

The **GSE** REPORT™

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Major Events

Treasury announces program requirements for the Making Home Affordable program
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- On March 4th, the Treasury Department released details on the Making Home Affordable program (MHA) to help homeowners at risk of losing their homes obtain taxpayer-subsidized reductions in their mortgage payments. Through the administration's \$75 billion Making the Home Affordable initiative, relief will be provided to approximately three to four million responsible homeowners to help them avoid foreclosure and assist up to 5 million homeowners refinance underwater mortgages.
- The MHA initiative consists of two key elements: a \$75 billion program to reduce mortgage payments for struggling borrowers and a refinancing program for homeowners who have little equity in their homes but are current on their mortgages. To help struggling homeowners, the government is offering financial incentives and subsidies to persuade mortgage servicing companies to modify the mortgages for homeowners who are experiencing financial hardships and are at-risk of losing their homes to foreclosures. Borrowers will be required to sign affidavits attesting to their financial hardships and fully document their income with pay stubs and tax returns. In return, the loan servicer will modify the loan by reducing the mortgage interest rate to as low as 2%, lengthen the borrower's payment period, and make other modifications aimed at reducing the monthly mortgage payment to 31% of the borrower's income. [Under the program, the loan servicer would reduce the mortgage payment to no more than 38% of the borrower's monthly gross income and Treasury would subsidize the mortgage to further reduce to the payment down to 31%]. The program will be limited to first-lien, owner-occupied, single-family mortgages with outstanding principal balances below \$729,750. Loan servicers will receive up to \$3,500 from the government to participate and receive a matching reimbursement for lenders' costs, dollar-for-dollar. Homeowners will receive up to \$5,000 each of federal funds to reduce their mortgage balance, as means of encouraging them to stay current on the modified mortgages. Treasury has committed up to \$10 billion in payments to discourage servicers, homeowners, and investors from pursuing foreclosures. In coming weeks, the administration plans to announce how the program will help servicers persuade holders of second mortgages for at-risk mortgages to extinguish their debt so that borrowers may participate in this program. According to Credit Suisse Group, roughly half of delinquent borrowers also hold second mortgages and would be unable to participate in the administration's MHA initiative. Banks and other financial institutions that have received capital injections under the TARP program will be required to implement the loan modification programs based upon Treasury's guidelines. Loans can be modified only one time under this program. The MHA loan modification program, which is available immediately, expires on December 31, 2012.

- The second component of the MHA program calls for Fannie Mae and Freddie Mac to refinance mortgages collateralized by owner-occupied, 2nd homes/vacation homes and investor properties, for borrowers who may owe more than their home is worth, even if they are current on their payments and can afford their existing mortgage. Under this program, the underlying mortgage must be owned by Fannie or Freddie and the unpaid loan balance may not exceed 105% of the appraised value of the collateral property. According to Treasury’s guidance document, “GSE lenders and servicers already have much of the borrower’s information on file, so documentation requirements are not likely to be so burdensome. In addition, in some cases an appraisal will not be necessary.” On December 31st, an estimated 13.6 million homeowners owed more than their homes were worth—up 15% from the end of the third quarter when 11.8 million homeowners were said to be “underwater.” The administration estimates that as many as five million homeowners will refinance their mortgages through this program, which is available immediately and expires on June 30, 2010.
- In a joint statement, the Federal Reserve, FDIC, OCC, OTS and NCUA said, “By providing servicers and holders of eligible residential mortgages with incentives to modify loans at risk of foreclosure, the program will promote sustainable alternatives.”
- Federal Housing Finance Agency director James Lockhart released a statement saying: “FHFA was pleased to work with the White House, the Treasury Department, [HUD], other regulators, and Fannie Mae and Freddie Mac in the development of the ‘Making Home Affordable’ loan modification program... This program is a major step forward in reducing preventable foreclosures and stabilizing the housing market.”
- In a March 4th statement, Tom Deutsch, deputy executive director of the American Securitization Forum said, “We support a number of aspects of this [MHA] program and look forward to continuing to work with the administration to refine additional details in a number of areas of the plan. Although we continue to work with our members to review the many important details in the package, we appreciate the administration working towards a single market standard for loan modifications. As ASF and its members have spent a great deal of time working together on standardization of these processes, we share the administration’s goal. Especially when combined with proposed Hope for Homeowners improvements and direct second lien purchases, these additional efforts can help substantially reduce unnecessary foreclosures.”
- John Courson, president of the Mortgage Bankers Association, said, “We have been advocating for one unified approach to help modify or refinance delinquent and underwater loans and thus we think this program will undoubtedly help servicers keep more at-risk borrowers in their homes, which is a crucial step to helping stabilize the mortgage and housing markets.” He cautioned, however, that servicers might be reluctant to act without congressional protection from lawsuits. A senior Treasury

official responded that the administration is “not going to see eye-to-eye.” with some investors. “Our role is not to use taxpayer resources to bail them out,” he added.

- Robert R. Davis, executive vice president of the American Bankers Association (ABA), said “[The] additional details provided today establish common sense limitations and practical financial considerations for operation of the Making Home Affordable Modification program. ABA stands ready to assist Treasury in providing other clarifications that may be necessary.”
- In a March 2nd letter to Treasury Secretary Geithner, HUD Secretary Donovan, National Economic Council chairman Summers, Senate Banking chairman Dodd (D-CT), and House Financial Services chairman Frank (D-MA), the American Home Mortgage Servicing, Inc, the Associated General Contractors of America, Nationstar Mortgage LLC, Residential Capital LLC, and the U.S. Chamber of Commerce embraced the administration’s plan and applauded the administration’s efforts to reduce homeowners’ mortgage payments. The groups urged the Obama administration and Congressional leaders to (i) address the negative equity problem by making immediate and meaningful reductions of principal balances for at-risk agency and non-agency mortgages to stabilize home prices; (ii) include non-agency mortgages [which account for 36% of outstanding mortgages] in MHA; and (iii) provide a statutory safe harbor to insulate servicers from litigation related to their loan modifications for at-risk homeowners.
- Questions also are being raised about how the GSEs’ statutory restrictions impact the mortgage refinance program. In a March 4th letter to Federal Housing Finance Agency director James Lockhart, Representative Scott Garrett (R-NJ), who serves member of the House Financial Services Committee, noted that GSE-backed mortgages currently require a 20% down-payment from borrowers or “credit enhancements.” for mortgages which exceed 80% loan-to-value [LTV]. “Due to falling housing values, many of the potential applicants for Treasury’s foreclosure mitigation refinancing plan will now find themselves over this LTV,” wrote Garrett. “If these applicants refinance, a new loan will have to be written subjecting them to increased credit enhancement explicitly required by statute.” Garrett asks Lockhart for a detailed explanation of how, under current statutes, the GSEs will be permitted under law to finance underwater mortgages.
- Others question if the refinancing program goes far enough, since the initiative excludes mortgages that exceed 105% of the value of the collateral property. “We think the refinance program could be even more effective if the 105 percent LTV limit were raised [particularly to help borrowers in high-cost real estate markets],” said MBA’s Courson. “It would allow the GSEs to help even more borrowers without any additional risk since the loans are already on their books.” The MBA also advocates expanding the refinancing program to include underwater loans owned by private investors.

- In an analysis of the MHA program, Amherst Securities’ analysts Laurie Goodman and Roger Ashworth wrote, “This program is detrimental to non-Agency [and agency] investors and will likely create consequences that we cannot easily anticipate.” The analysts make the following arguments:
 - The borrower still has any upside on the house without the downside. The analysts wrote, “This program produces a huge incentive for the borrower to essentially ‘rent’ the house for 5 years and see if it appreciates.” If the property is still underwater at the end of five years, the borrower is apt to walk.
 - The borrowers “who stretched to buy their house or ‘lied’ the most about their income.” receive the largest benefit. The analysts argue, “[T]he lower the borrower’s income relative [is] to mortgage size—the bigger the break received.” They continue, “To make this situation even more unfair, the plan creates a larger break if the loan balance is larger. ...It is important to realize that 65% of the borrowers in default did not initially provide full [loan] documentation. The Mortgage Brokers Association for Responsible Lending showed ...that almost 90% of the borrowers exaggerated their income by 5% or more. And almost 60% of the stated amounts were exaggerated by more than 50%. [Thus,] the largest subsidies from the government and from investors may in large part flow to financially irresponsible borrowers.”
 - The holder of the second mortgage is not forced to participate in the MHA initiative. Investors fear that servicers will modify the first mortgage and not touch the related second mortgage in order to modify the loan—in effect suspending contract law, which subordinates the claims of the second lien holder to the 1st lien holder. “These [contract] relationships are suspended under this government program, to the detriment of the 1st lien holders,” wrote the analysts.
 - Conflicts between servicer and investors are acute and viewed to be a “huge issue.” The authors wrote, “The servicer is incented to modify every loan: (1) the incentive fees are large, (2) the value of the servicing rights increases dramatically, and (3) the servicer is able to recover P&I advances.”
 - Moral hazard issues figure prominently in the MHA program with all delinquent loans being eligible for modification, along with current loans, if default is imminent.
 - Investor safeguards under the MHA initiative are virtually non-existent. The authors wrote, “There are only two safeguards to protect the investor from servicers modifying loans that shouldn’t be modified--- the NPV test and the threat of lawsuits. The NPV test has essentially been neutered [under the MHA program]. If this initiative is coupled with servicer safe harbor provisions in Congress, then investors are left with virtually no safeguards.”

- The analysts conclude, “[T]his program, as it stands now, makes it very hard to value these securities. We don’t know what implementation will look like, or how many borrowers will take advantage of it. And even for borrowers that don’t it will clearly increase the time to liquidation on delinquent loans.”
- Mortgage-backed securities investors—including hedge funds, insurance companies, and pension funds—are pressing the Obama administration to make changes in its MHA program. Many investors have met with Treasury officials in hopes of influencing parts of the plan, such as how second mortgages are treated. Some investors are contemplating legal action because they think the administration’s initiative and proposed safe harbor legislation before Congress will violate their rights. “Investors are given rights through the contracts in the securities, and we expect those rights to be honored,” said Jeffrey Gundlach, chief investment officer of TCW Group Inc. Gundlach argues that the program would be more palatable for investors if modifications weren’t given to borrowers who lied when they obtained their initial mortgage.
- In tandem with the MHA roll-out, Freddie Mac announced the introduction of Freddie Mac’s Relief RefinanceSM Mortgage and the implementation of the Obama Administration’s new Home Affordable Modification program, beginning on April 1st for Freddie Mac-owned or guaranteed mortgages originated on or before January 1, 2009. Freddie also opted to eliminate significant fees that compensate for risks of low credit scores and little equity in an effort to increase the number of borrowers who may qualify for the refinancing initiative. The company said it would continue to suspend foreclosure sales on mortgages which are eligible for the modification program. Further, servicers have been instructed not to complete a foreclosure sale without a complete and through effort to contact the borrower to discuss workout options. Freddie has also officially launched its new REO Rental Initiative, which allows tenants and former owners the option to lease recently foreclosed properties on a month-to-month basis.
- Fannie Mae announced similar initiatives—called the Home Affordable Refinance and the Home Affordable Modification programs—to help distressed homeowners. However, Fannie Mae surprised analyst by leaving their delivery fees largely unchanged for customers with high loan-to-value ratios and low credit scores. Analysts say that Fannie runs the risk of angering its lender partners whose customers will be left paying higher fees. “I suspect Fannie Mae is moving quickly to change their minds on this,” said Garry Cipponeri, SVP for Chase Home Finance. Failure to follow Freddie’s lead would be a public relations “disaster,” he added. Fannie Mae also announced that it is resuming sales of foreclosed homes that don’t qualify for the Home Affordable Modification program. The company has extended its stay on evictions through March 31st and its foreclosed property will be sold only if “all other foreclosure alternatives have been exhausted.” (*Wall Street Journal*, Ruth Simon, 03/12/09; *Bureau of National Affairs*, Mike Ferullo, 03/05/09; *Wall Street Journal*, Michael M. Phillips and Ruth Simon, 03/05/09; *Washington Post*, Renae Merle and Dina ElBoghdady, 03/05/09; *New York Times*, Edmund L. Andrews, 03/05/09; *U.S.*

Treasury Press Release, 03/04/09; Bloomberg News, Dawn Kopecki, 03/06/09; HousingWire, Paul Jackson, 03/05/09; Reuters, Al Yoon, 03/05/09; HousingWire, Diana Golobay, 03/05/09; American Securitization Forum Press Release, 03/04/09; Correspondence to Treasury Secretary Geithner, HUD Secretary Donovan, National Economic Council chairman Summers, Senate Banking chairman Dodd, and House Financial Services chairman Frank, the American Home Mortgage Servicing, Inc, the Associated General Contractors of America, Nationstar Mortgage LLC, Residential Capital LLC, and the U.S. Chamber of Commerce, 03/02/09; Federal Housing Finance Agency Press Release, 03/04/09; Los Angeles Times, E. Scott Reckard, 03/07/09; Correspondence to the Honorable James Lockhart, Representative Scott Garrett, 03/04/09; Amherst Mortgage Insight, Laurie Goodman and Roger Ashworth, 03/05/09)

House passes a revised cram-down bankruptcy bill

Fate of mortgage cram down is uncertain in the Senate

Unintended consequences in the prime mortgage market

House passes a revised cram-down bankruptcy bill

- On March 6th, the House passed by a vote of 234-191 a revised version of the Helping Families Save Their Homes Act (H.R. 1106). Revisions to the bill narrowed the instances in which bankruptcy judges would be allowed to write-down the mortgage principal for loans underwritten prior to the enactment of the bill. The revised bill would require judges to consider lowering the loan's interest rates in accordance to guidelines of the Obama administration's loan modification program, before reducing the loan principal. The bill would also require borrowers to seek voluntary loan workouts from their lenders at least 30 days before proceeding to bankruptcy court and to certify that all the necessary personal financial information was provided to the lender. The measure requires bankruptcy judges to consider if banks offered homeowners a "qualified" loan modification before granting judicial aid. The compromise language also would provide lenders a claw back provision, allowing them to collect a portion of the profit if the home is sold within five years. Under the provision, lenders would receive 90% of the home's appreciation if the home is sold within one year of modification; 50% after three years; and 10% after five years.
- The changes made to H.R. 1106 were part of a modified manager's amendment crafted by Rep. Zoe Lofgren (D-CA) and other Democrats, who voiced strong reservations about the bankruptcy cram-down language in the original bill. Lofgren said the narrowed bankruptcy provision is designed to work with other elements of the Obama foreclosure prevention plan and would serve only as "last resort" for a select group of borrowers. "This important bill gives families with home mortgages in distress a better opportunity to come to terms with their lender," she said during

floor remarks. “It is designed to keep families out of bankruptcy and out of foreclosure.”

- H.R. 1106 also loosens lending requirements for the voluntary HOPE for Homeowners program, by allowing lenders to write-off less principal than before, loosening eligibility requirements for the program, and reducing the maximum insurance premiums that borrowers are required to pay. The bill also provides safe harbor provisions intended to protect mortgage servicers from investor lawsuits, where servicers have engaged in good-faith efforts to modify mortgages, regardless of any provisions in their servicing agreements with their investors. H.R. 1106 also contains provisions which would permanently increase FDIC insurance to \$250,000. Given concerns that the FDIC provision may be delayed by slow passage of a mortgage bill in the Senate, Senate Banking Committee chairman Christopher Dodd (D-CT) has announced plans to move stand-alone legislation for the FDIC deposit insurance.
- The bill also contains a provision addressing how MBS tranches will absorb losses, resulting from mortgage cram downs. Specifically, Section 124 of the underlying H.R. 1106 reads: “No provision in any investment contract between a servicer and a securitization vehicle or investor in effect as of the date of enactment of this Act that requires excess bankruptcy losses that exceed a certain dollar amount on residential mortgages to be borne by classes of certificates on a pro rata basis that refers to types of bankruptcy losses that could not have been incurred under the law in effect at the time such contract was entered into shall be enforceable, as such provision shall be contrary to public policy. Notwithstanding this section, such reference to types of bankruptcy losses that could have been incurred under the law in effect at the time such contract was entered into shall be enforceable.” Observers expect the constitutionality of this provision, if passed by Congress, to be challenged in court in the near future.
- The American Council of Life Insurers has obtained a legal opinion on Section 124 of H.R. 1106 from Debevoise & Plimpton LLP stating: “ Although the Supreme Court’s precedents prescribe no bright-line test for the constitutionality of retroactive legislation, we believe that, under existing case law, Section 124 of H.R. 1106 as passed by the House on March 5, 2009 is clearly supportable as constitutional. ...Under longstanding Supreme Court precedent, the Constitution does not forbid Congress from enacting legislation merely because the legislation would alter or destroy existing contractual rights or upset otherwise settled expectations. Rather, federal legislation that alters existing contractual relationships is invalid only in those ‘rare instances’ where the legislation imposes a ‘severe’ retroactive liability that ‘bears no legitimate relation to the [governmental] interest’ that the statute was meant to advance. ...[I]n our view, Section 124 falls squarely on the permissible side of the line.”
- Representative F. James Sensenbrenner Jr. (R-WI) argued that the compromise language “still makes this modification of the bankruptcy law smoke and mirrors.”

Republicans complained that by stopping short of mandating that judges consider other options, the compromise language did nothing to move reductions in principal to the bottom of modification options. “Meaningful change also would have meant substantially narrowing the class of loans eligible for bankruptcy modification,” said Representative Lamar Smith (R-TX), the ranking member of the House Judiciary Committee. [Some lawmakers wanted the provision applicable only to subprime mortgages.]

- In a statement following the passage of H.R. 1106, Representative Scott Garrett (R-NJ) said, “...Mortgage cram downs incentivize bankruptcy, increase the cost of homeownership for future borrowers, and add greater uncertainty to the marketplace. The U.S. economy will not rebound until the housing market makes a full correction and certainty is restored to our financial markets. This cram down legislation stands in the way of accomplishing both tasks: it artificially props up home prices and adds increased uncertainty to the marketplace, thus barring the entry of private capital. Individuals and families looking to purchase a home in the future also have cause for concern with this legislation, as the increased risk of mortgage lending resulting from this legislation will require future borrowers to pay higher down payments and interest rates for their mortgages. Mortgage cram down legislation is counterproductive as we are trying to encourage potential homeowners to venture back into the housing market.” (*Bureau of National Affairs*, Mike Ferullo and Eileen Williams, 03/06/09; *Bloomberg News*, Dawn Kopecki, 03/06/09; *CQ Today*, Phil Mattingly, 03/05/09; *HousingWire*, Paul Jackson, 03/05/09; *Representative Scott Garrett Press Release*, 03/05/09; *American Banker*, Stacy Kaper, 03/06/09; *CQ Today*, Phil Mattingly, 03/12/09; *Debevoise & Plimpton LLP’s Opinion on the Constitutionality of Section 124 of H.R. 1106*, Wolcott B. Dunham, Jr., George E.B. Maguire, and Carl Micarelli, 03/11/09)

Fate of mortgage cram down is uncertain in the Senate

- Although H.R. 1106 passed the House by a wide margin, its future is less clear in the Senate. Bankruptcy cram down legislation has faced strong resistance in the past and proposals to further narrow the House language could take shape over the next few weeks. Senate Majority Whip Richard J. Durbin (D-IL), who is serving as point man on the bankruptcy provision, is working hard, attempting to find a compromise through negotiations with moderate members in the chamber. Durbin’s staff said it is starting to become clear that the House-passed provision, “narrowed” as it was, may still be too broad to attract the necessary votes in the Senate. “We have realized the reality of the political landscape,” said a Durbin aide.
- Senator Arlen Specter (R-PA), ranking member of the Senate Judiciary Committee, is working with Senator Evan Bayh (D-IN) to craft a compromise cram down mortgage amendment, applicable only to non-traditional and subprime mortgages issued between January 1, 2004 and December 31, 2007. The major provisions of a draft of the Bayh-Specter mortgage amendment include (i) restricting modifications only to

homeowners with sufficient income to cure all defaults and maintain payments on their mortgage during the three to five year period of the Chapter 13 plan; (ii) permitting judges to modify the terms of the mortgage to make payments not less than 31% and not more than 38% of the borrower's monthly income; (iii) permitting a cram down of mortgage principle only if adjusting the interest rate and extending the payment period does not reduce the mortgage payment to between 31% and 38% of the borrower's monthly income; (iv) [in the event of a cram down] reducing the mortgage principal to its fair market value using an appraisal approved by FHA or by up to one-third, whichever is less ; (v) prohibiting cram downs in the event of fraud or misrepresentation by the debtor or if a loan modification has already been obtained; (vi) permitting the lender to recapture any appreciation in the value of the home up to the original amount of the mortgage, if the house is sold during the life of the loan; and (vii) restricting the cram down provision to within a three year period following the date of enactment.

- H.R. 1106 has been referred to the Senate Banking Committee for possible consideration. It is unclear if the bill will be marked up by Committee or if Durbin is able to negotiate a compromise agreement which would allow the bill to skip the committee process all together. If a deal is not struck soon, the bill could have to wait until after the Senate's two week recess, beginning April 6th. In comments before the Consumer Federation of America, Senate Banking Committee chairman Christopher Dodd (D-CT) said, "We're going to try to get that adopted in the next couple of weeks." (*Bureau of National Affairs*, Mike Ferullo and Eileen Williams, 03/06/09; *Bloomberg News*, Dawn Kopecki, 03/06/09; *CQ Today*, Phil Mattingly, 03/05/09; *HousingWire*, Paul Jackson, 03/05/09; *Representative Scott Garrett Press Release*, 03/05/09; *American Banker*, Stacy Kaper, 03/06/09; *CQ Today*, Phil Mattingly, 03/12/09)

Unintended consequences in the prime mortgage market

- In the March 9th issue of *U.S. Structured Finance Newsletter*, DBRS analyst Bernard Maas wrote, "...Given the increased loss potential as a result of judicial principal reductions, investors in senior class prime and near-prime RMBS face considerable write-downs and rating downgrades. H.R. 1106 attempts to mitigate investor concern by rendering carve-outs as unenforceable. That is, if H.R. 1106 were to become law, cram-down losses would follow normal loss allocation rules in reverse sequential order (i.e., from the bottom up) as they already do for RMBS structured as senior-subordinate with overcollateralization. In the current situation, bankruptcy losses that exceed a stipulated carve-out limit will result in an unanticipated write-down to the senior RMBS class, which would not have otherwise taken credit losses at such time."
- "Investors in senior class prime and near-prime RMBS may take comfort once carve-outs are declared unenforceable under H.R. 1106; however, bankruptcy losses could spike and eventually erode subordination altogether. Currently, a borrower with

secured debt exceeding \$1,010,650 and unsecured debt exceeding \$336,900 is ineligible for Chapter 13 relief. H.R. 1106 notably eliminates the secured debt limit, which starkly contrasts with (1) efforts in the U.S. Senate that intend only for subprime borrowers to be cram-down eligible and (2) the Obama administration's Making Home Affordable program, which targets conforming balance mortgages on owner-occupied properties. Prime mortgagors, once characteristic of highly qualified borrowers, have shown deterioration in the ability to service high-balance mortgage debt amid a deepening recession. Thus, senior class RMBS could face additional loss exposure and rating downgrades from prime borrowers who are ineligible for recently expanded conforming balance limits." (*U.S. Structured Finance Newsletter*, Bernard Maas, 03/09/09)

FASB Chairman Hertz promises new guidance on fair value accounting in three weeks

Representatives Perlmuter and Lucas introduce legislation
to create the Federal Accounting Oversight Board

Marked-to-market accounting is the principle reason
why our financial system is in a meltdown

FASB Chairman Hertz promises new guidance on fair value accounting in three weeks

- In a hearing before the House Financial Services Capital Markets Subcommittee, Financial Accounting Standards Board chairman Robert Hertz promised that his board will issue further guidance on valuing financial assets in illiquid and inactive markets [FAS 157], which emphasizes a focus on cash flow analysis rather than trying to deduce a trading price in inactive markets. Hertz committed to issuing the guidance after Committee chairman Paul Kanjorski (D-PA) told the FASB chairman that Congress would legislate authority for greater flexibility in applying fair value accounting if FASB failed to act within that timeframe. House Financial Services Committee chairman Barney Frank (D-MA) also urged Hertz to take quick action, saying, "We do have to have you move now. You are the FASB. In this one, you can't be the slow-B."
- Initially, Hertz said FASB would propose the additional guidance "in early April for comment," but Kanjorski countered that wasn't good enough, since three bills intending to provide more flexibility in applying mark-to-market accounting currently are pending in the House. "I guarantee you that one of those pieces of legislation is going to become law before early April [unless FASB acts]," said Kanjorski. "We can ...no longer deny the reality of the pro-cyclical nature of mark-to-market accounting... [marked-to-market accounting] has produced numerous unintended consequences, and it has exacerbated the ongoing economic crisis. If the regulators and standard setters do not act now to improve the standards, then the Congress will have no other option than to act itself." Kanjorski urged that some form of mark-to-

market accounting be retained, since it “does provide transparency for investors, but its strict application in the current environment is, in too many instances, distorting, rather than clarifying the picture.”

- Hertz told the panel that the application of FAS 157 had focused on the wrong criteria during a period of illiquid markets. He said, “You ought to be doing cash flow projections, but somehow, it’s implemented on a last-trade basis. That’s not the intent. [FAS 157] has the ability to do cash-flow modeling rather than just take prices in the market that might have been fire sales ... that you don’t really know. We have told people repeatedly that [FAS 157] is not a last-trade model, particularly in these kinds of markets, yet for some reason that keeps on happening.”
- Kanjorski said his panel will hold a hearing the week of April 20 to review FASB’s progress in providing the additional guidance on marked-to-market accounting. If the committee is not satisfied, Congress probably will legislate anyway, said Kanjorski. Herz said he would discuss the situation with other FASB members. “I’ve heard you, I’ve heard you very clear,” said Hertz. James Kroeker, the acting chief accountant for the SEC, said his staff would work with FASB to help issue the additional guidance on FAS 157 “within [the three week] time frame.”
- During a break, Kanjorski told reporters that he and other lawmakers are not out to suspend marked-to-market accounting. “All we’re trying to do is not have the [accounting] purists win out, and have, ‘Damned be all, we’re going to stay with the rule as it is presently being applied, and we don’t want to repeal the rule,’” said Kanjorski. “If they have to define better ways of doing it, to move toward the center, and I think maybe FASB can do that, maybe accountants should call a summit meeting and discuss what’s wrong. We don’t know. And we shouldn’t be the accountants and we shouldn’t be the rule makers.” (*Bureau of National Affairs*, Steven Marcy, 03/13/09)
- Senate Banking Chairman Christopher Dodd warned against a “congressional response.” to the controversy over marked-to market accounting because authority over accounting standards lies with FASB. “I have been vehemently opposed to Congress getting into the business of accounting standards,” said Dodd. However, he spoke favorably about giving federal regulators additional flexibility to modify an accounting rule during times of crisis. “You would have to define in some ways what [crisis times] are, so you don’t interrupt the mark-to-market functions on a normal basis,” said Dodd in a speech before the U.S. Chamber of Commerce. He agreed with others who are urging FASB and the SEC “to provide relief by temporarily suspending or relaxing FAS 157 until the financial crisis subsides. (*CongressDaily*, Bill Swindell, 03/11/09; *Bureau of National Affairs*, Malini Manickavasagam, 03/12/09; *Financial Times*, Tom Braithwaite and Sarah O’Connor, 03/13/09)
- During a March 6th Council of Foreign Relations meeting, Federal Reserve Board chairman Ben Bernanke said current accounting and capital policies for financial institutions are excessively “pro-cyclical” and should be reformed. Determining asset

values in illiquid markets can be “very difficult, to put it mildly,” said Bernanke, but added he’s encouraged that the accounting standard setters propose to move “expeditiously.” in their efforts to improve mark-to-market accounting. “[F]urther review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their pro-cyclical effects without compromising the goals of disclosure and transparency,” said Bernanke. (*National Mortgage News*, 03/10/09)

Representatives Perlmutter and Lucas introduce legislation to create the Federal Accounting Oversight Board

- On March 5th, Representatives Ed Perlmutter (D-CO) and Frank Lucas (R-OK) introduced H.R. 1349, which would to create a new Federal Accounting Oversight Board (FAOB) to assure that U.S. generally accepted accounting principles are being applied correctly to the financial markets. The legislation would create a five member board, comprised of the chairman of the Federal Reserve, the secretary of the Treasury, the chairman of the SEC, the chairman of the FDIC, and the chairman of the Public Company Accounting Oversight Board, which would be charged with considering a “broad national and international financial markets and economic conditions when applying GAAP.” The legislation would provide “for discretion in the regulatory community to consider the overall condition of the financial markets in applying GAAP so the principles are not applied in a way that exaggerates or multiplies cycles in the markets.” H.R. 1349 would not change GAAP, but instead would create “an environment where [the FASB] will have the tools and flexibility it needs to adjust GAAP for future economic conditions,” said Perlmutter and Lucas. “The FAOB would fit into responsible regulatory reform because a broader group of individuals with a view of the greater economy should be in charge of applying GAAP, said the lawmakers.”
- Perlmutter and Lucas said, “[F]or the safety and soundness of the American financial system, regulators must have the tools to judge the value of assets being held to maturity. Arbitrarily decreasing capital levels of financial institutions puts our communities at risk by causing some financial institutions to show an artificial undercapitalization which prevents them from lending money to businesses and individuals. However, it is critical for investors to have data regarding the assets held by these financial institutions. This legislation allows for both.”
- American Bankers Association president Edward L. Yingling, said today’s financial crisis has escalated concerns among financial institutions “over the narrow focus of oversight for accounting standards by the SEC through the Financial Accounting Standards Board.” Yingling added, “The lack of timely and effective action on mark-to-market accounting in particular is seen as having been a key factor in exacerbating the current economic crisis. [Financial Institutions have been] forced to report market losses rather than economic losses, resulting in a continuous downward spiral of market prices and further losses. The current framework for accounting oversight, though well intentioned, has proved inadequate and must be fundamentally revised in

order to provide transparent information for the benefit of investors, customers, and the public. ...The Perlmutter-Lucas bill represents much-needed reform that will help address systemic risks that accounting standards can have on the economy. This bill also calls for a proper cost benefit analysis before changes are made to accounting standards.” (*Bureau of National Affairs*, 03/09/09)

Marked-to-market accounting is the principle reason why our financial system is in a meltdown

- In a March 6th commentary in the *Wall Street Journal*, Steve Forbes wrote, “What is most astounding about President Barack Obama’s radical economic recovery program isn’t its breadth, but its continuation of the most destructive policies of the Bush administration. These Bush policies were in themselves repudiations of Franklin Delano Roosevelt, Mr. Obama’s hero.”
- “The most disastrous Bush policy that Mr. Obama is perpetuating is mark-to-market or ‘fair value’ accounting for banks, insurance companies and other financial institutions. The idea seems harmless: Financial institutions should adjust their balance sheets and their capital accounts when the market value of the financial assets they hold goes up or down. That works when you have very liquid securities, such as Treasuries, or the common stock of IBM or GE. But when the credit crisis hit in 2007, there was no market for subprime securities and other suspect assets. Yet regulators and auditors kept pressing banks and other financial firms to knock down the book value of this paper, even in cases where these obligations were being fully serviced in the payment of principal and interest. Thus, under mark-to-market, even non-suspect assets are being artificially knocked down in value for regulatory capital (the amount of capital required by regulators for industries like banks and life insurance).”
- “Banks and life insurance companies that have positive cash flows now find themselves in a death spiral. Of the more than \$700 billion that financial institutions have written off, almost all of it has been book write-downs, not actual cash losses. When banks or insurers write down the value of their assets they have to get new capital. And the need for new capital is a signal to ratings agencies that these outfits might deserve a credit-rating reduction.”
- “So although banks have twice the amount of cash on hand that they did a year ago, they lend only under duress, or apply onerous conditions that would warm Tony Soprano’s heart. This is because they know that every time they make a loan or an investment there is a risk of a book write-down, even if the loan is unimpaired.”
- “If this rigid mark-to-market accounting had been in effect during the banking trouble in the early 1990s, almost every major commercial bank in the U.S. would have collapsed because of shaky Latin American and commercial real estate loans. We would have had a second Great Depression.”

- “But put aside for a moment the absurdity of trying to price assets in a disrupted or non-existent market, of not distinguishing between distress prices and ‘normal’ prices. Regulatory capital by its definition should take the long view when it comes to valuation; day-to-day fluctuations shouldn’t matter. Assets should be kept on the books at the price they were obtained, as long as the assets haven’t actually been impaired.”
- “Mark-to-market accounting does just the opposite. When times are good, it artificially boosts banks’ capital, thereby encouraging more investing and lending. In a downturn it sets off a devastating deflation.”
- “Mark-to-market accounting is the principle reason why our financial system is in a meltdown. The destructiveness of mark-to-market -- which was in force before the Great Depression—is why FDR suspended it in 1938. It was unnecessarily destroying banks. But bad ideas never die. Mark-to-market was resurrected by the Financial Accounting Standards Board and became effective in the fall of 2007 (FASB rule 157) to the approval of the Bush administration, its Treasury Department, and the Securities and Exchange Commission. Even as FASB 157 began to take its toll on financial institutions last year, Mr. Bush refused to kill or suspend it. When Congress voiced displeasure last fall, the administration and regulatory authorities made some cosmetic changes, but the poisonous essence remained.”
- “Another horrific Bush policy that Mr. Obama has left untouched concerns short selling. In 1938, the SEC, created by FDR, enacted the so-called uptick rule, which held that investors could not short a stock unless it went up in price. In July 2007, the SEC, whose commissioners were handpicked by the White House, got rid of the rule. Market volatility exploded.”
- “Compounding this lunacy was the SEC’s inexplicable failure to enforce the rule against ‘naked’ short selling. Before an investor can short a stock, he is supposed to borrow the shares and pay a broker or stockholder a fee. What sellers soon realized was that the SEC was turning a blind eye to naked short-selling, thus adding even more pressure to beleaguered bank equities. Short sellers quickly saw how mark-to-market made seemingly invincible companies vulnerable to destruction. They picked their targets and relentlessly sold financial stocks short.”
- “If the president really takes Roosevelt’s legacy seriously, he should suspend mark-to-market accounting rules, restore the uptick rule, and enforce the prohibition against naked short selling. If he doesn’t, historians will look back in utter amazement at Mr. Obama’s preservation of Mr. Bush’s worst economic policies.” (*Wall Street Journal*, Steve Forbes, 03/06/09)

President Obama signs the Omnibus bill with the TILA provision, but Senator Dodd assures fellow lawmakers that the provision will be fixed later

- On March 11th, President Barack Obama signed into law the omnibus spending bill (H.R. 1105), containing a provision that gives the Federal Trade Commission and state attorneys general authority to regulate independent mortgage brokers. This provision [Section 626] would have the FTC and state attorney generals enforce the Truth in Lending Act and certain other mortgage laws on independent mortgage brokers and other non-bank entities that write mortgages.
- The *American Banker* reported, “Lawmakers sent a novel message last week to nervous banking industry representatives raising concerns about a provision in an appropriations bill that would give state attorneys general the right to examine national banks: Just ignore it, we’ll fix it later. Banking lawyers ...said the provision is vaguely worded and would let the [FTC] write mortgage lending rules that would apply to banks and could be enforced by state attorneys general. Though the measure’s sponsor, Senator Byron Dorgan, D-N.D., insists it is aimed only at nonbanks, the industry worked overtime trying to scuttle the provision. Fearful of holding up the budget, however, lawmakers put off making any changes in the provision. Instead, they offered a promise that the measure does not apply to banks.”
- “Senator Mike Crapo, R-Idaho, withdrew an amendment to remove the language after Senate Banking Committee Chairman Chris Dodd and Dorgan promised him the measure did not say what he and others think it says. And just to make sure, they promised they will fix it later. ‘It is my understanding we have an agreement ...that will establish that we do not want to change the regulatory authority and the jurisdictional structures we now have for our federal regulators over our depository institutions ...and that we will, in a very expedited manner in the next available option for a legislative vehicle, make statutory changes to correct that.’ Dodd said he would get right on it. ‘Our intent is, at the earliest possible time, we will have legislation to correct what is in this bill and change that,’ he said.” (*American Banker*, Stacy Kaper and Cheyenne Hopkins, 03/09/09; *Bureau of National Affairs*, Jeff Day, 03/06/09; *Washington Post*, Binyamin Appelbaum, 03/04/09)

TARP

Treasury and Federal Reserve launch the Term Asset-Backed Securities Loan Facility

- On March 3rd, the Treasury Department and Federal Reserve launched the Term Asset-Backed Securities Loan Facility (TALF) to deploy \$200 billion of loans to revive the market for securitized consumer and business loans, including automobiles, small businesses, credit cards, and education loans. Ultimately, TALF could be expanded to include commercial real estate loans and possibly residential mortgages, said government officials. Starting March 17th, the Fed will provide low-cost financing to large investors—including hedge funds and private equity funds—buying newly-issued AAA securities secured by consumer and business loans, as a means of stimulating demand in these seized markets. Treasury has seeded the TALF with \$20 billion from its TARP funds. Ultimately, Treasury’s funding could increase the TALF funding to \$200 billion, which could generate \$1 trillion of new liquidity in the marketplace. Subscriptions for the first round of TALF funding are due by March 17th with funds being awarded by the New York Fed on March 25th.
- The Fed has “sweetened” some TALF terms to attract investors. For example, participants in TALF will not have to adhere to the executive compensation restrictions which apply to financial institution executives participating in TARP. “There were some issuers that we had spoken to that were not going to participate because of the executive compensation restrictions,” said Michael Wade, head of asset securitization for the American division of Barclays Capital. “The removal of those restrictions is a huge benefit to the plan.” In addition, the Fed also lowered the interest rates and “haircuts” [losses absorbed by the investors if the loans soured] for loans guaranteed by SBA or for government-guaranteed student loans.
- In a speech before the Council on Foreign Relations, New York Federal Reserve president William Dudley said the TALF will be implemented in a two stage process. In the first stage, the Fed will target its purchases for consumer debt and business loans. During the second stage, the TALF program will be expanded to create demand for other types of securities, such as low- and high-rated securities, and problem loans on the banks’ balance sheets. (*Bureau of National Affairs*, Aaron Lorenzo, 03/09/09; *Wall Street Journal*, Justin Lahart, 03/07/09; *Washington Post*, Neil Irwin, 03/03/09; *Bureau of National Affairs*, Aaron Lorenzo, 03/04/09; *Financial Times*, Arline Van Duyn, 03/04/09; *Wall Street Journal*, Liz Rappaport and Jon Hilsenrath, 03/04/09)
- In a March 10th interview on the *Charlie Rose Show*, Treasury Secretary Timothy Geithner said, “...[TALF is] going to be sustained over a long period of time. Although we’re beginning with the program, this targeted small business lending, student lending, auto finance, consumer credit markets, we’re going to expand that program in terms of the scope of types of financial assets. We’re going to provide

financing and expand the scale, could get as large as a trillion dollars. This is the largest program you've seen in any country, in any period of time, and it's a very important thing. Because it goes around the banking system to try to get the securities markets working again. Those markets typically provide 40% of the financing for, again, businesses and families. And they're not working now the way they need to work. And this is a necessary thing..." (*Charlie Rose Show*, 03/10/09)

- In a March 4th *Wall Street Journal* commentary, Peter Eavis wrote, "If you missed the first hedge-fund boom, now may be the time to put up your shingle. Looking at the terms of the Federal Reserve's new Term Asset-Backed Securities Loan Facility, investors using it should be able to generate hefty returns with little risk. The TALF effectively turns the Fed into a generous prime brokerage. The central bank lends money for up to three years to investment firms to buy bonds backed by assets like auto or credit-card loans."
- "...The TALF ladles out ...leverage, and it may well work in kick-starting the moribund market. For instance, investors can borrow \$92 million to buy \$100 million of bonds backed with prime auto loans. An investment firm would have levered its equity over 12 times, which could provide annual returns of over 20% on prime-auto ABS assuming no credit impairments. What's more, the Fed, unlike a bank, won't demand the investor post collateral if the ABS market value falls over the three-year life of the loan."
- "What could go wrong? There is the risk of political outcry if investors reap massive gains. From a macroeconomic perspective, the TALF could distort the consumer deleveraging necessary for a lasting economic recovery. Specific to the TALF itself, much depends on getting the pricing right. Hedge funds may want sweet returns, but issuers are going to want to issue at the lowest-possible interest rate. And since plenty of issuers can borrow cheaply elsewhere right now, some can hold out and keep loans on their own books."
- "Lenders also may balk at the fact they can only issue triple-A-rated securities to TALF-funded buyers, meaning they have to retain lower-rated, riskier slices of the bond. That is good because lenders are likely to be more careful when making the loan it will then package up. But it could also hamper their appetite to issue large amounts of securitized product"
- "Perhaps the biggest risk is that TALF sucks liquidity away from other important segments of the debt markets, like longer-term corporate bonds. The Fed could get round this by broadening the TALF to include more types of assets. But that sucks it ever further into supporting credit markets."
- "The best outcome is that the TALF acts as a spark to rekindle the broader securitization market. But if credit markets remain sickly, the Fed faces the uncomfortable prospect of being 'prime broker' to a huge investor base for years to come." (*Wall Street Journal*, Peter Eavis, 05/04/09)

Treasury's "bad bank" funding plan comes into focus

How Treasury can price banks' troubled assets

Too big to fail?

- During testimony before the Senate Banking Committee, Treasury Secretary Timothy Geithner outlined his agency's plans to structure a public-private partnership for the purchase of banks' toxic assets. "We are going to lay out within the next couple weeks details of a new program that would marry government financing, in this case from the mix of the Fed and the FDIC, alongside some capital from the government and some private capital to help provide financing to help unfreeze those markets for legacy assets," said Geithner. The new plan would help the government avoid overpaying for toxic assets and would put private capital in place to absorb losses on them, he said. "By using private capital along with public capital, you can reduce the risk that the government ends up dramatically overpaying for those assets, taking risks that we cannot understand and manage, doing so at greater cost to the taxpayer. ... Our program has these three critical elements, again: A program of capital as a bridge to private capital; very direct support to get these credit markets opening up again; and a carefully designed program of government financing alongside private capital to help unfreeze these markets for legacy assets."
- While no decision has been made yet on the final structure of the program, the "leading idea" for the private-public partnership to establish separate funds run by private investment managers that would invest some level of capital to the venture. Multiple funds, which would compete with one another, would create a market to determine market prices. The government would provide the partnership seed funding from TARP and additional financing (likely) from the Federal Reserve through its sale of government-backed debt. In exchange, the government would share in any profits and losses from the partnership. To encourage other investors to participate, the government would try to minimize the private investors' risk, possibly by offering the partnership non-recourse loans. Many details of the program are unclear—particularly how the government and private sector will share risk. The administration's key goal is to provide investors with "price safety" so they are comfortable reinvesting in the market, said a government official. The administration is also considering whether to expand the TALF program into funding [distressed] "legacy assets." from banks to help unclog the credit markets. (*Wall Street Journal*, Deborah Solomon and Jon Hilsenrath, 03/03/09; *American Banker*, Emily Flitter, 03/05/09; *Washington Post*, Binyamin Appelbaum, 03/10/09)

How Treasury can price banks' troubled assets

- In a February 26th commentary in the *Wall Street Journal*, AEI fellow Peter J. Wallison argued that the taxpayers, commercial banking system, and our economy

can “come out well” if the government were to buy the banks’ distressed assets at their “net realizable value,” based upon an assessment of the assets’ current cash flows, discounted by their expected credit losses over time. Wallison wrote, “...If the losses on banks’ assets are principally liquidity losses, they are temporary, and the only significant issue is whether the banks have the financing to carry the assets until liquidity returns to the asset-backed market. And if this is indeed the case, the banks are not in any sense insolvent, and nationalization would be a huge mistake. On the other hand, if the government were to buy the assets at their net realizable values—rather than their marked-down values--this would significantly improve the capital positions of the major banks.”

- “A hint of the true situation was contained in a remark by Vikram Pandit, the CEO of Citibank, in testimony before the House Financial Services Committee... He noted that Citi marks to market and that ‘those marks are reflected in the losses we’ve taken, as well as in our income statements and balance sheets.’ But Mr. Pandit then went on to point out that the bank has a duty to shareholders: ‘And the duty is if it turns out [the assets] are marked so far below what our lifetime expected credit losses are’—i.e., their net realizable value—‘I can’t sell [them].’ In other words, Citi has marked some assets below their net realizable value, and selling them at a price lower than that value would be unfair to its shareholders. This opens a key route to a solution for the government--buying the assets at the value that banks like Citi would be willing to sell them.”
- “Would the taxpayer be hurt if the government buys these troubled assets at these values? Not likely. The banks have already made an assessment of the assets’ net realizable values, as Mr. Pandit suggests was done at Citi. The government can quickly verify the accuracy of these valuations, including the rates used for discounting, and can of course come up with its own lower valuation if it disagrees. But the important point is that if the banks’ net realizable values are even close to correct, taxpayers will not lose much, if anything, if the government bought the assets at those values. Because their cash flows determine their value, the government should be able to sell the assets in the future at roughly what it paid for them. But the key benefit is the boost in the banks’ capital which comes from a sale now. This would eliminate doubts about banks’ solvency and free up their ability and willingness to lend again.”
- “If this is a win-win for the banks and the government, why is it that no one has thought about doing this before? Part of the answer is that the question has been phrased incorrectly. Most of those who recognize the problems created by mark-to-market accounting have asked that the system be suspended. This has run into opposition from the accounting industry and investor groups, who are afraid that it will be a license for banks to manipulate their financial statements. But no change in mark-to-market accounting is necessary for the government to buy the assets at net realizable value, only a decision to buy the assets at the value they would have if there were a liquid market. Unlike a private buyer, the government does not have to worry about selling at any particular time, since it can hold the assets indefinitely.”

- “Finally, one might ask why Mr. Geithner is claiming he needs more time to do something so simple and seemingly effective. The answer here, unfortunately, is that he seems to be barking up the wrong tree. Mr. Geithner may believe that the banks have not written their assets down below their net realizable value. Or he may believe that others believe purchasing these troubled assets at net realizable value will be unfair to the taxpayers, and he doesn’t want the criticism if he does so. That would explain why he is enlisting the private sector to make the pricing decision.”
- “But Mr. Geithner should check his premises. There’s a solution to his problem, the banks’ problem and the economy’s problem right in front of him.” (*Wall Street Journal*, Peter J. Wallison, 02/26/09)

Too big to fail?

- Asset sales to the public-private partnerships would occur, as a result of the stress test being performed by Treasury at the 20 largest banks in the country. According to the *Institutional Risk Analysts*, these banks likely include JPMorgan Chase & Co, Bank of America, Citigroup, Wells Fargo & Company, Morgan Stanley, PNC Financial Services Group, U.S. Bancorp, Bank of New York Mellon, SunTrust Banks, Inc., State Street Corporation, Goldman Sachs Group, Capital One Financial Corporation, BB&T Corporation, Regions Financial Corporation, Fifth Third Bancorp, American Express, Keycorp, Northern Trust Corporation, and Comerica Incorporated.
- During an interview on the *Charlie Rose Show*, Geithner discussed the banks’ stress test and what actions his agency might take, based upon the test results. Of the 20 banks taking the stress test, Geithner said “Some [of these banks] have a lot of capital and were very careful and prudent. Some may need some modest additional capital and are going to want to raise that in the market. And some may need significant amounts of capital. We are going to ...provide that [capital] on terms that make sure we’re protecting the taxpayer that these guys are cleaning up their institution, [and] that ...we have accountability for the mistakes up to this point. And this is very important, so that these institutions can return, can replace our investments, our private capital as quickly as possible. We want the government involvement to be temporary and short lived with a clean, quick exit strategy so that these positions, these firms are back operating with a stronger financial foundation, with private capital as quickly as possible. And we’re going to make it very clear as they go through this, that government is going to stand behind the system and make sure they have the go through this that government is going to stand behind the system and make sure they have the ability to meet their commitments.”
- “...My obligation is to protect the financial security of the American people and to ensure that this financial system does what it needs to do to help get recovery, get back on track. Everything we do is guided by that basic purpose. So where we put assistance in, it’s because we think that is necessary and essential to try to make sure

there is more lending capacity so that recovery can get traction quickly. That's what's going to guide our approach going forward."

- When asked by Rose if these 20 banks are "too big" to fail, Geithner responded that these banks account for the "vast bulk" of lending in the U.S. and account for between "two thirds and three quarters of the banking system as a whole now. Geithner added, "Their role is essential. We want to make sure they're able to continue to play that role going forward. This is a very important thing to understand. What the world is going through is really without precedent in generations. The scale of the pressure on economies global is so acute, the kind of pressures you're seeing across businesses are so acute that it is very important, and the best most effective way to get the recovery established is to make sure the financial system is doing what it needs to do to support recovery. That's what's going to guide everything we do in this country."
- Rose followed up, asking, "But I didn't hear the answer to whether these banks are too big to fail. Are they so crucial to the American economy? We're talking about Bank of America which is deep trouble. Citigroup, which is in trouble. Are they too big to fail?"
- The Treasury Secretary responded, "I'll say again, they play a critical role in our markets, in our financial system. We want to continue to make sure they play that role. Now, where they need temporary assistance through the government to get through that, we're going to make sure it comes with appropriately tough conditions so that they emerge stronger and that we're providing a level of conditions and accountability that's appropriate in this context." (*Charlie Rose Show*, 03/10/09)

Treasury's Kashkari urges lawmakers not to "micromanage" TARP participants
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- In testimony before the House Oversight Subcommittee on Domestic Policy, Neil Kashkari, the interim assistant Treasury secretary for financial stabilization responsible for administering TARP, deflected lawmakers complaints about the foreign lending activities of bailout recipients. "Government officials are not positioned to make better commercial decisions than lenders in our communities. The government must not attempt to force banks to make loans whose risks they are not comfortable with or attempt to direct lending from Washington," said Kashkari. He also cautioned that any move to restrict banks from lending abroad could spark retaliation abroad. Treasury should "take great care not to micromanage recipient institutions," said Kashkari. (*Financial Times*, Sarah O'Connor, 03/12/09; *Bureau of National Affairs*, Mike Ferullo, 03/12/09; *CQ Today*, Benton Ives, 03/11/09)
- Some bankers are saying that the conditions placed on the TARP funds have become so onerous that they want to return the federal funds. The list of institutions that have made such public statements now includes Northern Trust of Chicago, IL, US Bancorp of Minneapolis, MN, TCF Financial of Wayzata, MN, Iberiabank of

Lafayette, LA and Signature Bank of New York, along with “giants” Goldman Sachs, Wells Fargo, U.S. Bank (San Francisco), who all plan to return the TARP funds as soon as possible. In addition, a growing number of community banks, including Johnson Bank of Racine, WI, Oak Financial Corp. of Byron, MI, and Red River Bancshares of Alexandria, LA—which had expressed an interest in receiving TARP funds and changed their mind. Their biggest concern appears to be that program allows Congress and the administration to pile on new conditions for participants at any time. Other bankers expressed concern that the “spirit of [the TARP] deal has changed.” Blake Chatelain, president and CEO of Red River Bancshares said, “Along the way the entire spirit of the deal changed to ‘if you are taking the money from the government then you did something wrong and we are going to control you.’”

- A growing number of industry experts also warn that utilizing weak banks to carry out the government’s economic and social policies ultimately could increase the drain on taxpayers. “We are taking an approach that wants the banks to help the economy and whether it is ultimately good for a particular bank is secondary,” said former FDIC chairman L. William Seidman. “Weak banks are being asked to do things that will erode their position.” Brookings fellow Douglas Elliott said, “I honestly believe the people in power pushing this policy see it as a win-win—as something that is good for the banking industry and good for homeowners and others. But there is a slippery slope and there are potentially significant negative consequences.” (*New York Times*, Stephen Labaton, 03/11/09; *HousingWire*, Diana Golobay, 03/06/09; *American Banker*, Bonnie McGeer and Marissa Fajt, 02/27/09; *American Banker*, Katie Kuehner-Hebert, 03/05/09)

The bailout black hole: \$170 billion and counting at AIG

- At a March 3rd Senate Banking Committee hearing, Federal Reserve chairman Ben Bernanke told lawmakers: “If there is a single episode in this entire 18 months that has made me more angry, I can’t think of one other than AIG. AIG exploited a huge gap in the regulatory system, there was no oversight of the financial-products division, this was a hedge fund basically that was attached to a large and stable insurance company.” Today, the federal government’s bailout of AIG has swelled to \$170 billion, bringing government ownership to nearly 80%.
- At a March 5th Senate Banking Committee hearing, members were thrown into “near panic,” when they concluded that the support programs put into place for AIG are unsustainable. Committee chairman Christopher Dodd (D-CT) said, “These [CDS] payments aren’t sustainable under any set of circumstances. There must be changes and there must be changes.” Federal Reserve vice chairman Kohn told lawmakers that the central bank plans to continue to buy AIG’s CDSs at par, but refused to disclose the names of the counterparties which are confidential. Kohn argued that disclosing the counterparties might drive business away from AIG and worsen turmoil in the financial markets. The lawmakers demanded that Treasury and the Fed

come up with answers addressing their concerns to bring this “runaway freight train” under control. There will be no more bailout funds made available, said a number of the panel members, until satisfactory answers are provided to address the lawmakers’ concerns.

- Under pressure to reveal how it has spent government bailout funds, AIG disclosed (on March 16th) counterparty information pertaining to the \$105 billion it has paid to U.S. states and banks, led by Goldman Sachs Group Inc. (\$12.9 billion), Societe Generale SA (\$11.9 billion) and Deutsche Bank AG (\$11.8 billion), Barclays Plc (\$8.5 billion), Merrill Lynch (\$6.8 billion), Bank of America (\$5.2 billion), and UBS AG (\$5 billion). Banks that bought credit-default swaps or traded securities with AIG received \$22.4 billion in collateral, \$27.1 billion in payments from a U.S. entity to retire the derivatives, and \$43.7 billion tied to the securities-lending program, said the insurer. States have received \$12.1 billion tied to guaranteed investment contracts from AIG.
- Recent disclosures about AIG’ s compensation and bonuses programs triggered *another* firestorm on Capitol Hill over the government’s management of the failed insurer. In a March regulatory filing, AIG disclosed that it plans to spend as much as \$1 billion to retain key employees while the company sells its business units. Under pressure from Treasury, AIG had scaled back the bonus plans and pledged to reduce 2009 bonuses by 30%, in an effort to assuage lawmakers’ outrage over the initial compensation plan. White House officials and lawmakers lambasted the insurer for its plans to award \$165 million in retention pay to employees. On the Sunday morning television talk shows, Congressional leadership and Obama administration officials vowed to explore legal options to prevent the payout of AIG’s bonuses.
- On March 16th, President Barack Obama instructed Treasury Secretary Timothy Geithner “pursue every legal avenue” to block the payment of the \$165 million of bonuses to AIG executives. In a statement, Obama said, “This is a corporation that finds itself in financial distress due to recklessness and greed. Under these circumstances, it’s hard to understand how derivative traders at AIG warranted any bonuses, much less \$165 million in extra pay. How do they justify this outrage to the taxpayers who are keeping the company afloat? This isn’t just a matter of dollars and cents. It’s about our fundamental values.”
- In a March 15th interview on 60 Minutes, Federal Reserve chairman Bernanke said, “It’s absolutely unfair that taxpayer dollars are going to prop up a company that made these terrible bets.” Yet failing to rescue the company would “risk enormous impact, not just in the financial system, but on the whole U.S. economy,” said Bernanke. (*Bloomberg News*, Hugh Son and Robert Schmidt, 03/16/09; *Wall Street Journal*, Jonathan Weisman, 03/16/09; *Politico*, Lisa Lerer, 03/15/09; *Bloomberg News*, Craig Torres and Hugh Son, 03/03/09; *Reuters*, 03/15/09)

Insurance industry turns to TARP for aid

- With mounting losses weakening insurers' capital and eroding investor confidence, a dozen insurance companies have applied for aid from TARP in hopes of receiving a bank-style bailout in coming weeks. The Dow Jones Wilshire U.S. Life Insurance Index has fallen 59% since the beginning of the year [versus a 21% decline in the Dow Jones Industrial average], with the hardest-hit companies including Hartford Financial, Met Life, and Prudential Financial. The ramifications of a weakened life insurance industry for the national economy are significant. Collectively, the industry is one of the biggest holders of the nation's corporate debt—owning about 18% of all corporate bonds outstanding. (*Wall Street Journal*, Scott Patterson and Leslie Scism, 03/12/09)
- According to *Bridgewater® Daily Observations*, the insurance industry is facing large scale ratings downgrades and negative reviews on their structured products and corporate bonds, which will automatically put the insurers' capital ratios under pressure. *Bridgewater* wrote, "The net result of our analysis is that life insurance industry company losses are in the vicinity of 20% of total assets, while the total amount of capital for the industry is only equal to approximately 10% of total assets." (*Bridgewater Daily Observations*, Bruce Steinberg, Larry Cofsky, Nick Reber, and Jason Rotenberg, 03/05/09)

The 2009 "war" on the economy

- In the *New York Times*, Thomas Friedman wrote, "It's always great to see the stock market come back from the dead. But I am deeply worried that our political system doesn't grasp how much our financial crisis can still undermine everything we want to be as a country. Friends, this is not a test. Economically, this is the big one. This is August 1914. This is the morning after Pearl Harbor. This is 9/12. Yet, in too many ways, we seem to be playing politics as usual. Our country has congestive heart failure. Our heart, our banking system that pumps blood to our industrial muscles, is clogged and functioning far below capacity. Nothing else remotely compares in importance to the urgent need to heal our banks...." (*New York Times*, Thomas L. Friedman, 03/11/09)
- In the *Washington Post*, Steven Pearlstein wrote, "There is still way too much business as usual going on in Washington, on Wall Street and in the media. Not so on Main Street. All indications are that in response to the crisis, consumers have embraced a new frugality, paring debt and cutting consumption they know had become excessive. Businesses are moving to cut back on dividends and stock buybacks they can no longer afford, trim frills and reduce prices and capacity to post-bubble realities."

- “Contrast that with the approach to the crisis taken by members of Congress, who as far as I can tell, have changed nothing about how they go about their duties. Same leisurely three-day work week. Same bloated budgets for staff and security. Same unwieldy committees holding the same meaningless hearings. Same partisan posturing and gamesmanship. Same willingness to put narrow special or parochial interests over the national interest.”
- “Can you imagine a better way to undercut public support for fiscal stimulus and deficit spending than to report out an omnibus spending bill with nearly 9,000 earmarks totaling \$8 billion? But, of course, that is just what the Democratic Congress has done. Americans don’t need to be lectured by the House speaker and the Senate majority leader on the spending prerogatives of Congress. What they need are leaders who can demonstrate, in ways symbolic as well as substantive, that they know the difference between spending that is crucial to the country in times of crisis and spending that is not...”
- “What we are facing is the economic equivalent of a war—a war that caught us by surprise and threatens much of what we have taken for granted. It’s a war we can win, but only if we have leaders and opinion makers who commit to difficult sacrifices, a sustained effort and serious changes in the way things are done.”
(*Washington Post*, Steven Pearlstein, 03/11/09)

<p>TARP’s Congressional Oversight Panel says more federal tax dollars are needed to stabilize the U.S. financial system</p>

- In testimony before the Joint Economic Committee, Damon Silvers, deputy chair of the Congressional Oversight Panel, told lawmakers that the costs to stabilize the U.S. financial system will likely exceed the \$700 billion authorized for TARP and an additional \$250 billion will be needed. Silvers, who is associate general counsel for the AFL-CIO, told lawmakers that an estimated \$3.6 trillion could be needed to recapitalize banks and non-banks alone. He also cautioned that the stimulus package signed into law in February could prove “underpowered.” in face of the ongoing recession and that additional stimulus funds may be needed. Silvers also criticized Treasury for failing to implement specific plans to track the use of TARP funds, despite agency’s officials’ commitment to that principle. (*Bureau of National Affairs*, Aaron Lorenzo, 03/12/09)
- House Financial Services Committee chairman Barney Frank (D-MA) said his panel will move forward within the next month legislation to tighten the rules on mortgage lending, restrict abusive credit card practices, and curb questionable overdraft fees. Specifically, Frank proposes toughened underwriting reforms to ban 100% securitizations of mortgages, provide harsh penalties for offering unaffordable loans, and assign servicers the task of modifying loans to prevent foreclosure. Passage of this legislation will be necessary to muster support from lawmakers to make additional bailout funds available for stabilizing the financial system, said Frank.

“Bankers aren’t going to like it, but they have to understand this,” he said at a press conference. “There will not be the political support in this country to do further things to try and get the credit system flowing ... unless we show the American people that it is not all simply worrying about their psyche, and there is some need to protect people from further ... abuses.” Frank added that the political tide has turned, which will ease passage of stricter standards. “The lobbying by people in this industry was too strong,” said Frank. “That’s changed.” He also said his panel would take a look at revamping the insurance regulatory regime, which is currently overseen by the states. (*American Banker*, Stacy Kaper, 03/13/09; *CongressDaily*, Bill Swindell, 03/05/09; *American Banker*, Stacy Kaper, 03/06/09)

- Separately, the House Financial Services Committee has approved legislation (S. 383) which would broaden the authority of the special inspector general for TARP. In order to speed up passage of the bill through Congress, the committee passed the bill without amendment. S. 383 would (i) give the inspector general authority to hire auditors and investigators quickly; (ii) require the Treasury secretary to explain to Congress why a recommendation from the IG is not followed; (iii) require the IG to report to Congress by September how recipients are spending TARP funds; and (iv) allow the IG to hire up to 25 retired federal investigators and auditors at a time without having to off-set their pensions. (*CQ Today*, Kate Davidson, 03/12/09)

Congresswoman with ties to OneUnited helped bank seek TARP funds

- Treasury officials told the *New York Times* that they were “taken aback” when Representative Maxine Waters (D-CA), chairwoman of the Subcommittee on Housing and Community Opportunity, helped set up a meeting with Treasury officials and the OneUnited officials. The session with nearly a dozen senior banking regulators had been intended to allow minority banks and their trade association to discuss the losses they had incurred on their investments in Fannie Mae and Freddie Mac. Instead, Kevin Cohee, CEO of OneUnited, seized the opportunity to plead for special TARP assistance for his bank. Waters did not disclose to Treasury officials that her husband, Sidney Williams, had served on the OneUnited’s board [until early 2008] and had owned at least \$250,000 of stock in the institution. While the bank did not get the \$50 billion of funds it requested, OneUnited was among the first minority-owned banks to receive TARP funds—\$12 million—in December. Analysts were surprised to see the TARP award to OneUnited, since the program was intended for healthy banks. In October 2008, the FDIC sanctioned OneUnited for “unsafe and unsound banking practices.” and placed the institution under a Consent Agreement. (*New York Times*, Eric Lipton and Jim Rutenberg, 03/12/09)

Treasury staffing news

- According to former Federal Reserve chief Paul Volker, the personnel situation at the Treasury Department is “shameful.” He added, “The secretary of the Treasury is

sitting there without any undersecretaries, without any, as far as I know, assistant secretaries, at a time of very severe crisis.”

- On March 8th, President Obama announced the nominations of David S. Cohen to serve as Assistant Secretary of Treasury, terrorist financing; Alan B. Krueger, as Assistant Secretary of Treasury, economics policy, and Kim N. Wallace, as Assistant Secretary of Treasury, legislative affairs. Cohen was formerly a partner for the law firm, WilmerHale LLP, where he focused on complex civil litigation and white collar criminal fraud defense. Previously, Krueger was an economics professor at Princeton University and a research associate for the National Bureau of Economic Research. Wallace was formerly a managing director of Barclays Capital, where he headed its Washington research group.
- Lael Brainard, deputy national economic advisor for President Clinton, is expected to be nominated to serve as Treasury under secretary for international affairs, said administration officials
- To date, four nominees have withdrawn their names from consideration at Treasury. These former nominees include H. Rodger Cohen, chairman of Sullivan & Cromwell, who was under consideration for deputy Treasury secretary; attorney Annett Nazareth, who was under consideration for a deputy post, former Clinton Treasury official Lee Sachs, who was expected to be under secretary for domestic finance; and IMF official Carline Atkinson, who was in line for undersecretary for international affairs.
- Of the 18 positions at Treasury which require Senate confirmation, Treasury Secretary Timothy Geithner was the only one even nominated as of March 7th. The agency has 50 political appointees who do not require Senate confirmation in place. (*CongressDaily*, 03/11/09; *Washington Post*, David Cho, 03/13/09; *Bureau of National Affairs*, Aaron Lorenzo, 03/10/09; *Washington Post*, Al Kamen, 03/02/09)

TARP obtains office space

- The GSA has signed a lease for 71,000 square feet of office space at 1801 L Street NW for the use of TARP staff. Previously, TARP staff used leased space in buildings near the Treasury Department. The new space will house about 200 at a cost of \$39 a square foot, said the GSA. (*Washington Post*, Dana Hedgpeth, 03/02/09)

Financial Services Regulation Reform

Congress debates the creation of a systemic risk regulator

- As part of an overhaul of the nation’s financial system, House Financial Services Committee chairman Barney Frank (D-MA) would like a new “systemic risk” regulator to guard against widespread financial risks. Frank said this regulator should have the power to deal with failed non-bank lending institutions. “We have in the federal system [e.g., the FDIC] ...a pretty good way to unwind failed banks,” said Frank. “What we don’t have is a similarly orderly way to unwind failed non-banks. ...[The regulator also should] clearly be empowered to stop people from getting overleveraged.” Frank noted that the regulator would need the authority to require companies, which securitize debt, equities or other packages, to retain a portion of that offering so that they have some skin in the game; the ability to limit excessive leveraging by companies; and the power to unwind failed institutions and restrict executives’ pay.
- Lawmakers are considering granting the Federal Reserve the authority to serve as the systemic risk regulator; creating a new regulator, or designating the President’s Working Group on Financial Markets to serve in this role. Frank said he leans toward granting this authority and responsibility to the Fed, because creating a new regulator would take too long and granting decision making authority to a committee tends not to work.
- However, lawmakers have expressed concern about granting the Fed new powers to watch over the financial industry, worrying that Congress would be concentrating too much power in one government agency. Representative Paul E. Kanjorski (D-PA) said he was “trying to get my arms around just what is systemic risk,” adding it’s often easier to identify after the fact. Republican committee members expressed concern that such a regulator would end up picking winners and losers in the marketplace. If the government declares a company systemically important, “this clearly gives the institution a huge competitive advantage,” said Tom Price (R-GA). Representative Scott Garrett (R-NJ) said, “I’m not sure it’s wise to consolidate so much additional responsibility in an entity that does not have to answer to the American people.” (*CongressDaily*, Bill Swindell, 03/05/09; *CQ Today*, Benton Ives, 03/05/09)
- Senate Banking Committee chairman Christopher Dodd (D-CT) said his panel will move initial legislation to establish a systemic-risk regulator by late spring and later move a broader bill that would restructure the regulatory system for financial services. Dodd said he is wary of having the Federal Reserve as the systemic risk regulator, due to concern that the added responsibilities could overload an already-burdened central bank. But, Dodd said he remains open to the possibility because “the alternative of creating some new entity...[is] a daunting idea.” Senator Richard

Shelby (R-AL), the panel's ranking member, called for "clear lines of responsibility of regulators." He added, "Only then can congress hold regulators responsible." And, clarity would provide market participants with certainty and enable the financial markets to function.

- Federal Reserve chairman Ben S. Bernanke has endorsed the idea of creating a systemic risk regulator. "The extent to which this new responsibility might be a good match for the Federal Reserve depends a great deal on precisely how the Congress defines the role and the responsibilities of the authority, as well as on how the necessary resources and expertise complement those employed by the Federal Reserve in the pursuit of its long-established core missions." Bernanke also recommended that Congress toughen the capital requirements for big banks, place limits on investments by money-market mutual funds, and introduce a mechanism to allow the U.S. to wind down big financial institutions and possibly run them temporarily.
- In a press conference, Treasury Secretary Timothy Geithner said that the Federal Reserve would be the natural place for a systemic risk regulator. "What's really important is that we have a strong accountability vesting in an institution that has the capacities and the talent to bring the level of consolidated supervision necessary to make sure these major institutions don't pose this kind of risk in the future," said Geithner. "The Fed is a natural place for that responsibility." Geithner said he plans to present lawmakers an outline of the administration's regulatory reform plan during testimony before a Congress in a couple of weeks.
- The Obama administration has asked Congressional leaders to provide an outline of the regulatory overhaul before Obama and Geithner meet with the G20 in London in early April. Dodd said that he expects to be able to meet such a deadline. (*American Banker*, Cheyenne Hopkins, 03/12/09; *Bureau of National Affairs*, Malini Manickavasagam, 03/11/09; *CQ Today*, Phil Mattingly, 03/11/09; *Wall Street Journal*, Damian Paletta, 03/11/09)

<p>Senators Richard Durbin and Charles Schumer introduce legislation to create the Financial Product Safety Commission</p>
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- On March 10th, Senators Richard Durbin (D-IL) and Charles Schumer (D-NY) introduced a bill to create the Financial Product Safety Commission (FPSC) to protect consumers from fraudulent or misleading financial products and practices. The FPSC, comprised of a five member panel appointed by the president and confirmed by the Senate, would have rulemaking authority to prevent predatory or deceptive practices involving financial products such as mortgages, credit cards, and retirement accounts and would collect and investigate consumer complaints about financial products. The FPSC also would coordinate with federal and state regulators on enforcement matters and would be charged with identifying practices that undermine sound markets and educating consumers on the responsible use of financial products.

This commission would improve the current fractured oversight system involving at least 10 regulatory bodies which have some oversight over consumer financial products, but not as their primary mission. Representative William Delahunt, (D-MA) and Brad Miller (D-NC) also plan to offer a companion bill establishing a Financial Product Safety Commission in the House. (*Bureau of National Affairs*, Mike Ferullo, 03/11/09; *CongressDaily*, Bill Swindell, 03/10/09)

Senators John McCain and Byron Dorgan propose the creation of a bipartisan committee to investigate the causes of the economic crisis

- On March 3rd, Senators John McCain (R-AZ) and Byron Dorgan (D-ND) proposed legislation that would create a special, bipartisan committee to investigate the causes of the financial crisis. This independent panel would carry subpoena power and have “authority to get to the bottom of the crisis.” Any wrongdoing that the committee uncovers would be referred to the Justice Department or other authorities for prosecution.
- A spokesman for Senate Banking Committee Christopher Dodd (D-CT) said, “At first blush, it seems that a select committee would duplicate the Banking Committee's current work. The committee has held 30 hearings to identify the causes and consequences of this crisis. ...Chairman Dodd, at the president's request, has met with him, [Sen.] Shelby and their counterparts in the House to launch a comprehensive and collaborative way forward to ensure a crisis of this magnitude never occurs again.” (*Bureau of National Affairs*, Malini Manickavasagam, 03/04/09; *CongressDaily*, Dan Friedman, Katie Sanders, Bill Swindell and Darren Goode, 03/04/09)

Fannie Mae and Freddie Mac

Freddie Mac reports \$50.1 billion loss for FY2008, triggering a \$30.8 billion capital injection from the U.S. Treasury

- On March 12th, Freddie Mac reported a \$50.1 billion loss for FY2008, a loss more than 16 times its loss of \$3.1 billion in FY2007. For the fourth quarter of 2008, the company incurred a \$23.9 billion loss, accounting for more than 47% of the company's loss for the fiscal year. Freddie Mac blamed its swelling losses on rising mortgage defaults and declines in the value of derivatives used to hedge interest-rate risk. The market value of derivatives plunged \$11.8 billion and value of its guarantee business dropped \$4.7 billion in the fourth quarter.
- Freddie Mac has asked the U.S. Treasury to inject \$30.89 billion of new capital into the enterprise, bringing the taxpayer's total investment in senior preferred stock to \$45.6 billion or roughly 23% of the \$200 billion capital commitment made by Treasury for the enterprise. The company's annual dividend on the preferred stock is approximately \$4.6 billion, based up the stock's 10% yield. "This dividend obligation exceeds our annual historical earning in most periods, and will contribute to increasingly negative cash flows in future periods," said Freddie Mac in a regulatory filing. Rajiv Setia, fixed-income strategist at Barclays Capital, said, "Basically, there is no exit strategy. There is no way they can repay the taxpayer even when credit losses tail off."
- On December 31st, Freddie Mac reported a total single-family delinquency rate of 1.72% and multi-family delinquency rate of 0.01%. At year-end, Freddie Mac reported \$45.1 billion of non-performing mortgage loans and \$3.3 billion of net REO assets (29,346 units) for total non-performing assets of \$48.4 billion. "We expect the residential mortgage market will continue to deteriorate in 2009," said Freddie Mac.
- Freddie Mac's participation in the Obama administration's mortgage modification program may cost the enterprise as much as \$30 billion, said the company in its 2008 Annual Report. When Freddie modifies a loan that it guarantees which is current, the company must repurchase the loan from the securitized pool. Making such purchases on a large scale may trigger accounting for Freddie Mac's \$1.8 trillion of mortgage guarantees as derivatives at fair market value less credit reserves, said the company. Such a change in accounting, which might occur as early as next quarter, could result in a charge of \$30 billion, said Freddie. "[Management] is working internally and with regulatory agencies to consider the potential changes to our modification practices or current accounting policy," said the company.
- Analysts believe this estimate is likely a pro forma, worst-case scenario. Friedman Billings Ramsey analyst Paul Miller said the estimate is "probably overstated," but added Freddie will take a hit on the loan modification program. "We knew when the

government came out with the proposal that it was going to have a negative impact on their portfolio,” said Miller. “They have to estimate the true hit, and either way it’s going to cost them money to do this and have a negative impact on capital.”

- Freddie Mac also disclosed that the company has reached an agreement with JPMorgan Chase, in which the Bank will make a one-time payment to cover obligations related to loans “inconsistent with the representations and warranties Washington Mutual had made to the GSE. JPMorgan Chase has also agreed to assume the liability for Wamu loans sold with recourse to Freddie Mac.
- Freddie Mac has named board chairman John Koskinen to serve as the company’s interim chief executive while it searches for a permanent successor to former president David Moffett, who recently resigned. Koskinen is the former deputy mayor of Washington, DC and a former top official in OMB during the Clinton administration. Freddie Mac board member Robert F. Glauber, the former CEO of the NASD and a visiting professor at Harvard University, will serve temporarily as the board chairman. (*Wall Street Journal*, James R. Hagerty, 03/12/09; *Bloomberg News*, Dawn Kopecki, 03/12/09; *Washington Post*, Zachary A. Goldfarb, 03/12/09; *American Banker*, Kate Berry, 03/13/09; *Wall Street Journal*, James R. Hagerty and Aparajita Ssha-Bubna, 03/12/09; *Form 10-K*, Freddie Mac, 2008)

The government’s takeover of Fannie Mae and Freddie Mac isn’t looking “temporary”

- Lawmakers and company executives are quietly acknowledging that Fannie Mae and Freddie Mac will most likely never return to “private” hands. Over the past six weeks, the Obama administration has transformed Fannie and Freddie into arms of the federal government, using the enterprises to oversee a vast new loan modification program, expand their purchase of mortgages, and loosen their internal policies to facilitate lending to at-risk borrowers. The GSEs have been given access to up to \$400 billion of tax dollars—a sum more than twice the TARP commitments to Citigroup, Bank of America, JPMorgan Chase, General Motors, Wells Fargo, Goldman Sachs and Morgan Stanley combined—to absorb the GSEs’ losses (which, on a combined basis, exceeded \$100 billion in FY2008) and support the Obama administration’s mortgage initiatives.
- The lesson, many fear, is that placing the GSEs into conservatorship has hobbled the companies’ finances and made independent decision making nearly impossible. Moreover, lawmakers have gained a “lever” to influence the mortgage market and pursue social goals such as affordable housing, that many—particularly Democrats—will be loath to discard, say some lawmakers. Representative Scott Garrett (R-NJ) said, “Once government gets a new tool, it’s virtually impossible to take it away. And Fannie and Freddie are now tools of the government.” Many worry that if the government cannot—or will not—extricate itself from Fannie and Freddie, then it will face similar problems, if Treasury should eventually nationalize any large, failing banks. (*New York Times*, Charles Duhigg, 03/03/09)

The “future” of Fannie Mae and Freddie Mac

- In remarks at New York University’s conference on “Crisis is a Terrible Thing to Waste,” AEI fellow Alex J. Pollock said, “...A recent libertarian critique of the GSEs’ failure by Sheldon Richman has the title, *Bailing Out Statism*. Richman says, ‘The key to understanding the saga of Fannie Mae and Freddie Mac is this: They were created—intentionally—to distort the housing and mortgage markets. Government planners were not content to let voluntary exchange configure those industries. So they intervened.’ That is an accurate statement. The ongoing bailout of Fannie and Freddie is without question a government intervention to save a previous intervention. Richman continues, ‘The collapse of Fannie and Freddie is government social engineering predictably gone bad.’”
- “But here is something very interesting: Fannie and Freddie went bad in a way nobody predicted—namely: from credit risk, or put simply, bad loans. There were hundreds of articles and speeches either attacking Fannie and Freddie or defending them, many of them by the distinguished members of this panel, but everybody thought that the GSEs’ credit risk function was all right, that if anything, it demonstrated monopoly profits.”
- “Nobody predicted that credit risk would take Fannie and Freddie down. But it did. Now they are both insolvent, if you don’t count the preferred stock bought by the government. Their common stock has lost 99% of its value and represents a mere option on their possible future resuscitation.”
- “Many people have suggested that the way to fix Fannie and Freddie is to limit them to mortgage securitization—in other words, to guaranteeing credit risk. But the fact that they failed through credit risk must make us dubious about this notion. (Many people also assert that securitization was the “original” purpose of the GSEs. For Fannie, this is distinctly wrong: Fannie had existed for more than 40 years before it did its first securitization.)”
- “You could solve the problem of GSE credit risk by further limiting Fannie and Freddie securitization only to prime, high quality mortgage loans. But this would certainly render unhappy the many politicians who want them to finance riskier loans and make this course politically difficult, perhaps impossible. Of course, trying to make these same politicians happy with them contributed significantly to Fannie and Freddie’s credit risk expansion, resulting losses and current insolvency.”
- “More fundamentally: whatever may have been the case a generation ago, does the 21st century need GSEs in order to have securitization of prime loans? No, it doesn’t. It is true that private securitization of prime, conforming loans has not previously existed, but this is only because no private firms could compete with the government-granted advantages and economic subsidies enjoyed by Fannie and Freddie.”

- “Once past the panic and the bust, and without GSEs, there would be a private market for securitization of high quality loans. The financial technology is not very hard and well known. Such a market would work best if mortgage loan originators kept a significant, life-of-the-loan interest in the credit performance of the loans they originate—a key design improvement for future.”
- “So what should be done with Fannie and Freddie going forward? The answer must address two phases: first, a transition period during the current bust; then a long-term restructuring. In this transition period, Fannie and Freddie have already become part of the government, for all intents and purposes. They have almost entirely changed from being GSEs to being government housing banks. They are therefore available to be directed by the government to fund Hope for Homeowners loans, for example, or in general to participate in refinancing the mortgage bust based on political policy, not profit. [This was made clear by their assigned role in the new administration’s “Homeowner Affordability and Stability Plan,” announced February 18, 2009, subsequent to our conference.]”
- “This transition role could be made more efficient by completing Fannie and Freddie’s conversion to temporary government housing banks by adding a legal Treasury guaranty of their debt. The government, as agent for the involuntary taxpayer participants, is already fully and in fact on the hook for all the debt and MBS obligations of Fannie and Freddie. But this is not legally explicit, however real.”
- “The formal documentation of the government’s relationship with Fannie and Freddie specifies explicitly that their debt is not explicitly guaranteed. When the lawyers for international investors discovered this and pointed it out to their investor clients, it made them all nervous. So the government could say that the debt was ‘effectively guaranteed’ which is true, but had to admit that it was still not ‘explicitly guaranteed.’ Why have this bond market uncertainty, since the public has all the risk anyway? Using Fannie and Freddie to address the bust would be cheaper and easier if Congress would simply enact an explicit guaranty of their debt, reflecting the de facto reality.”
- “At the same time, the remaining common shares of Fannie and Freddie could be removed from private hands, definitively ending GSE status. Some of my colleagues argue for doing this by receiverships, which would wipe out the shareholders, but you could also have a government tender for all remaining shares. This would not cost very much money at current prices, and make Fannie and Freddie into 100% government-owned corporations—exactly how Fannie started out in 1938.”
- “This transition government housing bank status should have a firm sunset safely on the other side of the bust: in five years. At that point, the long term restructuring of Fannie and Freddie would be effected. I suggest for your consideration that this long term restructuring should divide Fannie and Freddie into three parts: 1. Prime mortgage securitization[;] 2. Mortgage portfolio investing[; and] 3. Government activities.”

- “Fannie and Freddie’s prime loan securitization businesses should be privatized—sent out into the world to compete like anybody else. They would become not GSEs, but private companies, sink or swim, flourish or fail.”
- “Some have suggested that such companies could be organized as cooperatives, not ordinary corporations. The problem with the cooperative idea is that the industrial structure of the mortgage business has profoundly changed. From the historical pattern of thousands of small, mostly local savings and loans and mortgage banks, it has shifted to a concentrated industry with four dominant companies: Bank of America, Wells Fargo, Morgan-Chase, and Citi. After the further concentration the mortgage crisis has engendered, these four now represent 63% of all U.S. mortgage servicing. Would we want these four as the dominant “cooperators” in charge of a cooperative form? I don’t think so. We want a more competitive outcome: regular, for-profit corporations.”
- “As for the business of owning a leveraged portfolio of mortgage loans and MBS, this should be moved into a banking charter or a mortgage real estate investment trust (REIT), and then carry on life like any other bank or REIT, as part of the private market, once again, sink or swim, with a fresh start. The existing government-backed debt and assets should be put in a liquidating trust and liquidated over time (as was done in the privatization of Sallie Mae).”
- “The final element of the former Fannie and Freddie consists of those activities which are properly those of the government: such as providing housing subsidies in one form or another and providing non-market financing of risky loans. These would stay in the government. Their funding would have to be appropriated by Congress in a transparent way, instead of escaping appropriations discipline by being hidden in the GSEs.”
- “These governmental functions of Fannie and Freddie should be merged into the structures of the Department of Housing and Urban Development-FHA-Ginnie Mae.”
- “The total result of the three steps: No GSEs are left—a consummation devoutly to be wished.” (*Prepared Remarks*, Alex J. Pollock, 02/13/09)

Fannie Mae and Freddie Mac affordable housing goals will be cut

- Federal Housing Finance Agency director James Lockhart said that Fannie Mae and Freddie Mac’s 2008 affordable housing goals mandated by the government were “infeasible.” and will “need to come down a bit” in 2009. In a speech to the Asian Real Estate Association of America and National Association of Hispanic Real Estate Professionals, Lockhart said, “One of the ways Fannie and Freddie made their goals in previous years was to buy those subprime mortgages in private-label securities and that wasn’t a safe and sound practice.” He added that going forward, the GSEs will

be directed to finance “sustainable” mortgages. Lockhart added that new affordable-financing goals will be announced “shortly,” with “the right incentives in them so that they do have a relationship to the loan modifications and refinancing that [the GSEs] are doing in the affordable space.” (*Bloomberg News*, Dawn Kopecki, 03/13/09)

Fannie and Freddie resign themselves to becoming major landlords

- As inventories of foreclosed homes continue to pile up, banks, mortgage investors, and the GSEs are having to turn to renters to generate cash flows and prevent the deterioration of the properties and risk of vandalism. On December 31st, Fannie Mae owned 65,538 REO properties, nearly twice as many as a year earlier, and Freddie owned 29,346 units, more than double the number of units owned in 2007. Fannie Mae spokeswoman Amy Bonitatibus said it is “considering different rent-to-own options. However, Freddie Mac said it has no plans to offer rent-to-own options to its tenants at this time. (*American Banker*, Kate Berry, 03/09/09; *Form 10K*, Freddie Mac, 2008)

Other GSE notes

- Representatives Adam Putnam (R-FL) and Edward Markey (D-MA) have introduced the Fannie Mae and Freddie Mac Full Disclosure Act, which would require the GSEs to pay registration fees and disclose information required by the SEC similar to other publicly-traded companies. “There are many factors that were involved in our current economic meltdown,” said Putnam. “And one of them was a failure to require enough transparency and accountability from Fannie and Freddie.” (*Dow Jones*, 03/11/09)
- On March 9th, the Financial Industry Regulatory Authority said it is proposing a major expansion of its Trade Compliance and Reporting Engine (TRACE) to include debt issued by federal government agencies, government corporations, and GSEs. Through this expansion, TRACE would include the debt of Fannie Mae, Freddie Mac, the Federal Home Loan Banks, TVA, and the Financing Corporation. (*Bureau of National Affairs*, 03/11/09)

RESPA builder reprieve

- HUD will reconsider a new RESPA provision, prohibiting builders from offering homebuyers discounts and upgrades that are tied to the use of the builder’s affiliated mortgage and title companies. The agency said, “HUD will delay the planned implementation of RESPA’s ‘required use’ provision for 90 days, or until July 16, as it solicits public comment on whether to withdraw its new definition that would have taken effect in January.” The Bush administration postponed the effective date of the

RESPA provision from January 16 to April 16 after the NAHB sued HUD to block implementation of the required use provision. A U.S district court is scheduled to hear arguments on the controversial RESPA provision April 3. (*National Mortgage News*, 03/09/09)

Staffing on Capitol Hill and HUD

- The Senate Banking Committee has hired three staff members--Charles Yi to serve as a senior policy adviser and counsel to cover insurance and commercial banking law, regulatory modernization, Troubled Asset Relief Program oversight, and other legislative issues; Beth Cooper to serve as a committee professional working on affordable housing and community development; and Mitch Warren to serve as a senior policy advisor handling transportation issues for the committee as a senior policy adviser. Previously, Yi was a counsel to the House Financial Services Committee and a lawyer at Wilmer, Cutler, Pickering, Hale, and Dorr in Washington. Cooper was formerly a congressional liaison for the National Association of Housing and Redevelopment and served on the House Budget Committee staff. Warren previously handled Senate Environment and Public Works Committee work for Majority Leader Harry Reid and transportation and other issues for the Senate Budget Committee. (*American Banker*, Stacy Kaper and Cheyenne Hopkins, 03/09/09)
- President Barack Obama has nominated Helen Kanovsky to serve as COO and General Counsel for HUD. Kanovsky previously was COO and General Counsel for AFL-CIO Housing Investment Trust. (*HUD Press Release*, 03/04/09)

Fannie Mae

Fannie Mae alumni news

- Amherst Holdings, LLC, the Austin, Texas-based mortgage industry advisor, has hired Fannie Mae's top portfolio manager—Ramon de Castro, who will serve as chief risk officer for Amherst Securities Group. (*Reuters*, Al Yoon, 03/02/09)

Freddie Mac

Freddie Mac agrees to indemnify three executive officers

- Freddie Mac has entered into an indemnification agreement with Michael Perlman, EVP of operations and technology, acting CFO David B. Kellerman, and Michael A. May, SVO of multifamily, which protects the officers from any liabilities and expenses related to any threatened or pending lawsuits. Any liabilities or expenses incurred by the officers due to willful misconduct or knowing violation of criminal law are excepted from the agreement. The agreement is effective as of September 6, 2008, the date the company was placed into conservatorship by the U.S. Treasury. (Dow Jones Newswires, John Kell, 03/06/09)

Why did Freddie Mac CEO David Moffett resign?

- Six months after being installed by the company's conservator, Freddie Mac CEO David Moffett unexpectedly resigned, days before the release of the company's financial results for FY2008. According to sources, Moffett resigned because of his frustration in having to consult with regulators on all major decisions and follow mandates that he didn't necessarily see as good for the company. Moffett's resignation portends the challenges that the Obama administration will face in finding and retaining highly experienced bankers to lead financial institutions and implement the government's policies without large pay packages.
- According to the *Wall Street Journal*, "A person briefed on the decision said Mr. Moffett saw conflicts between government policy mandates and his efforts to turn around the company. In his prior banking career, Mr. Moffett dealt with shareholders, community representatives and rating firms, as well as regulators, but he found the Freddie job 'one-dimensional: It's just policy,' this person said. Another person close to the situation said Mr. Moffett's decision was partly due to frustration

with a job offering little freedom to maneuver. ‘He’s a private-sector guy,’ this person said. “What Freddie Mac has become is completely different even from a government agency,” said a former Freddie Mac executive who worked with Moffett. “If you’re a senior person at the U.S. Treasury or another agency, you still have tremendous authority, the ability to shape policy. At Freddie Mac, it’s unclear if anybody has any ability to shape any policy except at the micro-management level.”

- Others argued that Moffett’s departure reflects the Obama administration’s desire to put their own people in charge of the enterprises. “In the wake of conservatorship, the CEOs of Fannie and Freddie are effectively political appointments,” said Howard Glaser, a former HUD official during the Clinton administration and mortgage industry consultant. “Handpicked by the prior administration, and with Fannie and Freddie returning from exile to play a central role in the Obama administration’s plan to stabilize the housing market, one would expect that Team Obama might like to have its own leadership at the companies.”
- Finding a permanent successor for Moffett could be a challenge, say some recruiters. Potential candidates for such a position will be retired or unemployed executives with little recent crisis experience and “a burning desire to make sure that these great financial institutions come out of this,” said Barrett J. Stephens, a managing director of RSR Partners. “The problem is there are very few people like that out there.” (*Washington Post*, James R. Hagerty, Damian Paletta, 03/03/09; *American Banker*, Harry Terris, 03/03/09; *Washington Post*, Zachary A. Goldfarb, 03/03/09)

Federal Home Loan Banks

FHLB-Seattle reports \$199.4 million loss for FY2008 and “exhausts” its retained earnings and falls short of a capital requirement
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- The FHLB-Seattle reported a \$199.4 million loss for FY2008, as a result of \$304.2 million of “other than temporary” charges for the Bank’s private-label mortgage-backed securities portfolio. “The ...Bank’s financial results reflect the effects of mark-to-market accounting treatment for private-label mortgage-backed securities that are other-than-temporarily impaired,” said the FHLB-Seattle in a statement. The Bank estimates that it will incur actual losses of just \$12 million over the life of the securities. On December 31st, the Bank reported at total capital-to-assets ratio of 4.6% and a leverage ratio of 6.8%, remaining in compliance with both requirements. However, the distressed prices of certain held-to-maturity mortgage-backed securities resulted in a risk-based-capital deficiency for the Bank at yearend and as of February 28, 2009.

- “We are more than disappointed by these results, particularly in light of the significant gains we have made over the past several years,” said Bank president and CEO Richard M. Riccobono. “I want to stress, however, that even in this very challenging time for our industry and our economy, we continue to fulfill our mission by serving as a steady source of liquidity and funding for the members of the Seattle Bank cooperative.”
- As a result of its FY2008 losses, the FHLB-Seattle is the first bank in the 76-year history of the system to run out of retained earnings, triggering what once was an unthinkable scenario by “breaking the buck” and placing the value of member capital at the Bank at risk. The Bank’s 380 members [and their external accountants] will be forced to make a tough decision—write down the value of their stock investment or ride out the troubles at the FHLB-Seattle and hope shares regain their \$100 par value.
- “There is not a tremendous amount of guidance out there,” said Brian Harris, a Moody’s Investors Service analyst. “It may be a challenge for smaller member banks to perform their evaluations.”
- The problems at the Seattle Bank and within the FHLB System may only intensify in the months ahead, as continued deterioration in the housing market could lead to bigger other-than-temporary impairment charges and further erode the System’s retained earnings by the end of the first quarter. Several FHLBS have very low levels of retained earnings, including the FHLB-Boston that reported only \$22.9 million of retained earnings on December 31st. “We simply have, over time, lurched from one crisis to another with things getting ever worse,” said a source close to the FHLBs. “We’re heading toward a crisis of some sort with the Federal Home Loan Bank System that will most likely come to fruition in the May time frame when you have first-quarter reports.”
- The immediate impact on members remains unclear. “If the Federal Home Loan Bank of Seattle got liquidated today ... then the member banks would not get back 100 cents on the dollar for their investment,” said Bert Ely, an independent consultant from Alexandria, Va.
- If accountants believe the Seattle Bank’s estimate of actual losses it will incur, Moody’s analyst Harris argues that a write-off of the Bank’s stock would likely be unnecessary. “I would expect that what the regulator and the individual banks and their members would look at would be the economic losses that the Home Loan banks are estimating for their securities portfolio,” said Harris. “That \$12 million may or may not be realized. Ultimately, they could realize more or less. But as of a point in time, that’s their best estimate of the economic loss, and if that’s true, it’s highly unlikely that you could come to a conclusion that the stock is impaired.”
- The Federal Housing Finance Agency confirmed that the FHLB-Seattle bank is the first Home Loan bank with negative retained earnings, which “breaks the buck.” The FHFA added, “However, breaking the buck does not have to equate to impairment of

FHLBank of Seattle capital stock, which is based principally on the ‘ultimate recoverability of par.’” (*FHLB-Seattle Press Release*, 03/09/09; *HousingWire*, Diana Golobay, 03/10/09; *Wall Street Journal*, James R. Hagerty, 03/10/09; *American Banker*, Steven Sloan, 03/11/09)

Ginnie Mae

FHA “quick defaults” have nearly tripled over the past year

- With the surge of distressed borrowers to FHA-insured mortgages comes a new threat—quick defaults. According to a *Washington Post* analysis, the number of borrowers who have defaulted before making a single payment on their FHA-insured mortgages has nearly tripled, far outpacing the agency’s overall growth in new mortgages. Kenneth Donohue, HUD’s inspector general, said, “[If a loan] is going into default immediately, it clearly suggests impropriety and fraudulent activity.” Many experts attribute the spike in quick defaults to the weak economy, lax scrutiny of borrowers, and “most notably, foul play among unscrupulous lenders looking for a quick buck,” writes the *Washington Post*.
- Over the past two years, more than 9,200 FHA-insured loans have gone into default after no or only one payment—with the default rate of these loans tripling over the past year. By the fall of 2008, on average more than 24 FHA-insured loans were defaulting every day, seven days a week.
- Housing finance experts have warned that FHA has inadequate staffing and technology to keep up with the growth in its mortgage originations and number of mortgage originators. Over the past three years, FHA’s share of the mortgage market has grown from 2% to nearly 33%, while its number of active lenders has more than doubled to 2,300 over the past two years. The agency’s staff which approves and polices new lenders has not expanded during this period, and its fraud unit, which once employed 130 HUD investigators, was dismantled in 2003.
- In response to these adverse trends, Wells Fargo and Bank of America are not waiting for FHA to tighten its underwriting requirements. Instead, these banks are imposing new rules on mortgage brokers that they work with and requiring higher credit scores on certain FHA loan transaction and better on-time payment history. “We have some self-preservation methods,” said Joe Rogers, EVP at Wells Fargo.
- Some experts argue that FHA should not wait for lenders to take the lead on toughening underwriting standards. “Even if the market eventually gets these guys, they shouldn’t have to wait for the market to do it,” said former FHA official Brian Chappelle. “The most frequent question I get asked by the groups I talk to is: ‘Is

FHA going to implode?’ ...They haven’t seen HUD do anything significant in the past two years to tighten up its lending.” (*Washington Post*, Dina ElBoghdady and Dan Keating, 03/08/09)

HUD increases the FHA-insured loan limits for 2009

- In a February 24th Mortgagee Letter, HUD set forth the revised FHA loan limits for 2009, based upon the higher of either the loan limit provisions in either the Economic Stimulus Act of 2008 (ESA) or the Housing and Economic Recovery Act of 2008 (“HERA”), pursuant to the American Recovery and Reinvestment Act of 2009 (“ARRA”). Based on this directive, the FHA national “floor” limits remain at 65% of the conforming loan limit—or \$271,050 for single-family properties. HUD defines a “high cost area” as any area where the limits exceed the floor. Pursuant to the ARRA, HUD set the national ceiling limits at 175% of the conforming loan limit, or \$729,750. HUD has provided a list of these geographic areas in which the FHA mortgage limits are at the ceiling. For those geographic areas between the floor and ceiling, the maximum loan limit for 2009 will be set by the higher of the loan limits established by either the ESA or the HERA. HUD provides a complete schedule of FHA mortgage limits for all areas at <https://entp.hud.gov/idapp/html/hicostlook.cfm>. (*HUD Mortgagee Letter 2009-07*, 02/24/09)

Farm Credit System / Farmer Mac

39 farm groups voice opposition to the Obama administration’s proposed \$16 billion cuts in farm subsidies

- The American Farm Bureau Federation (AFBF) and 38 other agricultural and commodity groups have expressed strong opposition to the more than \$16 billion in cuts to the farm safety net proposed in President Barack Obama’s 2010 budget. In a March 11th letter to the leadership of the Agriculture and Budget Committees in the House and the Senate, the broad coalition of farm groups warned that the cuts “threaten, once again, to change the rules midstream on American farm and ranch families.” The coalition also noted that the cuts are being proposed just eight months after passage of the 2008 farm bill, which contained more than \$7.6 billion in cuts to the farm safety net. The administration’s proposed cuts constitute less than 0.25% of the total federal budget and make up just 16% of the total farm bill’s cost. “The proposed budget cuts overlook the fact that producers and lenders alike have made long-term business decisions based upon the commitment made by Congress in the five-year farm bill and thus will exacerbate the current credit crisis,” said the coalition.

- “You don’t change the rules in the middle of a basketball game and you don’t change the provisions of a farm bill that was implemented less than a year ago with the support of more than 500 nutrition, conservation and farm organizations,” said AFBF president Bob Stallman. “The ink is barely dry on the new farm bill, and all of the provisions have not yet been fully implemented. The bill must be fully implemented and allowed to work before changes are considered.” (*Voice of Agriculture*, 03/12/09)

Farm advocacy groups urge Treasury to ensure farmers have the ability to restructure their mortgages to avoid foreclosure

- In a letter to Treasury Secretary Timothy Geithner and Agriculture Secretary Tom Vilsack, more than 50 farm advocacy groups urged the administration to ensure that family farmers also have the ability to restructure their mortgages to avoid foreclosure. Specifically, the farm advocacy groups urged that banks that accepted federal bailout funds be required to work with farmers to restructure farm loans to keep farmers on the land and in their homes. “The United States is re-laying the groundwork of its economic stability, and family farmers are the key to a strong foundation,” said Farm Aid board member [and singer] Neil Young. “It’s time ...to recognize the unmatched ability of family farmers to strengthen local economies. We can all learn from the ingenuity and innovation that family farmers demonstrate time and time again in the face of challenge.” (*PRNewswire*, 03/10/09)

FCA proposes rule to clarify the election process for FCS institutions

- The Farm Credit Administration board of directors has approved a proposed rule to clarify the director election process for Farm Credit System (FCS) institutions and update the rules to incorporate interpretations issued recently through bookletters. The intent of the proposed rule is to increase stockholder participation in the director election process and enhance impartiality and disclosure in director elections. The rule would amend FCA regulations at Parts 611, 615, and 620 to consolidate Farm Credit bank and association director election and voting rules and enhance reporting and disclosure rules. The proposed rule will be published in the Federal Register for a 60-day comment period. (*FCA Press Release*, 03/12/09)

Motor makers are wary of higher ethanol levels in gasoline

- As the nation’s ethanol producers urge the EPA to raise the 10% limit on motor fuel to 15% or more, automakers and makers of outdoor equipment contend that science has not yet demonstrated that higher levels of ethanol in gas are acceptable for engines. Boat engines, chain saws, lawn mowers, snowmobiles, motorcycles,

generators and other small-engine equipment could be permanently damaged from using a 15% ethanol blend, said Kris Kiser, executive director of the Outdoor Power Equipment Institute. “We have very real concerns [including poor engine performance and overheating],” said Kiser. In a Department of Energy test, all 28 engines tested had significant problems with the higher ethanol blend, he added.

- While Ford Motor Company has said it would endorse a 15% ethanol blend, other auto manufacturers aren’t convinced that it wouldn’t damage vehicle engine parts. Edward B. Cohen, vice president of government and industry relations at American Honda, said, “I think that displacing petroleum with ethanol is a plus, but before moving precipitously, we need to make sure that the products are going to continue to perform and that emissions will not be adversely affected.” John Cabaniss, energy and environment director for the Association of International Automobile Manufacturers, said, “We don’t know what the cumulative effects are over thousands of miles. We aren’t against the use of more ethanol as long as it’s compatible with everything out there. Consumers shouldn’t have to go from gas station to gas station, checking the pumps for the type of fuel they need.”
- A number of ethanol producers are pressing EPA to make a quick decision on raising the limit to 15%, saying it would advance the use of renewable energy and would reduce the nation’s dependence on foreign oil and create jobs. “This is about jobs, energy security for America, improving the environment and meeting our legal responsibilities under the 2007 energy bill,” said retired General Wesley Clark, co-chairman of Growth Energy, a “proactive” advocacy group of ethanol firms. Raising the cap on an ethanol fuel blend would give consumers more choices, argues Josh Morby, executive director of Wisconsin Bio Industry Alliance. “We aren’t asking for a mandate or a requirement.” The ethanol industry has a capacity to produce 12.5 billion gallons of corn-based ethanol a year—about 9% of the nation’s motor fuel supply. However, demand has fallen about 2 billion gallons short of the industry’s production capacity as energy prices have fallen during the economic downturn.
- Critics argue that the ethanol industry’s push for higher ethanol limits is really about propping up the heavily subsidized industry and giving a boost to venture capital firms that are struggling to find an economically competitive means of producing other forms of ethanol from plants to that do not compete with food products.
- To approve the request for 15% ethanol content, the EPA needs to determine whether it will affect emission control systems in vehicles. In a statement, the agency said it will review the request and will act based on the best available science. (*Journal Sentinel* [Milwaukee, WI], Rick Barrett, 03/10/09; *Washington Post*, Steven Mufson, 03/06/09; <http://www.growthenergy.org/2009/index.asp>)
- In a March 16th editorial, the *Wall Street Journal* wrote, “...Congress and the ethanol lobby argue that if some outcome would be politically nice, it should be mandated (details to follow). Then a new round of market interventions is necessary to fix the economic harm resulting from the previous requirements, while creating more

damage in the process. Ethanol is one of the most shameless energy rackets going, in a field with no shortage of competitors.” (*Wall Street Journal*, 03/16/09)

FCA board member nominated to serve as Agriculture Department under secretary

- President Barack Obama has nominated Dallas P. Tonsager to serve as Under Secretary of Agriculture for Rural Development. Tonsager is currently a board member of the Farm Credit Administration and board member for the Farm Credit System Insurance Corporation. (*Brownfield Ag News*, Bob Meyer, 03/13/09)

Michael A. Gerber appointed president and CEO of Farmer Mac

- Farmer Mac’s board of directors has appointed Michael A. Gerber as President and CEO of Farmer Mac, effective immediately. Gerber has served as acting president and CEO since October 1, 2008, while the Board conducted a search for a permanent chief executive. Previously, Gerber served as president and CEO of Farm Credit of Western New York, a FCS member, and served on the Farmer Mac board since June 2007. Lowell L. Junkins, acting chairman of the board, said, “Mike Gerber has provided tremendous leadership to Farmer Mac over the last five months—a critical time period for the company. During his tenure, the company has successfully raised net new capital of \$115 million through private investors and implemented a new program to encourage guarantee and purchase transactions with commercial banks and Farm Credit System institutions. Mike has the vision and leadership skills to advance Farmer Mac’s mission and continue Farmer Mac’s invaluable service to rural America.” (*Farmer Mac Press Release*, 03/11/09)

FCS all a twitter

- Farm Credit System news is now available on Twitter—<http://twitter.com/farmcredit>.

Postal Service

A close look at how the economic downturn has impacted the USPS

- In the March issue of *Postal Watch*, the National Association of Letter Carriers wrote, “While the Postal Service has battled the electronic diversion of mail for years, the rapid downturn in the financial sector in 2008 was profoundly bad news—a deep, cyclical decline in volume was layered on a gradual structural decline. And the particulars of this recession to date are especially bad for the Postal Service because the real estate, housing, banking and insurance sectors are among the most mail-intensive industries in the country. In fact, revenue rich mail from these industries accounts for 10 to 20 percent of the mail we deliver. In 2008, credit card mail plunged 24 percent. Mortgage-related volume fell even more—an eye-popping 37 percent.”
- “The link is undeniable: The volume of mail has plummeted because Americans are building and buying fewer homes and the credit markets have seized up, unable to get running again in the current atmosphere of financial fear and mistrust. The bleak landscape facing these industries has created a nearly unprecedented crisis for the Postal Service. In the first quarter of the new fiscal year, mail volume is down by another 9.3 percent—the largest quarterly decline since the Great Depression of the 1930s.”
- “With the economy sinking into a deep recession, postal management responded with a rigorous campaign to cut costs. In FY 2008, it slashed more than 57 million work hours across all crafts, a 4 percent decline from a year earlier. While the USPS has not resorted to layoffs, nearly 30,000 career jobs were eliminated in 2008 through early-outs and attrition coupled with hiring freezes. And, in cooperation with the NALC, the Postal Service has embarked on an innovative interim route adjustment program that will expedite operational savings in the delivery function.”
- “Despite these measures to weather the economic storm, the Postal Service still faces a severe financial crisis as we move deeper into the new fiscal year. With a significant economic recovery unlikely before 2010, USPS is projecting volume losses in the range of 12 to 15 billion pieces for FY 2009. Volume loss on that scale would smash past last year’s numbers straight into the basement and lead to a huge deficit. Postmaster General Jack Potter recently estimated the loss would amount to ‘\$6 billion or more.’”
- “The key to avoiding a huge deficit is winning legislative relief for the Postal Service. Congress must reduce the financial burden of pre-funding future retiree health benefits on a schedule that seemed tolerable three years ago, but which is totally unaffordable in the face of this recession. In 2006, the postal reform law required USPS to pre-fund 80 percent of projected retiree health obligations in just 10 years—

a mandate never before imposed on any federal agency or private enterprise. Unless it is changed, the requirement will cost the Postal Service more than \$5.5 billion per year through 2016. This 10-year amortization schedule would be difficult to meet in a good economy, but it is impractical in today's circumstances."

- "NALC is supporting bipartisan legislation, H.R. 22, to allow the USPS to pay its current retiree health obligations out of the existing \$32 billion retiree health fund, and to reduce the level of pre-funding by an average of \$3.5 billion per year. The legislation would save the Postal Service billions by evening out its payments over time without affecting the health benefits of future retirees... The next year will be a critical period for the Postal Service, just as it will be for the economy as a whole. While waiting for the Obama stimulus package to take effect, the postal community—mailers, management and labor—is working together to ride out the storm." (*Postal Watch*, March 2009)

Omnibus funds for the USPS

- On March 11th, President Obama signed H.R. 1105, making omnibus appropriations for the fiscal year ending September 30, 2009. Under the omnibus bill, the Postal Service will receive a payment of \$111,831,000 to the Postal Service Fund, including \$29,000,000 for repayment of revenue forgone. The bill also includes an advanced appropriation of \$82,831,000—not available until October 1, 2009—is provided to continue free mail for the blind and overseas voters. (www.postalwatch.com, 03/12/09)

Another poke in the eye of the US taxpayer

- In a March 13th editorial, the *Frederick News-Post* wrote, "...[T]he Postal Service has a program through which it buys the houses of relocating employees—instead of the employees having to sell them like everyone else does. In more stable times, that policy might not be a big deal. But in these times of plummeting home prices, it is a huge deal."
- "Here's a painful case in point: The Postal Service bought the McMansion (five acres, six bathrooms, indoor swimming pool) owned by the former postmaster of Lexington, S.C., when he was transferred to Carrollton, Texas. The Postal Service paid \$1.2 million for the house. According to a local real estate agent, there aren't a lot of buyers for \$1 million-plus houses in that area these days. That might be a problem for Joe Homeowner trying to sell his house, but if you work for the Postal Service, forgetaboutit!
- "Here's the skinny on this program for 2008: Of the 500-plus homes bought and sold in its relocation program, the Postal Service lost an average of \$58,000 on each one.

You can do the math, but be warned: It's painful. [\$29 million] Such relocation programs are fairly common in the private sector, but that's their business. The Postal Service, while not supported by taxpayer funds, is a semipublic corporation that was chartered by the federal government."

- "The real point is that this is the country's national mail service. While our tax dollars may not support it, the public must pay to use it, and the price continues to go up. The next increase in the postage rate—to 44 cents for a standard letter—is scheduled for May 11. But, never fear, the Postal Service is reforming. Whereas in the past, houses up to \$2.8 million in price have been bought through the relocation program, beginning in February the cap was set at a paltry \$1 million."
- "In other words, like Wall Street, where incredibly inept and/or venal executives continue to receive huge bonuses, the Postal Service "doesn't get it" either. And, like Wall Street, the Postal Service is choosing to continue this program because it wants to and because it can. This is just the latest in a long series of pokes in the eye for ordinary Americans. We wonder just how many more they can take before becoming blinded by rage." (*Frederick News-Post*, 03/13/09)

USPS abandons its plans to outsource the work its 21 bulk mail centers
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- The Postal Service has abandoned plans to outsource the work performed at 21 Bulk Mail Centers (BMC), and instead will revamp the BMC network, said William Galligan USPS Senior Vice President for Operations. During a briefing of the Association of Postal Workers Union's leadership, Galligan said his agency's change in strategy was prompted by the nation's financial crisis and the subsequent drop in the volume of flats. "The world changed under our feet," said Galligan. "It would be foolhardy to proceed with a plan that was based on flat volume growth."
- The Postal Service's revised plan calls for a three-tiered network, called the Network Distribution Centers, in which some facilities would distribute only local and destinating mail and would continue to process standard mail, packages, and some periodicals. Significant changes also are planned for transportation within the network.
- APWU president William Burrus said, "We are pleased that the Postal Service has decided against contracting out BMC operations, but we withhold any endorsement of the new plan until we are able to determine its impact on service and on employees represented by the APWU. We will monitor the progress of the new plan closely, and we will vigorously enforce the Collective Bargaining Agreement as it is implemented." (*APWU Web News Article #027-09*, American Postal Workers Union, AFL-CIO, 03/12/09)

TVA

Obama administration to propose new regulations on coal-ash ponds

- The Obama administration will propose new regulations governing coal combustion waste by year-end and will act immediately to prevent ash spills, said an EPA official. The agency's commitment to begin regulating the solid waste produced by coal-fired power plants was made in the wake of December's massive coal ash spill in Harriman, TN at TVA's Kingston Fossil Plant. "We're committing to develop a regulatory proposal for comment by the end of this calendar year," said Matthew Hale, director of the agency's Office of Resource Conservation and Recovery. The agency also will decide whether to regulate the waste as hazardous or nonhazardous, added Hale. [In 2000, the EPA deemed coal ash to be nonhazardous.]
- In the short term, EPA will seek to prevent ash spills by sending a questionnaire to 163 utilities that manage an estimated 300 ash ponds, said agency officials said. Plant operators are being asked to list any spills or unauthorized releases from the ponds in the last decade and to provide information about their design, engineering and inspections. EPA will follow-up on the questionnaire, by conducting on-site visits, said agency spokesman M. Allyn Brooks-LaSure. The agency will then order improvements to any sites it deems unsafe, added the spokesman. (*New York Times*, Shaila Dewan, 03/08/09)

TVA CEO Tom Kilgore says employees are unlikely to get performance bonuses

- In a television interview, TVA CEO Tom Kilgore said he wished he hadn't accepted a pay raise last year, which boosted his pay to over \$2.5 million, which angered his utility's customers and lawmakers. Kilgore said, "I wish I hadn't done that," said Kilgore. "I mean, last year, I asked the board not to raise my pay. This year, I conceded to it. But in retrospect, the board reconsidered, and as you know, has since lowered the compensation not only for me, but for many of our employees." When asked if TVA would award performance bonuses this year, Kilgore said, "What the board said was that I would get nothing, my senior executives, those reporting to me, would get nothing on their annual incentive, but we did reserve the right to look at each plant [including the Kingston plant, the site of December's massive coal spill]... It will be very difficult. Well, I'm not going to say [employees won't receive performance bonuses] at all, because, again, the folks that were in the plant and operating the plant were not out at the ash pond. But the likelihood is that'll be no."
- Kilgore acknowledged that TVA customers will likely have to pay for the cleanup of the ash spill, but said he doesn't know how much of the burden there will be for ratepayers. "I don't know that yet," said Kilgore. "There hasn't been any rate increase so far out of all of this, even with all of the costs we're incurring. Our rates

our going down right now. We've announced that we'll have another decrease on April 1." (*MSMV-TV Channel 4* [Nashville, TN], Marc Stewart, 03/06/09)

TVA power assets could be sold by US government to raise revenue, says CBO

- In a March 6th letter to Representative Ron Kind (D-WI), CBO identified a number of federal assets that could be “sold, leased, licensed, or otherwise conveyed to raise revenue” which included selling “portion” of TVA’s electric power assets. CBO wrote, “...Under this option, TVA would return to its original, more limited function of managing the region’s hydropower resources. TVA’s other power assets for which a commercial market exists—such as the agency’s fossil-fuel and nuclear power plants and its transition lines—would be sold. CBO estimates that such sales could potentially generate tens of billions of dollars over the next ten years, depending on market conditions and the terms of sales...” (*Correspondence to the Honorable Ron Kind*, CBO Director Douglas W. Elmendorf, 03/06/09)

TVA’s supervision of company credit card expenses criticized

- According to a two-year review by the TVA’s inspector general’s office, agency staffers made millions of dollars of questionable purchases on the utility’s credit cards. The IG found that employees charged more than \$360,000 from October 2005 to December 2007 on electronic items, including X-Boxes and TiVos for an employee awards program; made questionable purchases of alcohol, beer and wine [exceeding \$500] for training sessions and other meetings; and purchased software to “erase evidence of Internet usage.” The IG’s investigators also discovered that some employees sought refunds or made balance transfers from TVA-issued cards because of fraudulent transactions, including \$20,000 for United Airlines tickets, \$2,500 paid to WeddingBands.com, and hundreds of dollars in fraudulent engineering and electrical costs. A former TVA vendor is serving a three-year prison term for fraudulently using a TVA card for nearly a month.
- In 1995, TVA established its purchasing card program for business-related expenses not exceeding \$5,000 for the purchase of materials, supplies, equipment, books or periodicals, or pay for memberships with professional organizations. Annual purchases on the cards have fluctuated between \$23 million and \$87 million over the life of the program, according to the report. Nearly a third of the credit card purchases in 2007 were for more than \$5,000, many of which were apparently “rubber-stamped” by the utility’s administrators. “Our work uncovered significant lack of compliance with the controls established by TVA policy,” wrote Robert Martin, TVA assistant inspector general for audits and inspections.
- “TVA agrees with the IG’s findings and we have implemented steps to improve controls and add additional key practices to the purchase card program,” said TVA

spokesman Jim Allen. (*Associated Press*, Duncan Mansfield, 03/03/09; *Washington Post's Federal Eye*, Ed O'Keefe, 03/06/09)

- In a March 3rd editorial, the *Jackson [TN] Sun Times* wrote, “Ouch! That’s what [TVA] electric utility consumers must be feeling after it was revealed TVA employees charged more than \$75 million on their TVA credit cards, a lot of it apparently for questionable purchases. If this is how TVA manages its employee’s use of TVA credit cards, consumer confidence in the giant utility is about to experience a power outage. ...With millions of TVA customers struggling to pay their electric bills, the utility’s spendthrift ways are the stuff of consumer outrage. TVA is often singled out by other utility companies as having an unfair advantage because it is a government operation. The bloated credit card spending gives the utility a black eye and fuels calls for it to be privatized. There is no excuse for the lack of TVA employee credit card oversight. The giant utility owes it to consumers to rein in its business credit card use and to hold managers and other employees fully accountable for the abuses.” (*Jackson Sun Times*, 03/03/09)

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