposal. The Kingston ash spill will put a particular leadership burden on TVA.”
- “Given the range of issues sure to be on the agenda, new board members no longer can be just bankers and political cronies. Fortunately, there are several competent appointees at hand. Chattanooga’s Dr. Barbara Haskew, a highly regarded economics professor at MTSU, is a former head of the rate-design division at TVA. She possesses rare insight into the design of rate charges to influence on-peak/off-peak power use for all classes of electricity users, from residential to huge industries. She also understands energy policy trends across the board, and the financial implications of long-term corporate investments. Dr. Stephen Smith, executive director of the Southern Alliance for Clean Energy, has been a close observer of TVA energy policies and their environmental impact for decades. He is an astute expert

broadly on energy policy. Jim Hall, a Chattanooga attorney and long-time Democratic political adviser, gained national prominence and deep federal agency expertise in his stint as chairman of the National Transportation Safety Board under the Clinton administration. Nashville attorney Bob Tuke, the Democratic opponent of Sen. Lamar Alexander in the election last November, is a well-informed advocate of sound public and energy policies.”

- “There surely are other qualified candidates, as well, but these four stand out. The task for Tennessee congressional Democrats now is to establish a clear channel to the White House to make sure that the focus is be on competent candidates who understand both TVA’s public mission and its vital role in the agency’s seven-state service region. It’s time the nation’s largest electric utility gets the board leadership it, and its rate payers, deserve.” (*Chattanooga Times Free Press*, 04/09/09)

TVA purchases 70 properties impacted by ash spill at a cost of \$20 million

- To date, TVA has purchased at 70 properties affected by the utility’s massive coal ash spill for a total cost of approximately \$20 million, but has turned down requests from 160 property owners, who hoped to sell out. “We are trying to balance between doing the right thing by the people that were impacted by this,” said Peyton T. Hairston Jr., a TVA senior vice president, but added that they are also “keeping in mind that this is ratepayer money. As we work through this process, we have been able to determine that some people are just outside the area that we feel has been impacted.” The December spill of 5.4 million cubic yards of ash covered about 300 acres and damaged 12 homes. The utility is spending approximately \$1 million a day on the clean-up efforts. (*Associated Press*, 03/24/09; *Associated Press*, 04/12/09)

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