September 14, 2010

The GSE REPORT ™

Tracking the Government's Role in the Financial Services Industry

"While we'd all like to find the inexpensive, magic bullet to our economic troubles, the truth is, it almost surely doesn't exist. The only surefire way for policy makers to increase aggregate demand in the short-run is for the government to spend more and tax less. And in my view we should be moving forward on both fronts… the key is that we need to take action, and we need to do it quickly."

Dr. Christina Romer,
Retiring Chair of the Council of Economic Advisers
Speech at the National Press Club,
September 1, 2010

Table of Contents

Major Events

GSE reform:
Treasury conducts Future of Housing Finance Conference
Fannie Mae and Freddie Mac "should be abolished," say Chairman Frank and Representative Hensarling
The 'Julius Caesar strategy' for reforming Fannie and Freddie: Divide them into three parts

Treasury conducts Future of Housing Finance Conference

- The government must continue to play a fundamental role in the future of housing, said a panel of experts at Treasury's Future of Housing Finance Conference. Treasury Secretary Timothy Geithner and HUD Secretary Shaun Donovan told the participants of economists, consumer advocacy groups, investors, market researchers, loan originators, securitizers, servicers, and private mortgage insurers that the challenge is how to build more stable housing system, providing sustainable mortgages. A video of the conference is available at http://www.c-spanvideo.org/program/295074-1.

- In his opening remarks at the conference, Geithner said, "Fixing [the housing] system is one of the most consequential and complicated economic policy problems we face as a country. … [I]t's worth stepping back and asking the basic questions: What went wrong over the past few years? And what are the most important flaws in the system that we have to fix?"

- "Alongside the broader failures that contributed to this financial crisis, there are several that directly involved the government sponsored entities, Fannie Mae and Freddie Mac. … [The GSEs] lowered their underwriting standards, providing guarantees for increasingly risky types of mortgages without charging nearly enough to cover the risk. And Fannie and Freddie were allowed to build up substantial portfolios of mortgage-backed securities, which rose to a level of more than $1.6 trillion dollars at their peak, without the financial resources to cover potential losses."

- "These two strategies were pursued to maximize short-term returns to shareholders and senior management. They were possible only because of the toxic combination of a perceived guarantee by the government and an absence of effective oversight. They were not the sole causes of the crisis, but they made the financial crisis worse. And they resulted in huge losses for the taxpayer. Now, these failures in our housing finance system were avoidable. And it is our responsibility to make sure that we create a system that is not vulnerable to these same failures happening again."

- "…It's safe to say there's no clear consensus yet on how best to design a new system. But this Administration will side with those who want fundamental change. It is not tenable to leave in place the system we have today. We will not support returning Fannie and Freddie to the role they played before conservatorship, where they fought to take market share from private competitors while enjoying the privilege of government support. We will not support a return to the system where private gains are subsidized by taxpayer losses. We need to delineate more clearly the public policy goals of how best to promote reasonably priced and stable mortgage costs for most Americans from how best to provide access to affordable housing for lower income Americans. The challenge of reform has many different dimensions."

- Geithner posed four key questions underlying reform and outlined some of the key policy choices that we face in answering them:

    - *What role should the government play to provide stability to the housing finance system, both in times of prosperity and during downturns?* Geithner said, "This question is really about whether the government—in order to make sure that Americans can borrow at reasonable interest rates to buy a house even in a downturn—has to provide a form of guarantee or insurance against losses. Many countries do this, but they do it in very different ways. Some do it through the banking system, with the array of instruments used to protect banks. Some do it with specialized mortgage finance companies, with backing from the government. Some do it with covered bonds, which are bonds issued by banks but backed by individual mortgage loans. Some make the insurance or guarantees explicit. Many leave them implicit or hidden. Without such support, the risk is that future recessions could be more severe because the financial system would not have the capital to support mortgage lending on an adequate scale. House price declines could be more acute, with even greater damage to financial wealth and economic security. **The policy question is to what extent the private market can provide that form of insurance or guarantee on its own, or whether this is fundamentally a role for government**." [Emphasis added.] I believe there is a strong case to be made for a carefully designed guarantee in a reformed system, with the objective of providing a measure of stability in access to mortgages, even in future economic downturns. The challenge is to make sure that any government guarantee is priced to cover the risk of losses, and structured to minimize taxpayer exposure."

    - *What role should the government play in providing financial support to improve access to affordable housing?* Geithner said, "The choices here range from whether we should provide more support or less; whether we should realign our incentives for owning or renting a house; and how we delineate our support for affordable housing from the mechanisms we use for general housing finance."

  - *What should we do about the securitization market more generally?* Geithner said, "In the lead-up to this crisis, we saw a fundamental breakdown in incentives around underwriting. Risk migrated away from banks to non-banks that were not subject to supervision. Many firms in the mortgage business were not required to hold capital against the risks they took. Credit ratings agencies did not adequately capture the risks of a significant fall in housing prices. The Dodd-Frank reforms require very substantial changes to the securitization markets—markets that are so important to how we finance housing in America. Among other things, these reforms require a level playing field in terms of constraints on risk taking across financial firms—whether banks or non-banks—operating in the housing finance market, stronger consumer protections, new disclosure requirements, reforms of the credit rating agencies, and risk retention thresholds for specified mortgage products. We hope the discussions today will help us shape the rules required to implement these reforms."

- Panelist Bill Gross, co-founder and co-chief investment officer of PIMCO, argued that the GSEs should be restructured to provide "100 percent government financing" and consolidated into "one true Ginnie Mae." The GSE's hybrid public/private models are more expensive and tended to "favor Wall Street over Main Street," Gross argued. Government guarantees are crucial to providing liquidity in the marketplace and reducing mortgage rates, said Gross. Without government guarantees "rates would be hundreds of basis points higher"---perhaps by as much as 300 to 400 basis points, he argued. Gross also called on policy makers to "[re-engineer] refinancing" for all mortgages currently held by Fannie Mae and Freddie Mac. Gross suggested that dropping mortgages with interest rates ranging from 5% to 7% to 4% would "lift" housing prices by 5% to 10%, providing a tremendous shot in the arm for today's sluggish economy. Gross provides an expanded discussion of his proposal is in the September issue of *Investment Outlook* (www.scribd.com/doc/37357297/Investment-Outlook-September-2010)

- [Bill Gross appeared in the "*Vanity Fair* 100," the magazine's list of the 100 most influential people in the Information Age. In the October issue, *Vanity Fair* wrote, "With investors fleeing the stock market in droves, many are finding refuge at PIMCO, Gross's bond behemoth, which manages more than $1 trillion of other people's money. In 2008, while the broader stock market dropped 38%, PIMCO's flagship Total Return fund was up 4.3%. His biggest gamble: buying $200 billion worth of distressed debt from Fannie Mae and Freddie Mac. On the day the Treasury announced it would bail out the two mortgage giants, Gross's funds made a $2.5 billion profit." (*Vanity Fair*, 10/10)]

- Panelist Alex Pollock, resident fellow at the American Enterprise Institute, called for a dramatically smaller role for government in the mortgage market. Pollock argued that the private secondary markets could handle the bulk of mortgage loans, perhaps as much as 70%, providing mortgages to the middle and upper middle class. If Fannie Mae and Freddie Mac survive, the enterprises should be limited to operating in the "bottom half" of the mortgage market, Pollock said. Under this structure, Fannie and Freddie should be moved into HUD, along with Ginnie Mae and the FHA, he added.

- Panelist Susan Wachter, Richard B. Worley Professor of Financial Management, and Professor of Real Estate, Finance, and City and Regional Planning at the University of Pennsylvania's Wharton School, said that transparency and standardization are the elements for reforming our housing finance system. In the past, the market took on risks that it did not understand, so it was unable to price and control for the risk, said Wachter. "We need transparent information and databases," as well as standardization and regulation to preserve securitization, she added. In our housing finance system, the taxpayer always "owns the tail risk" to ensure stability, Wachter concluded.

- Ingrid Gould Ellen, professor of urban planning and public policy at New York University's Wagner Graduate School of Public Service and co-director of the Furman Center for Real Estate and Urban Policy, said a carefully designed government guarantee program is "critical in creating a stable, liquid system," but cautioned that getting guarantees right is "tricky business." Our challenge is designing a guarantee program to maintain liquidity, but at the same time minimizing moral hazard, said Ellen. She suggested "ideas" for creating a careful balance might include (i) limiting the scope of the guarantee program to mortgage backed securities; (ii) making any guarantee explicit, and having the government charge fees for the guarantees and create a reserve fund; (iii) limiting the type of mortgages that could be guaranteed to the "plain vanilla, safest and most easily understood"; and (iv) making sure that the government guarantees only kick in to cover catastrophic losses, after the private market insurers and securitizers have covered the first losses.

- Panelist Marc Morial, president and CEO of the National Urban League, said the housing finance reform debate offers the perfect opportunity to strengthen the government's commitment to affordable housing. Morial called on lawmakers to retain and expand the Community Reinvestment Act. He also pleaded with the administration not to allow GSE reform debate to evolve into a "weapon of mass deception," in which critics argue that government commitments to affordable housing, particularly for "communities of color" caused the economic meltdown. We must preserve the dynamic role of both the government and the private sector, Morial argued. "[GSE reform] must weigh the impact of decision making on Main Street America and Back Street America," he said, urging policy makers to pay careful attention to possible impacts on communities and families. Morial also urged policy makers to take a long-term look at national housing needs. Housing finance reform provides us a chance for a reset—an opportunity "rebuild the economy for the 21st Century"—and fix what is broken, but do not throw away what has worked, he said.

- There was an emerging consensus among the panelist—with the exception of Bill Gross—to create an insurance fund to guarantee mortgage-backed securities, using an explicit narrowly targeted government guarantee to cover catastrophic losses. Under a plan advanced by several panelists, Fannie Mae and Freddie Mac would be replaced by privately capitalized, federally chartered companies, which would buy mortgages and securitize them with a federal guarantee. The companies would pay a risk-based fee used to establish an insurance fund, similar to FDIC, which would be used to cover catastrophic losses on mortgage-backed securities. The transition from Fannie Mae and Freddie Mac to a new system will be difficult, as the government continues to absorb hundreds of billions of dollars in bad loans that the GSEs guarantee.

- "Public participation should be limited to providing only a layer of guarantee and setting credit standards for tightly defined conventional mortgages behind the borrower down payment, private mortgage insurance, and layers of reserves and capital at whatever future entities play this limited role," said S.A. Ibrahim, CEO of Radian Group Inc. "Public participation can be paid for through fees and further protect taxpayers through sound underwriting and appraisals, while additionally limiting the government guarantees to a historically safer catastrophic loan-to-value gap of, say, 70% or lower."

- A number of industry representatives endorsed this reform proposal, including the Housing Policy Council of the Financial Services Roundtable, the Mortgage Bankers Association and Wells Fargo & Co. Additional information on the proposal is provided in the Housing Policy's comment letter, available at www.scribd.com/doc/35846345/Housing-Policy-Council-Comment-Letter-on-the-Reform-of-Housing-Finance). (*Bloomberg News*, Lorraine Woellert and Rebecca Christie, 08/17/10; *American Banker*, Donna Borak, 08/18/10; *New York Times*, Binyamin Appelbaum, 08/18/10; *Washington Post*, Zachary Goldfarb, 08/18/10; *Wall Street Journal*, Nick Timaros, 08/17/10; *Treasury Press Release*, 08/17/10; *Bureau of National Affairs*, Thecla Fabian and Aaron Lorenzo, 08/18/10; *Vanity Fair*, October 2010; *Investment Outlook*, Bill Gross, September 2010)

Fannie Mae and Freddie Mac "should be abolished," say Chairman Frank and Representative Hensarling

- In a *Fox News* interview, House Financial Services Committee Chairman Barney Frank (D-CT) said Fannie Mae and Freddie Mac should be abolished rather than reformed as part of the administration's efforts to overhaul the housing finance system. "They should be abolished," said Frank. "The only question is what do you put in their place. There is no more hybrid public-private. …If we have it [guarantees], it has to be self-financed by the people who are benefiting. …If we want to subsidize housing, then we could do it upfront and let the budget be clear about it." Frank said he believes that the federal government should have a role in building affordable rental housing, but feels the money should go toward projects being built by private developers. (*Reuters*, Jo Anne Allen, 08/18/10)

- "I don't think [Fannie Mae and Freddie Mac] are needed," said Representative Jeb Hensarling (R-TX), a senior Republican on the House Financial Services Committee. "Why, when I look at other industrialized nations, do I see higher rates of home ownership and no … [Fannie and Freddie]? I see lower rates of foreclosure. I don't see the compelling reason except that we've done it this way." Hensarling has proposed legislation that would eliminate Fannie Mae and Freddie Mac within five years. (*Dallas Morning News*, Dave Michaels, 09/10/10)

<u>The 'Julius Caesar strategy' for reforming Fannie and Freddie: Divide them into three parts</u>

- In an August 26 commentary in the *American Banker*, AEI resident fellow Alex J. Pollock wrote, "…The giant GSE risk turkey has been roosting in the dome of the U.S. capital ever since Fannie and Freddie entered into regulatory conservatorship almost two years ago. It won't go away, so the elected representatives of the people cannot forget the mistakes they made in fattening it up so much. …The taxpayer bailout of Fannie and Freddie is without question a government intervention to save previous government interventions."

- "Since the entire intellectual premise of the Dodd-Frank regulatory expansion act is that government intervention in financial markets will improve things, it was obviously difficult for its supporters to admit that the massive intervention represented by Fannie and Freddie turned out to be a massive government blunder. Does the 21st century need GSEs in order to have securitization of prime mortgage loans? No, it doesn't."

- "The future mortgage finance system should have a robust private secondary market for the largest segment of the business: prime, middle-class mortgage loans. In this market, private investors should put private capital at risk, and prosper or lose as the case may be. This is the most obvious case where the risks are manageable and no taxpayer subsidies or taxpayer risk exposures are required or desirable. … [A]s we move into the future mortgage finance system, the prime mortgage market should stand on its own."

- "A private secondary market for prime mortgages should have been a natural market development. Why did it never develop? The answer is obvious: no private entity could compete, or can now compete, with the government-granted advantages, and now the huge explicit subsidies, of the GSEs. There can be no evolution of a private prime mortgage loan market while the GSEs make private competition impossible."

- "The core issue about GSEs is this: You can be a private company, with market discipline; or you can be part of the government, with government discipline. But you can't be both."

- "As recommended by the Congressional Budget Office, Fannie and Freddie should now be on the federal budget. Honest, on-budget accounting would give Congress a strong incentive to junk the failed GSE model and proceed to restructure Fannie and Freddie on the correct principle of 'one or the other, but not both.'"

- "Julius Caesar famously wrote that Gaul overall was divided into three parts ('Gallia est omnis divisa in partes tres'). The fundamental reform of Fannie and Freddie should be the 'Julius Caesar strategy': divide them into three parts. The first part, unfortunately, must be two liquidating trusts or 'bad banks' that will bear Fannie and Freddie's deadweight losses, the nearly $150 billion already spent by the Treasury and the additional embedded losses that will be recognized over time, unjustly but at this point unavoidably borne by the taxpayers. These trusts can be modeled legally on the structure used for the privatization of Sallie Mae in 1996."

- "The second part of Fannie and Freddie should be formed by the privatization of their prime mortgage loan securitization and investing businesses. All of their intellectual property, systems, human capital and business relationships should be put into truly private corporations, sold to private investors, and sent out into the world to compete like anybody else—sink or swim, flourish or fail. They will be free to do anything they think will create a successful business—except trade on the taxpayers' credit card."

- "The final element of the former Fannie and Freddie consists of those activities that are properly those of the government: such as providing housing subsidies in one form or another and providing nonmarket financing of risky loans. These should be put explicitly in the government. They should be fully subject to the discipline of congressional approval. Funding for these activities would have to be appropriated by Congress in a transparent, democratic way. These governmental functions of Fannie and Freddie should be merged into the structure of the Department of Housing and Urban Development along with the government mortgage programs of the FHA and Ginnie Mae."

- "In sum, the GSEs should be divided into three parts: liquidating trusts, private mortgage businesses and a government agency inside HUD. No GSEs would be left." (*American Banker*, Alex J. Pollock, 08/26/10)

- The Bank for International Settlements (Basel) announced on September 12 its new capital standards, designed to increase capital buffers and avoid another financial crisis. Basel III will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress, bringing the total common equity requirements to 7%.

Calibration of the Capital Framework

Capital requirements and buffers (all numbers in percent)

	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

Source: Bank for International Settlements Press Release, 09/12/10

- At *Seeking Alpha* blog, Felix Salmon wrote, "Possibly the most important thing here is the existence of the first column, setting minimum standards for common equity—which is also known as core Tier 1 capital. Such standards did exist in the past, but they were set extremely low, at just 2%, and so were generally ignored. As of now, common equity is the main thing that matters. No more throwing any old garbage into the Tier 1 bucket and calling it capital: the new standards for common equity are significantly tougher than the old standards for Tier 1 capital in total. The absolute bare minimum for core Tier 1 capital is 4.5%, and the new minimum for Tier 1 capital in general has now been raised to 6%. The minimum for Tier 2 remains at 8%."

- "But that's just the beginning. On top of that there's a 'conservation buffer' of another 2.5 percentage points; to a first approximation, any bank you've heard of is going to want to be well outside that buffer, because they won't be able to pay dividends if they don't have the full buffer in place. If there's some kind of crisis and they're forced to write down a lot of bad loans, they can eat into the buffer — but that will bring extra regulatory oversight, and they won't be able to pay dividends. That's sensible. With the conservation buffer, then, banks need 7% common equity, 8.5% Tier 1 capital, and 10.5% Tier 2 capital."

- "And it doesn't stop there, either. When credit in an economy is growing faster than the economy itself, a countercyclical capital buffer kicks in, which essentially says that banks need to have more capital in good times. That countercyclical buffer won't be set by the BIS in Basel; it'll be left up to national regulators. But you can probably expect the UK, US, and Switzerland to enforce it up to the maximum of 2.5%. So when the economy's booming, banks are going to need 9.5% common equity, 11% Tier 1 capital, and 13% Tier 2 capital."

- "But wait, there's more! 'Systemically important banks should have loss absorbing capacity beyond the standards announced today,' says the BIS—we don't know what they're going to announce on that front, but the chances are that when an announcement comes, the biggest banks are going to need significantly more capital than what we're seeing here."

- "This is all very welcome stuff. But it neither can nor should be implemented overnight. Instead, there's a timetable built in to the new capital standards:"

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

Source: Bank for International Settlements Press Release, 09/12/10

- Under the agreement, some changes will go into effect in 2013, while others won't be in place until the beginning of 2019. For example, banks will have to begin building a 2.5% buffer of capital in 2015, which must be fully in place by January 1, 2019. Technical changes to the definitions of capital won't be fully phased in until 2023.

- Under pressure to avoid derailing the stuttering economic recovery by restricting credit, regulators agreed to phase in the rules over more than eight years—a longer time frame than U.S. regulators had hoped for. "The recovery is slow and we want to move to these higher standards in a gradual way," said Stefan Walter, secretary general of the Basel Committee on Banking Supervision. "It's a balanced approach." (*Bank for International Settlements Press Release*, 09/12/10; *Wall Street Journal*, Damian Paletta and David Enrich, 09/13/10; *The Conglomerate*, David Zaring, 09/12/10; *Business Insider*, Joe Weisenthal, 09/12/10; *SeekingAlpha*, Felix Salmon, 09/12/10)

- *The Economist* wrote, "Since it did not change this risk-weighting, Basel III effectively doubles down on Basel II. Banks will need to hold more common equity than ever—against their risk-weighted assets. That massively increases the incentive to find low-risk-weight assets with some return, since these assets can be leveraged much more highly than risky assets. Unless I've missed something, lending to AA-rated sovereigns still carries a risk-weight of zero. So one result of Basel III could be to encourage banks to increase their lending to sovereigns at the margins of zero-risk-weight status. If that happens, anyone want to guess where the next crisis will crop up?"

- "The sad truth is that there is no set of rules that will ensure the solvency of the banking system, or its resiliency in a crisis. In a competitive market, banks have no choice but to seize any available opportunity to increase their return on capital. That means that regulators need to be dynamic in their response to changes in the marketplace, and anything that appears to generate returns with low risk should raise a red flag. In other words, if Basel III appears to be working—and banks are lending healthy amounts, generating good returns, and running less risk than ever—that's exactly what should make us worry." (*The Economist*, 09/13/10)

- In a September 14 commentary in the *Wall Street Journal*, George Melloan wrote, "…There's something to be said for holding banks to higher capital standards, even at the cost of more constrained lending and slower economic growth. But the much-bruited idea that Basel rules will make the world freer of financial crises is highly doubtful, given current political circumstances. The 2008 financial meltdown was not primarily the result of lax regulation but of co-option and abuse of the U.S. financial system by the political class in Washington. The federal government's 'affordable housing' endeavors, beginning in the 1990s, allowed and even forced banks to make highly risky mortgage loans. Those loans were folded into mortgage-backed securities (MBS) sold in vast numbers throughout the world, most promiscuously by two government-sponsored enterprises, Fannie Mae and Freddie Mac."

- "The Federal Reserve contributed a credit bubble that caused house prices to soar, a classic asset inflation. When the bubble began to deflate in 2007, the bad loans in mortgage securities became poisonous. The MBS market seized up, and financial institutions holding them became illiquid and began to crash. The Lehman Brothers collapse was the biggest shock."

- “The only way Basel standards might have helped prevent this would have been if they had been applied to Fannie and Freddie as well as to banks. They weren't. President Bill Clinton exempted the two giants from Basel capitalization rules because they were the primary instruments of a federal policy aimed at helping more lower-income people become homeowners. This was a laudable goal that ultimately wrecked the housing and banking industries.”

- “Washington has learned nothing from this debacle, which is why the next financial crisis is likely to have federal policy origins and may come sooner than we think. Fannie and Freddie—now fully controlled by Uncle Sam and exempt from the Dodd-Frank financial ‘reform’ legislation—are still going strong, guaranteeing and restructuring loans while they continue to rack up huge losses for taxpayers. Meanwhile, instead of backing off from such dangerous welfare-state initiatives, the new Obama administration and Pelosi-Reid Congress last year doubled down.”

- “Futile ‘stimulus’ spending and union bailouts swelled the deficit, as will ObamaCare. The U.S. Treasury's gross borrowing has been running as high as $1.9 trillion a year to finance a $1.5 trillion federal deficit. Very few economists think the U.S. government can continue to borrow 42% of its vast spending budget, much of it from abroad, without running into trouble.”

- “The reason is that as federal borrowing exhausts the cheap credit available at home and abroad, Washington politicians will likely once again call upon the Federal Reserve to finance Treasury borrowing directly—just as it did for a time after the 2008 crash. The Fed bailed out Fannie and Freddie to the tune of over $1 trillion by buying mortgage securities, and as those securities mature it will free up cash for U.S. bond purchases. But most of the Fed's support for Treasury borrowing will ultimately have to be financed by printing new money. The Fannie-Freddie redemptions will themselves be a drain on the Treasury, adding to its financing needs.”

- “Meanwhile, Mr. Bernanke and his central banking colleagues have forged a new Basel agreement. It is a fine document and may even be incorporated into the banking laws of the signatory nations over the next decade, although there is no certainty of that.”

- “Even so, not everyone is thrilled. Banking analysts are rightly skeptical of new layers of regulation. At the moment the industry is faced with digesting Dodd-Frank (fashioned by Fannie and Freddie's two biggest fans in Congress). The full consequences of this massive law will only be known after its implementation. But it's a safe bet it will raise costs, divert more resources to pointless regulatory compliance and, because of its imprecision and complexity, create a lot more work for lawyers.”

- “The record since the Basel process began 22 years ago doesn't generate faith in banking regulation either. Basel rules didn't prevent the collapse of Japanese banking in 1990, they didn't prevent the 2008 meltdown, and they are not preventing the banking failures that plague the financial system even today. They most certainly will not instill wisdom and a sense of fiscal responsibility in the men and women who design U.S. government spending policies and write the laws that implement them."

- "A T-shirt slogan of years back read, 'Some day, I'm going to get organized.' The Basel rule makers, after beavering away once more trying to define such abstruse concepts as strong and weak capital and high versus low risks, obviously hope that they have finally got things right. Given the inherent limitations of any effort to regulate and instill safety into highly complex and variable human transactions, they and we are likely to be disappointed." (*Wall Street Journal*, George Melloan, 09/14/10)

President Obama considers bypassing Congress with his appointment of Elizabeth Warren as "interim head" of the Consumer Financial Protection Bureau

- President Obama is considering appointing Harvard law professor Elizabeth Warren as interim head of the Consumer Financial Protection Bureau (CFPB), bypassing a likely Senate confirmation battle, according to sources. A little-noticed provision in the Dodd-Frank Act allows the person charged with setting up CFPB to be an outright appointment, rather than a nomination subject to Senate confirmation. Under Dodd-Frank, The Treasury Secretary is explicitly authorized by an Act of Congress to pick an interim head for the new agency—with a view to getting the bureau up and running immediately. By naming Warren interim head, the administration would sidestep a likely fight over her nomination, leaving the president the option to formally nominate Warren to the position sometime next year or select another candidate if she becomes too polarizing.

- The White House is facing intense pressure to nominate Warren, a favorite of liberal groups and labor unions. A White House spokeswoman said, "Elizabeth Warren has been a stalwart voice for American consumers and families and she was the architect of the idea that became the Consumer Financial Protection Bureau. The President will have more to say about the agency and its mission soon."

- On September 14, Senate Democrats generally supported appointing Warren to head the CFPB, arguing that the administration should use any method possible to appoint her—even as a temporary head of the agency. However, Senate Banking Committee Chairman Chris Dodd (D-CT) joined with Republicans, arguing that such a move would be a mistake. Senate Republicans insisted that Warren's appointment should go through the traditional Senate confirmation process, requiring cat least 60 votes to block a potential filibuster. (*National Mortgage News*, 09/10/10; *Baseline Scenario*, Simon Johnson, 09/10/10; *American Banker*, 09/13/10; *Wall Street Journal*, Damian Paletta, 09/13/10; *American Banker*, 09/14/10)

President Obama unveils $50 billion infrastructure plan to create jobs

- President Barack Obama called on Congress to pass legislation authorizing an initial $50 billion investment in infrastructure projects and renewing a six-year surface transportation infrastructure bill. The president also unveiled a set of principles for surface transportation authorization with an emphasis on high-speed rail. Obama's long-term framework calls for the establishment of an Infrastructure Bank [a government-sponsored entity] to leverage federal dollars that will focus on investments of national and regional significance. Obama also recommended that Congress replace earmarks with performance-based funding. The president's initiative is designed to create jobs with the infusion of tax dollars and overhaul the way infrastructure is funded.

- "It will change the way Washington spends your tax dollars, reforming the haphazard and patchwork way we fund and maintain our infrastructure to focus less on wasteful earmarks and outdated formulas and more on competition and innovation that gives us the best bang for our buck," said Obama.

- Senator John Kerry (D-MA) pledged to help President Obama with his infrastructure initiative. Kerry said, "I am developing legislation to establish an American Infrastructure Bank that will attract and channel private capital to our domestic infrastructure needs. These large private investments will provide the funding we need to modernize our infrastructure while creating jobs and a competitive base for American businesses and workers. It will help reconnect America by linking urban centers and rural communities through a network of high speed rail and road investments. It's no secret that I've long supported high speed rail and I believe we need to build upon the investment we made with the Recovery Act. Now is the time to act on the kind of ideas outlined by President Obama and I plan to work in the Senate to make that happen." (*Politico*, Mike Allen and Abby Phillip, 09/16/10; *CQ Today*, Kathryn A. Wolfe, 09/06/10; *Press Release from the Office of Senator John Kerry*; 09/06/10)

- In a September 8 editorial, the *Washington Post* wrote, "President Obama's Labor Day proposal to create a national infrastructure bank and accelerate infrastructure spending may or may not be good politics. It certainly would be good policy, both short- and long-term. The proposal, which would require congressional approval, will not create jobs right away, but it has become painfully clear that slow job growth is a problem that will take years to resolve."

- Front-loading the spending so that $50 billion would be available quickly is a sensible idea in this environment. In the construction industry, the unemployment rate is 17 percent, almost double the national average, and at risk of growing even higher as stimulus spending peters out. To dismiss this proposal, as did House Minority Leader John A. Boehner (R-OH), as 'more of the same failed stimulus spending,' misunderstands both the effectiveness of the current spending and the particularly useful nature of infrastructure investment, which is not dependent on consumers' decisions to spend rather than pay down their debt. Mr. Obama proposes to pay for this spending by doing away with tax breaks for oil and gas companies.

- "But even in a rosier economic climate, Mr. Obama's proposals would make sense. The nation's infrastructure is fraying. Improvements—Mr. Obama spoke of investments in such areas as high-speed rail and next-generation air traffic control—could strengthen America's global competitiveness. Meanwhile, spending by earmark and formula is a recipe for waste. The current system skimps on long-term planning and is stacked against maintaining existing roadways and other components."

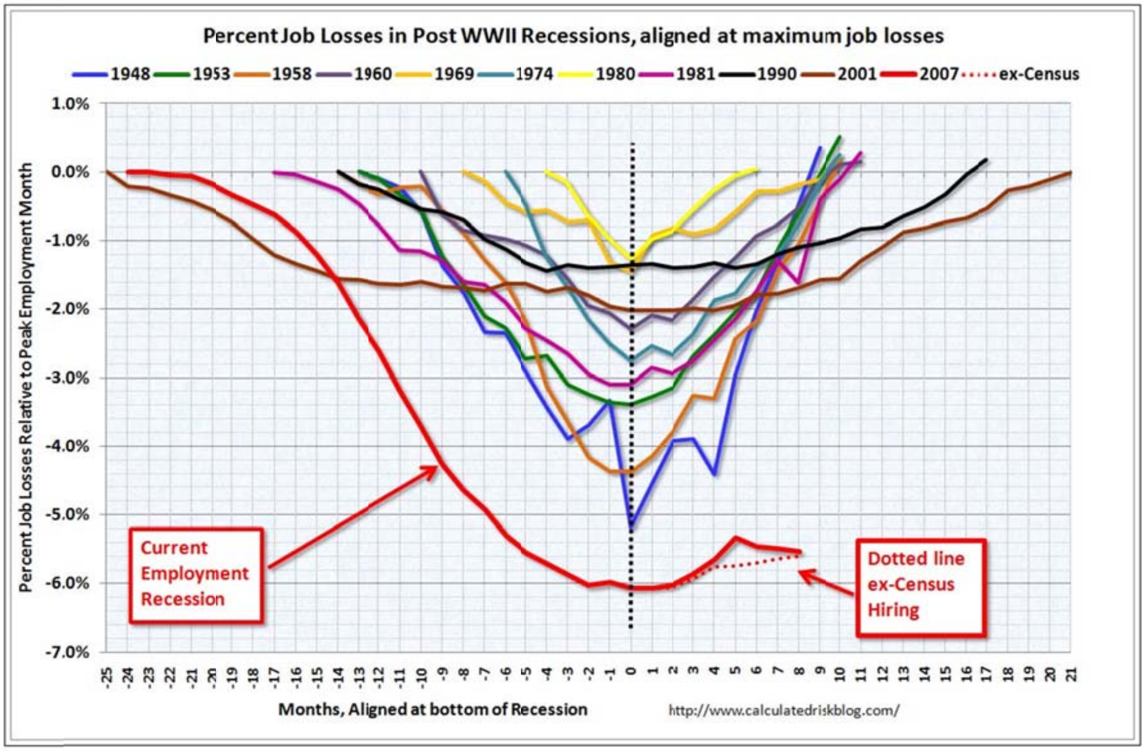
- "An infrastructure bank, structured with some degree of political independence, could add a welcome degree of rationality to the existing hodgepodge of projects dictated as much by congressional seniority and whim—see, e.g., the bridge to nowhere—as by merit. An infrastructure bank could better take regional needs into account and leverage private capital. A companion proposal, to bring a 'Race to the Top'-type competition to transportation funding, is also promising."

- "There are reasons to be doubtful about whether any of this will come to pass. It's not at all clear that Congress is prepared to fork over an additional $50 billion. The president has proposed the infrastructure bank twice before. Perhaps he will, as administration officials argue, have better luck in the context of the broader reauthorization of transportation funding that is now overdue."

- "In addition, as Robert Puentes of the Brookings Institution points out, the president's proposal leaves out one key question: long-term funding. Mr. Obama unwisely has ruled out an increase in the gasoline tax and quashed any talk of an even more justifiable vehicle-miles-traveled tax. Reduced driving and more-efficient vehicles have depleted the highway trust fund, which is fueled by the gas tax. As Mr. Puentes put it, 'A jump start now is no good if we stall again down the road.'" (*Washington Post,* 09/08/10)

- The administration's push for stimulus spending seeks to boost job creation, as economists fear the jobless rate will approach 10% with the economy failing to grow enough to employ new entrants into the workforce. The economy expanded at a 1.6% annual rate in the second quarter, down sharply from 3.7% for the first quarter. The economy needs to grow at rate of about 2.5% for the unemployment rate to remain constant. Bank of America-Merrill Lynch projects the unemployment rate will peak at 10.1% in 2011, as growth slows to 1.8% for all of 2011.

- The economy would have to create 240,000 jobs a month for the next five years to return to pre-recession levels of employment, according to the U.S. Chamber of Commerce. (*Bloomberg News,* Timothy R. Homan, 09/07/10; *Associated Press,* Christopher S. Rugaber, 08/27/10; *Reuters*, Ros Krasny, 07/27/10; *Bureau of National Affairs*, 09/03/10)



Source: *http://calculatedriskimages.blogspot.com/2010/09/percent-job-losses-aligned-at-bottom.html*

Will Dodd-Frank Act end bailouts?

- At a hearing on "too big to fail" institutions, the Financial Crisis Inquiry Commission asked Federal Reserve Board Chairman Ben Bernanke and FDIC Chairman Shelia Bair if the new systemic risk council will have the political will to break up risky firms, raising concerns about "living wills" and the risk that regulators would be eventually forced to provide assistance to large troubled companies. "Why should we believe that this Council is going to be uniquely different and keep us out of trouble?" asked Commissioner John Thompson.

- Testifying separately, Bernanke and Bair assured the panel that the days of bailouts are officially over. Bair insisted that the Financial Stability Oversight Council (FSOC) created by Dodd Frank, will be held accountable. "If there is a systemic crisis, we can't go and say, 'Well, the Fed had the bank holding companies, the OCC had national banks, and the SEC had the investment banks,' we are all put together in the same room," said Bair. "It is our job to manage systemic risk and make sure there are no regulatory gaps. We have accountability. We have ownership. If we don't do our job, we should be held strongly accountable."

- Some members on the Commission were not swayed by the regulators' assurances. Douglas Holtz-Eakin, former economics advisor to Senator John McCain's 2008 presidential campaign, asked, "Isn't the new stability council just the President's Working Group with a coat of paint?" Bair insisted that the FSOC is different because it has "specific responsibilities with specific timetables for jobs. I think it will be a more robust, comprehensive effort." Bair and Bernanke pointed to the FSOC's powers, which include the authority to break up an institution if it is deemed risky and responsibility to set higher capital, liquidity and leverage standards.

- Commissioners questioned if the members of the FSOC would have the fortitude to break up a company—and if other policymakers would support their actions. "Do you believe that there is the political support both in the executive branch and in the Congress to implement these available powers to being the process of restraining the growth of these companies" asked former Senator Robert Graham, a member of the commission. Bernanke responded, "If there's a lack of political will, there's probably no solution that is sustainable." But, he added, regulators will try to follow through. "We have both the living will requirement, but in addition we also have the authority—the regulators collectively—to break up firms, if necessary," he said. "You may ask if there's political will to do that, and I don't know the answer to that question. But certainly, that's the charge that Congress has given the regulators and we take very seriously that charge."

- "Regulators must have the courage to act on the Council's recommendations, if we are to address systemic risk before they result in damage to our economy," said Bair. "We're certainly forging ahead and I think everybody else is just as committed."

- Asked if large, complex firms should be broken up, Bernanke repeated that size in and of itself is not the problem, but whether the firm has the ability to properly manage the institution. "It's our responsibility to make sure their management is effective," Bernanke added. "If we are persuaded that they cannot manage the risks of their organization because it is too complex, we have the ability to change their structure. Whether there is a failure of risk management or business management because of business complexity, it's very important regulators work to address the problem, and I assure you that we will."

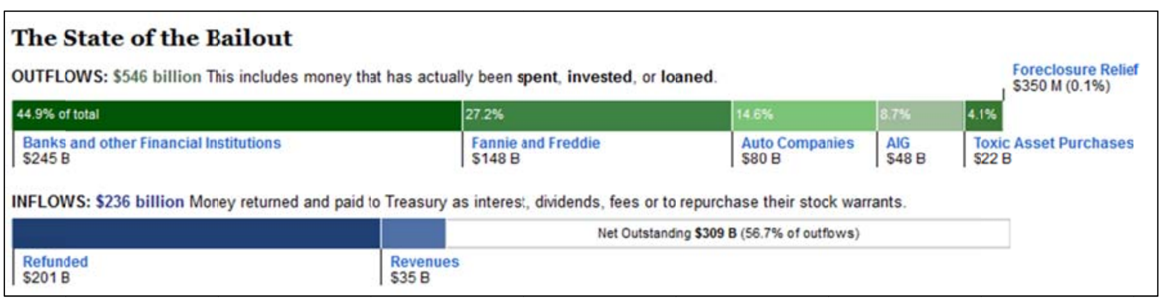
- Bair said she hopes that the FDIC will promulgate rules for living wills before the Dodd Frank deadline of 18 months following the bill's enactment. She has established a target of setting up a general framework for resolution authority in the interim, followed by a detailed plan within the next several months. "Markets in the United States are very resilient, and I think they understand what the rules are, they will be able to live within the rules," said Bair.

- "What's different now?" asked Holtz-Eakin. "How would it play out for Bear [Stearns], Lehman, AIG—if those authorities were in place?" Bernanke responded that all three companies would have been seized and unwound by the regulators. "In all three cases, they would have been appropriate candidates for use of resolution authority," he said. "I don't know what the alternative would have been unless we could have stopped the [liquidity] runs with cheery words. But, I don't know how to do that."

- If the FDIC had the Dodd Frank authorities in 2008, Bair said her agency would have had a detailed resolution plan for Wachovia Corp before it intervened in September 2008. "We would have had better information about its structure and risk profile," she said. "And, we would have faced fewer impediments to effecting its orderly resolution. In short, Wachovia, or Lehman for that matter, could have been resolved without a bailout and without disrupting financial markets."

- Bernanke and Bair assured the commissioners that the federal government will no longer bail out financial firms. "Changes in the bill have eliminated the ability of the Fed to lend to an individual institution," said Bernanke. "Barring some midnight session of Congress that rewrites the law, I don't think it would be feasible for us to bail out firms the way we did during the crisis." Bair added, "Bailouts are just not acceptable, going forward. We pushed for this line. The statute specifically prohibits any kind of open institution assistance. So if it happens, it's going to be Congress doing it. The regulators have no authority to do bailouts anymore, and that's a good thing." (*The Hill*, Silla Brush, 09/12/10; *American Banker*, Donna Borak, 09/03/10; *New York Times*, Swell Chan, 09/03/10)

TARP



Source: http://www.propublica.org/ion/bailout

TARP's costs to taxpayers falls to $66 billion, according to CBO estimates

- The Congressional Budget Office projects the overall deficit impact of TARP will be approximately $66 billion, a 40% drop from its previous estimate of $109 billion made earlier this year. CBO attributed its lower cost estimate to a provision in the Dodd Frank Act that prevents future spending of TARP funds, along with better returns on TARP funds loaned to banks and lower loss estimates for the assistance provided to the auto industry. (*Reuters*, Dave Clarke and David Lawder, 08/19/10; *Bureau of National Affairs*, 08/24/10)

Congressional Oversight Panel urges policymakers to create an international plan to handle the collapse of major, globally significant financial institutions

- In an August 12 report to Congress, the Congressional Oversight Panel evaluated the global context and international effects of TARP. COP compiled the following chart detailing the potential international dimension of the federal government's bailout programs.

U.S. Firms	Federal Funds Received (*$millions*)[313]	Non-U.S. Revenue (*$millions*) 2005	Non-U.S. Revenue (*$millions*) 2006	Non-U.S. Revenue (*% Total*) 2005-2006
American Express[314]	3,389	8,180	8,760	33%
AIG[315]	69,835	49,685	55,899	48%
Bank of America[316]	35,000	5,178	10,699	12%
Bank of New York-Mellon[317]	3,000	1,810	2,063	30%
Capital One[318]	3,555	1,088	997	8%
Chrysler[319]	14,310	NA	NA	NA
Citigroup[320]	50,000	33,414	38,211	41%
General Motors[321]	50,745	54,557	63,310	35%
GMAC[322]	16,290	2,170	2,091	11%
Goldman Sachs[323]	10,000	10,599	17,304	44%
JPMorgan Chase[324]	25,000	11,480	16,091	24%
Merrill Lynch[325]	10,000	8,518	12,056	34%
Morgan Stanley[326]	10,000	9,540	13,511	38%
State Street[327]	2,000	2,130	2,741	41%

Source: August Oversight Report, Congressional Oversight Panel, 08/12/10

- The Panel wrote:

> "Even at this late date, it is difficult to assess the precise international impact of the TARP or other U.S. rescue programs because Treasury gathered very little data on how TARP funds flowed overseas. As a result, neither students of the current crisis nor those dealing with future rescue efforts will have access to much of the information that would help them make well informed decisions. In the interests of transparency and completeness, and to help inform regulators actions in a world that is likely to become ever more financially integrated, the Panel strongly urges Treasury to start now to report more data about how TARP and other rescue funds flowed internationally and to document the impact that

the U.S. rescue had overseas. Going forward, Treasury should create and maintain a database of this information and should urge foreign regulators and multinational organizations to collect and report similar data."

"The crisis also underscored the fact that the international community's formal mechanisms to resolve potential financial crises are very limited. Even though the TARP legislation required Treasury to coordinate its programs with similar efforts by foreign governments, the global response to the financial crisis unfolded on an ad hoc, informal, country-by-country basis …These ad hoc actions ultimately restored a measure of stability to the international system, but they underscored the fact that the internationalization of the financial system has outpaced the ability of national regulators to respond to global crises."

"In particular, the crisis revealed the need for an international plan to handle the collapse of major, globally significant financial institutions. …Additionally, the development of international regulatory regimes could help to discourage regulatory arbitrage, instead encouraging individual countries to compete in a 'race to the top' by adopting more effective regimes at the national level."

"…Moving forward, it is essential for the international community to gather information about the international financial system, to identify vulnerabilities, and to plan for emergency responses to a range of potential crises. The Panel recommends that U.S. regulators encourage regular crisis planning and "war gaming" for the international financial system. This recommendation complements the Panel's repeated recommendations that Treasury should engage in greater crisis planning and stress testing for domestic banks. Financial crises have occurred many times in the past and will undoubtedly occur again in the future. Failure to plan ahead will only undermine efforts to safeguard the financial system."

"Careful policymakers would put plans in place before the next crisis, rather than responding on an ad hoc basis at the peak of the storm." (*August Oversight Report*, Congressional Oversight Panel, 08/12/10)

Court refuses to ok Citigroup's $75 million settlement with the SEC
Citigroup faces questions regarding the value of its deferred tax assets
Citigroup to triple its China workforce over the next three years

Court refuses to ok Citigroup's $75 million settlement with the SEC

- The U.S. District Court for the District of Columbia declined to approve Citigroup's proposed agreement to pay the SEC $75 million in a settlement for charges related to subprime disclosures during the summer of 2007. Judge Ellen Huvelle said she is "baffled" by the proposed pact. "I look at this and say, 'Why would I find this fair and reasonable?'" said Huvelle at a 90 minute hearing on August 16. "You expect the court to rubber-stamp, but we can't."

- Huvelle asked the SEC to submit details about the agency's charges against Citigroup and information on the penalty determination. The judge has schedule a September 23 conference to reconsider the settlement. The court's decision exemplifies an increasing trend among courts and lawmakers to scrutinize the adequacy of settlement agreements that the SEC is reaching with Wall Street firms.

- Separately, the SEC brought related cases against Citigroup's then-CFO, Gary Crittenden, and its then-head of investor relations, Arthur Tildesley, Jr., which were filed in administrative court outside Judge Huvelle's purview. The former Citi executives settled with the SEC by paying fines of $100,000 and $80,000 by Crittenden and Tildesley, respectively without admitting or denying wrong-doing. (*Wall Street Journal*, Kara Scannell, 08/17/10; *Bureau of National Affairs*, Malini Manickavasagam, 08/18/10)

<u>Citigroup faces questions regarding the value of its deferred tax assets</u>

- Citigroup is at the center of a dispute among Wall Street analysts over whether the bank should write-off portions of the $50 billion of deferred taxes (DTAs), a step which would reduce its capital levels and weaken its balance sheet. On June 30, Citigroup's deferred taxes comprised more than a third of Citi's tangible capital.

- Citi argues that it is confident that it will earn $99 billion in taxable income over the next decade—a key test under current GAAP rules that would allow the Bank to avoid making any DTA write downs. During the 2002-2006 period, Citi reported annual pre-tax profits of at least $20 billion.

- Skeptical analysts argue that Citi is being too optimistic with its projections, in light of the Bank's pre-tax losses for 2008 and 2009 with topped $60 billion and today's continued global economic uncertainly. "Why should auditors, investors, regulators and others rely on Citigroup projections …to justify the use of their DTAs?" asked CLSA analyst Mike Mayo in a note to investors. "Citi's position defies imagination," said Lynn Turner, former chief accountant for the SEC. "Instead of talking about making money, what Citi ought to do is to reserve for at least part of the DTAs and reap the benefit of reducing the reserves once it actually makes money."

- The SEC evaluated Citigroup's DTAs last year, but declined to comment on whether it was pursing the matter. The issue of DTAs for Citi and other banks has arisen because the GAAP rules governing these assets are vague—stating that reserves are not needed if management believes that it is "more likely than not" that the company will generate adequate taxable income in the future to utilize the DTAs. (*Financial Times*, Francesco Guerrera and Jean Eaglesham, 09/07/10)

Citigroup to triple its China workforce over the next three years

- Citigroup plans to triple its workforce to as many as 12,000 over the next three years, ramping up its presence in the world's fastest growing economy and intensifying its rivalry with HSBC Holdings PC. The expansion would make China the Bank's third largest market by staff after the U.S. and Mexico, said Stephen Bird, Citigroup's co-CEO for the region.

- Citigroup CEO Vikram Pandit is raising his bet on the China market in which banks originated a record $1.4 trillion in new loans in 2009. Citigroup currently employs 4,500 employees in China and 50,000 in Asia, said Bird. "China is one of Citi's priority markets globally," said Bird. "We have aggressive consumer banking expansion plans and want to open more branches as fast as the regulators will let us." Citi has 29 branches in China and plans to open 10 new facilities this year. Citi will fund its expansion in China with money generated in its Asian operations, rather than selling shares in the market (as planned by HSBC and Standard Charter Plc), he added. (*Bloomberg News*, Cathy Chan, 08/31/10)

AIG pays back nearly $4 billion of federal loans

- AIG made its single-biggest repayment of bailout funds on August 23, repaying $3.9 billion of loans from the Federal Reserve Bank of New York from proceeds raised through a recent debt sale. AIG's International Leasing Finance Corp, an aircraft leasing subsidiary, completed the sale of $4.4 billion of debt. "[The offerings] are a direct reflection of our company's viability and future prospects as a leader in leasing aircraft to the world's airlines," said Henri Courpon, ILFC's CEO. The repayment will trigger release of $10 billion of that ILFC pledged to the Federal Reserve under AIG's credit agreement.

- AIG will book a pretax charge of $650 million against third quarter earnings related to the loan repayment. The insurer has $15 billion outstanding on its line of credit with the Fed with a total owed of $21 billion, including interest. In addition, AIG owes $31 billion in Fed borrowings secured by the insurer's Maiden Lane companies; $49 billion for Treasury's investment in preferred stock. According Wall Street source, AIG is considering a bond offering of its own in response to high demand for paper by the "yield chasers" in the credit markets.

- "This is continuing tangible evidence of AIG's progress in repaying the American taxpayers," said AIG CEO Robert Benmosche. "AIG is getting stronger every day. We still have more work to do, but we will finish the job and make sure we repay the American taxpayers." (*Associated Press*, 08/23/10; *Fortune's Street Sweep Blog*, 08/23/10)

General Motors files its Form S-1 with the SEC

A dash of realism about GM's "pension time bomb"

US auto sales hit a 28-year low in August

General Motors files its Form S-1 with the SEC

- General Motors filed its Form S-1 with the SEC to begin the legal process of conducting an initial public offering of stock to be sold by shareholders, including the U.S, and Canadian governments. GM will issue Series B mandatory convertible junior preferred shares with the amount and price range to be determined at a later date. The company hopes to sell 20% of Treasury's 304 million shares, which would reduce the government's stake from 61% to less than 50%. The United Auto Workers are also expected to sell some of its stock during the offering, according to sources. (The UAW's 17.58% ownership stake is held in an independent trust, dedicated to paying the costs of GM retirees' health care costs.)

- Treasury released a statement after the filing, saying that the agency retains the right to determine how much of the government's $42.2 billion equity holdings in the company will be included in the IPO. Treasury said it will determine the size of the offering, based upon the state of the financial markets and investor sentiment at the time of the offering. The offering will not include any of the $2.1 billion in Series A preferred stock that agency holds in GM, added Treasury. Sources familiar with the offering expect the IPO to raise between $10 and $15 billion.

- For the government to break even on its GM investments, the company's shares must be worth at least $69.4 billion—10 times GM's market capitalization before the automaker declared bankruptcy in June 2009. The government's stake would have to be even more, if bondholders and UAW exercise warrants for 106 million shares with strike prices ranging from $30 to $126.92 each, according to the Form S-1.

- The government "is likely" to take a loss on its shares sold in the first GM offering with subsequent offerings sold at a profit [depending upon a market acceptance], according to sources close to the IPO preparation. Selling the GM stock at a discount in the first offering could help ally investor concerns about the slow economic recovery and flat auto sales and assure the offering's success, said sources. It could take more than three years for Treasury's remaining stake in GM to be sold The question of whether taxpayers ultimately coming out "whole" on the GM investment could remain

- In the 734-page filing, GM described its corporate strengths that serve as a foundation for future growth which include (i) the company's global presence; (ii) the size and dealer network; (iii) its attractive market share in fast growing regions such as China and Brazil; (iv) the quality of GM's vehicles; (v) its competitive cost structure; and (vi) its commitment to new technologies.

- GM also listed a number of risk factors, including (i) uncertainty in the economy; (ii) the capital-intensive nature of the automobile industry; (iii) government limits on executives' compensation that may hamper its ability to attract and retain managers; (iv) the consolidation of the dealer network; and (v) the outlook for restructuring its European operations. GM also disclosed in the filing that it is unable to assure the accuracy of its financial details about its operations because of material weaknesses in its internal financial controls. While GM has taken steps to resolve the weaknesses, the company will not be able to test its systems until next year, when year-over-year comparisons can be evaluated to test the system's effectiveness.

- David Dreman, chairman of Dreman Value Management, said he is "a little wary" of investing in GM, adding that non-US auto stocks are a more attractive to him because of how investors were treated in GM's and Chrysler's restructuring.

- Morgan Stanley and JPMorgan Chase are the lead underwriters for the GM offering with the syndicate to include Bank of America Corp. and its Merrill Lynch unit, Citigroup, Goldman Sachs, Barclays, PLC, Suisse Group, Deutsche Bank, Royal Bank of Canada, and UBS. GM is expected to conduct road shows on the IPO immediately after the November election with the offering expected to debut on November 18, according to sources.

- In a separate SEC filing, GM announced the terms of the $9 million compensation package for the company's new chief executive officer, Daniel Akerson. GM will pay Akerson, a former telecommunications executive and private equity executive, a $1.7 million salary, $5.3 million in short-term stock payable over three years, and $2 million in stock in the company's long-term executive program. Akerson agreed to the pay package, after the Kenneth Feinberg, the government's pay czar, approved the package.

- Senator Charles Grassley (R-IA) has asked Neil Barofsky, the special inspector general for TARP, to "determine whether Treasury and GM are taking the steps necessary to ensure that the IPO results in the highest possible return for the American taxpayer." Specifically, Grassley asked Barofsky to calculate how much Treasury would have to make in the IPO to ensure that taxpayers do not suffer a loss on the bailout of GM. "In the interest of transparency and accountability, it is essential that American taxpayers know whether they are getting a fair deal on the GM IPO and how large a financial loss they are likely to suffer," wrote Grassley in a letter to the SIG-TARP. "There is no reason that this should not be determined before, rather than after, the transaction is complete." (*CQ Today*, Joseph J. Schatz, 08/13/10; *Bureau of National Affairs*, Nora Macaluso, 08/19/10; *Wall Street Journal*, Sharon Terlep and Dan Fitzpatrick, 08/19/10; *Washington Post*, Peter Whoriskey, 08/19/10; *Bloomberg News*, David Welch and Michael Tsang, 08/19/10; *Reuters*, Clare Baldwin, Soyoung Kim and Kevin Krolicki, 09/03/10; *Associated Press*, Tom Krisher, 09/10/10)

A dash of realism about GM's "pension time bomb

- GM noted in its Form S-1 filing that its defined-benefit pension plans are underfunded and its pension funding obligations may increase due to weak financial markets, triggering the need for "significant contributions" to its pension plans of as much as $4.3 billion in 2014 and $5.7 billion in 2015 with possible more to follow.

- *Financial Times*' reporter Tony Jackson cautioned investors to take a close look at GM's pension analysis. Jackson wrote, "The assets in [GM's pension] fund are still officially expected to return 8.5% a year. How exactly that is to be achieve is not clear. But it stands in curious contrast to the conventional prudent assumption, which is the pension assets should give a risk-adjusted return equal to the yield on Treasury bonds… [of] just 2.6% [for 10 year bonds]. …Part of the problem is common to all venerable and declining companies—too many pensioners and not enough workers. At the last count, GM had 531,000 pensioners in the US to 87,500 active employees. …The reality of all of this is that GM …is in economic terms a hedge fund with its operations a mere sideline." (*Financial Times*, Tony Jackson, 08/22/10)

- In an August 27 editorial, the *Washington Post* wrote, "…With almost $100 billion in liabilities, GM's defined-benefit plans for U.S. employees (one covers a half-million United Auto Workers members, another, 200,000 white-collar personnel) are the largest of any company in America. Yet they were underfunded by $17.1 billion as of the end of 2009, and the underfunding had only slightly lessened, to $16.7 billion, as of June 30. [Emphasis added.] … [A]s GM's prospectus acknowledges, federal law will require it to start pumping in 'significant' amounts by 2014 if not sooner. GM does not say exactly how much, but an April [GAO] report suggested that a $5.9 billion injection might be required initially, with larger ones to follow. In other words, any investor who buys GM stock is buying stock in a firm whose revenue is already partially committed to retired workers."

- "When companies go bankrupt, their underfunded pensions often are taken over by the Pension Benefit Guaranty Corp. (PBGC), a government-run, industry-funded insurance agency, which then pays retirees a fraction of what they were owed. But that didn't happen in the GM-Chrysler bankruptcy. The UAW resisted what would have been a huge reduction in the generous benefits of its members, especially the many who retire before age 65. And the Obama administration chose not to push back."

- "The net effect is that the pension time bomb is still ticking. If GM earns robust profits, even more robust than it is making now, the bomb won't detonate. Otherwise—well, in a worst-case scenario, GM winds up back in bankruptcy, with

PBGC intervention both unavoidable and more expensive than it would have been last year. And that could necessitate a bailout from Congress, because of the PBGC's own deficits."

- "We're not offering investment advice—just a dash of realism about a still-troubled industry, and a warning that its dependence on taxpayers may not be ended so easily." (*Washington Post*, 08/27/10)

<u>August U.S. auto sales the worst since 1983</u>

- U.S. auto makers reported disappointing auto sales in August, marking the lowest sales volume in 27 years. Autodata reported new car sales just short of 1 million vehicles (11.5 million vehicles annualized), a drop of 21% from a year ago and a 5% drop from July levels. August sales historically have outpaced July sales, as deals become available on older model cars ahead of the fall introduction of new model year autos.

- Year-ago-sales figures reflect the government's Cash for Clunkers Program that created a "sugar rush" of sales by dangling a $4,500 cash incentive for buyers who traded in older gas guzzlers for more new efficient autos.

- GM sales dropped 25% in August from a year ago and 7% from July, falling well short of forecasts from sales trackers Edmunds.com and TrueCar. "We are realistic," said Don Johnson, GM's vice president of U.S. car sales. "We do think that customers will continue be cautious in their spending."

- "Car buying is far from repaired and consumers hesitate before they make a big ticket purchase," said Jesse Toprak, analyst with Truecar.com. "It shows that the recovery is going to be much slower and more painful than expected." Economists view the soft demand for autos as a sign of growing weakness among nervous consumers. (*CNNMoney.com*, Chris Isidore, 09/01/10)

- "It's a tad early [for a GM IPO]," said former car czar Steve Rattner. "The IPO market is terrible at the moment. It's a pretty suboptimal time to go public." (*Fortune Magazine*, Nina Easton, 08/19/10)

Chrysler bosses sue over lost pensions

- Over 450 Chrysler executives, including former chairman Lee Iacocca, sued Daimler AG and Cerberus, claiming they lost $100 million in pensions as a result of the company's bankruptcy. In the class action lawsuit, the plaintiffs claimed that Daimler failed to protect their supplemental pensions properly. Sheldon Miller, a lawyer for the plaintiffs, said the supplemental pensions were not transferred to the new Chrysler during its restructuring in 2009. "As a result, each of the plaintiffs lost large percentages of their earned retirement pensions," said Miller.

- The lawsuit also charges that Cerberus, which acquired Chrysler in 2007 and surrendered ownership of the company to the federal government, appears to have converted the plaintiffs' supplemental pension account or left it unprotected from creditors in the company's bankruptcy. (*AFP*, 09/10/10)

Former car czar's observations of the auto bailout

- Steve Rattner, the Obama administration's architect of the auto industry bailouts, has penned *Overhaul*, a 300-page book that depicts him swashbuckling through the financial crisis. Key excerpts from pre-release reviews of Overhaul include:
    - When Obama was told of the plan to pay a $7.1 million severance package to out-going GM CEO Rick Wagner after the President ordered he be sacked, Rattner wrote, "Suddenly I felt that I was indeed in the presence of a community organizer."
    - Rattner described presidential adviser David Axelrod attending a car meeting armed with poll data to support the government's takeover of the companies. He also described Chief of Staff Rahm Emanuel identifying Congressmen in whose districts large Chrysler facilities were located. When reminded that tens of thousands of jobs were at stake, Emanuel uttered a "common profanity" expressing disdain for the United Auto Workers.
    - Obama was frustrated with the auto companies from the start of negotiations. According to Rattner's account, Obama asked, "Why can't they make a Corolla?" His advisors responded, "We wish we knew."
    - "If [Obama's] team had linked arms with the outgoing administration, as President Bush's advisors proposed, billions of dollars could well have been saved," wrote Rattner.

- In a *Fortune* interview, Rattner said, "We never said we were going to be made whole [on the auto bailouts]. I think the administration would rather lose money and get out sooner. We saved millions of jobs. If the government loses $10 to $20 billion, that one of the most effective stimulus programs around." (*Fortune Magazine*, Nina Easton, 08/19/10; *Washington Post*, Peter Whoriskey, 09/02/10; *Fox News*, Chris Stirewalt, 09/02/10)

FDIC reports higher profits for the banking industry for the second quarter, while the number of problem institutions grows to over 10% of the industry

Commercial real estate values fall more than 40% from their peak

More than 400 problem institutions projected to fail

FDIC reports higher profits for the banking industry for the second quarter, while the number of problem institutions grows to over 10% of the industry

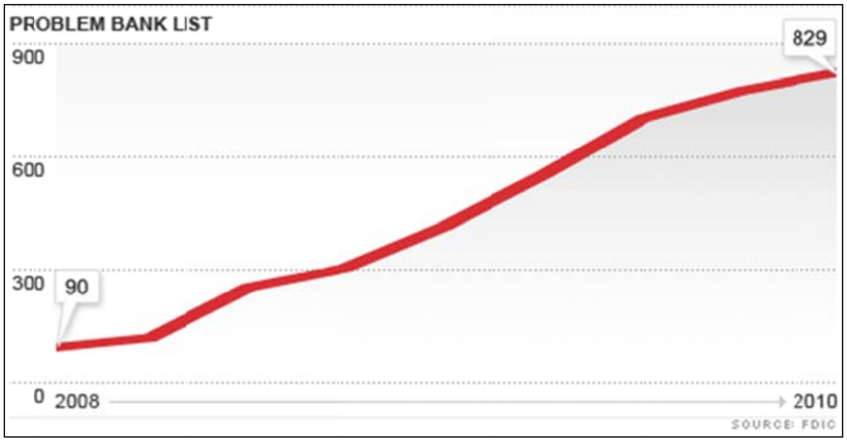
- Commercial banks and thrifts reported their highest quarterly profit for the second quarter in nearly three years, while the number of problem institutions increased to 10.6% of all FDIC-insured institutions, according to the agency's Quarterly Banking Profile. Banks and thrifts earned an aggregate profit of $21.6 billion for the second quarter, the highest quarterly earnings total since the third quarter of 2007. The industry's average return on assets rose to 0.65%, up from the industry's year-ago loss of 0.13%.

- The primary factor contributing to the industry's second quarter profitability was a reduction in loan loss provisions, which were 40% lower ($27.1 billion) than in the second quarter of 2009. Total loan loss reserves fell for the first time since the fourth quarter of 2006, declining by $11.8 billion (4.5%) as net charge-offs ($49 billion) exceeded loss provisions ($40.3 billion). While 61.7% of banks increased their loan loss provisions in the second quarter, a number of the large banks reduced their loss provisions, producing net declines in their reserve levels. As a result, the industry's reserve ratio fell from 3.51% to 3.40% during the quarter, while its coverage ratio—the ratio of reserves to noncurrent assets—improved from 64.9% to 65.1%.

- The industry's net interest income ($8.5 billion) was 8.6% higher than a year ago, while non-interest expenses ($1.5 billion) were 1.5% lower. Noncurrent loans and leases (delinquent 90 days or more) declined $19.6 billion (or 4.8%) during the second quarter to $385.8 billion. On June 30, the industry's level of noncurrent assets and real estate owned comprised 3.31% total assets.

- The second quarter results provide evidence that the banking sector "is moving along the road to recovery," said Shelia Bair, chairman of the FDIC. "[However,] the industry still faces challenges. Earnings remain low by historical standards, and the number of unprofitable institutions, problem banks, and failures remain high."

- The number of problem institution rose to 829 in the second quarter, a 7.4% increase from the first quarter (775 institutions). FDIC's problem banks comprise 10% of the agency's insured institutions and have total assets of $403 billion. A list of FDIC's problem institutions, along with links to their regulatory agreements can be found at http://calculatedriskimages.blogspot.com/2010/09/unofficial-problem-bank-list-september_11.html.

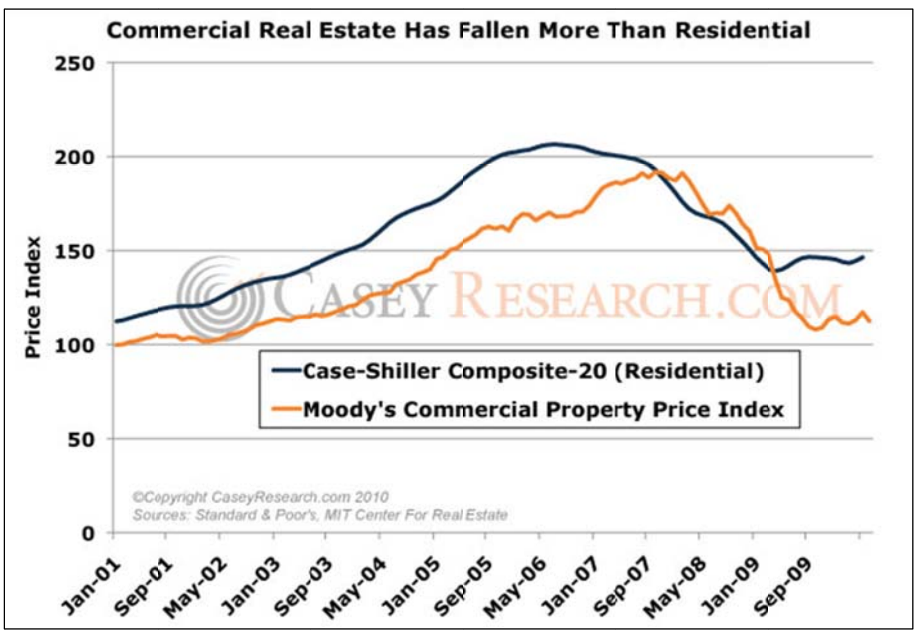


Source: http://money.cnn.com/2010/08/31/news/companies/fdic_problem_bank_list/index.htm

- On June 30, the FDIC's Deposit Insurance Fund balance was -$15.2 billion, an improvement of $5.5 billion during the period, which resulted from a reduction of the agency's contingency loss reserve from $40.7 billion to $27.5 billion. (*Bureau of National Affairs*, Thecla Fabian, 09/01/10)

Commercial real estate values fall more than 40% from their peak

- Commercial real estate values, which peaked in October 2007, have lost 41.4% of its value as of June 30, according to Moody's Commercial Property Price Index



Source*: CaseyResearch.com*

- Delinquency rates for commercial mortgage-backed securities topped 8.22%, up from 3.91% a year ago and 6.83% for the first quarter. Among property types, delinquencies among retail property loans declined 14 basis points in August to 6.75%, while hotel delinquencies increased 51 basis points to 18.92%.

- Delinquency rates for CMBS continued to grow in July (8.71%) and August (8.92), according to the analytics firm Trepp. In August, the level of serious-delinquent CMBS (including 60-plus day delinquency, foreclosure and other nonperforming pools) increased 20 basis points to 8.51%. A year ago, the rate of serious-delinquent CMBS stood at 3.08%.

- Fitch Ratings expects to downgrade CMBS throughout the next one to two years, according to the agency's managing director Mary MacNeill. "Defaults on CMBS will continue through 2012, so further negative rating actions are likely, albeit to a lesser extent," said MacNeill. "Future downgrades will be predicated on updated valuations as many highly leveraged loans move closer toward maturity." (*HousingWire*, Jason Philyaw, 09/02/10; *Casey's Daily Dispatch*, Chris Wood, 08/26/10; *HousingWire*, Christine Ricciardi, 08/27/10; *HousingWire*, Jon Prior, 09/07/10)

Year-to-date, FDIC has closed 119 banks on September 10
Shorebank—the nation's first and largest CDFI—is seized by FDIC
Eight CDFIs listed as problem institutions by FDIC

<u>Year-to-date, FDIC has closed 119 banks on September 10 with as many as 400 more problem banks projected to fail.</u>

- FDIC has closed 119 banks as of September 10, 2010, including five banks that received $8.7 million TARP funds. On August 23, approximately 100 banks had skipped their TARP dividend payments (totaling $146 million)—including OneUnited Bank, which skipped its sixth consecutive payment on its $12.1 million of TARP funds. OneUnited, the "first black-owned Internet bank" (according to the company's website), is under intense scrutiny because of its central role in an ethics controversy concerning Representative Maxine Waters (D-CA), who has been accused by the Ethics Committee of helping OneUnited secure TARP funds when her husband was an investor in the Bank. Waters has denied any wrongdoing and disputed the Committee's allegations. OneUnited, a $517.6 million bank headquartered in Boston, MA, is operating under a Cease and Desist Order, dated October 27, 2008. (*Wall Street Journal Online*, Devlin Barrett and Damian Paletta, 08/17/10; *Wall Street Journal*, 08/23/10; *FDIC Press Release*, 09/10/10)

- More than half of FDIC's 829 problem institutions will likely fail, predicts economist Nouriel Roubini, chairman and co-founder of Roubini Global Economics LLC. "In the second half of 2010, the [U.S.] fiscal policy becomes a headwind, no more cash for clunkers," said Roubini. "The positive scenarios are that the growth will be below par. The big risk is that there will be a downturn in the markets that could impact the bond, the equity and credit markets. Job losses have been higher, the U.S. jobs numbers show that. There is no private sector job growth. Consumption is weak, exports are weak and housing is weak. If there are no final sales and no final demand, companies will not invest."

- "…The biggest banks have been backstopped [by the federal government], but the 800+ small- and medium-banks in the U.S. remain on the critical list and half of those will go bust." Roubini added that corporate and consumer debt problems will deteriorate, causing more problems for the commercial and residential real estate markets. "Policymakers are running out of bullets. The problem is we need fiscal consolidation—fiscal policy is constrained by the debt problem—[so] monetary policy becoming ineffectual. We are in a liquidity trap and we have insolvency problems." (*CNBC.com*, Patrick Allen, 09/03/10)

- Officers and directors of Goldman Sachs, JP Morgan Chase, Citigroup and Wells Fargo have sold approximately $100 million of stock through the end of August, amid relatively small buying activity, according to InsiderScore. Recent insider sales by banks' executives signifies that "business is back to normal," said Ben Silverman, director of research for InsiderScore. "[After wild swings in banks' valuations,] we've got a degree of stabilization at banks." Insider sales have likely been impacted by changes in executives' compensation in which a larger percentage of annual bonuses is comprised of stock or options, rather than cash. Bank spokesmen said that many of the stock sales were triggered by strict timing parameters placed on insiders by bank regulation, rather than a lack of confidence in the company's stocks. Some sales were motivated largely by pent-up selling activity that resulted from restrictions under TARP, said the spokesmen. (*CNBC.com*, Kate Kelly, 08/31/10)

<u>Shorebank—the nation's first and largest CDFI—is seized by FDIC</u>

- On August 20, the FDIC seized Shorebank and sold all of its deposits and nearly off of its assets ($2.16 billion) to Urban Partnership Bank, a newly chartered institution that will carry on its predecessor's mission as a CDFI. Urban Partnership's new management team, led by former First Chicago Corp senior executive David Vitale, agreed to pay a 0.5% premium for Shorebank's deposits and received an asset discount of $146 million on the Bank's assets. In addition, FDIC entered into a loss sharing agreement with Urban Partnership on Shorebank's assets.

- FDIC projects the estimated losses for Shorebank's failure will be $367.7 million. The agency noted that Urban Partnership's bid, which was the sole offer received by FDIC, would save the CDIF fund between $250 million and $334 million under a plain bank liquidation. "[Shorebank's board and executives] who presided during the deterioration of the condition of the institution will not be retained [at Urban Partnership]," said the FDIC.

- Urban Partnership raised $150 million of capital to secure Shorebank acquisition. Investors in the partnership include Goldman Sachs Group, JPMorgan Chase, Bank of America, American Express, Harris N.A., General Electric Company's investments arm, PNC Investment, State Farm Insurance, Wells Fargo, Key Community Development Corp, Citigroup, the Ford Foundation, and the John D. and Catherine T. MacArthur Foundation. Urban Partnership will pursue much of the same mission of its predecessor. "Urban Partnership Bank will provide access to financial services and support to distressed neighborhoods in order to help transform distressed neighborhoods into strong, stable communities, said Vitale, who will serve as executive chairman. William Farrow, Vitale's former First Chicago colleague will serve as the Bank's president and CEO. Urban Partnership's board members include former First Chicago executives Eileen Kennedy and Daniel Lupiana and Jerome Szott, a former employee of National Bank of Detroit.

- Urban Partnership later announced that 60 of the bank's 300 jobs were cut, ranging from executive vice presidents to teller. "It's a difficult decision, but a smaller workforce is needed for Urban Partnership Bank in order to continue providing quality financial services to our low-income communities in a strong and sustainable manner," said the bank's spokesman.

- On August 22, Shorebank Corp., the holding company of Shorebank, announced was selling its Shorebank Pacific bank to OneCalifornia Bank, a community development bank, for an undisclosed sum. It was unclear if FDIC would claim the proceeds from the sale—a question that neither Shorebank nor the agency would address, when asked by an *American Banker*'s reporter.

- Ellen Seidman, EVP of Shorebank Corp., said Shorebank's failure would not interrupt the operations of the holding company's non-profits. "The nonprofits are not affected by the Midwest bank closure. They are just going on and moving ahead with total continuity."

- Some industry observers criticized the Shorebank "reinvention." Kip Weissman, a partner with Luse Gorman, said, "It got federal help and the new management team was able to stay in place. That is tantamount to open bank assistance (OBA). …They were able to obtain the benefits of OBA without the political firestorm."

- However, Jeannine Jacokes CEO of the Community Development Banks Association and Partners for the Community Good, contends that "Shorebank is a historically and symbolically important institution in the world of community development lending, [which over the past 40 years] debunked the long-held banking myth that lending to redlined neighborhood, low income individuals and people of color was unsafe and unsound. To the contrary, they proved that community development lending was not just safe and sound but also good business. ….CDFIs are of crucial importance because of the communities they serve. ..In these harsh economic times, CDFIs need to be preserved and promoted…" (*American Banker*, Jeannine Jacokes, 05/26/10; *Seattle Times*, Sanjay Bhatt, 08/30/10; *American Banker*, Rob Blackwell and

Cheyenne Hopkins, 08/30/10; *Chicago Business*, Lorene Yue, 08/30/10; *American Banker,* Robert Barba, 08/23/10; *Chicago Business*, Lorene Yue, 08/27/10; *American Banker*, Robert Barba, 08/24/10; *Chicago Business*, Steve Daniels, 08/20/10)

Eight CDFIs listed as problem institutions by FDIC

- On June 30, eight of the 63 certified CDFI banks were listed as problem institutions by FDIC: Albina Community Bank in Portland, OR (operating under a Cease and Desist Order); Broadway Federal Bank in Los Angeles, CA (Cease and Desist); One United Bank in Boson, MA (Cease and Desist); Neighborhood National Bank in San Diego, CA (Consent Order); Pan American Bank in Los Angeles, CA (Cease and Desist); Shorebank (Cease and Desist); City National Bank in Newark, NJ (Formal Agreement); Native America Bank in Denver, CO (Formal Agreement); and Legacy Bank in Milwaukee, WI (Written Agreement). (*http://calculatedriskimages.blogspot.com/2010/09/unofficial-problem-bank-list-september_11.html*)

Federal Reserve approves the Chinese sovereign wealth fund's acquisition of nearly 10% stake in Morgan Stanley

- The China Investment Corp (CIC), a wealth fund owned 100% by the Chinese government, converted its Morgan Stanley preferred shares into common stock on August 17, in accordance with a 2007 agreement, according to a Federal Reserve Board statement. CIC's ownership of Morgan Stanley, directly and through its subsidiaries, is nearly 10%, according to sources. The Department of Justice reviewed the transaction before the Federal Reserve approved CIC's application. "CIC has stated that it does not propose to control or exercise a controlling influence on Morgan Stanley and that its indirect investment will be a passive investment," said Federal Reserve officials. (*Bureau of National Affairs*, Stephen Joyce, 09/02/10; *The Daily Caller,* Amanda Carey, 09/02/10)

Fannie Mae and Freddie Mac

The state of the government's loan modification program:

HAMP appears to be losing steam, as the number of eligible borrowers diminishes

"Proprietary" loan modifications top 750,000 during the first seven months of the year

A day of reckoning is near

Policymakers begin to tackle the question of what to do with foreclosed homes

HUD awards an additional $1 billion to stabilize neighborhoods, bringing the program's expenditures to $7 billion

<u>HAMP appears to be losing steam, as the number of eligible borrowers diminishes</u>

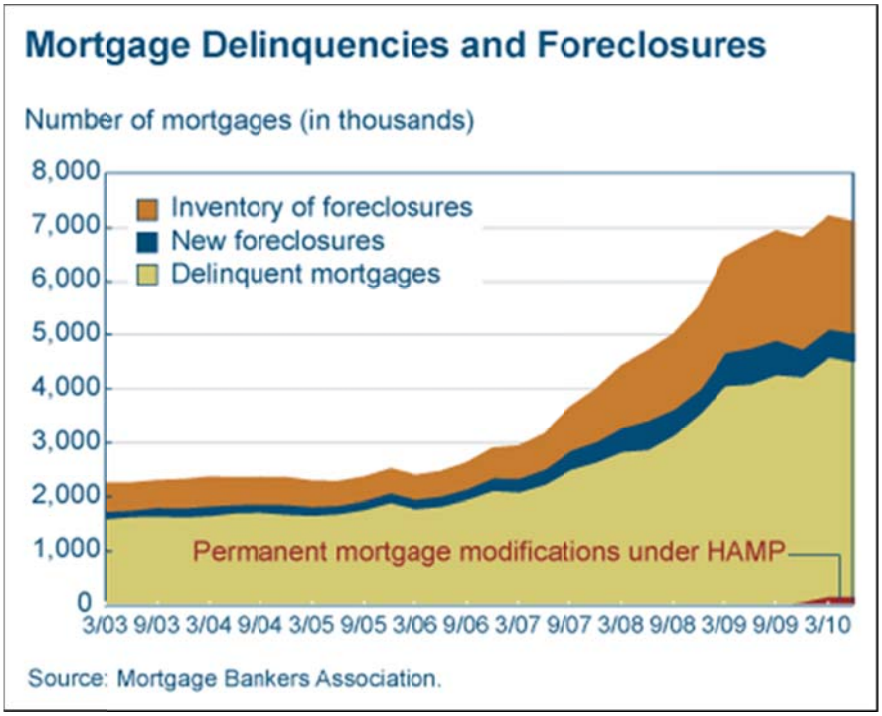
- As of July 31, 43% of HAMP's trail loan modifications had failed, while nearly 422,000 trials (29%) had been converted to permanent loan modifications. Approximately 9.5% of the eligible loans were in trial modifications and another 8.1% were in "aged trials" with 10.2% of applications not yet in placed in trial mods. ProPublica provides an analysis of each loan servicer's loan modification performance at http://bailout.propublica.org/loan_mods/list. In mid-June, Treasury had spent $490 million on HAMP out of the $75 billion ear-marked to help stem the wave of foreclosures.

Total Eligible Loans: 1,456,363 *as of Jul. 31, 2010*

Not Yet in Trial Mod	148,874	10.2%
In Trial	138,609	9.5%
"Aged" Trials	117,325	8.1%
Perm Mods	421,804	29.0%
Failed Mods	629,751	43.2%

Source: http://bailout.propublica.org/loan_mods/list

- The administration's HAMP appears to be running out of eligible borrowers who can qualify for the program's loans, as evidenced in the July results. As nearly 17,000 new HAMP trial modifications were started in July, more than five times as many borrowers saw their trial mods cancelled, because either they failed to make their mortgage payments, didn't provided the required financial documents, or didn't meet the program's guidelines.



Source: HousingWire, Jacob Gaffney, 09/01/10

- "The government program, as currently structured, is petering out," said Mark Zandi, chief economist for Moody's Analytics. "It is taking fewer homeowners, more are dropping out and fewer people are ending up in permanent modifications." Zandi projects that HAMP will help only 500,000 homeowners lower their payments through permanent modifications—a small percentage of relative to those who have already lost their homes to foreclosure or through distressed sales (e.g., short sales or deeds in lieu). Zandi expects an additional 1.5 million homes will be lost to foreclosure or through short sales in 2011. "We still have a lot more foreclosures to come and further home price declines," said Zandi, who estimates that home prices would drop an additional 5% by next spring—over-and-above the 30% price decline that has occurred since the peak of the housing boom.

- It is unclear how many of the borrowers, who drop out of HAMP, will ultimately lose their homes. For the top eight servicers, about half of all borrowers who exit HAMP end up receiving a "proprietary" modification from the lender or become current with just 15% moving into some stage of foreclosure.

- Treasury warned that HAMP cancellations will exceed new modifications over the next few months as banks "clear the backlog of aged trials." Administration officials argued that it is unfair to write-off the HAMP initiative as a failure because they argued it forced the mortgage industry to focus its efforts on providing homeowners sustainable loan modifications. "The program has actually been transforming the mortgage-servicing industry," said Herbert Allison, Assistant Treasury Secretary. "What we're seeing now is that the [private sector] modifications are modeled on the

HAMP modification. They're providing affordability modifications [sic] for the very first time."

- Critics contend that massive amounts of time and effort was expended on a program that officials claimed would help at least three million homeowners. "They should be ashamed of themselves," said Kenneth Rosen, professor of economics and real estate at the University of California, Berkley. "It's embarrassing."

- HAMP's current focus on lower payments may lead to re-default rates that are better than earlier modification efforts. Nevertheless, the borrowers receiving permanent modifications still have high levels of other (non-mortgage) debt, which result in a median ratio of total debt payments to pretax income of 63.5%. At least 20% of the borrowers with permanent modifications are likely to re-default largely because of their high debt levels, said Laurie Goodman, senior managing director for Amherst Securities.

- In a four page letter to Treasury Secretary Timothy Geithner, Chris Katopis, executive director of the Association of Mortgage Investors (AMI), said HAMP has largely been a "disappointment" because its default probability model failed to consider the defaulted borrower's total debt burdens, including credit cards, auto loans, and second liens. Using a front-end debt to income ratio is "useless outside the given context" of a borrower's overall debt obligation, wrote Katopis. A second critical weakness of HAMP is its failure to factor in second mortgages into loan-to-value ratios. "[That] is a critical oversight that was a significant problem in the securitization process that created the financial crisis," wrote Katopis. "The ongoing foreclosure crisis reflects many factors, including an underlying consumer credit crisis," which grows as the crisis drags on and borrowers' debt load increase. The back-end debt-to-income ratio (total debt to income or TDIR) of the average HAMP borrower jumped to 79.9% in June before loan modification, up from 76.1% in January. After modification, the average borrower had a 63.7% TDIR in June, up from a 59.7% TDIR in January. (*Wall Street Journal*, Nick Timiraos, 08/21/10; *National Mortgage News*, 08/31/10; *http://bailout.propublica.org/loan_mods/list*; *Associated Press*, Martin Crutsinger, 08/21/10; *National Mortgage News*, 08/13/10; *CNNMoney.com*, Tami Luhby, 08/30/10; *National Mortgage News,* 09/01/10; *HousingWire*, Jacob Gaffney, 09/01/10)

<u>"Proprietary" loan modifications top 750,000 during the first seven months of the year</u>

- Since 2007, mortgage servicers have competed 3.4 million loan modifications through "proprietary" loan modifications—including 757,750 mods in the first seven months of this year, according to the HOPE Now Alliance. Approximately 78% of proprietary modifications utilized interest rate and principle reductions. Banks are now completing twice as many modifications under their own foreclosure prevention programs than under HAMP. However, consumer advocates caution that the banks' programs may not be as attractive as HAMP, which lowers monthly payments to 31%

of pre-tax income. "We don't know if they are sustainable based in the monthly payment," said John Snyder, manager of foreclosure prevention programs for Neighborhood Works America, "We're not sure what to think [since banks don't release a lot of information about their modifications]." (*National Mortgage News*, 09/01/10; *HousingWire*, Jacob Gaffney, 09/01/10)

A day of reckoning is near

- Ever since the housing collapse began, industry analysts have been warning of a coming wave of foreclosures—but the flood hasn't happened and experts question if delaying foreclosures is about to backfire. With home prices expected to fall an additional 10%, the industry's reluctance to foreclose quickly and sell REO at inventory-clearing prices may contribute to the stall of the overall market and increase the likelihood of more strategic defaults. "All the excuses have been used up," said Sean O'Toole, CEO of ForeclosureRadar.com. "This is blatant."

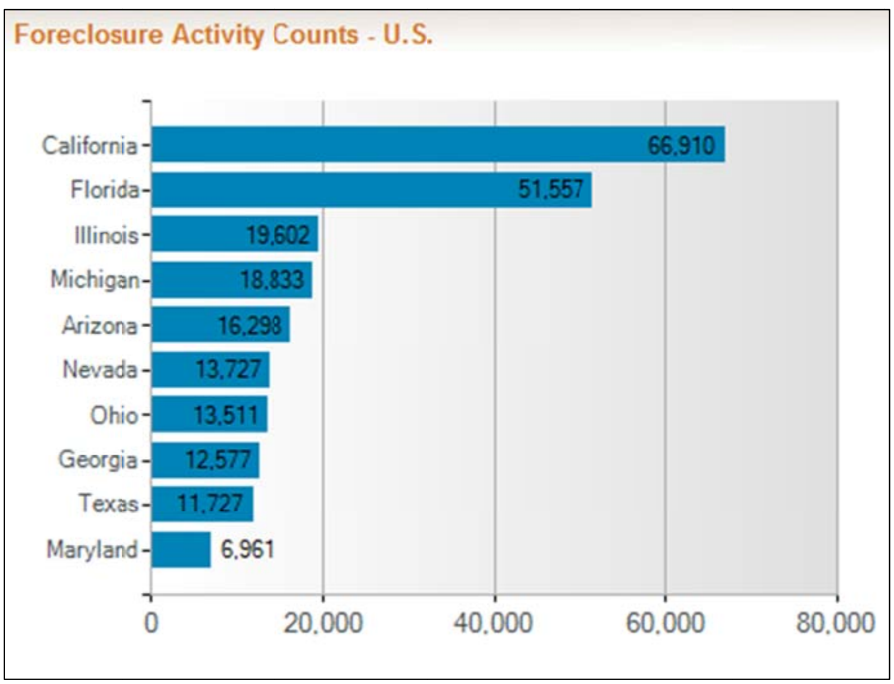
- Some servicers acknowledged that delaying foreclosures will exacerbate losses—and that the day of reckoning may almost be here. "The industry as a whole got into a panic mode and was worried about all these loans going into foreclosure and driving prices down, so they got all these programs, started HAMP and internal mods and short sales," said John Marecki, vice president of East Coast foreclosure operations for Prommis Solutions. "Now they're looking at this, how they held off and they're getting to the point where maybe they made a mistake in that realm."

- Foreclosures mandated by Fannie Mae and Freddie Mac jumped 12% during the second quarter to 275,000 units. With Fannie Mae and Freddie Mac stepping up their foreclosure processing of failed HAMP modifications, the share of foreclosure activity by other market participants is even "less robust" than the aggregate. "The math doesn't bode well for what is ultimately going to occur on the real estate market, "said Herb Blecher, vice president at LPS. "You start asking yourself the question—when you look at these numbers—whether we are fixing the problem or delaying the inevitable." The GSEs' increase in foreclosure starts "is nowhere near" what is required to address the 4.5 million mortgages that were 90 days or more delinquent or in foreclosure on July 31. What we're seeing is things are starting to move through the system, but the inflows and the outflows are not clearing the system yet, said Blecher. On July 31, defaulted borrowers were spending on average 469 days—more than 15 months—in their home after ceasing to make their payments.

- "Borrowers are savvy now and they know that once they lose the house, they can milk the system for time and cash," said Eric Peterson, managing director of Praxis Capital, Inc. "A year ago, nobody knew what 'cash for keys' [a program paying homeowners $1,500 to $3,000 to incentivize the borrower to move out]. It was all the defaulted borrowers held a secret meeting and now they all know." Defaulted borrowers are staying in their homes much longer, dragging the foreclosure process out and largely ignoring the government's push for graceful exits through short sales and deeds-in-lieu. "I think everybody overestimated the borrower's desire to do a short sale versus living for free until a foreclosure date," said Christopher Saitta, CEO of Equator.

- To date, only 4.2% of borrowers rejected for loan modifications under HAMP have paid off their mortgages through a short sale or deed-in lieu, while 12.1% of dropouts had a foreclosure initiated in July but not completed and 30.1% had no action taken by the servicer. It will take time for servicers to move the defaulted loans through the foreclosure process, said Travis Olsen, COO of Loan Resolution Corp. "It's just starting to get to the point of closing deals. We're ahead of the curve, so the number will pick up in the next three months."

- Foreclosure filings, including default notices, scheduled auctions and bank repossessions, were filed for 325,229 properties in July, a nearly 4% increase from the previous month but a nearly 10% decrease from July 2009, according to RealtyTrac®. One in every 397 U.S. housing units received a foreclosure filing during the month. (*American Banker*, Jeff Horowitz and Kate Berry, 08/27/10; *National Mortgage News*, 09/10/10; *RealtyTrac Press Release*, 09/12/10; *U.S. Foreclosure Market Report*™, RealtyTrac, July 2010; *Associated Press*, Alan Zibel, 09/01/10; *Prepared Remarks for the Federal Reserve REO and Vacant Properties Summit*, Elizabeth A. Duke, 09/01/10; *REO Insider*, Kerry Curry, 09/02/10; *Washington Post*, 09/04/10; *American Banker*, Kate Berry, 09/09/10)



Source: *U.S. Foreclosure Market Report*™ for July 2010, RealtyTrac

Policymakers begin to tackle the question of what to do with foreclosed homes

- "Homeownership, long promoted by federal policy and facilitated by local housing organizations, cannot and should not be the only alternative for REO properties," said Federal Reserve Board Governor Elizabeth Duke in a September 1 speech. "Indeed, redevelopment strategies … [should] include rental housing, lease-purchase, and even converting owners to renters to avoid vacancies. Including rental options among the mix of stabilization strategies makes particular sense at a time of high unemployment. Even in the best of times, homeownership limits mobility in the labor market. …The challenges faced by communities with large inventories of REO and vacant property will not be resolved overnight. What began as a problem rooted in poorly underwritten loans has been exacerbated by high unemployment and slow economic growth. As delinquencies and foreclosures continue to grow, they will hinder the ability of communities to heal and ultimately to thrive."

- "Rather than treating the symptom—the high REO problem—we need to better understand how to resolve the more general problems in communities that lead to higher concentrations of REOs and exacerbate the effects of high REOs," said Eric Rosengren, president and CEO of the Federal Reserve Bank of Boston. "Do we need more holistic approaches to addressing this crisis? Should there be more state and federal revenue sharing focused on providing flexible funds to the communities most affected? My answer to both of these questions is a yes. But I would also argue that we need to not only explore alternative solutions, but also do a much better job of establishing which solutions work."

- It's important to consider how the foreclosure problem should be framed, said Rosengren, who outlined three different existing views among housing and policy experts:

    - "[If it is] a foreclosure and REO problem rooted in the housing bubble, the solutions will tend to emphasize mitigating the foreclosure problem or accelerating the disposition of REO properties," said Rosenberg.

    - "[If it's defined as a housing problem, then the country] might focus on solutions that result in sustainable home ownership … focusing on financial education, addressing predatory home financing and redefining appropriate underwriting standards," he said.

    - If viewed through the community lens, issues such as code enforcement, unemployment and crime must be addressed in neighborhoods disproportionately affected by foreclosures, he concluded.

- The current crisis contains elements of all three frameworks, said Rosengren. "This is a foreclosure problem. This is a housing problem. This is a community problem," he said.

- The Obama administration announced that Bank of America and Wells Fargo have agreed to give local governments and nonprofit groups the opportunity to purchase foreclosed homes before they are sold to private investors. The banks have agreed to provide the neighborhood groups 48 hours to evaluate the properties, before they are offered for sale to the public. "This agreement helps us level the playing field to give communities a better chance to stabilize these neighborhoods," said HUD Secretary Shaun Donovan, who expects about 100,000 properties to be sold through this program.

- Although Congress has provided $7 billion of taxpayer funds to local governments and nonprofits to purchase REO, the groups have struggled to utilize the federal funds because investors often outbid them on the foreclosed properties. "The fear is that they will purchase the property, make very minimal to no improvements on it, and either put it back on the market as a rental unit or let it sit waiting for the market to come back," said Sarah Greenberg, senior manager for community stabilization for NeighborWorks America.

- The National Community Stabilization Trust, a nonprofit sponsored by Enterprise Community Partners, the Housing Partnership Network, the Local Initiatives Support Corporation and NeighborWorks America, will collect information about foreclosed properties and help local groups identify properties to purchase. (*American Banker*, Jeff Horowitz and Kate Berry, 08/27/10; *National Mortgage News*, 09/10/10; *RealtyTrac Press Release,* 09/12/10; *U.S. Foreclosure Market Report*™, RealtyTrac, July 2010; *Associated Press*, Alan Zibel, 09/01/10; *Prepared Remarks for the Federal Reserve REO and Vacant Properties Summit*, Elizabeth A. Duke, 09/01/10; *REO Insider*, Kerry Curry, 09/02/10; *Washington Post*, 09/04/10; *American Banker*, Kate Berry, 09/09/10)

<u>HUD awards an additional $1 billion to stabilize neighborhoods</u>

- Separately, HUD has awarded an additional $1 billion of funding provided under the Frank Dodd Act to states and counties for use in minimize the damage caused to certain neighborhoods by home foreclosures. The agency did not provide a breakdown on where the money was distributed. This round of government funding will not be used to assist struggling homeowners, but may be used for down payment assistance for new homeowners to buy foreclosed homes. These grants are provided under HUD's Neighborhood Stabilization Program, which has previously provided $6 billion of foreclosure-related assistance. "These grants will support local efforts to reverse the effects these foreclosed properties have on their surrounding neighborhoods, said HUD Secretary Shaun Donovan." We want to make certain that we target these funds to those places with especially high foreclosure activity so we can help turn the tide in our battle against abandonment and blight." (*National Mortgage News,* 09/08/10)

Where will the housing market go from here?

- The Federal Reserve's September Beige Book said home sales are in the tank again with "evidence of very low or declining" interest from consumers in buying a home, largely because of the expiration of the $8,000 first-time homebuyer's tax credit. While refinances are strong, the purchase money market is very weak, accounting for only 20% of new mortgage applications. "Some [Fed] Districts, such as New York and Dallas, noted the expiration of the tax credit created especially weak conditions for lower-priced homes, while others, including Philadelphia and Kansas City, identified the high end of the market as the primary weak spot," wrote the central bank. Residential construction activity declined in most regions with the exception of the Cleveland, St. Louis, and Minneapolis Districts. "Inventories of available homes rose in general... Price movements were mixed with most districts reporting stability or declines of late; a few, notably Boston, Minneapolis, and San Francisco, noted that prices rose in some areas compared with the previous reporting period." (*National Mortgage News*, 09/08/10)

- Home mortgage delinquencies showed modest improvement in the second quarter, but "short-term" delinquencies (30 days delinquent) ticked up, reported the Mortgage Bankers Association. The delinquency rate for single-family mortgages dropped to a seasonally-adjusted 9.85% of all loans outstanding, a decrease of 21 basis points from the first quarter. The percentage of loans on which foreclosure action was begun during the second quarter was 1.11%, down 12 basis points from the previous quarter. However, the delinquency rate for loans that were one payment past due rose 20 basis points to 3.51% from year-end. "The good news is that foreclosure starts are down and the inventory of homes anywhere in the process of foreclosure fell for the first time since 2006…," said Jay Brinkman, MBA's chief economist. "The disappointing news is that, after declining since the beginning of 2009, the rate of short-term delinquencies may ultimately drive the foreclosures back up." (*Mortgage Bankers Association Press Release*, 08/26/10)

- In August 2 issue of *Guggenheim's Weekly Market Perspective*, Scott Minerd wrote, "The number of homes that lurk in the 'shadows' is nebulous. Recently, Standard & Poor's estimated the principal balance of properties 90 days or more delinquent, in foreclosure, or in REO status, but not yet on the market, to be $480 billion, or the equivalent of 30 percent of the entire non-agency market. Estimates for the number of homes that could potentially emerge from the shadows are as high as 5.5 to 7 million."

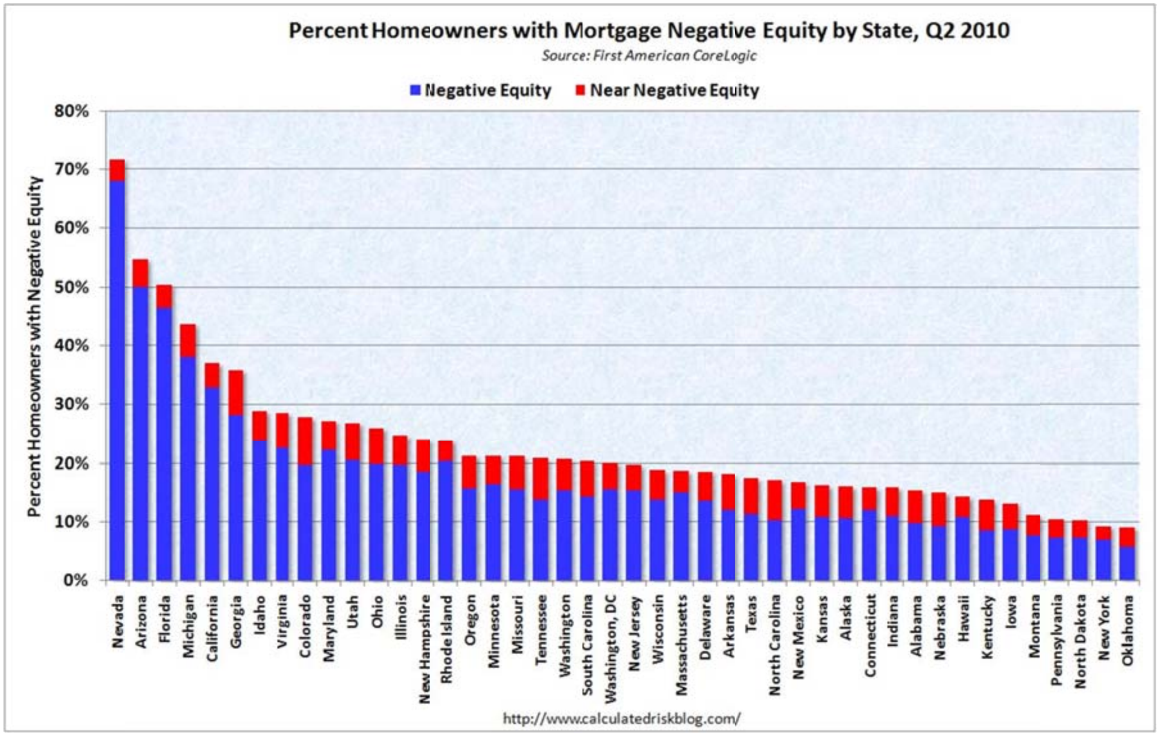
- "Currently, inventory of existing homes for sale is estimated to be 3.99 million (and is growing at an annualized rate of 48 percent over the past six months). Including the estimates for shadow inventory, this would result in 9.5 to 11 million homes waiting to be sold. At the current sales rate of 5.37 million homes per year, this would result in approximately 21 to 25 months to get through just the existing inventory of homes for sale. When you add in the number of homes that would normally come on the market over the course of the year, it's easy to imagine the process taking much longer. Not only will the market need to sell more houses than are becoming available each year, it will need to somehow gobble up an existing inventory that would take at least two years to digest by itself. This is a pretty bleak picture, something that could take five to ten years to clean up, especially in light of all the other problems the economy faces." (*Guggenheim's Weekly Market Perspective*, Scott Minerd, 08/02/10)

- The shadow inventory of delinquent mortgages will ultimately liquidate, adding downward pressure on real estate values. Laurie Goodman, Senior Managing Director for Amherst Securities, estimates approximately 6.9 million units are already in the foreclosure pipeline and will eventually liquidate. (*Housing and Residential Securitization, Laurie Goodman*, 08/30/10)

Category (seasonally adjusted)	MBA Delinquency Survey %	Probability of Liquidation (based on estimated cure rates)	Probability Weighted Liquidation (Delinquency X Probability of Default)
Foreclosure	4.57%	100.0%	4.57%
90+ Days	4.82%	94.7%	4.56%
60 Days	1.52%	85.4%	1.30%
30 Days	3.51%	56.1%	1.97%
Total Distressed Inventory	14.42%		12.40%
Number of Defaults (in million, based on 55.9 million homes)	8.02		6.89

Source: Housing and Residential Mortgage Securitization, Amherst Securities, 08/30/10

- Sales of existing homes plunged 27.2% in July to a 3.83 million-unit pace, the lowest level of sales on record. Time homebuyers accounted for 38% of home sales in July, while distressed transactions accounted for 32% of these sales. (*Existing Home Sales Plummet*, Wells Fargo Economics Group, 08/24/10)



Sources: Corelogic, www.calculatedrisk.com

- Home-equity loans (HELOCs) are shaping up to be the next problem area in housing with Bank of America, Wells Fargo and JPMorgan Chase being particularly vulnerable to "changes in the consumer cycle," according to Britain's *Telegraph*. In a *Bloomberg* interview, CreditSights' senior bank analyst Baylor Lancaster said, "While a lot of people are looking for dramatic improvement in the short term, one area that still has to be worked through in a material way is home equity." He added that write downs from HELOCs are not likely to show up in earnings reports until later this year, Lancaster said.

- The three biggest banks in the U.S reported a total of $321 billion in outstanding HELOCs on their balance sheet and have charged off $6.62 billion of these loans during the first half of 2010, according to their second quarter 2010 Call Reports. (*HousingWatch*, Charles Feldman, 04/13/10; *Real Estate Channel*, Keith Jurow, 09/07/10)

- The nation's housing stock has shed from between $4 trillion to $7.1 trillion of value, depending on who's counting. Equifax Inc. and Moody's concluded that the Great Recession that began in the early 2007 has cost homeowners $4 trillion through March. The Federal Reserve reported that the downturn began in the fourth quarter of 2006 and cost homeowners $7.1 trillion through March. (*Philly.com*, Alan J. Heavens, 09/05/10)

- Jon Daurio, CEO of distressed loan purchaser Kondaur Capital Corp., expects housing prices to fall an additional 20% over the next three years. There may be isolated pocket communities that may not experience this much of a drop and may have some moderate price appreciation, but those will be the rare exceptions, said Daurio. The unemployment rate is unlikely to improve and could, in fact, get worse, he added. The sustainability of record low mortgage rates is feeble, and HAMP is failing, credit will further tighten, said Daurio. FHA loans will become the new subprime, he said. Daurui believes that the faltering state of the economy will bring housing prices to a mid-90s level. “We’re in unique times,” said Daurio. “We haven’t had this much national debt on the balance sheet before. Federal and state governments’ balance sheets are insolvent. There are just far too many people with homes and loans they can’t afford.” (*HousingWire*, Christine Ricciardi, 09/10/10)

- Over the past few months, Moody’s Investors Service has downgraded MBS ratings because of the deterioration in the performance of the underlying mortgage pools backing the transactions. Moody’s continues to see “an increasing potential for a double-dip recession, which could cause a further 20% decline in home prices.” (*HousingWire*, Jason Philyaw, 09/10/10)

Chairman Frank urges the administration to use all tools to recover fraud losses at Fannie Mae and Freddie Mac

- House Financial Services Committee Chairman Barney Frank (D-CT) and Representative Paul E. Kanjorski (D-PA), who chairs the Capital Markets Subcommittee, called on the White House to instruct the Federal Housing Finance Agency to “vigorously pursue all available legal claims as conservator of Fannie Mae and Freddie Mac to limit losses to taxpayers.” Kanjorski will hold a hearing on the issue in September.

- The lawmakers wrote, “FHFA has pursued two kinds of legal claims to limit taxpayer losses. First, FHFA has demanded that lenders from which the enterprises purchased mortgages buy back mortgages that did not satisfy contractual representations and warranties. As of March of this year, Freddie Mac had demanded that lenders repurchase $4.8 billion in mortgages. In addition, the two enterprises own approximately $255 billion in ‘private-label’ or ‘non-agency’ mortgage-backed securities. The enterprises have suffered significant losses on those private-label mortgage-backed securities.”

- “FHFA appears to be considering claims similar to the claims asserted by private mortgage investors against issuers of private-label mortgage-backed securities, generally Wall Street firms and the largest banks. FHFA must vigorously pursue all available legal claims for losses sustained from the conservatorship of Fannie Mae and Freddie Mac. It is critically important to protect taxpayer funds. It is equally important that the American people know that their government is acting on their behalf, not on behalf of powerful financial institutions. The failure to pursue legitimate legal claims to limit losses to taxpayers would be another indirect subsidy for an industry that has received too many such subsidies already.”

- “As you consider the nomination of a permanent FHFA Director, we ask that you take appropriate steps to assure that efforts to investigate and assert legal claims to limit taxpayer losses from the enterprises’ conservatorship will continue to be pursued vigorously.” (*Correspondence to President Barack Obama*, Representative Barney Frank and Representative Paul E. Kanjorski, 08/13/10)

Fitch will review GSE repurchases and bank ratings

- Fitch Ratings will review Fannie Mae’s and Freddie Mac’s mortgage loan repurchases demands to determine if repurchases will affect the ratings of U.S. banks. While the major banks have “effectively acknowledged” this development and are increasing their representation and warranty reserves, Fitch said it still believes that the banks’ ratings could be “vulnerable.” The ratings agency plans to assess whether Fannie and Freddie could become more aggressive in demanding mortgage repurchases, which could expose some banks “to future losses that had not previously considered in Fitch’s ratings. On June 30, Fannie Mae and Freddie Mac had combined troubled assets—delinquent mortgages and REO—of $354.5 billion.

- Fitch estimates that the four largest banks—Bank of America, Wells Fargo, JP Morgan Chase and Citigroup—have received pending repurchase requests totaling $19.1 billion with $10.1 billion related to repurchase demands by the housing GSEs. To date, these banks have established $8.3 billion of representation and warranty reserves. The four largest banks face the greatest likelihood of material risk for Fannie’s and Freddie’s repurchases, since they collectively service approximately 50% of the GSEs’ mortgages, according to Fitch.

- “It is conceivable that the pool of ‘at-risk’ loans eligible to be repurchased by the four largest banks could total about $175 billion-$180 billion,” wrote Fitch. Fitch estimates the banks could suffer an aggregate gross loss ranging from $17 billion to $42 billion from GSE repurchases, before factoring in their ability to cure deficiencies in loans. “To put these figures in perspective, these institutions had annualized pre-provision net revenues and net income of $164 billion and $54 billion, respectively, in aggregate and $391 billion of tangible common equity,” Fitch added.

- The rating agency continued"…Fitch will have to give further consideration to its existing analytical approach to assessing returns, capital, and liquidity for U.S. banks. Historically, Fitch typically regarded loan sales to the GSEs as a transfer of both credit and interest rate risk, and thus excluded these from calculations of leverage and liquidity for the banking industry, bolstering these ratios compared to banks that kept originated mortgages on their own balance sheet. Adjustments to the current view that an effective sale has occurred between the bank and the GSE could have negative repercussions to how Fitch ultimately views the U.S. banking industry on a go-forward basis, particularly for those banks active in mortgage banking."

- Bank of America, Wells Fargo, JP Morgan Chase and Citigroup have booked $9.8 billion of losses on loans they have repurchased or expect to repurchase through the second quarter of this year. Credit Suisse analyst Moshe Orenbuch thinks the banks' repurchase losses will rise to $20 billion or $30 billion before the repurchase wave is over. Other analysts think that losses could be significantly higher. (*Fitch Ratings Press Release*, 08/18/10; *New York Times*, Floyd Norris, 08/20/10)

- Originators and underwriters of private label mortgage-backed securities face a (estimated) liability risk ranging from 5% to 15% of their tangible book value related to litigation by investors in the firms' securities, according to a white paper written by Chris Gamaitoni, an analyst with Compass Point Research. Investors trying to claw back loan losses include the FHLBanks of Pittsburgh, Seattle, and San Francisco, who have requested rescission on about $25.6 billion of MBS purchases. In addition, a large investor syndicate with $500 billion in residential securities is requesting trustees to enforce servicing breaches for improperly-originated loans.

- Gamaitoni estimates the total liability for rescission on alternative-A loans to be $67.9 billion with JPMorgan Chase & Co. topping the list with $13.1 billion of estimated losses related to Bear Stearns' paper, followed by Deutsche Bank ($10.3 billion of losses) and Bank of America ($10.2 billion). (*American Banker*, Sara Lepro, 08/19/10)

GSEs' losses were driven by their 2006-2007 single-family guarantee business

- The key driver in the failure of Fannie Mae and Freddie Mac was the GSEs' Single-Family Credit Guarantee business segment, which accounted for 73% of the enterprises' losses from the end of 2007 though the second quarter of 2010, according to the Federal Housing Finance Agency The bulk of the GSEs' capital reduction was associated with mortgages originated in 2006 and 2007, said FHFA in its first *Conservator's Report on the Enterprises' Financial Performance*, dated August 26. Fannie Mae and Freddie Mac lost $166 billion in their guarantee business (73% of total losses), while $21 billion of their losses were attributable to the GSEs' retained mortgage portfolios and investments in private-label MBS (9% of total losses). Since late 2007, Fannie Mae and Freddie Mac have lost nearly $230 billion and received $150 billion of taxpayers' assistance since the enterprises were placed into conservatorship in September 7, 2008.

- Fannie Mae and Freddie Mac began tightening their credit underwriting standards for new mortgage acquisitions and virtually ceased acquiring non-traditional and higher risk mortgages beginning in 2008. The GSEs also have enhanced their standard loss mitigation programs to address the needs of delinquent borrowers and expand the options available to borrowers to retain or give up their hones while avoiding foreclosure, said FHFA. (*Federal Housing Finance Agency Press Release,* 08/26/10; *Bureau of National Affairs*, 08/30/10; *Conservator's Report on the Enterprises' Financial Performance*, Federal Housing Finance Agency, 08/26/10)

The Mortgage Bankers Association expresses concerns over GSE receivership framework

- The Mortgage Bankers Association has weighed in on the Federal Housing Finance Agency's proposed regulatory framework for the agency's receivership operations for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. On July 9, FHFA published a framework in the Federal Register that covered (i) the powers of FHFA as a conservator or receiver; (ii) the authority and time limits to review and enforce contracts; (iii) alternative procedures and time period for determination of claims; (iv) priority of expenses and unsecured claims; (v) the process for setting up a limited-life regulated entity (LLRE) to assume or succeed to the assets and liabilities of a regulated entity in default or danger of default, (vi) the authority of an LLRE to obtain credit; (vi) capital distribution while in conservatorship; and (vii) payment of securities litigation claims of the conservatorship.

- In a letter to FHFA General Counsel Alfred M. Pollard, MBA President and CEO John A. Courson and Chairman-Elect Michael D. Berman expressed concerns that the framework as being "overly theoretical." It is unclear what the trigger would be for placing the entities into receivership, wrote Courson and Berman. The goals of any receivership are unclear, they added.

- With regard to the framework, the authors make the following suggestions:

    - FHFA should make it clear how various claimants will be treated once the Enterprises are placed into receivership—specifically whether subordinated debt holders or whether the claims of senior debt holders will be treated differently than those of MBS holders.

    - FHFA should more closely follow guidelines used by FDIC in repudiating contracts for the enterprises' two businesses—MBS guarantees and mortgages held in portfolio, which could be split and liquated separately. If it follows FDIC practices, FHFA could determine if it wishes to pay the contracted interest rates on debt or simply pay off the debt at par. FHFA appears to have the power to eliminate no-call provisions in contracts under its authority to repudiate contracts, which would allow the conservator to seek cheaper short-term bridge financing to fund the portfolios in liquidation. FHFA should address if this is—or is not—a possibility.

  - FHFA would have to liquidate the GSE's mortgage portfolios in a manner similar to that FDIC's process with goal of minimizing the impact that sales have on market prices. If Treasury or the Federal Reserve could provide a long-term home for the portfolios, FHA could treat the guarantee business separately, which would help enable the conservator to sell the guarantees to the bidder with the strongest capital.

  - FHFA must protect all cash flows associated with the MBS from demands of any other class of claimants. This protection is critical to the continued value of the MBS and any potential role the securities may play in a new secondary market system.

  - FHFA needs to make clear that the servicing arrangements and agreements will not be candidate for repudiation and that keeping servicing rights in place would be a precondition of any sale or transfer to a qualified buyer.

  - FHFA should indicate what current operations or departments of the Enterprises will be retained in receivership.

- With Treasury's continued financial support of the GSEs in conservatorship, there is no clear mention of what would cause FHFA to place the enterprises into receivership. The authors wrote, "[It is] not unlike a brain dead patient who is being kept alive indefinitely by artificial life support." Absent objective and transparent criteria, the timing of placing an Enterprise into receivership will appear to be arbitrary. FHFA should discuss the criteria that would trigger receivership, since delays will likely increase the ultimate costs borne by taxpayers.

- The authors also urge FHFA to make explicit their goals for the receivership. Specifically, the agency should make clear if it intends to follow the least-cost resolution or take into account other considerations, given the Enterprises' unique role in the mortgage market. FHFA should also consider the degree to which the Enterprises' assets will be used to seed the new secondary market structure. (*Comment Letter to the Federal Housing Finance Agency*, John A. Courson and Michael D. Berman, 09/07/10; *Mortgage Daily News*, Jane Swanson, 09/08/10)

FHFA establishes new housing goals for Fannie Mae and Freddie Mac

- The Federal Housing Finance Agency issued a final rule on September 2, which creates home purchase and refinancing goals for Fannie Mae and Freddie Mac. Under the new rules, 27% the GSE's loan purchases should benefit low-income families, having incomes below 80% of area median income, while 8% of purchases should benefit very low-income families with incomes less than 50% of median income. For refinancings (including loan modifications), 21% of the GSE's loan purchases should benefit low-income families. The GSE's third housing goal for single-family housing states that 13% of the mortgages purchased by Fannie and Freddie should benefit very-low-income-families in low-income/high minority areas.

- For the multifamily goals, FHFA also expects Fannie Mae to acquire mortgages to finance at least 177,750 low-income rental units and 42,750 very low-income and Freddie Mac to finance at least 161,250 low-income housing units and 21,000 very low-income units.

- FHFA makes it clear that Fannie and Freddie are not expected to "undertake economically adverse or high-risk activities" to meet these housing goals. (Federal *Housing Finance Agency Press Release*, 09/02/10; *Bureau of National Affairs*, 09/03/10)

- Separately, the FHFA issued final rules to bar the GSEs from purchasing mortgage-backed securities to meet their affordable housing goals. Fannie Mae and Freddie Mac will no longer receive affordable housing credit by purchasing mortgage-backed securities collateralized by commercial and residential mortgages. Rejecting Freddie Mac' appeal that the enterprises be allowed to preserve the option as long as the company conduct "substantial due diligence" on the mortgage collateral, FHFA said it didn't intend for the GSEs to undertake "economically adverse or high risk activities" to meet their AH goals. (*Wall Street Journal*, Nick Timiraos, 09/03/10)

FHFA proposes ban on private transfer fees

- On August 12, the Federal Housing Finance Agency proposed guidance that would prevent Fannie Mae and Freddie Mac from purchasing or guaranteeing mortgages secured by properties with private transfer fee covenants that allow the developer to collect fees after the initial sale is closed. The August 12 guidance also would prohibit the FHLBs from investing in mortgages with private transfer fees. Such covenants require the homeowner to pay a fee to the developer when the property is sold, typically 1% of the sales price. The covenants, which often are in effect for 99 years, are used by some developers to lower the initial purchase price for buyers. In some cases, the fees collected often are used for community projects or the homeowners association—but not always, said the agency. "FHFA is concerned that the fees fund purely private streams of income for select market participants and do not benefit the homeowners. Further, even if the fees are dedicated to homeowners associations, they are not proportional or related to the purposes for which the fees are to be collected," said the guidance.

- Edward J. DeMarco, acting director of FHFA, said the proposed ban is necessary because fees "may impede the marketability and the valuation of properties

…contribute to reduced transparency for homeowners because the fees are not disclosed by sellers and are difficult to discover through customary title searches" and may raise homeownership costs. FHFA is also concerned that the fees may expose lenders, title companies and secondary market participants to risks from potential liens and title defects.

- The proposal's wording may extend beyond developer transfer fees and extend to mortgages with covenants requiring payments to homeowner associations, affordable housing groups, or other nonprofit groups upon resale of the property. FHFA's guidance explicitly includes a broad spectrum of such programs in the ban, stating: "if where such fees are payable to homeowners associations, [they are] likely to be unrelated to the value rendered and at tunes may apply even if the property's value has significantly diminished since the time the covenant was imposed."

- Andrew Fortin, vice president of government affairs for Community Associations Institute, said banning the GSEs' investment in mortgages with transfer fees payable to associations is "potentially a big problem." While CAI shares DeMarco's concerns of programs that" create neo-feudal arrangements" with outside investors, FHFA needs to better distinguish between profit-motivated transfer fees and those that benefit the public interests and nonprofit groups.

- FHFA will accept public comments on the proposed guidance after it first appears in the *Federal Register*. (*Washington Post*, Kenneth R. Harney, 08/21/10; *Bureau of National Affairs*, Mike Ferullo, 08/16/10)

Fannie Mae and Freddie Mac publish guidelines on PACE loans

- Fannie Mae and Freddie Mac published guidelines for Property Assessed Clean Energy programs (PACE), which have been approved in 22 states to promote investments in energy efficient improvements, such as solar panels. Under the August 31 guidelines, Fannie and Freddie will require homeowners to pay off their PACE when refinancing their mortgages. Lenders must first try to qualify the borrower for either a cash-out or limited cash-out refi with the proceeds used to pay-off the PACE loan. If the borrower doesn't have adequate equity, the lender may underwrite the loan as a limited cash-out loan with the green lien remaining in place. The PACE loan must be included in the borrower's monthly housing expense calculation. Otherwise, Fannie Mae and Freddie Mac will not purchase mortgages secured by properties with PACE liens which have priority over the first mortgage lien. (*American Banker*, Kate Berry, 09/018/10)

Federal Reserve issues proposed final mortgage rules

- The Federal Reserve stepped up its efforts to restructure rules governing the mortgage issuers with the August 16 release of five separate rules and guidance. Specifically, the central bank published a 930-page proposed rule amending Regulation Z to complete its regulatory review of mortgage lending rules. The revised Reg Z rule would (i) expand disclosures consumers receive for reverse mortgages and impose rules for reverse mortgage advertising to ensure it provides "accurate and balanced" information; (ii) prohibit certain unfair practices in the sale of financial products along with reverse mortgages; (iii) improve disclosure that explains a consumer's right to rescind certain mortgage transactions and clarify the responsibilities of the creditor if the consumer rescinds the loan; and (iv) ensure that consumers receive new disclosures when parties agree to modify key terms of an existing closed end loan. The Fed said it would issue final rules that combine its 2009 and 2010 proposals after reviewing the public's comments on the rule.

- The Federal Institutions Examination Council released on August 16 guidance on reverse mortgage product, which like the proposed rule, emphasized consumer protection concerns raised by reverse mortgages and addressed general features of the product, the relevant legal requirements, and related policies, procedures, internal controls and third-party risk management.

- Other portions of the Fed rule on mortgage disclosure applies to all types of mortgages to ensure that consumers have time to review their loan cost disclosures before they are obligated for fees, by requiring banks to refund fees if the consumer withdraws from the loan within three days of receiving the disclosure. The rule also clarifies that when a consumer requests information about his or her loan, the loan servicer must provide the information within a reasonable period of time—generally 10 days.

- The Fed's second proposed rule would revise escrow account requirements for jumbo mortgages to conform to the Dodd Frank Act standards, by increasing the annual percentage rate threshold for jumbo loans with APRs that are 2.5 percentage points or more above the applicable prime rate as the threshold for a lender to establish an escrow account for the mortgage.

- The central bank issued final rules on compensation for loan originators, banning remuneration based upon an interest rate or other loan terms. The rule also prohibits a loan originator from receiving compensation directly from the borrower from also receiving pay from a lender or other third party. The rule also prohibits loan originators from directing—or steering—a consumer to accept a mortgage that is not in their best interest in order to increase their personal compensation. A second final rule would implement a statutory amendment to TILA, consumers to receive notice when their mortgage has been sold or transferred.

- The Fed also issued an interim rule, advising disclosure requirements for closed end mortgage loans under Reg Z and implements provisions in the Mortgage Disclosure Improvement Act that requires lenders to disclose how a borrower's regular mortgage payments can change over time. Under the interim rule, lenders' disclosures must include a payment summary table that contains (i) the initial interest rate and corresponding monthly payments, (ii) the maximum interest rate and payment that can occur during the first five years for adjustable rate loans, along with a "worst case" example showing the maximum rate and payment possible over the life of the loan; and (iii) a reminder that consumer may not be able to avoid increased payments by refinancing their loans. The interim rule requires lenders to disclose certain loan features, such as balloon payments or options to make minimum monthly payments that would cause the loan amounts to increase. Lenders must comply with the interim rule on all applications received on or after January 30, 2011. The Fed will accept comments on the interim rule for a period of 60 days.

- Additional information on the Federal Reserve's rulemaking efforts is available at www.federalreserve.gov/newsevents/press/bcreg/20100816a.htm; www.federalreserve.gov/newsevents/press/bcreg/20100816b.htm; www.federalreserve.gov/newsevents/press/bcreg/20100816c.htm; www.federalreserve.gov/newsevents/press/bcreg/20100816d.htm; and www.federalreserve.gov/newsevents/press/bcreg/20100816e.htm. (*Wall Street Journal*, Meena Thiruvengadam, *New York Times*, David Steitfeld, 08/17/10; *Bureau of National Affairs*, Thecla Fabian, 08/17/10; and *American Banker*, Cheyenne Hopkins, 08/17/10)

November will bring big changes banking committees in Congress

- The Senate Banking Committee is going to look a lot different in the 112th Congress, regardless of which party controls the chamber. Chairman Christopher Dodd (D-CT) and four panel members will be leaving at the end of this Congress. In addition to Dodd, Senators Evan Bayh (D-IN), Jim Bunning (R-KY), Judd Gregg (R-NH), and Robert Bennett (R-UT), the panel's number two Republican will be leaving the panel.

- "It's really a very high-stakes time for the financial services industry and it's a very, very uncertain time," said Kenneth Guenther, the former president of the Independent Community Bankers of America. "The bottom line is that the Senate Banking Committee is just going to be a less effective place with this enormous, enormous turnover."

- No matter which party is in charge of the chamber, slimmer margins of control will make it more difficult for passing legislation. "Whoever is in the majority is going to have a smaller majority than the majority today. There's no way the Republicans are going to pick up so many seats that they'll have the numbers that the Democrats do today," said Mark Calabria, the head of financial regulation studies for the Cato Institute. "Things will be a lot tougher to do, particularly as you go into a presidential election. There is a real risk that the next Congress just ends up being nasty partisan gridlock regardless of who is in the majority."

- Committee members facing competitive races this November include Senators Michael Bennet (D-CO), David Vitter (R-LA), while Senators Richard Shelby (R-AL), Chuck Schumer (D-NY), and Jim DeMint (D-SS) are up for re-election but are considered safe. (*American Banker*, Stacy Kaper, 09/09/10)

- Representative Paul Kanjorski (D-PA), the number two lawmaker on the House Financial Services Committee who chairs the subcommittee on capital markets, is facing a tough re-election battle in November, after barely beating back an election challenge in 2008 by a 52% margin, thanks largely to a groundswell of support for Barack Obama. Without a presidential contest and down in the polls, Kanjorski is once again in the race for his life. If Democrats were to retain control of the House and Kanjorski did not prevail at the polls, Representative Maxine Waters (D-CA) would move up to the number two position on the panel. If re-elected, Kanjorski is expected to play a large role in debate over housing reform, as the chairman of the subcommittee, with oversight responsibilities for the GSEs. (*American Banker*, Stacy Kaper, 09/08/10)

Accounting notes

- The Financial Standards Accounting Board is considering a new method to calculate reserves, representing the biggest change to reserving practices in more than three decades, said experts. Under the proposal, banks would shift more to an "expected loss" model, setting reserves based upon their long-term loss expectations rather than wait for possible signs of imminent default. This valuation method would provide a more accurate balance sheet, reflecting the present value of cash flows expected to be collected, argue supporters. However, opponents argue that the method would front-load credit costs, which would reduce income and constrain capital, without "empowering" banks to pad reserves during good times. "In theory the new proposal is subject to more guesstimates," said University of Georgia accounting professor Dennis Beresford, who chaired FASB from 1987 to 1998. "Will there be sufficient systems and procedures and can it be done reliably?" Observers agree that the method does not remove subjectivity from the reserving methods, which vary widely among banks. "There is likely to be a huge and immediate charge [to the bottom line, if implemented]" said Dorsey Baskin, a partner with Grant Thornton. "That's because you would be taking an allowance based on past losses and include more reserves for future losses." (*American Banker*, Paul Davis, 09/30/10)

- Bankers uniformly object to the Financial Standards Accounting Board's controversial proposal to book loans at fair values on the balance sheet (with changes to loan values not expected to be reflected in the net income statement). In separate letters, the Independent Community Bankers of America and the Financial Services Roundtable advised FASB to scuttle the draft accounting standards update (ASU). "ICBA urges FASB to withdraw the proposal and not go forward with the accounting changes contained in the exposure draft," Ann Grochala, the trade group's vice president for lending and accounting policy. "The fair value accounting changes applied to financial institutions, particularly community banks, are more likely to mislead investors and financial statement users than provide them a clear picture of financial condition."

- The American Bankers Association, the Center for Capital Markets Competitiveness of the Chamber of Commerce, and two committees of Financial Executives International, criticized the pending proposal, but stopped short of calling on FASB to drop the proposed rules. "ABA strongly urges the FASB to reject the proposal to record all financial assets (including loans) and liabilities at fair value on the balance sheet," wrote the trade group. The Center for Capital Markets Competitiveness (CCMC) "strongly urges FASB to reconsider the substance of the proposal." Among other things, CCMC, ABA and the Financial Services Roundtable, argued that U.S. banks subject to the proposed U.S. standard would face a competitive disadvantage with foreign banks. The nation's four prominent accounting firms, Deloitte & Touche, KPMG, Pricewaterhouse, and Grant Thornton, were critical of the FASB proposal, supporting instea ISAB's recipe for classification and measurement, which encompasses the fair-value-versus-amortized cost question. FASB plans to hold six public roundtable discussions on the proposal on three dates in October. (*Bureau of National Affairs*, Steve Burkholder, 09/03/10; *American Banker*, Heather Landy, 09/08/10)

- FASB will issue a proposal by the end of September, providing guidance to lenders in determining whether a loan modification is a troubled debt restructuring. The FASB board's discussion focused on (i) when a modification constitutes a concession; (ii) the concept of financial difficulty; (iii) the interpretation of what constitutes a significant delay; (iv) whether to change the existing disclosure requirements for TDRs, (v) potential changes to accounting for purchases or credit-impaired loans; and (vi) transition issues. The board instructed staff to proceed with issuing a ballot draft of the proposal, which generally is subject to a 60-day comment period. (*Bureau of National Affairs*, Denise Lugo, 08/26/10)

- FASB will soon consider whether to require companies to account for the potential cost of ongoing litigation. While supporters argue the proposal would merely be a disclosure, opponents contend the requirement would hurt investors by offering roadmaps for new litigation and bigger settlements. Another provision proposes to require companies to disclose the "average settlement amount" for various categories of litigation. (*Wall Street Journal*, 08/18/10)

- Financial Standards Board Chairman Robert Hertz will retire in September after serving eight years in that role. Effective October 1, FASB member Leslie Seidman will assume the role of acting chairman. Before joining the board, Seidman owned a private consulting firm that provided services to major corporations, accounting firms and other organizations. Previously, she served as vice president of accounting policy at JP Morgan & Co. and was an auditor for Arthur Young & Co.

- The Financial Accounting Foundation also announced that FASB will increase the size of its board from five to seven members—the original size of the board from 1973 until 2008. Returning to a seven member board will enhance FASB's convergence agenda with IASB and address the challenges in the U.S. capital markets, said FAF Chairman Jack Brennan. (*Bureau of National Affairs,* Denise Lugo, 08/25/10)

Jules Kroll acquires credit rating firm Lace Financial with goal of obtaining the licenses to compete with S&P, Moody's and Fitch

- Jules Kroll, the 69-year mogul who sold Kroll Inc. for $1.9 billion, has acquired the boutique ratings firm Lace Financial. Kroll plans to build the company's staff and obtain the required licenses needed to compete with the "big three" credit rating agencies, S&P, Moody's and Fitch. "There's a need for a creditable alternative," said Knoll, who launched Knoll Bond Rating Agency last year, using $5 million of his personal funds. With $5 million of new investors' capital, Knoll acquired the 25-year old Lace Financial, which has regulatory licenses with the SEC to be a nationally recognized bond-rating firm. Knoll's credit rating venture model calls for (i) performing more due diligence beyond data from bond issuers; (ii) accept much of its pay from investors who subscribe to the company's service; (iii) provide ratings in some cases when issuers don't want one from Knoll; and (iv) provide supporting materials with ratings so investors can see why a rating was given. (*Wall Street Journal*; 08/30/10)

Fannie Mae

Fannie Mae's mortgage holdings declined 1.9% in July

- In July, Fannie Mae's Book of Business—including its gross mortgage portfolio, commitments to purchase, net and new business acquisitions—declined 1.9% on an annualized basis, exclusive of company's delinquent loan repurchases. Fannie Mae's retained mortgage portfolio declined at an annualized compound rate of 8.2% during the month to $812.0 billion. On June 30 (the latest data available), the company reported a 4.99% serious delinquency rate for single-family mortgages, down 16 basis points from the prior month, while its serious delinquency rate for multifamily loans increased four basis points to 0.80%. Fannie's effective duration gap was zero months in July, unchanged from June. (*Monthly Volume Summary*, Fannie Mae, July 2010)

Fannie Mae urges servicers to process defaulted loans as quickly as possible and sets up monitoring process to track the foreclosure process Fannie Mae launches the Home Path Program to finance REO sales Representative Conyers urges Fannie Mae to stop "bankrolling lawsuits against homeowners"

<u>Fannie Mae urges servicers to process defaulted loans as quickly as possible and sets up monitoring process to track the foreclosure process</u>

- With the economic recovery stalled and housing prices expected to fall further, Fannie Mae is stepping up its efforts to pursue foreclosure on seriously delinquent mortgages. To that end, Fannie Mae notified its loan servicers on August 31 that it will begin closely monitoring their work on defaulted loans to determine why delays are occurring in the foreclosure process. If servicers are unable to justify the delays, Fannie will perform on-site reviews and assess fines against the servicer to provide them "a financial incentive to comply with Fannie Mae policies and improve overall quality of their performance."

- In its *Servicing Guide*, Fannie Mae established time frames by states by which servicers would be expected to complete routine foreclosure proceedings.

State	Number of days
Alabama	90
Alaska	120
Arizona	120
Arkansas	90
California	120
Colorado	150
Connecticut	180
Delaware	210
District of Columbia	120
Florida	185*
Georgia	60
Hawaii	120
Idaho	180
Illinois	300
Indiana	210
Iowa	180**
Kansas	120
Kentucky	150
Louisiana	180
Maine	300
Maryland	90***
Massachusetts	120
Michigan	60
Minnesota	90
Mississippi	90
Missouri	60
Montana	150

State	Number of days
Nebraska	120
Nevada	150
New Hampshire	90
New Jersey	300
New Mexico	180
New York- Downstate	420****
New York- Upstate	300****
North Carolina	120
North Dakota	150
Ohio	210
Oklahoma	210
Oregon	150
Pennsylvania	270
Rhode Island	90
South Carolina	180
South Dakota	150
Tennessee	60
Texas	60
Utah	150
Vermont	300
Virginia	60
Washington	150
West Virginia	60
Wisconsin	300
Wyoming	90
Puerto Rico	360
Virgin Islands	300
Guam	120

Source: *Fannie Mae Servicing Guide*

- In a separate announcement, Fannie Mae said it will require servicers to assign seriously delinquent loans collateralized by Florida properties to an attorney from the company's Retained Attorney Network prior to the initiation of foreclosure proceedings.

- "This is a shot across the bow that servicers have to start paying attention," said Kevin Kanouff, founder of mortgage servicer Statebridge Co. "Now they're going to put their feet to the fire and expect to move these loans along as opposed to throwing them in a program and just collecting fees." Steve Horne, president of Wingspan Portfolio Advisors added, "What you're seeing is a tremendous level of frustration at Fannie, because the servicer is not pursuing foreclosure."

- Holding servicers accountable for unwarranted delays is not a new concept, argued Fannie Mae spokeswoman Janis Smith. "I think it's fair to say that considering the volume of delinquency activity, and the volume of loans at some states of this process, it was appropriate to issue this reminder."

- Observers aren't certain that Fannie's announcement represents "big" news. Vicki Vidal, VP of public policy at the Mortgage Bankers Association, said many delays are caused by external factors, such was state and local regulations and court delays. "I don't think they'll apply [compensatory penalties] across the board for minor infractions." Greg Hebner, president of MOS Group, said he expects to see an increase in notices of default and of foreclosure, as a result of Fannie Mae's announcement. "It's a good tactic by Fannie because it will bring more borrowers to the negotiating table," said Hebner.

- On June 30, Fannie Mae reported an inventory of 129,310 properties with a carrying value of $13 billion, more than double the inventory from a year earlier. Fannie noted in its second quarter SEC filing, "We have seen an increase in the percentage of our properties that we are unable to market for sale in the first half of 2010 compared with the first half of 2009." (*HousingWire*, Christine Ricciardi, 09/01/10; *American Banker*, Kate Berry and Jeff Horwitz, 09/02/10; *MorgtgageOrb.com*,)9/01/10

<u>Fannie Mae launches the Home Path Program to finance REO sales</u>

- Fannie Mae has quietly rolled out its new Home Path Program, which offers "subprime-era" terms to purchasers of the company's real estate owned. The Home Path Program offers participants "as is" and "renovation" financing with:

    - Minimal down payments, consisting of 3% down for owner-occupied properties and 10% for investor-owned properties;
    - No mortgage insurance required;
    - No appraisal requirement, unless the borrower is borrowing additional funds to renovate the property;
    - Generous "seller contribution" limits of up to 6% of the sales price;
    - A minimum credit score of 660; and
    - Maximum loans tied to conforming loan limits--$729,750 in high cost markets; $625,000 in select markets; and $417,000 elsewhere.

- Fannie Mae is limited the Home Path Program financing of purchases of REO properties listed on www.HomePath.com. Fannie will entertain offers that come through participating brokers that are listed on the website, not directly from consumers. A borrower may obtain renovation financing up to a maximum of $30,000 or 20% of the completed value of the improvement. (*Los Angeles Times*, Kenneth R. Harney, 09/05/10)

Representative Conyers urges Fannie Mae to stop "bankrolling lawsuits against homeowners"

- [W]hat do the American people get for investing $86 billion and owning an 80% share in Fannie Mae?" asked Representative John Conyers (D-MI) in a September 1 post on *The Hill's Congress Blog*. "Have many millions of homeowners who are delinquent on their Fannie mortgages been helped? Has Fannie devised a method or a path to prevent the estimated 13 million foreclosures that will occur over the next five years?"

- "Unfortunately, Fannie has decided to go down a different, far less productive path. It recently announced that it will sue underwater homeowners who "strategically default" on their mortgage payments. That's right—Fannie is proposing to spend your taxpayer dollars to sue underwater homeowners."

- "A person facing foreclosure shouldn't be threatened with taxpayer-funded lawsuits during one of the most difficult moments of his or her life. That is why I've written a letter with my colleagues, Representatives Marcy Kaptur (D-OH), Raul Grijalva (D-AZ), Steve Cohen (D-TN), Zoe Lofgren (D-CA), Barbara Lee (D-CA.), and Mike Honda (D-CA), asking Secretary Geithner and FHFA Acting Director DeMarco to exercise the federal government's authority as Fannie Mae's conservator to suspend the implementation of this policy until Fannie, the Administration, and the Congress, seriously consider the many problems associated with this policy and determine whether it conflicts with the Administration's efforts to help keep homeowners in their homes." (*The Hill's Congress Blog*, John Conyers, 09/01/10)

Fannie Mae's policy prohibiting "appraisal cutting" goes into effect

- In September, Fannie Mae's policy to prohibit lenders that sells the company loans from changing appraisals—a practiced called appraisal cutting. In a June, Fannie Mae told underwriters that they would have to contact the appraiser to resolve any disagreements about the valuation. If the parties are unable to resolve the opinion-of-value dispute, Fannie instructed the lender to order a second appraisal. The lender will no longer be able to just reduce the value of the appraisal, which had become common practice, or shop around for a lower appraisal.

- "They aren't rendering an opinion on the value, but the lender is saying that they will only loan "x" amount," said Griff Straw, president of the valuation company Solidifi, Inc. "What Fannie Mae has done is put some definitions around the process that is fair to everyone so you don't arbitrarily have a lender who whacks the appraisal. You have the flexibility to question it." (*American Banker*, Kate Berry and Marc Hochstein, 08/26/10)

New online help for distressed borrowers at Fannie Mae

- Fannie Mae launched a new website---www.KnowYourOptions.com—to help distressed borrowers find assistance with a goal of avoiding foreclosure. The web portal, which is available in English and Spanish, provides homeowners video instructions on how to take action on your mortgage, along with contact information for mortgage companies and loan counselors. The site includes video testimonials from borrowers who have faced similar problems and were successful in avoiding foreclosure. Information is also available on "graceful exits," with information on tools such as short-sale/s and deeds-in-lieu as alternatives to foreclosure. (*New York Times*, Bob Tedeschi, 08/23/10)

Former Fannie Mae lobbyist rumored to be in line as the next White House chief of staff

- Deputy national security advisor Tom Donilon is rumored to be in line to serve as the next White House chief of staff, if Rahm Emanuel elects to leave his post to run for mayor of Chicago. In 1999, Donilon was named executive vice president of Fannie Mae, where he served as the company's chief lobbyist through 2005. (*The Examiner*, Timothy P. Carney, 09/08/10; www.whorunsgov.com, 09/08/)

Freddie Mac

Freddie Mac's total mortgage portfolio shrinks at an annualized 3.9% in July

- Freddie Mac's total mortgage portfolio decreased at an annualized rate of 3.9% in July, closing the month at $2.215 trillion. The company's refinance-loan purchase volume totaled $18.1 million, down 5.2% from June. Freddie Mac's single-family delinquencies declined 7 basis points to 3.89%, while its delinquent multi-family loans increased 2 basis points to 0.30% (*Monthly Volume Summary*, Freddie Mac, July 2010)

Freddie Mac to sell its fourth MBS offering, collateralized by multi-family properties

- Freddie Mac plans to sell about $1 billion of securities backed by loans on apartment buildings in mid-September. The debt offering, the fourth of six transactions the company expects to bring to market this year, is guaranteed by Freddie Mac. In the event of default, buyers of the K-008 Certificates will be in line to be paid ahead of other creditors, said the company. Goldman Sachs and JPMorgan Chase will lead the underwriting for the offering. (*Bloomberg News*, Jody Shenn, 09/09/10)

Ginnie Mae

Are FHA's problems "immediate"?

- On October 4, the FHA will implement increases in FHA's insurance premiums, which the agency claims will add $300 million a month to its insurance fund. Specifically, FHA will cut its upfront premium from 2.25% to 1%, while the monthly yield will increase from 0.55% to 0.90%. FHA Chief Risk Officer Bob Ryan said FHA's premium increases will be "the biggest contributor" to getting the fund back to a 2% capital ratio as mandated by Congress.

- However, some claim FHA's problems are more "immediate" and the proposed premium increase is not a cure all for the agency's financial condition. Tim Cornelison, a mortgage broker with United Community Bank in Georgia, argues that because the monthly yield increase is less than the cut to the upfront fee, it would take up to 43 months before the fund realizes any gains. "It would take three years to make up unless the increase could go into effect on post-closed loans, which it can't," said Ryan. "But the issue is that we would expect on average that those loans would last a good bit more than three years. In fact, it would be a little bit more than double, to the seven- to eight-year range."

- Further, Cornelison argues that the ailments of the insurance fund isn't a problem that is seven years away—"The problem is immediate." While the current FHA book of mortgages has improved from last year and is "considerably better for the 2007 and 2006 books, " FHA's seriously delinquent loans (in arrears 90 days or more) has increased 31.5% from a year ago. (*HousingWire*, Jon Prior, 09/09/10)

FHA launches a new refinance program for underwater mortgages

- On September 7, FHA launched its new "Short Refinance Program" (SRP) for underwater borrowers, allowing lenders to refinance the mortgages into FHA-insured loans if the original loan is written down to less than the value of the collateral property. To qualify for the program, investors must accept write downs of first and second mortgages to a combined loan-to-value ratio of 115% with first liens written down by at least 10%.

- The administration designed the new program for mortgages that were securitized by Wall Street firms and purchased by investors, who have been clamoring for help to address distressed loans whose values have been written down. (The program will not be available to loans held by Fannie Mae and Freddie Mac.) "It'll take some really crappy loans out of the marketplace …and replace them with much higher-quality [mortgages]," said Scott Simon, managing director at Pacific Management Investment Co. Industry experts caution, however, that obstacles still remain.

- The short refinance program attempts to address the stubborn problem of second liens by requiring that them to be written down so that total mortgage debt does not exceed 115% of the current market value of the collateral property. In this program, FHA will make partial payments to encourage banks to reduce second liens. However, banks have been very reluctant to write down seconds that are current. In turn, investors are reluctant to write down their first mortgages without extinguishing second liens, which are in a first-loss position. For underwater mortgages with second liens, "do I take the write-down and effectively pay off the second?" asked Vincent Fiorillo, portfolio manager at Doubleline Capital. "I don't think so. The second is worthless." Fiorillo said the short refinance program could work for mortgages without seconds, but questioned if many borrowers would meet FHA's debt level requirements to qualify for the new loan.

- Mortgage servicers are overwhelmed with distressed loans and borrowers may be reluctant to participate in the program, because the loan reduction will be reflected in their credit score. Investors' participation may be limited due to certain contracts governing mortgage securitizations, which allow modification only if there is "imminent risk" that the borrower would default. If loan servicers reduce mortgage balances on mortgages that are current, they risk exposing themselves to lawsuits from investors holding the riskiest slices of the MBS. "Lenders are going to be especially reluctant to do short refinance on folks who are current," said Alan White, an assistant professor at Valparaiso University [Valparaiso, IN]. Analysts expect the program will most likely be useful for mortgages that banks already own in their portfolio and a vehicle for investors to liquidate modified mortgages that are current. "It's going to be a 'take out' for modified loans," said Laurie Goodman, senior managing director for Amherst Securities Group.

- The new program will not be a panacea, said FHA officials, who are "cautiously optimistic" about the initiative that they hope will bring relief to between 500,000 and 1.5 million underwater borrowers. Government officials concede that the program will face a projected default rate of roughly 20% and have set aside $14 billion of previously earmarked housing aid from TARP to cover the program's losses. In mid-June, approximately 11 million homes—or roughly 23% of all properties that secured mortgages—had mortgage values that exceeded the value of the property, according to Corelogic. (*National Mortgage News*, 08/07/10; *Wall Street Journal*, Nick Timiraos, 09/04/10; *National Mortgage News*, Brian Collins, 08/26/10)

HUD will launch emergency loan program for unemployed in coming weeks

- HUD Secretary Shaun Donovan said the Obama administration plans to set up an emergency loan program for the unemployed and a government mortgage refinancing effort to help homeowners. "The July numbers were worse than we expected, worse than the general market expected, and we are concerned," said Donovan. "That's why we are taking additional steps to move forward." The administration will start an emergency homeowners' loan program for unemployed borrowers so they can stay in their homes, said Donovan. "We're going to continue to make sure folks have access to home ownership," he said. (*Bloomberg News*, Holly Rosenkrantz, 08/30/10)

FHA implements new underwriting requirements

- Effective September 7, FHA raised the underwriting requirements for its refinancing program, establishing a maximum loan-to-value ratio for a rate-and-term refinance of 97.75% and maximum combined loan-to-value ratio of 85% for cash-out financings. "We are bringing the guidelines back into the norm with a carve-out for the FHA Short Finance Program," said HUD deputy assistant secretary Vicki Bott. In 2007, FHA began accepting an "unlimited CLTV ratio" to provide distressed borrowers a refinancing option during the throes of the subprime crisis.

- FHA published a final rule, effective October 4, which requires borrowers with low credit scores to provide up to a 10% down payment to qualify for an FHA-insured mortgage. Under the rule, borrowers with credit scores ranging from 500 to 579 will qualify for an FHA mortgage only if their loan-to-value ratio is 90% or less. Borrowers with credit scores below 500 are ineligible for an FHA loan. According to the rule, "The new LTV and credit score requirements will reduce the risk to the [FHA's Mutual Mortgage Insurance Fund] and to ensure that homebuyers are offered loans that are sustainable." The final rule applies to all FHA-insured loans, except reverse mortgages. However, the agency is providing a "special temporary allowance" for less creditworthy borrowers, who hope to participate in the new Short Refinancing Program. (*Wall Street Journal,* Nick Timirados, 09/04/10; *National Mortgage News*, 09/07/10; *National Mortgage News*, 08/26/10; *Bureau of National Affairs*, Mike Ferullo, 09/08/10)

FHA production down 2% in July

- In July, FHA insured $25.9 billion of mortgages with $18.6 billion used to purchase homes and $5.6 billion to refinance existing mortgages—with 63% of borrowers trading in their Fannie Mae or Freddie Mac mortgage for an FHA loan product. The agency also insured $1.5 billion of reverse mortgages in July. FHA's serious delinquency rate on its $873.5 billion single-family insured portfolio was 8.32%, unchanged from June.

- FHA endorsements for the first ten months of FY2010 totaled $248.5 billion, down 5% from the year-ago period, while the agency's HECM originations, which totaled $27.8 billion for the period, were down 31% from last year. (*National Mortgage News*, 09/01/10)

FHA is developing a new HECM program with more affordable terms

- The FHA is working on a new reverse mortgage loan product, designed to provide seniors access to the equity in their homes to pay for daily living expenses and health-care costs. The new HECM Saver Mortgage would charge borrowers a substantially lower up front premium of only one-tenth of one point of the property's value, as opposed to the two points charged for the standard HECM product. However, the HECM Saver Mortgage would restrict the loan amount by 10% to 18% relative to the standard HECM product. HUD expects to introduce the HECM Saver Mortgage in October.

- "The up-front premium has been a deterrent to some prospective borrowers, particularly those needing less than the full amount available under the traditional HECM Standard program," said Peter Bell, president of the National Reverse Mortgage Lenders Association. "This new variation, the HECM Saver, presents a sensitive response to their needs." (*American Banker*, Brian Collins, 08/30/10; *HousingWire*, Jacob Gaffney, 08/27/10)

- FHA must guide mortgage servicers on how to address a rising number defaults in its HECM portfolio arising from unpaid taxes and insurance, concluded HUD's inspector general. In a 19-page audit, the IGs found that four servicers were holding 13,000 FHA-insured equity conversion mortgages totaling more than $2.5 billion. The IG estimated that FHA could incur losses of $1.47 billion on the HECM defaults, if the agency foreclosed on the loans. The servicers have paid $35 million to pay the delinquent taxes and insurance without informing HUD, said the auditors. Two services told the IGS auditors that they are awaiting guidance from HUD on how to handle HECM defaults.

- "If HUD does not take action, additional payments will occur within the next 12 months," wrote the IG. The level of defaults in the HECM portfolio may be higher than what the study reflects, since the auditors focused on only four of the 16 home equity conversion servicers. HUD discontinued collecting data on HECM defaults in April 2009, which totaled 7,000 at the time.

- FHA is drafting new guidance to instructing servicers to contact the defaulted borrowers and "require specific actions to bring the loans into compliance," wrote agency officials in a response to the report. (*American Banker*, Brian Collins and Kate Berry, 08/31/10)

- In August, the Mortgage Equity Conversion Asset Trust Corporation issued a $92 million reverse mortgage securitization, collateralized by 760 home equity conversion mortgages and yielding 4.75%. Bank of America is the lead servicer for the private-label reverse mortgage securitization, the first such deal to close since the recession began. Most of the mortgages are in some form of distress, typically related to nonpayment of property taxes or homeowners insurance. (*HousingWire*, Jacob Gaffney, 08/24/10)

FHA begins the overhaul of its technology systems

- HUD has begun an ambitious overhaul of FHA's processes and technology, issuing a series of requests for proposals with a reported $250 million budget. In August, GSA announced that Deloitte & Touche has been awarded a $62 million contract to assist HUD with the implementation of the project. In the RFP, HUD outlined 25 priorities the FHA makeover, including risk and fraud mitigation, multifamily business process re-engineering, FHA infrastructure to replace CHUMS and single-family automated underwriting system implementation.

- In the meantime, lenders continue to bear the expense of reaching FHA TOTAL Scorecard via LP and DU. "Fannie and Freddie are raking in a quarter billion dollars apiece off of fees, $35 apiece for all their certs," said Jeff Lebowitz, the president of MORTECH. "That hurts when you are hitting them just to get to FHA." FHA's TOTAL scorecard interfaces for only a few AUS systems—LP, DU, Chase's Zippy and Countrywide CLUES. Recently, FHA approved four new vendors to the list—Avista Solutions, Loan-Score Decisioning Systems, MeridianLink Inc. and Overture Technologies. (*Mortgage Technology*, Scott Kersnar, 09/09/10)

Farm Credit System / Farmer Mac

Farm Credit System is "woefully deficient" in disclosing information on troubled FCS institutions

- In the August issue of *Farm Credit Watch*, Bert Ely wrote, "[T]he Farm Credit Administration (FCA) is woefully deficient in alerting the public and the FCS's borrower-owners about asset-quality and management problems in troubled FCS institutions. This insufficient disclosure now extends to the Quarterly and Annual Information Statements the Federal Farm Credit Banks Funding Corporation (the FCS's access to Wall Street) distributes to investors in FCS notes and bonds. "

- "According to the June 30, 2010, Quarterly Information Statement, five FCS associations with total assets of $1.441 billion (.67% of total FCS assets) were operating under written enforcement agreements with the FCA. Subsequently, one of the smaller of those five institutions was merged into another FCS association. Yet in a July 12, 2010, speech at the annual meeting of AgFirst Farm Credit Bank, FCA Chairman Leland Strom reported that 'we now have 17 institutions under special supervision or enforcement actions. Also, the Financial Institution ratings for many [FCS] institutions have slipped during the past year.'

- "Unfortunately, Strom failed to provide any information about the total assets of these problem institutions, as the FDIC does about problem banks, nor where there are geographical concentrations of troubled FCS institutions. Far worse, the Funding Corporation did not make any mention in its June 30 Information Statement about FCS institutions under 'special supervision,' which effectively represents an informal enforcement order. This troubling lack of disclosure by the Funding Corporation about the extent of problems within the FCS that Strom referenced in his speech is a key reason why FCS financial reporting should be subject to oversight by the Securities and Exchange Commission, as is now the case with the other four GSEs." (*Farm Credit Watch*, Bert Ely, August 2010)

EPA delays its approval of E15 until mid-November

- The Environmental Protection Agency delayed its decision to increase the concentration of ethanol legal in gasoline from 10% to 15% until after the November elections.

- The proposed E-15 standard has sparked concern on a number of fronts. The National Renewable Energy Laboratory's tests found E15 ethanol causes a raft of problems in cars, ranging from loss of fuel economy to spikes in exhaust temperatures. The auto manufacturers voiced concern about raising the ethanol standard, noting that most car warranties only cover E10, which could leave customers stuck with hefty bills if the new fuel standard damages engines. The Alliance of Automobile Manufacturers found in a recent study that E15 "made engines run hot, compromised catalytic converters, and even damaged cylinder walls."

- The agriculture industry strenuously supports the new E15 standard, arguing the new standard would immediately ignite ethanol production and allow the industry to meet the government's ethanol production mandates of 15.2 billion by 2012 and 36 billion by 2022. Recent studies show that ethanol producers are losing ten cents on every gallon of gasoline over and above the $0.45 a gallon federal subsidy [totaling $6 billion] in place today. The agriculture industry needs E15 and is expected to receive EPA approval later this fall. (*Associated Press*, Mary Clare Jalonick, 07/16/10; *American Spectator*, Matt Purple, 08/27/10)

- "The price of ethanol has surpassed that of gasoline in the U.S. for the first time since December 2009," reported Shelley Goldberg in *RGE Strategy Flash*. "By the end of August, the benchmark ethanol futures contract had risen 22% since May—the official start of the U.S. driving season—and was up 14% in the month of August alone. Yet wholesale unleaded gasoline blend stock prices fell 6.5% in the same period." (*RGE's Daily Top 5*, Wednesday, 09/08/10)

Farm Credit System's mission-related investments totaled $4.7 billion on March 31, 2010

- On March 31, the Farm Credit System had $4.7 billion of mission-related investments, which included investments in Farmer Mac ($1.4 billion), Rural Housing MBS ($1.2 billion), USDA guaranteed paper ($888.5 million) and Rural Development Debt Securities ($631.8 million).

- According to an agency presentation on mission-related investments, "FCS is building new and stronger relationships with USDA state and local offices, which have rekindled mutual mission objectives. [The] System philosophy remains conservative with focus on projects with ample equity, government support, and credit enhancements. Collaboration with commercial banks continues to increase and is having a positive effect on program and attitudes toward FCS. [And,] private placements, such as Rural America Bonds, are becoming increasingly important for rural communities as financial markets remain soft and issuers face obstacles to access public capital markets

- Over the next 6 to 12 months FCA plans to (i) enhance their on-going reporting and oversight processes for mission-related investments; (ii) further evaluate the economic impact of Investments in Rural America; (iii) consider changes to pilot program criteria to ensure effectiveness; (iv) monitor general economic conditions that are adding stress to some projects, which may necessitate adjustments to original projects and our oversight; (v) continue to identify success stories and challenges; and (vi) participate in an open dialogue with USDA on non-leveraged RBICs, NMTCs, and secondary market sales of USDA guaranteed paper. (*Mission-Related Investments Update*, Farm Credit Administration, 08/12/10)

Mission-Related Investments

Investment Type	Total Volume 3/31/10*	Total Volume 12/31/09*	Total Volume 12/31/08*	Annual Change	Annual Percent Change
Investments made under prior-approval authorities					
Rural Housing Mortgage-Backed Securities	$1,162,301	$1,242,526	$1,552,005	($309,479)	-19.9%
Rural Development Debt Securities**	631,757	635,195	477,445	157,750	33.0%
Credit-Linked Agricultural Notes	11,733	12,261	13,951	(1,690)	-12.1%
Equity Investments	5,274	4,708	2,992	1,716	57.3%
Subtotal	**$1,811,065**	**$1,894,690**	**$2,046,393**	**($151,703)**	**-7.4%**
Investments made under other regulatory authorities					
Farmer Mac	1,433,330	1,267,409	1,461,320	(193,911)	-13.3%
Tobacco Buyout	548,239	695,503	771,586	(76,083)	-9.9%
USDA Guaranteed Paper***	888,543	799,092	647,436	151,656	23.4%
Farmers' Notes	12,843	12,601	16,392	(3,791)	-23.1%
Subtotal	**$2,882,956**	**$2,774,605**	**$2,896,734**	**($122,129)**	**-4.2%**
Total all mission investments	**$4,694,021**	**$4,454,447**	**$4,943,127**	**($273,833)**	**-5.5%**

Amounts in Thousands
***** Includes Agribusiness***
****** Estimated Secondary Market Purchases***

(Source: *Mission-Related Investments Update*, Farm Credit Administration, 08/12/10)

Postal Service

USPS—the government zombie

- The Postal Service's costs—and losses--continue to climb, thanks largely to (i) high unionized labor costs; (ii) huge, monopolistic bureaucracies that, by nature, don't thrive on efficiency; (iii) electronic communications that are displacing "snail mail" postage revenue; and (iv) a migration of advertising revenue from print to electronic distribution. Together, these factors have created a cumbersome bureaucracy for the USPS, which services a declining market.

- As mail volume declined 15% from 2001 to 2009, the USPS reduced its work force 20%. However, the agency's average compensation and benefits rose more than 28% to $85,000 over the same period. In a commentary, Jack Curtis wrote, "In traditional government fashion, the Service has managed to do less work at greater expense by exploiting its monopoly to raise its income. That means, postal service without competition costs more than it should; it's actually worse than that since Congress appropriates from the taxpayers who already overpay for postage, whatever is needed to make up for losses."

- Curtis continued, "The Postal Service is both a boondoggle and an anachronism; it lived its useful life but now staggers on with increasingly costly life support; a government zombie. The 2009 operating cost per delivered mail piece was up 22% from 2001 even with 20% fewer people. …Although the Postal Service has essentially died, the aged obsolete, limping thing lurches on, bleeding money. It's time for a decent funeral…" (*American Thinker,* Jack Curtis, 09/06/10)

- The USPS is the largest civilian federal agency that employed approximately 599,000 career employees on December 31, 2009. According to CBO, the USPS pays the highest percentage of health benefit premiums than other federal agencies—80% versus 72%, respectively. In addition, the Postal Service pays 100% of employee life insurance premiums, while other federal agencies pay approximately 33%. Employee pay and benefits constitute 80% of the USPS's cost structure, which has remained unchanged since the 1960s (despite increased automation). The average postal employee receives $83,000 a year in total compensation. GAO also noted that the USPS has one of the largest retail networks in the U.S (36,500)--larger than McDonalds, Starbucks, and Walgreens combined, yet each post office averages only 600 visits per week, only 10% of an average Walgreen store. As a result of declining mail volumes, high labor costs and inefficient delivery channels, the USPS reported losses of nearly $12 billion for FY2007 through FY2009 and projects cumulative losses of over $230 billion by FY2020, if planned cost reduction and revenue generation initiatives are not implemented. In July 2009, GAO added the USPS's financial condition and outlook to its High Risk List and reported to Congress that urgent action is need to improve the agency's financial viability.

- In testimony before a Senate subcommittee, Postmaster General John Potter told lawmakers, "If the Postal Service were provided with the flexibilities used by businesses in the marketplace to streamline their operations and reduce costs, we would become a more efficient and effective organization. Such a change would also allow us to more quickly adapt to meet the evolving needs, demands, and activities of our customers, now and in the future." Cato's Ted DeHaven responds, "This is precisely why the USPS needs to be privatized and subjected to the demands of the market and not the whims of Congress. Members of Congress always raise a fuss when the USPS targets postal outlets for closure in their districts. … We also need the ability to expand our products and services, and ensure prices for our Market-Dominant products are based on the demand and cost of each individual product."

- DeHaven concludes, "What Potter wants–and needs–is something that only the private sector can provide. If the Senate hearing is any indication, Congress has no present plans to relinquish its control over the dying government monopoly. Instead, the USPS will likely continue to bleed red until policymakers run out of Band-Aids and are finally confronted with the choice of either privatization or direct taxpayer funding." (*www.downsizingthefederalgovernment.org*, Tad DeHaven, 03/23/10; *GAO: U.S. Postal Service—Financial Crisis Demands Aggressive Actions*, Phillip Herr, 03/18/10)

"5 Day Mail Delivery? No Way!"

- Thousands of American Postal Workers Union packed the streets of downtown Detroit on August 34 to protest the USPS' proposal to eliminate Saturday mail delivery. The APWU estimated that more than 3,000 members from around the country gathered in Detroit to protest the change, shouting "Five day, no way?!" (www.freep.com/apps/pbcs.dll/gallery?Site=C4&Date=20100824&Category=NEWS&ArtNo=8240804&Ref=PH&Params=Itemnr=1)

- APWU president William Burrus told protestors that ending Saturday mail service would drive businesses away from the Postal Service and hasten the agency's demise. Instead, Congress should relieve the USPS of its legal obligation to prefund health care benefits for future retirees, said Burrus. (*Detroit Free Press*, Elisha Anderson, 08/25/10)

USPS seeks to reclassify packages under 16 ounces ahead of 23% rate increase

- The Postal Service has asked the Postal Regulatory Commission to reclassify standard mail parcels, weighing less than one pound, from the "market dominate" category to the "competitive product" category to allow the agency greater pricing flexibility. If the Commission grants this reclassification, prices for this product would rise approximately 23% under the USPS's proposed rate increase. (*Bureau of National Affairs*, Andy Medici, 08/17/10)

TVA

TVA's new vision includes increased nuclear capacity and less reliance on coal

- TVA is embarking on a plan to nearly double their production of nuclear energy and reduce its reliance of coal for power generation, as part of its strategic plan for the future. "We want to be one of the nation's leading providers of low-cost and clean energy by 2020," said TVA CEO Tom Kilgore.

- The utility's multi-billion undertaking would increase its nuclear power production, which generates about 25% of TVA's power to about 45%, and reduce its reliance on coal production from 60% to about 45%. The plan calls for idling nine coal-fired power plants between 2011 and 2015, reflecting TVA's move to cleaner sources of energy. The nine plants that will be shuttered have a power generation capacity of 1,000 megawatts.

- "It's really about taking a look at the future, understanding where we are and the infrastructure base that we have, where we have been," said TVA Chief Operating Officer Bill McCollum. "The infrastructure we have in place has provided a tremendous value to people in the [Tennessee] Valley for a long time. At some point, it makes sense to look at the future and say you can't continue to just operate the same infrastructure forever." While no rate increases are incorporated in the plan, electricity costs are likely to increase in the future, he cautioned.

- The TVA board approved the utility's FY2011 budget, calling for $9.6 billion in operating expenses and $2.9 billion in capital projects. TVA's capital projects include (i) $635 million for Unit 2 at Watts Bar Nuclear Plant, which is expected to be completed by FY2013; (ii) $314 million for the 2012 completion of the John Sevier Combined Cycle Plant; and (iii) $248 billion for the possible reopening of one of Unit 1 at Bellefont Nuclear Plant for initial engineering design and site preparation for the partially constructed reactor. McCollum estimates that TVA would spend $4 billion to $5 billion to complete construction of Unit 1. (*Associated Press*, Kristin M. Hall, 09/20/10; *The Huntsville Times*, Paul Gattis, 09/04/10; *Reuters*, 08/30/10)

The Senate needs to act quickly on the president's nominees to TVA's board of directors

Senate appears ready to take action on TVA nominees

<u>The Senate needs to act quickly on the president's nominees to TVA's board of directors</u>

- In a September 8 editorial, *The Tennessean* (Knoxville) wrote, "The power of politics to cripple the operation of government has never been more apparent than in the holdup of key nominees to federal judgeships and panels. Tennesseans are seeing the results of the two-party stalemate acutely now with …four appointees to the Tennessee Valley Authority board of directors unable to take their seats. The TVA nominees include three from Tennessee: Barbara Haskew, an economics professor from Chattanooga; Neil McBride, an Oak Ridge attorney; and William Sansom of Knoxville, who previously served on the board appointed by a Republican administration. The fourth, Marilyn Brown, is an energy policy expert and former Oak Ridge National Laboratory official from Atlanta."

- "The four empty seats leave five actively serving on the board, so there is a quorum — for now. Alabamian Howard Thrailkill's term expired in May, but he has stayed on until the current Congress adjourns, probably in October. After that, any vote the TVA board takes can be called into question. And it appears that the Republican leadership in the U.S. Senate is fine with that.

- "Why? Because it might gall the president, and because a good many Republicans in Congress would like to render TVA ineffective so that it, a symbol of FDR's New Deal, could be dismantled and its operations handed over to private companies. Never mind that TVA has for decades brought billions of dollars in business to the companies it partners with or that its sitting board members are all appointees of George W. Bush. Republicans in Washington don't want to accommodate the president, nor do they want much-needed new blood on the board."

- "Though the nominations were approved in committee and sent to the full Senate in March, nothing further has happened because a senator or senators placed a 'hold' on the nominations. Senate rules allow such a hold to be placed in secret and without giving a reason. Such a lack of transparency is offensive in a nation that is supposed to be run by a government "of the people.''

- "The decisions that are being made and will soon need to be made by the TVA board are of long-term importance to Tennessee and the six other states that the agency serves. A push for increased nuclear-power production in TVA might lead to less reliance on coal-fired plants that pollute the air, but there are serious concerns about the cost and safety of ramping up new or expanded nuclear plants. That debate should be held with a full, nine-member TVA board leading the discussion."

- "Other matters, too, would benefit from fresh minds: TVA's commitment to energy conservation, its handling of the coal-ash spill cleanup, and more. There can be a conversation about the existence of TVA, as well. But in the meantime, the region needs qualified, duly chosen directors taking charge of its future. The Senate should move quickly to seat them." (*The Tennessean*, 09/08/10)

Senate appears ready to take action on TVA nominees

- The Senate appears ready to confirm four new TVA members, following months of delays by Republican Senators. Both of Tennessee's Senators said they expect Senate confirmation after lawmakers return from its summer recess. "My understanding is things have been worked out and we should get a confirmation vote shortly," said Senator Bob Corker (R-TN) during an interview during the August recess. Senator Lamar Alexander (R-TN), the chairman of the TVA Congressional Caucus and the Senate Republican Caucus, added, "I think we need the four new members on the board, and I expect all four will be confirmed later this month." (*Chattanooga Times Free Press*, Dave Flessner, 09/10/10)

Obama administration sides with TVA in Supreme Court case about greenhouse emissions

- Acting Solicitor General Neal Katyal weighed in on behalf of TVA in a climate change lawsuit before the Supreme Court, arguing that the EPA was using its authority to regulate carbon dioxide under the Clean Air Act and made the lawsuit unnecessary. "EPA has already begun taking actions to address carbon-dioxide emissions," wrote Katyal in his brief to the court. "That regulatory approach is preferable to what would result if multiple district courts—acting without the benefit of even the most basic statutory guidance—could use common-law nuisance claims to sit as arbiters of scientific and technology-related disputes and de facto regulators of power plants and other sources of pollution."

- However, environmentalists argue that the administration had talked about—but not imposed—limits on emissions from existing power plants. Moreover, they argued that administration's brief also employed arguments that threatened to undercut a basis for legal action that have been used for a century, dating back to Georgia suing over damage to the state's forests by a Tennessee copper smelter. "We're very angry and very disappointed that they would take this tack," said David Doniger, policy director of the climate center at the Natural Resources Defense Council.

- An unnamed administration official contended that the EPA has been taking "a series of regulatory actions indicating that it's moving forward on greenhouse gases and really making it inappropriate for the courts to step in and take on this issue." The administration had no choice but to submit the brief on behalf of the utilities, said the official. "It would inappropriate to read too much about the administration's policy based on this narrow litigation," he added.

- The Supreme Court is hearing a 2004 case in which eight states, New York City and three land trusts sued TVA and five other utilities that burn fossil fuels to generate electricity. The plaintiffs argued that the utilities' greenhouse emissions posed a "public nuisance" given their contribution to climate change. Although the plaintiffs lost their case district court, a two-judge panel of the Second Circuit Court of Appeals ruled in their favor on September 29, 2009.

- In a September 7 commentary, the *Washington Post* wrote, "Setting aside the legal technicalities, these sorts of cases are not the best way to reduce America's carbon emissions. Pursuing separate torts against different emitters will result in a patchwork of judicial mandates in lieu of comprehensive regulation, the nature, scale and expense of which will no doubt depend on which judge hears each case. EPA regulation, too, has deficiencies, including the possibility that different presidents will apply it inconsistently. But it's more predictable, and it's universal."

- "Still, environmentalists rightly worry that the White House won't ever allow the EPA's prepared rules to come into force, given high political opposition to EPA carbon regulation. Congress may also try to strip the EPA of its ability to regulate. If the administration declines to regulate, after all -- or if Congress forces the EPA to desist -- the plaintiffs will have better grounds and better reason to sue than they do now." (*Washington Post*, Steven Mufson, 08/26/10; *Washington Post*, 09/07/10)

> "First, 'the market' did not fail. One part of one sector did. … [G]overnment also failed. Regulations failed. Politicians failed. Monetary policy failed. Debt became way too cheap. But that wasn't a conspiracy of the banks; it was a consequence of the apparently benign confluence of loose money policy and low inflation."
>
> Former Prime Minister Tony Blair
> *A Journey*

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