

# The **GSE** REPORT™

*Tracking the Government's Role in the Financial Services Industry*

“No one will know until [the Dodd Frank Act] is actually in place how it works. But we believe we’ve done something that has been needed for a long time. It took a crisis to bring us to the point where we could actually get this job done.”

Senator Christopher Dodd (D-CT)  
June 25, 2010

“Well, as the artist formerly known as Cat Stevens used to sing,  
‘we’re on the road to find out.’”

Scott Johnson,  
reacting to Dodd’s description to the reform bill  
[www.powerlineblog.com](http://www.powerlineblog.com), 07/16/10

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## *Major Events*

The Dodd-Frank Wall Street Reform and Consumer Protection Act is the law of the land

Next up: The challenge of implementing Dodd Frank

Dodd Frank “corrections” bill already in the works

Battle looms over who will head the Consumer Financial Protection Bureau

Dodd pledges to focus on international effort to prevent “arbitrage” of financial rules

Congress approves Basel III before it even exists

The costs of Dodd Frank revealed in Bank of America’s second quarter earnings release



Source: © 2010 Reuters/ Jim Young

The Dodd-Frank Wall Street Reform and Consumer Protection Act is the law of the land

- On July 21st, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act), marking the most sweeping overhaul of U.S. financial regulations since the 1930s. According to Davis Polk, “This legislation will affect every financial institution that operates in this country,

many that operate from outside this country and will also have a significant effect on commercial companies. As a result, both financial institutions and commercial companies must now begin to deal with the historic shift in U.S. banking, securities, derivatives, executive compensation, consumer protection and corporate governance that will grow out of the general framework established by the Act. While the full weight of the Act falls more heavily on large, complex financial institutions, smaller institutions will also face a more complicated and expensive regulatory framework.” In a 26-page slide deck, Davis Polk outlines the implementation process for Dodd-Frank, available at [www.scribd.com/doc/35836970/Davis-Polk-Dodd-Frank-Act-Implementation-Slides](http://www.scribd.com/doc/35836970/Davis-Polk-Dodd-Frank-Act-Implementation-Slides).

- Davis Polk added, “...U.S. financial regulators will enter into an intense period of rulemaking over the next 6 to 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty.”([Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#), Davis Polk &Wardwell LLP, July 21, 2010 )

<b>Dodd Frank Rulemakings by Agency</b>	All	One-time	New
<u>Agency</u>	<u>Rulemakings</u>	<u>Reports &amp; Studies</u>	<u>Periodic Reports</u>
Bureau of Consumer Financial Protection	24	4	5
Commodities Futures Trading Commission	61	6	2
Financial Stability Oversight Council	56	8	4
FDIC	31	3	1
Federal Reserve	54	3	3
Federal Trade Commission	2	0	0
GAO	0	23	2
OCC	17	2	2
Office of Financial Research	4	1	2
SEC	95	17	5
Treasury	9	1	1
Total <sup>1</sup>	243	67	22

<sup>1</sup> Total count eliminates double counting for joint rulemakings.

Source: *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*  
Davis Polk &Wardwell LLP, July 21, 2010

- Senate Banking Committee chairman Frank Dodd (D-CT) said the success of the regulatory reform bill will ultimately depend on regulators’ performance. “We can’t legislate wisdom or passion,” said Dodd. “We can’t legislate competency. All we can do is create the structure and hope that good people will be appointed, who will

attract other good people.” In a July 15 article, *New York Times*’ reporters Binyamin Appelbaum and David M. Herszenhorn wrote, “The legislation will be carried out mostly by the same federal workers who were on duty as the financial system collapsed. ...Administration officials said they are confident that providing new leaders for those employees and granting them new powers, would produce better results.” (*New York Times*, Binyamin Appelbaum and David M. Herszenhorn; 07/15/10)

- In its July 1 issue, *The Economist* wrote, “In America, Dodd-Frank’s actual impact will depend greatly on how regulators like the Fed and the new consumer agency enforce its provisions. The risks cut two ways. Banks and their lobbyists may persuade regulators to interpret the new rules in the friendliest possible way to Wall Street, as they did before the crunch: the treatment of the ratings agencies, which seem to live a charmed life, will be a good test. In the opposite direction, regulators may overreach—stifling innovation which, for all its recent excesses, has over time been a force for good.”
- “At the G20, Mr. Obama boasted of ‘leading by example’ on financial reform. In fact, Dodd-Frank is too idiosyncratically American and too incomplete to be a true template for others. And his claim that it would keep a financial crisis like the one the world just went through ‘from ever happening again’ is bound to prove wrong. Yet imperfect though it is, the reform is proof that even a government as fractious as America’s can move with impressive speed when the motivation is there. (*The Economist*, 07/01/10)

#### Next up: The challenge of implementing Dodd Frank

- With Dodd Frank signed into law, the beginning of the tougher task of implementing regulatory reform has begun. Beyond the daunting task of drafting more than 240 new rules largely over the next two to three years, regulators must flesh out the details of a host of highly complex requirements with little or no guidance from Congress at this stage. “The amount of work that the regulators are going to have to undertake under this legislation is nothing short of breathtaking,” said Charles Horn, a partner at Mayer Brown specializing in financial services regulation. “It isn’t just a question of the sheer number of studies, regulatory implementation requirements and things like that they have to comply with, but it is also the fact that the legislation in so many areas is, frankly, deliberately vague and does not really create a lot of substantive, quantitative support. ...This is going to be close to an unprecedented challenge for the regulatory bodies in general.” Many industry experts, academics, and banking lawyers concurred that the toughest challenges of implementing Dodd Frank include creating the new council to detect systemic risk; crafting new capital and liquidity standards; building a new consumer financial protection bureau (and selecting the bureau’s new head); and enforcing a ban on proprietary trading and setting standards for derivatives. (*American Banker*, Stacy Kaper, 07/22/10)

## Dodd Frank corrections bill already in the works

- Top lawmakers acknowledge that another bill is needed to “clean up” the Dodd Frank Act. “Any time you have a 2,000-page bill there’s always a technical corrections bill that comes at some point, because ...there’s always some things you want to look at,” said Senator Chris Dodd (D-CT), the bill’s co-sponsor. “As I pointed out..., none of the provisions go into effect for another year, so we have some time.” Representative Barney Frank (D-MA), the bill’s co-sponsor, hinted during the final conference session that the next bill may go beyond “technical” repairs, but refused to elaborate, when asked by reporters, saying was unsure which issues would be tweaked or how. “I don’t know yet,” said Frank. “There were a couple of drafting errors. ...Look, these people who work here have do an enormously complicated job very well. There are some typos, some that would be considered technical, some which can’t be considered technical and go beyond that. I don’t know what the answer is yet ...but yeah, you’ll need a minor corrections bill, you always do for something this big.”
- One technical issue receiving a lot of attention among lawmaker is Section 9291 of the Dodd Frank Act that would exempt the SEC from aspects of the Freedom of Information Act. House Financial Services Chairman Barney Frank (D-MA) has announced that his panel will hold a hearing on September 23 to “explore concerns” raised by a growing bipartisan group of lawmakers regarding the breadth of SEC’s FOIA exemption in the reform bill. Holding the hearing on September 23 “should provide ample time” to take corrective action, said Frank. On August 5, Senators Ted Kaufman (D-DE), Patrick Leahy (D-VT), Charles Grassley (R-IA) and John Cornyn (R-TX) introduced a bill to eliminate the Section 9291 and clarify language related to hedge funds and other entities to ensure their treatment as “financial institutions” for purposes of applying FOIA and allow the SEC to give these entities the same treatment as sensitive information for other financial institutions
- FDIC chairman Shelia Bair also voiced concerns about a provision restricting the use of private credit ratings in gauging banks’ capital levels. The requirement has forced regulatory agencies to put on hold their effort to efforts to craft new capital standards, particularly for smaller banks, creating uncertainty over the rule for a year or more. While Bair acknowledged that credit rating agencies were a “key contributing factor” to the financial crisis, she defended them as an effective way to evaluate the quality of investments like corporate debt. “I think we will also find that some of the more likely replacements ...are far from perfect,” said Bair. Comptroller of the Currency John Dugan, who serves on FDIC’s board, added, “I do worry about there is a little bit of throwing the baby out with the bath water. It might be worth Congress taking a look at.”
- Under another Dodd Frank provision, credit rating agencies will be held legally liable for the quality of their ratings. In response to this provision, the firms yanked

their consent for the use of their ratings in hopes of a reprieve from the SEC or Congress. In turn, issuers—such as Ford Motor Company’s financing arm—pulled recent offerings, because asset-backed bond are required by law to include ratings in their official documents. On July 22, the SEC relaxed its rules, saying a credit rating agency sign-off is not needed for the sale of certain newly-issued bonds. The SEC’s rule change will be effective for the six months.

- The items on the banking industry’s “wish list” for changes to Dodd Frank provisions include those addressing (i) the Federal Reserve Board’s regulation of interchange fees for debit cards; (ii) the Volker rule that bans proprietary trading and limits investments in hedge funds; (iii) the elimination of trust-preferred securities as Tier 1 capital; and (iv) the autonomy given to the new consumer protection regulator. Ed Yingling, president and CEO of the American Bankers Association, said, “There are dozens of changes we would like, but they’re not technical corrections. The scary thing is that even if you had a bill that had a lot of items everybody agreed needed to be corrected, we’ve all seen how any bill at any time can be held hostage.” Yingling added, “In the next Congress, you would at least have the opportunity, and we will certainly be looking at things we want to have changed. Next year, ...that’s where the line between technical corrections and substantive changes will come into play.” (*American Banker*, Stacy Kaper, 07/22/10; *Bureau of National Affairs*, 08/05/10; *Bureau of National Affairs*, Malini Manickavasagam, 08/06/10; *Wall Street Journal*, Michael R. Crittenden, 08/11/10; *Associated Press*, Daniel Wagner, 07/22/10; *Wall Street Journal*, Anusha Shrivastava, 07/22/10)

### Battle looms over who will head the Consumer Financial Protection Bureau

- A number of Democrats and liberal interest groups have launched a campaign to have Elizabeth Warren, the head of the Congressional Oversight Panel and Harvard law professor, nominated as the head of the Consumer Financial Protection Bureau (CFPB). The Progressive Change Committee said an online petition to appoint Warren has drawn tens of thousands of signatures from the public. The Americans for Financial Reform, a coalition of nearly 200 consumer, labor and civil rights organizations, have voiced their support, saying: “[she] has shown a steadfast and tireless commitment to protecting consumers throughout her distinguished career and is without question the best candidate to run the CFPB.” Senator Tom Harkin (D-IA) has circulated a letter, praising Warren as an excellent candidate to head CFPB.
- In an interview on the Diane Rehm Show, Senate Banking Committee chairman Christopher Dodd (D-CT) said, “Elizabeth [Warren], I think would be a great nominee. The question is: Is she confirmable? And there’s a serious question about it. ...[Warren is] not the only potential nominee. There are many fine nominees. I don’t think it’s limited to one person, either. I get a little concerned when people think there’s only one individual who can do the job. That’s not true.” According to

media reports, Dodd approached FDIC chairman Sheila Bair to discuss her interest in the position, but she asked not to be considered for the appointment.

- To secure Warren’s confirmation for the position, all 59 Democrats would have to vote in favor of her nomination along with one Republican in order to break a filibuster. Some observers on Capitol Hill and in the administration question if Warren’s nomination could attract 60 votes, given her forceful personality and her history of questioning some of the administration’s decisions on TARP in her role as chairman of the Congressional Oversight Panel. According to media reports, Treasury Secretary Timothy Geithner opposed nominating Warren—something his advisors disputed, saying Geithner thinks she is “well qualified.”
- Aside from Warren, the other top candidates to head CFPB are Treasury Assistant Secretary Michael Barr, a former law professor at the University of Michigan and senior fellow at the Center for American Progress, and Eugene Kimmelman, deputy assistant attorney in the Justice Department’s antitrust division. Other names “floated” as a possible candidates to head CFPB—Ellen Seidman, EVP for Shorebank and Nicolas Retisinas, director of Harvard University’s Joint Center for Housing Studies—have said they aren’t interested in the job. (*Bloomberg News*, Alison Vekshin, 08/03/10; *Politico*, Gloria Park, 07/28/10; *Bloomberg News*, Lorraine Woellert and Joshua Zumbrun, 07/16/10; *Wall Street Journal*, Damian Paletta, 08/01/10; *Washington Post*, Brady Dennis, 07/20/10)

#### Dodd pledges to focus on international effort to prevent “arbitrage” of financial rules

- On August 4, Senate Banking Committee chairman Chris Dodd (D-CT) said he will spend his remaining months in office pushing for common international standards on derivatives and other areas to prevent “sovereign arbitrage” by global financial firms. Dodd said he may attend the upcoming Group of 20 summit in Seoul, Korea to seek harmonization of the U.S. rules with those of member nations. “There is a danger of sovereign arbitrage, in a sense,” said Dodd in a speech to the Atlantic Council. “That nations might decide to become safe harbors where you won’t face any of the restrictions in the [Dodd Frank] legislation.” Specifically, Dodd is concerned about the “very lucrative and highly complex” \$500 trillion over-the-counter derivatives market. “We need to begin work, principally with our major partners in the European community, and I’m prepared to do all I can in the months before my retirement.”
- Dodd said he would like to see the G-20 establish a principle group, in which senior U.S. regulators could meet with their international counterparts ahead of G-20 summits. “We are very much interconnected with what happens globally,” said Dodd. “The upcoming meeting in Korea is very important; in a sense the G-20 has taken over in many ways.” (*Bureau of National Affairs*, Mike Ferullo, 08/06/10)

### Congress approves Basel III before it even exists

- In the Dodd Frank Act, Congress gave regulators the authority to adopt Basel III standards, eliminating the risk that the newest version of international capital standards would get caught up in Congressional opposition as Basel II did. “We got all the authority that we needed in this legislation that just passed,” said Assistant Treasury Secretary Mike Barr in a conversation with a Reuters reporter. “The regulatory community will be ready to implement it in the U.S.” (*Reuters*, 07/15/10)
- In late July, central bankers and regulators reached a nearly unanimous preliminary agreement on new capital standards, which will require banks hold more capital and liquidity to withstand shocks without taxpayer aid. The full scope of Basel III won’t be clear until later this year, when regulators agree to a new Tier 1 capital requirement, currently 4%, and how long the banking industry has to meet the new capital requirements. The G-20, which is spearheading the reform effort, is set to endorse the complete Basel III package in November with the implementation of the new requirements to become effective at the end of 2012. (*New York Times*, 07/28/10; *Reuters*, 07/28/10)

### The costs of Dodd Frank revealed in Bank of America’s second quarter earnings release

- In its second quarter earnings release, Bank of America (BoFA) warned investors that financial regulatory reform could cost the bank as much as \$4.3 billion in lost earnings and a one-time charge (to extinguish goodwill) of \$7 to \$10 billion. Specifically, BoFA estimated that the Durbin interchange fee provision could decrease BoFA’s debit card revenue by as much as \$1.8 billion (62% of projected debit card revenue for FY2010) to \$2.3 billion (79% of debit card revenue) on an annualized basis, beginning in the third quarter of 2011. Lost fees on check overdrafts (\$1 billion) and new credit card restrictions (\$1 billion) will further reduce BoFA’s profits. These “shortfalls” in credit card revenue would, in turn, result in a \$7 billion to \$10 billion charge-off of BoFA’s goodwill (\$22 billion) related to its Global Card Services segment. This non-cash impairment charge, however, would have no impact on the Bank’s reported Tier 1 and Tangible Equity ratios. BoFA was the only “Big Four” bank to provide investors an estimate of the cost of Frank Dodd, in conjunction with their second quarter earnings announcement. Others—such as Wells Fargo and Citi—made mention of the “negative consequences” of the reform bill, but provided no guidance its impact on future earnings.
- “[Bank of America] is laying it all out there and, boy, I will tell you that it hurts,” said Nancy Bush, a bank analyst for NAB Research LLC. Jeffery Harte, an analyst with Sandler O’Neill & Partners, asked, “[With regulatory overhaul costing billions of dollars,] where can revenue come from?”
- In a note to clients, BMO Capital Markets analyst Lana Chan wrote, “We now fear that the Durbin bill could have a great negative impact on bank revenue—[greater]

than we originally estimated.” The “big four” banks won’t be the hardest hit by the Durbin provision, said Chan. Instead, expect regional players, such as Regions Financial and Fifth Third to suffer the largest loss of revenue. Each of these banks generated over 3% of their total revenue from interchange fees versus 2% for Bank of America, according to Chan.

- Another regional facing lower earnings as a result of the Durbin provision is the Minnesota-based TCF Financial, which generated more than 10% of its revenue through interchange fees in 2009. Paul Miller, an analyst with Friedman Billings Ramsey, projects that TCF’s earnings could fall by as much as \$0.40 a share as a result of the provision. Banks have already started eliminating free checking accounts and raising fees to offset this loss of income—ultimately pushing the cost of Dodd Frank to the consumer. “That’s probably what’s going to happen here,” said TCF Financial’s CEO Bill Cooper in a recent conference call with investors. (*CNNMoney.com*, David Ellis, 07/19/10; *Wall Street Journal*, Dan Fitzpatrick, 07/17/10; )

#### Some closing thoughts on Dodd Frank

- In the July issue of *The Regional Economist*, James Bullard, president and CEO of the Federal Reserve Bank of St. Louis, wrote, “...[S]ome of the proposals in the pending legislation remain problematic. For example, I am not convinced that a council of regulators and political appointees can effectively oversee systemic risks. Preventing the recent crisis would have required that such a committee have (i) the insight to recognize the housing bubble five years ago, (ii) the ability to agree on the appropriate course of action and (iii) the authority and fortitude to implement regulatory policies to stabilize the situation. Such actions would have been very unpopular at the time, given public policies aimed at supporting greater home ownership and given that everyone—the mortgage originator, the mortgage investor, the homeowner, home builders and so on—seemed to be benefiting from the boom.”
- “The proposal for a new consumer financial protection agency also needs honing. I support the intention of the proposed legislation, but if this agency is going to be housed in the Fed, it needs to be accountable to the Fed. If not, it should stand on its own. As we continue to reform our financial system, we must keep in mind two additional facts. First, financial markets are global. We will need the cooperation of regulators in other countries if we are to prevent crises. Such cooperation may not come easily. Second, the financial system is not just the banking system. As the recent crisis illustrates, nonbanks—the GSEs, the investment banks, the insurance conglomerates—are as much of a concern, if not more so, than the banks. We must take into account and regulate the entire financial landscape. Success at this task is still far down the road. The Fed, with an arm’s-length separation from daily politics and a long-term view of the economy, may be a better candidate to monitor systemic risk.” (*The Regional Economist*, James Bullard, July 2010)

*Fannie and Freddie: The taxpayers' Gordian knot*

Fannie Mae and Freddie Mac report lower losses for the second quarter

Is the turnaround for Fannie and Freddie within sight?

National Association of Realtors calls on Treasury to reduce, retroactively, the dividends paid by the GSEs on the agency's preferred stock

Treasury begins the reform process for Fannie Mae and Freddie Mac

And the public debate on GSE reform continues...

Fannie and Freddie—the taxpayers' Gordian knot

- In July 29 *Bloomberg*, commentary, Jonathan Weil wrote, “[Fannie Mae’s and Freddie Mac’s] legacy for taxpayers is a Gordian knot that no one know how to sever.” Collectively, the enterprises have lost \$224.7 billion since the onset of the financial crisis, which has triggered the injection of more than \$148 billion of taxpayer funds to preserve the enterprises’ solvency. “Without Fannie and Freddie, the housing market would be in free fall instead of merely dismal,” wrote Weil. “They own or guarantee most of the new home loans being underwritten, driving mortgage interest rates to record lows. Ending their subsidies, such as the government’s guarantee of their debt, isn’t an immediate option. Doing so now would shock the financial system back to the brink of insolvency.” (*Bloomberg News*, Jonathan Weil, 07/28/10; *Bloomberg News*, Lorraine Woellert, 08/09/10)

Fannie Mae and Freddie Mac report lower losses for the second quarter

- On August 5, Fannie Mae reported a second quarter loss of \$1.2 billion, its smallest loss in three years. The company’s conservator, FHFA requested \$1.5 billion of taxpayer assistance to cover its losses and facilitate the payment of \$1.9 billion in dividends payable on Treasury’s preferred stock investments. Fannie’s improved financial outlook is attributed to (i) a 48 basis points decline in its serious delinquencies [reflecting, in part, a growing number of trial modifications that are converting to permanent mods]; (ii) a higher rate of recovery on the disposition of “bad” loans; and (iii) a change in the GSE’s computer model to project future losses showed it had already reserved more than necessary to cover losses.
- During the second quarter, Fannie Mae’s credit-related expenses, including mortgage delinquencies and defaults, fell to \$4.9 billion—a decrease of \$13.9 billion from a year earlier of \$18.8 billion. On June 30, Fannie Mae reported \$217.2 billion of non-performing assets, representing 7.29% of total mortgages. On that date, the

company's serious delinquency rate for single family mortgages and multi-family mortgages was 4.99% and 0.80%, respectively, at the end of the second quarter. In addition, Fannie reported a carrying value for real estate owned of \$13.0 billion, which consisted of 129,310 properties. On June 30, Fannie Mae reported a fair market value of negative \$138.0 billion. (*Washington Post*, Zachary A. Goldfarb, 08/06/10; *Bloomberg News*, Lorraine Woellert, 08/05/10; *Wall Street Journal*, Nick Timiraos, 08/06/10; *Fannie Mae News Release*, 08/05/10; *Fannie Mae 2010 Second Quarter Credit Supplement*, 08/06/10)

- On August 9, Freddie Mac reported a second quarter loss of \$4.7 billion [\$6.7 billion after its payment of dividends owed to Treasury for taxpayers' senior preferred stock]. As a result, FHFA will request a \$1.8 billion draw from Treasury to preserve the company's solvency. Freddie Mac's second quarter results were largely driven by derivatives-related losses of \$3.8 billion. The company's loan loss provisions for the period dipped 11% from the second quarter of last year to \$5.03 billion, while net charge-offs and nonperforming assets rose. On June 30, Freddie Mac reported \$118.7 billion of non-performing assets, representing 6.30% of total mortgages. On that date, the company's serious delinquency rate for single family mortgages and multi-family mortgages was 3.96% and 0.28%, respectively. In addition, the company reported a carrying value for real estate owned of \$11.3 billion, which consisted of 62,190 properties. On June 30, Freddie Mac reported a negative fair market value of \$46.3 billion.
- "I think you'd be hard pressed to look at Freddie's results and see good news or see that much," said Brian Harris, senior vice president at Moody's Investors Services. "You're still talking about a large loss." (*Bloomberg News*, Lorraine Woellert, 08/09/10; *Freddie Mac Press Release*, 08/09/10; *Freddie Mac 2010 Second Quarter Credit Supplement*, 08/09/10; *American Banker*, Sara Lepro, 08/10/10)

#### Is the turnaround for Fannie and Freddie within sight?

- Some analyst suggest that Fannie's and Freddie's second quarter reports suggest that there is light at the end of the tunnel with the potential for one or both of the companies possibly turning a profit, or at least breakeven, in the next couple of quarters. "The trend line, if you want to follow it out, may indicate that we can be more patient and thoughtful about the reforms that are introduced and there doesn't need to be any massive intervention that has to occur with lightning speed," said Mark Nuccio, co-head of the banking practice at the law firm Ropes & Gray.
- However, other analysts caution that neither Fannie nor Freddie are out of the woods, particularly if home prices decline or unemployment triggers higher mortgage delinquencies. "If the 2008 vintage gets worse, then you have a new round of reserves and losses," said Jim Vogel, an analyst with FTN Financial. Vogel noted, however, a "markedly slower rate of erosion" in the GSEs' portfolios in the second quarter, reflecting that the ruinous losses" on loans made from 2005 to 2008

could be subsidizing. (*Wall Street Journal*, Nick Timiraos, 08/06/10; *Bloomberg News*, Lorraine Woellert, 08/09/10; *Freddie Mac 2010 Second Quarter Credit Supplement*, 08/09/10)

National Association of Realtors calls on Treasury to reduce, retroactively, the dividends paid by the GSEs on the agency's preferred stock

- In an August 13 letter, the National Association of Realtors® urged Treasury Secretary Timothy Geithner “to reduce, on a retroactive basis, the dividend rate on senior preferred stock issued to the U.S. Treasury Department in exchange for contributing capital to Fannie Mae and Freddie Mac...” The NAR argues that the 10% dividend rate on this preferred stock is “a punitive dividend that works as an unnecessary drag on housing and the economic recovery.”
- NAR president Vicki Cox Golder wrote, “First, the GSEs are working assiduously to reduce their losses, as they should. But the unintended consequence of their imposing high fees and very tight underwriting standards is to delay the housing recovery. NAR supports strong underwriting standards. ... We now just as firmly believe that the pendulum has swung too far and potential homeowners who are reasonable credit risks are too often unable to find a fair and affordable mortgage. As noted in one recent article, the GSEs’ current book of mortgage business is ‘pristine.’ We think that achieving a pristine book of business means that the GSEs are falling short of their mission to maintain a liquid residential mortgage market, throughout the nation, that serves a wide range of borrowers, including qualified low- and moderate-income families. Reducing the current punitive dividend will enhance their ability to eliminate their losses, which will be further enhanced as the housing markets continue to stabilize and recover. This will give the GSEs the flexibility to adjust their underwriting standards to take into account reasonable lending risks, which will benefit the consumer and the entire economy, without undue risk of additional cost to the taxpayer”.
- “Second, minimizing the amount of preferred stock held by the Treasury Department will make the challenge of restructuring the GSEs easier. One of the thorniest problems will be how to handle the amount of outstanding preferred stock held by the Treasury Department. From today’s perspective, it is hard to imagine how the capital infused into each GSE can ever be repaid. But whatever the solution, it will be easier if the obligation of the GSEs is not artificially increased by imposing the current punitive dividend rate at a level not imposed on banks or other firms, such as A.I.G., receiving government financial support.”
- “Finally, it makes no apparent sense for the Treasury Department to transfer amounts to the GSEs so they will have enough money to pay the dividend back to Treasury. If the GSEs were not required to pay the 10 percent dividend, which significantly increases each of their quarterly losses, it would reduce the amount of additional capital Treasury is called upon to provide to them. The problem is exacerbated because a growing amount is necessary to pay the dividend on amounts received in order to pay earlier dividends. The ‘miracle’ of compounding in this case has become a nightmare that is creating a permanent drag on the ability of the GSEs to fully

achieve their mission. It would make more sense to charge the GSEs an amount equal to the Treasury borrowing cost, or the borrowing cost to the GSEs based on the current federal assurance that they will maintain a positive net worth. Both of these amounts are far less than 10 percent.” (*Correspondence to Treasury Secretary Timothy Geithner*, Vicki Cox Golder, 08/13/10)

### Treasury begins the reform process for Fannie Mae and Freddie Mac

- On April 17, the Treasury Department requested public input on seven fundamental questions driving the reengineering of the mortgage system and reform of Fannie Mae and Freddie Mac. Treasury received more than 570 comment letters by the July 23 comment deadline from a wide range of stakeholders, including financial institutions, trade groups, construction firms, state housing agencies, and affordable housing advocates concerning the future of housing finance and reform of Fannie Mae and Freddie Mac.
- Submissions from the financial services largely coalesced around the GSE reform proposal submitted by the Housing Policy Council (HPC) of the Financial Services Roundtable (see: <http://www.scribd.com/doc/35846345/Housing-Policy-Council-Comment-Letter-on-the-Reform-of-Housing-Finance>). In substance, the HRC sets forth the goal of providing the public “consistent affordable access to 30-year fixed rate mortgages and other prudent mortgage loans in a way that minimizes taxpayer exposure.” Specifically, the group’s plan calls for:
  - **Minimizing Risk to Taxpayers by:**
    - Eliminating the hybrid GSE structure and removing the implicit federal support for the GSEs;
    - Creating a new form of privately-capitalized, federally-chartered entities to credit enhance MBS, called Mortgage Securities Insurance Companies (MSICs);
    - Limiting the type of mortgages that could be included in the MSICs’ MBS to conventional, prudently underwritten mortgages with known risk profiles;
    - Empowering the Federal Housing Finance Agency (FHFA) to issue federal charters and regulate MSICs;
    - Allowing the investors in the MSICs to determine the form of organizational structure (co-operative, utility, or traditional corporation);
    - Limiting portfolios to product incubation and multi-family loans, not for arbitrage purposes.
    - Providing for a strong, independent regulator of MSICs, with clear authority to unwind failed MSICs.
  - **Maintaining Access to Mortgage Credit through an Explicit Federal Guarantee on MBS that Takes the Form of Catastrophic Reinsurance, and the Creation of a Single MBS, specifically by:**

- Providing for an explicit federal guarantee of payment of principal and interest on MBS issued by MSICs to be triggered only upon the failure of MSICs;
  - Requiring the MSICs to pay a risk-based premium for federal guarantee to ensure that the guarantee is budget neutral;
  - Establishing the federal guarantee on MBS as catastrophic reinsurance with private capital—e.g., down payment on mortgage; private mortgage insurance; capital of MSICs; and reserve established by fees paid by MSICs for federal guarantee—standing before the federal guarantee.
  - Creating a single facility to service MBS for all MSICs.
  - Creating a single MBS.
- **Supporting Affordable Housing by through a number of vehicles, including:**
- Providing a portion of MSICs revenue stream to state and local housing finance agencies;
  - Establishing a FHLB-like grant program; and/or
  - Dedicating a MSIC to affordable housing.
- The HPC argues, however, that the MSICs should not be subject to specific affordable housing goals.
  - Chart 1 provides an outline of various stakeholders' positions on GSE reform, as set forth in comment letters to Treasury and testimony before the House Finance Services Committee in April. Live links, highlighted in blue, provide access to the stakeholder's submission.

**Chart 1: GSE Reform Proposals**

<u>Stakeholder</u>	<u>Business model</u>	<u>Government Guarantee</u>	<u>Retained Portfolio</u>	<u>Regulator</u>	<u>Affordable Housing</u>
<a href="#">Federal Reserve</a>	Cooperative	Explicit-Tail Risk	De minimis	--	--
<u>Trade Groups</u>					
<a href="#">American Bankers Association</a>	--	--	--	"Strong"	None
<a href="#">Housing Policy Council</a>	Private Ins.	Explicit <sup>1</sup>	De minimis	FHFA	Fees to NHTF
<a href="#">Independent Community Bankers of America</a>	--	Implicit	--	--	From Earnings
<a href="#">Mortgage Bankers Association</a>	Utility	Explicit <sup>1</sup>	--	--	None
<a href="#">National Association of Home Builders</a>	Private	Explicit <sup>1</sup>	--	--	--
<a href="#">National Association of Realtors</a>	Cooperative	Explicit	--	--	Mission
<a href="#">National Low Income Housing Coalition</a>	--	--	--	--	First Priority
<a href="#">Securities Industry and Financial Markets Assn.</a>	--	Explicit <sup>1</sup>	--	"Strong"	--
<u>Commercial Banks, Wall Street, and REIT</u>					
<a href="#">Bank of America</a>	Multiple Models	(Based on Model)	Covered Bonds	--	--
<a href="#">Credit Suisse</a>	Co-op or Utility	Explicit <sup>1</sup>	Smaller	FHFA	--
<a href="#">Wells Fargo</a>	--	Explicit <sup>1</sup>	De minimis	"Strong"	--
Andrew Davidson & Co.	Cooperative	Explicit Sr. Bonds	--	--	--
<a href="#">Keefe Bruyette &amp; Woods</a>	Cooperative	Explicit (MBSs)	De minimis	(phase out)	--
<a href="#">Redwood Trust</a>	Cooperative	Explicit (MBSs)	None	"Strong"	--
<u>Foundations</u>					
<a href="#">American Enterprise Institute</a>	Private	--	--	--	None
<a href="#">Cato Foundation</a>	Co-op	None	None	"Strong"	--
<a href="#">Center for American Progress</a>	Utility/Co-op	Explicit (MBS)	De minimis	"Strict"	Fee on MBSs
<a href="#">Economic Policies for 21<sup>st</sup> Century</a>	Private	Explicit <sup>1</sup>	None	--	--
<a href="#">Reason Foundation</a>	Eliminate GSEs	None	--	--	FHA

<sup>1</sup>Explicit government guarantee on MBSs to cover catastrophic losses

- On August 17, Treasury will hold an invitation-only conference on the future of housing finance, portions of which will be webcast on the agency’s website. The panelists Treasury has asked to participate, include
  - Barbara Desoer, president of Bank of America home loans;
  - Mike Heid, co-president of Wells Fargo home mortgage;
  - S.A. Ibrahim, CEO of Radian Group, Inc.;
  - Ellen Seidman, executive vice president for Mission and Strategy at ShoreBank Corp.;
  - Susan Wachter, professor of financial management, real estate and city planning at the University of Pennsylvania’s Wharton School;
  - Alex Pollock, resident fellow at the American Enterprise Institute;
  - Ingrid Gould Ellen, professor of Urban Planning and Public Policy at New York University;
  - Marc Morial, president and CEO of the National Urban League;
  - Michael Stegman, director of policy and house for the Program on Human and Community Development of the John D. and Catherine T. MacArthur Foundation;
  - Mark Zandi, chief economist of Moody’s Analytics
  - Lewis Ranieri, Chairman of Ranieri and Company, Inc. and
  - Bill Gross, co-founder of PIMCO.
  
- “This conference is an opportunity for us to broaden our perspectives on a number of key issues in a transparent way to make certain that all of the best are on the table,” said Treasury in a press release. The conference announcement came on the day that PIMCO’s Gross, a panelist, told the *Financial Times* that he won’t buy MBS without government guarantees. “Without a government guarantee, as a private investor, I’d require borrowers to put at least 30% down, and most first-time homebuyers, can’t afford that,” said Gross.
  
- Consumer advocates expressed disappointment that Treasury’s panel on GSE reform contained no representatives for consumers and just two (out of twelve panelists), who focus on the role of housing in communities. “It’s really disappointing, said Bruce Marks, CEO of Neighborhood Assistance Corporation of America. “You have an administration that puts the interest of the consumer secondary and the interest of the industry as primary.” John Taylor, CEO of the National Community Reinvestment Coalition said, “Ironically if you’re a community organizer, you can qualify for the presidency but not for Treasury’s discussion about what to do with housing. Some of the people in this room are the people who created this problem.” One CEO of a housing nonprofit added that the Obama administration “has decided already what outcome they want.” (*CNNMoney.com*, 08/12/10; *Treasury Press Release*, 08/12/10; *CQ Today*, Steven Sloan, 08/12/10)
  
- In an August 2 speech, Treasury Secretary Timothy Geithner said “dramatic” changes will eventually need to be made to Fannie Mae and Freddie Mac, but warned against

hastily doing away with the GSEs' support of the housing market while the real estate market remains fragile. "[Fannie and Freddie] are going to require sweeping fundamental change, but we also have to make sure that we advance this process of repair in the housing market," said Geithner. There will always be some government support of the mortgage industry to "provide the reasonable security that you can borrow to finance a house even in a deep recession." (*Dow Jones Newswire*, Michael Casey, 08/02/10)

- House Financial Services Committee Chairman Barney Frank has announced plans to hold hearing on reforming Fannie Mae and Freddie Mac after Congress returns from its recess. Frank also plans to introduce a white paper or legislative framework for GSE reform in early October prior to the November election. On July 20, the Committee approved a bill, sponsored by Representatives Paul Kanjorski (D-PA) and Scott Garrett (R-NU) to create a regulatory framework for the U.S. covered bond market, marking the fourth attempt to establish a binding framework for covered bonds in the U.S. (*Interview on Bloomberg News' Political Capital*, Barney Frank, 07/16/10)

...and the public debate continues

- In an July 26 commentary, *Wall Street Journal* editorial page editor Brian M. Carney wrote, "There's simply no room in this story [e.g., the media's storyline that greedy bankers caused the financial crisis] for two giant government-sponsored enterprises [Fannie and Freddie] that distorted the housing and credit markets, took advantage of implicit government guarantees to operate at leverage ratios that would have made Lehman Brothers executives blush, and finally, and predictably, collapsed under the weight of that leverage and their bad bets on the housing market."
- "...Fannie and Freddie's continuing collapse ...calls into question the very premise of the 2,000-plus page law [the Dodd Frank Act] the president [recently] signed... that the federal government can shape credit markets to its own purposes and the benefit of consumers without incurring any of the attendant costs. Lawmakers like Barney Frank and Chris Dodd, who defended Fannie and Freddie to the end and beyond, say that they'll get around to fixing them, eventually. But they and their colleagues, who delivered to the president a bill longer than all the previous financial legislation in history put together, tell us that Fan and Fred are 'too complicated' to fix right now.
- "The real reason, I suspect, is that they still don't have any idea what went wrong with Fan and Fred. They were supposed to be doing good. They were chartered by the government and did its bidding. That they failed so spectacularly, and have already cost so much money to prop up, is not something for which they have any adequate explanation."

- “They were also, in the imaginations of their backers on Capitol Hill, the opposite of the greedy bankers that the Dodd-Frank financial bill is designed to punish and restrain. It would be unjust to their memories, according to this view, to deal with them in the same legislation as those bad bankers. Fannie Mae and Freddie Mac are seen as victims, rather than perpetrators, of the financial crash of 2008. But this inability to account for Fan and Fred’s demise and rescue betrays the poverty and incompleteness of the standard account of the crisis. And until they are wound down, the work of cleaning up after the financial crisis won’t be nearly done.” (*Wall Street Journal*, Brian M. Carney, 07/26/10)
- In an August 3 Letter to the Editor of the *Wall Street Journal*, Franklin Raines, Fannie Mae’s former CEO, wrote, “...The facts about the financial collapse of Fannie and Freddie are pretty clear and a matter of public record. The company managers, their regulator and the Treasury have all said that the losses which crippled the companies were caused by the purchase of loans with lower credit standards between 2005 and 2007. The companies explicitly changed their credit standards in order to regain market share after Wall Street began to define market credit standards in 2004. As proved to be the case for most other investors in Alternative-A and sub-prime mortgages, this was a very bad idea.”
- “So the cause of the financial problems for Fannie and Freddie was bad decisions, not their government sponsored status. Had the companies maintained their credit standards they would have fared much better. The same is true for Wall Street. Bad decisions, not bad government charters, caused the financial crisis.”
- “*The Journal* had been warning for years that the on-balance sheet portfolios of Fannie and Freddie would lead to their demise. [WSJ reporter Briand M.] Carney suggests that excessive leverage was the culprit. Unfortunately, neither of these were involved. Nope. Just bad credit judgments. Decisions made, by the way, while operating under close regulatory scrutiny.”
- “Perhaps one reason Congress and the administration are being careful before eliminating Fannie and Freddie is that they have noticed that Wall Street and the commercial banks have virtually abandoned the mortgage market leaving only Fannie, Freddie and the Federal Housing Administration to keep housing finance flowing. They may also be pondering just how the private-market players or any new entities created to replace Fannie and Freddie would be able to avoid bad credit decisions in the future. It seems reasonable to some of us that they think about those issues before acting.” (*Wall Street Journal*, Franklin Raines,, 08/03/10)
- In response to Mr. Raines’ Letter to the Editor, the *Wall Street Journal* wrote, “If you want proof that the Washington establishment has learned nothing from the 2008 financial panic, look no further than the nearby letter from former Fannie Mae CEO Franklin Raines. Our old antagonist is signaling where the debate is heading as Congress finally begins to consider what to do about Fannie and its failed sibling, Freddie Mac.”

- “Mr. Raines writes that ‘the facts about the financial collapse of Fannie and Freddie are pretty clear.’ So let’s review those facts. In Mr. Raines’s telling, Fannie Mae was undone by a decision—made after he left in 2004—to purchase loans ‘with lower credit standards’ just before the bust. But even this managerial decision wasn’t entirely the companies’ fault. Rather, according to the man who presided over one of the largest accounting scandals in history while at the helm of Fannie Mae in 2003, Fan and Fred’s big mistake was chasing Wall Street’s credit standards downward at the end of the boom.”
- “What he doesn’t say is that Fan and Fred had a political and legal mandate to support low-income housing. At the end of 2004, the U.S. Department of Housing and Urban Development released its ‘housing goals’ for Fannie Mae and Freddie Mac for 2005-2008. The new rule required the two government-sponsored mortgage giants to increase each year the share of their business that went to low- and moderate-income borrowers, with subgoals for ‘underserved areas’ and ‘special affordable’ housing. The purpose, according to HUD, was to ensure that Fannie’s and Freddie’s mortgage purchases would ‘promote the national priority of increasing homeownership.’”
- “The mandate had two effects. First, it meant that in order to keep growing, Fan and Fred had to grow their affordable-housing business even faster to meet the targets. But not every borrower is a prime borrower, and that goes triple for low-income borrowers. Fannie and Freddie could only meet their politically mandated lending goals by looking for new ways to extend credit to subprime borrowers. So when Mr. Raines says that ‘the cause of the financial problems for Fannie and Freddie was bad decisions, not their government sponsored status,’ well, let’s just say he’s not telling the whole story.”
- “Mr. Raines also says that neither ‘leverage’ nor mortgage-backed securities portfolios were a problem. Hmmm. In fact, the wonder twins were put into federal conservatorship in September 2008 because their losses in the first eight months of that year had very quickly overwhelmed their capital cushion, which under law needed to be the irresponsible level of less than 2% of their assets. Only some of those losses came from their portfolios directly; most of the rest came on MBS they’d guaranteed. But if the companies had been required to hold more capital (and less leverage) in the first place, they, and taxpayers, would have had a much larger margin for error.”
- “Former Treasury Secretary Hank Paulson has also said explicitly that he rescued Fan and Fred in part to reassure foreigners that the U.S. government stood behind their debt. With some \$5 trillion in liabilities at the time, they were too indebted to fail. So their leverage was a problem.”
- “Of the many private companies that got into trouble in the fall of 2008, most have since rebuilt their balance sheets and repaid their TARP money. But not Fannie and

Freddie. They're direct cost to taxpayers so far, [\$148 billion], is only the beginning as Congress and the Obama Administration continue to use them to rescue homeowners from foreclosure."

- "Mr. Raines is signaling the coming political debate when he says 'that Wall Street and the commercial banks have virtually abandoned the mortgage market.' But this is like murdering your parents and demanding clemency because you're an orphan. No private bank can compete with the federal government's borrowing costs, so no one can afford to compete with Fannie and Freddie. It was hard enough to compete when the two companies had to maintain a (subsidized) profit margin for their shareholders. Now that they're being run at an intentional loss, it's impossible."
- "Before Fan and Fred collapsed, in July 2008, NYU professor Lawrence White estimated that the two had saved homebuyers \$100 billion, total, in interest over the companies' lifetimes. If that number is remotely accurate, Fan and Fred have already cost far more than they ever saved borrowers. Taxpayers would have been better off handing out checks to everyone who bought a house."
- "On second thought, forget we said that. Fan and Fred, having distorted the housing market for decades, have now all but nationalized it, and their losses continue to mount. And yet Mr. Raines is speaking for the Beltway chorus in insisting that this only makes them more indispensable than ever. They want to go back to the status quo pre-panic, resurrecting Fannie and Freddie as mortgage oligopolists, using them to subsidize the housing industry and leverage campaign contributions. And they'll get away with it unless the American public says no."
- "Other countries have a buoyant home mortgage market without a Fannie or Freddie, and Canada has higher rates of home ownership than the U.S. without having either Fannie or Freddie or a home-mortgage interest tax deduction. American capitalists could also figure out a way to lend to homeowners, if the political class would let them." (*Wall Street Journal*, 08/03/10)
- In an August 11 *New York Times* commentary, William Poole, former president of the St. Louis Fed, wrote, "On [August 17], the Obama administration plans to hold a conference to address the question of what to do with [Fannie Mae and Freddie Mac]. Clearly, it would be an inexcusable mistake to reconstitute them as private companies in anything close to their prior form. Some people have suggested recasting them as a single new "Fan-Fred agency" that would continue to securitize and guarantee home mortgages. It's true that Fannie and Freddie played an important role in developing the market for mortgage-backed securities. But they have completed that work, and they should not be preserved in any form. They should be thanked for their successes and gracefully retired."
- "Can the home mortgage market stand on its own, without support from federally sponsored mortgage companies? Experience tells us that the answer is an unambiguous yes. When Fannie and Freddie curtailed their operations after the

disclosure of accounting irregularities in 2003, there was no effect on mortgage rates. We have seen how the jumbo mortgage market, for loans too large to be eligible for Fannie and Freddie purchases, has long operated efficiently, with rates only slightly above the rates on smaller mortgages. And many other asset markets, like the one for securitized auto loans, have functioned well without federal intermediaries. If Fannie and Freddie were to continue to operate with the government absorbing all their risk, they would keep a large share of the market. But that system has been terribly expensive for home mortgages efficiently on its own. While it's true that the private market brought on the financial crisis by creating so many subprime mortgages, Fannie and Freddie did not block that parade; they joined it — indeed, in some respects led it.”

- “In principle, it ought to be possible for government financial agencies to be self-supporting. But decades of observation have convinced me that there is no practical way to prevent the government from inserting hidden subsidies and special interest mandates into the agencies’ operations. If there are to be more federal housing subsidies — and I hope there are not — they should be legislated transparently. The danger in having any new mortgage agency is that its guarantees would subsidize mortgage risk, eventually leading to further taxpayer losses. The only sure way to prevent that outcome is to phase out Fannie and Freddie. If the home finance market were fully private, then it would bear the losses from its own mistakes in pricing and insurance. The proper government role is regulatory oversight and not direct operation of financial firms.”
- “Fannie and Freddie could not be shuttered immediately; they are too large. A sensible transition plan would have them stop buying new mortgages, and their portfolios would decline as the mortgages they own are paid down. Within 10 years, the portfolios would shrink to insignificance. Their securitization business, whereby they purchase mortgages and issue securities against them, should likewise be wound down. A practical approach would be to set a gradually rising schedule of fees, motivating private companies to enter the securitization business. In 10 or 15 years, the companies would be gone, closing a chapter in American financial history that enjoyed considerable success but ended very badly and at great taxpayer cost.” (*New York Times*, William Poole, 08/11/10)
- In an August 5 editorial, the *Washington Post* wrote, “No institutions played a larger role in the nation’s over-investment in single-family housing than Fannie Mae and Freddie Mac, the government-sponsored mortgage-securitization giants. And no institutions fell harder when that over-investment went sour; they are in government hands and absorbing hundreds of billions of dollars in taxpayer support. Dismantling Fannie and Freddie without collapsing what’s left of the mortgage market -- or spooking the foreign creditors who hold that debt -- will be the biggest challenge facing the officials who must now redesign federal housing policy. It’s good that the Obama administration is turning to this job in earnest. Whatever solution Congress and the administration choose must strike a far more realistic balance between homeownership and rental housing than the government has struck

in the past. It will be politically difficult to shrink federal support for the American Dream. But it's the only way to prevent another financial nightmare." (*Washington Post*, 08/05/10)

- “The world famous, now infamous, [GSEs], Fannie Mae and Freddie Mac, made a huge contribution to inflating the housing and mortgage bubble,” wrote AEI senior fellow Alex Pollock in a comment letter to Treasury on the reform of housing finance. “Now that they are broke, it is essential to remember that their ongoing taxpayer bailout is a government intervention to save a previous government intervention.” (*Comment Letter on the Reform of Housing Finance*, Alex Pollock, 07/21/10)

## **TARP**



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

Federal government's financial support has increased \$700 billion over the past year

- In his July 21 report to Congress, the Special Inspector General for TARP wrote, "...[T]he signs of the gradual winding down of TARP are unmistakable: seven of the 13 TARP programs are effectively closed or are closing; this quarter marked an important milestone, with more TARP money having been repaid than is currently outstanding; and pending legislation would reduce the upper limit of TARP and prevent any new spending except on programs already initiated on June 25, 2010."
- “Notwithstanding this scaling back of TARP, ...the current outstanding balance of overall Federal support for the nation's financial system, in actual expenditures and guarantees, ...has actually increased more than 23% over the past year, from approximately \$3.0 trillion to \$3.7 trillion—the equivalent of a fully deployed TARP program, largely without additional Congressional action—even as the banking

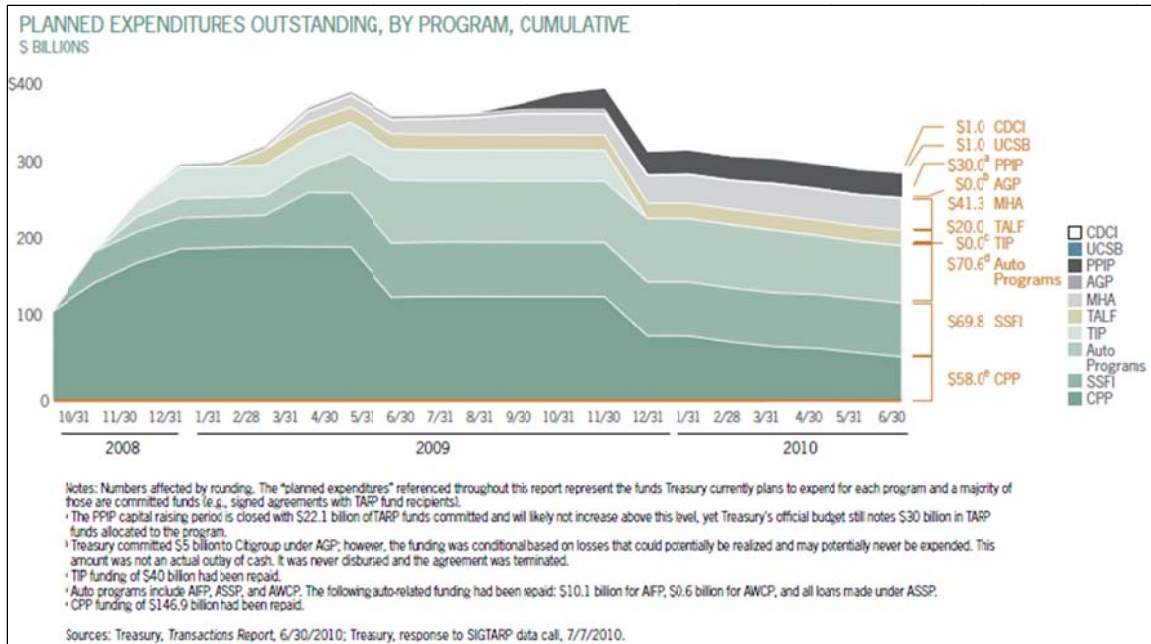
crisis has, by most measures, abated from its most acute phases.” The government’s increased support has focused on the still-distressed housing market through additional support of asset prices and low interest rates, primarily through FHA, Fannie Mae and Freddie Mac.

<b>INCREMENTAL FINANCIAL SYSTEM SUPPORT, BY FEDERAL AGENCY SINCE 2007 (\$ TRILLIONS)</b>		
	<b>Balance as of 6/30/2009</b>	<b>Current Balance as of 6/30/2010</b>
Federal Reserve	\$1.5 <sup>a</sup>	\$1.7
FDIC	0.3	0.3
Treasury — TARP (including Federal Reserve, FDIC components)	0.6	0.3
Treasury — Non-TARP	0.3	0.5
Other: FHFA, NCUA, GNMA, FHA, VA	0.3	0.8
<b>Total</b>	<b>\$3.0</b>	<b>\$ 3.7</b>

Notes: Numbers affected by rounding. Amounts may include overlapping agency liabilities, and does not account for collateral pledged. See the “Methodology for Estimating Government Financial Commitments” discussion in Section 3: “TARP in Context: Financial Institutions Support and Public Policies Outside of TARP — 2010 Update” of this report for details on the methodology of this chart. Other agencies include: FHFA, National Credit Union Administration (“NCUA”), Government National Mortgage Association (“GNMA”), Federal Housing Administration (“FHA”), and U.S. Department of Veterans Affairs (“VA”).  
<sup>a</sup> This amount has changed from last year’s report due to a change in methodology in accounting for the Federal Reserve’s Maiden Lane facilities. See notes to Table 3.2 in this report for further explanation.

Source: SIG-TARP’s Quarterly Report to Congress, 07/21/10

- Estimates of TARP’s ultimate cost to taxpayers have fallen dramatically over the past 12 months. For example, OMB’s original cost estimate of \$341 billion (August 2009) has fallen to \$116.8 million (February 1). Similarly, CBO estimated a \$109 billion cost in March, followed by a Treasury estimate of \$105 million in May. The TARP losses are expected to be concentrated in assistance programs for AIG, the automotive industry and distressed homeowners. The following chart summarizes planned expenditures by program over the life of TARP.



- On June 23, Treasury approved the distribution of \$1.5 billion of the \$50 billion of TARP funds designated for Making Homes Affordable initiatives to the states hardest hit by the aftermath of the housing crisis. The following table summarizes the funds approved for the HFA Hardest Hit Fund.

	<u>Allocation</u>	<u>Administrative Costs</u>	<u>Expenses/ Allocation</u>	<u>Estimate of Max. Borrowers</u>	<u>Allocation per Borrower <sup>1</sup></u>
Arizona	\$125,000,000	\$13,200,000	10.6%	6,383	\$17,515
California	\$699,600,000	\$52,470,001	7.5%	46,092	\$14,040
Florida	\$418,000,000	\$38,413,800	9.2%	12,500	\$30,367
Michigan	\$154,500,000	\$8,808,139	5.7%	22,634	\$6,437
Nevada	\$102,800,000	\$16,656,945	16.2%	7,959	\$10,823
Total	\$1,499,900,000	\$129,548,885	8.6%	95,568	\$14,339

<sup>1</sup> Based upon the maximum estimated number of borrowers helped

- On March 29, Treasury allocated an additional \$600 million to the HFA Hardest Hit Fund and expanded the program to five more states—North Carolina (\$159 million), Ohio (\$172 million), Oregon (\$88 million), Rhode Island (\$43 million) and South Carolina (\$138 million)—bringing the fund total to \$2.1 billion. At the end of June, Treasury was reviewing proposals submitted for this second round of funding, which it expects to approve in August.

- On August 11, the Obama administration announced \$3 billion of *additional* support to help homeowners struggling with unemployment through two targeted foreclosure-prevention programs. Through the existing Housing Finance Agency (HFA) Innovation Fund for the Hardest Hit Housing Markets, Treasury will make \$2 billion of additional assistance available for HFA programs for homeowners struggling to make their mortgage payments due to unemployment. These funds will be allocated to 17 states—Alabama (\$60.7 million), California (\$476.3 million), Florida (\$238.8 million), Georgia (\$126.7 million), Illinois (\$166.4 million), Indiana (\$82.8 million), Kentucky (\$55.6 million), Michigan (\$128.5 million), Mississippi (\$38.0 million), Nevada (\$34.0 million), New Jersey (\$112.2 million), North Carolina (\$120.9 million), Ohio (\$148.7 million), Oregon (\$49.3 million), Rhode Island (\$13.6 million), South Carolina (\$58.8 million), Tennessee (\$81.1 million)—and Washington, DC (\$7.7 million).
- In addition, HUD will soon launch a complementary \$1 billion Emergency Homeowners Loan Program to provide assistance—for up to 24 months—to homeowners who are at risk of foreclosure and have experienced a substantial reduction in income due to involuntary unemployment, underemployment, or a medical condition. Under this program, HUD would make interest-free loans of up to \$50,000 for borrowers in the “hardest hit local areas” to make mortgage, tax and insurance payments. Collectively, the Obama administration has dedicated \$4.1 billion of TARP funds to the HFA’s Hardest Hit Housing Markets fund and \$1 billion to HUD’s Emergency Homeowners Loan Fund from the \$50 billion of funds designated to Making Homes Affordable initiatives.
- On June 30, 105 financial institutions participating in the Capital Purchase Program had missed scheduled dividend payments to Treasury, totaling \$159.8 million. SIG-TARP noted that as a result of late payments after the end of June, the unpaid dividends had been reduced to \$157.7 million. (*Quarterly Report to Congress*, Office of the Special Inspector General for TARP, 07/21/10; *Treasury Department Press Release*, 08/04/10; *Treasury Press Release*, 08/11/10; *Bloomberg News*, Lorraine Woellert and Kathleen M. Howley, 08/11/10)

<p>Congressional Oversight Panel concludes that small banks that participated in CPP “have no clear path to repay” their TARP funds</p>
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- In a July 14 oversight report, the Congressional Oversight Panel found that of many of the 690 small banks that obtained \$24.9 billion from the Capital Purchase Program are struggling to meet their obligations to taxpayers. COP determined that (i) the regulators are quite willing to close these small banks; (ii) the banks are disproportionately exposed to commercial real estate, where future losses are likely; and (iii) these institutions’ stocks are typically privately held or thinly traded and have limited access to the capital market. COP wrote, “In the current distressed financial market, however, smaller banks may find it difficult or impossible to raise the capital necessary for repayment ...[and] some banks are already having difficulty

making their dividend payment.” The report concludes, “[M]any ...of the smaller ...institutions have no clear path for repaying their CCP investments and exiting the program. Facing weak profits, without practical or cost-effective access to the capital markets, and generally below the radar of private equity investments, these banks may depend on retained earnings or neighbors, family, friends, or angel investors to help them raise sufficient capital to repay their CPP investments.” Assuming the economy remains sluggish, Treasury will continue to hold a large portion of these functionally illiquid CPP investments for years to come.

- Given the potentially long holding period and increased uncertainty of Treasury’s CPP investments in small banks, the COP recommended that the administration (i) review these investments; (ii) determine options for the illiquid portions of its portfolio; (iii) articulate clear measures for risk-testing its portfolio; (iv) determine a process for appointing board members to the banks that are in arrears in their dividend payments; (v) retain a workout team for CPP participants that need to raise capital; (vi) articulate a restructuring policy that protects the recovery of the taxpayers’ investment; and (vii) exercise Treasury’s shareholder rights. (*July Oversight Report*, Congressional Oversight Panel, 07/14/10)

AIG posts \$2.7 billion loss for second quarter
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- AIG reported a \$2.7 billion loss for the second quarter due to a large goodwill impairment charge for an overseas life insurance subsidiary that is being sold to MetLife. AIG’s second quarter results reflect stable or improved profits among its insurance units, which posted operating profits totaling \$2.2 billion. AIG recently began negotiations with the its federal overseers on developing an exit strategy to repay the Federal Reserve Bank of New York and liquidate Treasury’s nearly 80% ownership stake in the company. AIG is expected to repay about \$100 billion of the \$130 billion in taxpayer assistance it received from the New York Fed and Treasury.
- AIG CEO Robert Benmosche said, “I want to make sure that I’m here to see the government exit, and it could be another 12 to 18 months before AIG is out of the woods.” He said that AIG is currently focused on repaying the New York Fed for the \$23.6 billion it is owed and the central bank’s \$26 billion stake in two overseas units that are being divested. AIG has hired Citigroup Inc. and Bank of America Corp to explore options to repay loans within AIG’s \$182.3 billion bailout.
- Benmosche recently assured the AIG board that he’s “willing to stick around for the long haul and they can count me in” to ensure the company has returned to a sound financial footing and has a leadership succession plan in place. In July, the AIG board named Robert “Steve” Miller as its new nonexecutive chairman, after Harvey Golub resigned after clashes with Benmosche, who threatened to quit if Golub didn’t leave. Miller, who retired as executive chairman of Delphi Corp in 2009, has served on the boards of Bethlehem Steel, Federal-Mogul, Waste Management and Morrison Knudsen and was a director at UAL Corp (UAUA.O) during its reorganization. He

currently is chairman of the New York private equity firm MidOcean Partners that specializes in middle market investments and is a director of Symantec Corp and UAL. (*Wall Street Journal*, Serena Ng, 08/07/10; *Bloomberg*, James Sterngold and Hugh Son, 07/14/10)

- On July 16, Ohio Attorney General Richard Cordray announced a \$725 million settlement with AIG and certain executives related to class securities fraud charges. The settlement, which brings total recovery for shareholders to over \$1 billion is subject to court approval. [Previously, settlements have been reached with General Reinsurance Corp. (\$97.5 million), PricewaterhouseCoopers (\$72 million), AIG CEO Maurice Greenberg and other executives (\$115 million) for lawsuits related to their role in AIG's failure.] AIG has agreed to pay \$725 million to the shareholder class in the primary settlement, which consists of an initial payment of \$175 million payable after the court grants preliminary approval of the settlement with the remaining \$500 million being funded "by AIG through one or more common stock offerings." (*Bureau of National Affairs*, Serena Nig, and Joann S. Lublin, 07/19/10)

The SEC reaches a \$75 million settlement with Citibank over its failure to disclose more than \$40 billion of investments in subprime mortgages
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The SEC reaches a \$75 million settlement with Citibank over its failure to disclose more than \$40 billion of investments in subprime mortgages

- On July 29, Citigroup agreed to pay \$75 million to settle a SEC complaint that it misled investors about \$40 billion of its holdings in subprime mortgage investments. The Citigroup settlement marks the first time a major Wall Street bank has faced regulatory punishment for hiding from investors its exposure to the subprime mortgage market. In an unusual move, the SEC also sanctioned former CFO Gary L. Crittenden and former investor relations head Arthur Tildesley for concealing important information from investors in regulatory disclosures in the second and third quarters of 2007. Under the terms of the settlement, Crittenden has agreed to pay \$100,000, and Tildesley agreed to pay \$80,000 to the SEC.
- The settlement marks the third time this year that a major bank has agreed to regulator sanctions for behavior that contributed to the financial crisis. Earlier in July, Goldman agreed to pay the SEC a \$500 million settlement related to civil fraud allegations concerning subprime mortgage products. In February, Bank of America reached a \$150 million settlement with the SEC concerning its disclosures to shareholders regarding the Bank's acquisition of Merrill Lynch. (*New York Times*, Andrew Ross Sorkin, 08/08/10; *Washington Post*, Zachary A. Golfarb, 07/30/10; *Associated Press*, Larry Neumeister, 02/22/10; *Insurance Journal*, Ernest Scheyder, 07/21/10; *Wall Street Journal*, Randall Smith and Matthias Reiker, 07/29/10)

General Motors gears up for initial public offering in August

GM pays \$3.5 billion for AmericanCredit Corp

GM's Volt: The \$41,000 question

Motors Liquidation continues the task of selling more than 200 properties from the bankruptcies of GM and Chrysler

### General Motors gears up for initial public offering in August

- General Motors reported a \$1.3 billion profit for the second quarter, bringing its year to date earnings to \$2.2 billion. In tandem with the earnings release, CEO Edward E. Whitacre, Jr. announced his plans to step down as the company's chief executive and chairman. "It was my plan all along ...to help return this company to greatness and I didn't want to stay a day beyond that," said Whitacre during a conference call with reporters and investment analysts.
- Dan Akerson, managing director at The Carlyle Group and GM board member since July 2009, will replace Whitaker effective September 1. Akerson will also assume Whitacre's position as chairman of the board by the end of the year. Ackerson declined to say if he plans to make changes to GM's management team, saying: "I have to get my feet on the ground before I discuss that subject." Ackerson acknowledged, however, that he doesn't foresee any big changes.
- GM's second quarter financial results were buoyed by stronger sales around the globe and higher prices on cars and trucks sold in the U.S. and sharply lower expenses as a result of last year's bankruptcy. According to Edmunds.com, customers paid \$32,584 a GM car or truck in the second quarter, up 5% from a year-ago and 1.4% from the first quarter.
- Whitaker said he is eager to cut GM's ties with the U.S. government as soon as possible, saying the automaker's reliance on government financial support is a turnoff to potential customers. "We want the government out period," said Whitaker, who hopes Treasury will sell its entire stake in the company in an upcoming initial public offering. "We don't want to be known as Government Motors." GM is expected to file registration papers for an initial public offering with the SEC in August in which the company will describe its business plan, the risks the company faces and its financial condition. Thus far, the company's underwriters and banks are reporting a great deal of interest from hedge funds and big money managers in the IPO, which could be potentially the largest stock offering in U.S. history. Analysts expect GM to offer nearly \$20 billion of company shares, which will consist of \$10 billion to \$12 billion of shares owned by the federal government. The IPO would reduce the government's current 61% stake in GM to between 41% and 37%, depending upon the final deal structure. "The pricing and ultimate size of Treasury stake are decisions for later on in the year," said a Treasury

official. Instead of selling shares itself, GM plans to sell about \$3 billion in mandatory convertible securities that convert to shares in the future, said a source. GM expects to use IPO proceeds to repay debt and help fund GM's pension liability. A successful IPO would be an important "political win" for President Obama, who engineered the 2009 bailouts of GM and Chrysler in the face of Republican criticism and public opposition.

- Whitaker dismissed analysts' concerns that GM is moving too fast with an offering timed to occur before the November election. "We're trying to not tie it to any elections or anything like that, truly," said Whitaker. "We just want it to be right." (*Wall Street Journal*, Sharon Terlep, 08/10/10; *New York Times*, Nick Bunkley, 08/06/10; *Reuters*, Clare Baldwin, Phillip Halstrick and Soyoun Kim, 07/02/10; *USA Today*, James R. Healey, 08/12/10)

#### GM pays \$3.5 billion for AmericanCredit Corp

- General Motors will expand its auto lending to customers with poor credit through its acquisition of AmericanCredit Corp. for \$3.5 billion [in a cash transaction], which is expected to close in the fourth quarter. AmericanCredit is an independent auto financing company that currently works with nearly 4,000 GM dealers. Chris Liddell, GM's CFO, said the auto manufacturer had been missing sales opportunities due to lack of credit for lease deals and financing for subprime borrowers (with credit scores below 620), which now account for 40% of U.S. customers. "Clearly there's an opportunity to bring more people into our showrooms and help them with finance," said Liddell. The AmericanCredit acquisition will help facilitate increased sales and be helpful, but not essential, for GM's IPO. "I'll describe it as another useful building block in the foundation for an IPO," said Liddell.
- "If GM wants to build a strategic relationship with AmericanCredit, that's fine, and anybody who's bullish on GM would be more than welcome to buy AmericanCredit shares at the same time," said *Reuters* analyst Felix Salmon. "But I see no great upside—lots of danger—in bundling the two. And in any case, the last person who should spend \$3.5 billion on a subprime lender is anybody at Treasury."
- In the July 22<sup>nd</sup> issue of *Casey's Daily Dispatch*, David Galland wrote, "...[D]id you hear the one about General Motors, the failed auto company, pulled down in no small part by the subprime lending activities of their GMAC financing division, spending \$3.5 billion to buy... a subprime lender? Of course, given that the U.S. government owns 61% of the 'new' GM, the reality of the situation is that it is the dear taxpayers who are going to be on the hook for this latest bit of folly. ([Casey's Daily Dispatch](#), David Galland, 07/22/10; *Associated Press*, Tom Krisher, 07/22/10; *Wall Street Journal*, 07/22/10)

## GM's Volt: The \$41,000 question

- It's official—the Chevy Volt, the new electric hybrid, will sticker for \$41,000 (\$44,600, fully loaded), about the price of a BMW 335i. After federal tax subsidies of \$7,500, the price is “reduced” to \$33,500—still more than \$10,000 (29.9%) above a comparably sized gasoline powered car. Early reviews of the Volt have been unfavorable, noting the car's requirement for premium gas, its limited four person capacity, and limited head and leg room, and much higher price tag versus the \$17,000 Chevrolet Cruz (the gasoline version of the Volt).
- With a battery range of 40 miles before the gasoline motor kicks in for another 300 miles, the Volt will cost about three cents a mile to operate on electricity versus ten cents a mile on gasoline. A driver traveling 10,000 miles a year in the Volt on electric power will save approximately \$700 annually in fuel costs. The payback for the Volt owner is about 14 years—a long time to keep a car, particularly for first-generation technology.
- GM's first year production of the Volt will be only 10,000 units. However, GM has announced plans to increase its 2012 production of Volts by 50% to 45,000 cars.
- In a survey of industry experts and 2,000 potential car buyers, Deloitte Consulting found that from now until 2020 only “young, very high-income individuals” from households making more than \$200,000 would even consider buying a plug-in hybrid or all-electric car.
- In the July 29 issue of the *New York Times*, Edward Niedermeyer wrote, “...[Although] President Obama's task force reported in 2009 that the Volt ‘will likely be too expensive to be commercially successful in the short term’ it didn't cancel the project. In short, the Volt appears to be exactly the kind of green-at-all costs car that some opponents of the [GM] bailout feared the government might order GM to build. ...If GM were honest, it would market the car as a personal donation for, and vote of confidence in, the auto bailout. Unfortunately, that's not the kind of cross-branding that will make the Volt a runaway success.”
- In an August 2 editorial, *Investor's Business Daily* wrote, “...If a camel is a horse designed by committee, the Chevy Volt is a car designed by government. It is a perfect example of industrial policy run amok, of what happens when government picks winners and losers. Without heavy subsidies and government ownership, it would never have been built. ...It used to be said that what's good for General Motors is good for America. That's not true anymore.”
- Just how much has the American taxpayer invested in the Volt and electric car technology? It's hard to say. In *Power Hungry: The Myths of “Green” Energy and the Real Fuel of the Future*, Robert Bryce concludes that taxpayers have invested “some” \$2.4 billion in grants to about 50 entities in electric car technology as part of an “electric drive vehicle battery and component manufacturing initiative”

(see [www1.eere.energy.gov/recovery/pdfs/battery\\_awardee\\_list.pdf](http://www1.eere.energy.gov/recovery/pdfs/battery_awardee_list.pdf)). Other taxpayer subsidies for the electric cars include (but not limited to) \$150 million in federal money to the Volt's Korean battery supplier, \$15 million in stimulus funds for the manufacturing of 5,000 electric charging stations provided by the American Recovery and Reinvestment Act (with Volt buyers eligible for a free \$2,000 charging unit), up to \$1.5 billion in tax breaks for purchasers and other consumer incentives, and some significant portion of the government's \$14 billion loan in 2008 to "retool" its plants. "In the end, making the bailout work—whatever they cost—is the only good reason for buying a Volt," wrote Niedermeyer in the *New York Times*. (*Time Magazines' The Detroit Blog*, Brian Dumaine, 07/27/10; *USA Today*, 06/17/10; *Investors Business Daily*, 08/02/10; *GreenAutoBlog.com*, Sebastian Blanco, 07/30/10; *TopNewsContent.com*, Ethan Oliveria, 06/03/10; *New York Times*, Jim Motavalli, 07/28/10; Edward Niedermeyer, 07/29/10)

### Motors Liquidation continues the task of selling more than 200 properties from the bankruptcies of GM and Chrysler

- A year after GM shed its bad assets through bankruptcy, only one of 200 properties shed by the auto manufacturer has been sold—but only with the assistance of government financing. In bankruptcy, Treasury lent the "Old GM," renamed Motors Liquidation, \$1.175 billion to help administrators liquidate unproductive assets—closed offices, decrepit plants, parts depots, etc. Some of the properties are contaminated with toxic waste, while others are entirely too large for alternative uses. And, few have "good" locations. Over the past year, one property has been sold to Fisker Automotive for \$20 billion for use in building plug-in hybrid electric cars. However, the federal government had to provide \$529 million in loans to Fisker to facilitate the sale, as a part of the administration's effort to stimulate the development of advanced technology vehicles. Many potential sales have been put on hold, as officials work on details for a trust to oversee a massive environmental cleanup on numerous properties. The Obama administration recently unveiled a program to dole out \$836 million from the wind-down loan to more than a dozen states to clean sites and, in some cases, demolish improvements. The funds will be set up in a trust for use in paying property taxes, the cost of security and other expenses. When Old GM's liquidation's plan is approved by the bankruptcy court, Motors Liquidation will disappear and the trust will complete the disposal of properties. (*Wall Street Journal*, Mike Spector, 07/28/10)

Progress has been made with the U.S. auto industry, but the future remains uncertain

- Clearly, there are signs of a turnaround in the U.S. automobile manufacturing sector thanks largely to the bankruptcies of GM and Chrysler and the taxpayers' bailouts of these companies. In July, GM, Ford and Chrysler sold vehicles at an average cost of \$30,400—4.7% (\$1,350) higher than a year ago and higher than the entire industry's gain of \$1,100.

- The industry's production capacity has been reduced through the closure of 26 of the 60 assembly plants that were operational in 2000. In turn, overall capacity has declined 40% from 13.7 million vehicles a year to about 8 million. However, the manufacturers may have retained too much capacity. Auto sales, which nosedived to 10.4 million units in 2009 from years of topping 16 million, are projected to edge up to about 12 million this year (with Detroit's share running currently at 46%--or 5.52 million). They've carved out a lot of capacity, but I'm not sure it's enough," said Peter Morici, an economics professor at the University of Maryland. "There's still an excess."
- However, Obama administration officials contend that the U.S. auto industry's turnaround is sustainable. "They were just barely making money or breaking even in a market of 16 to 17 million a year," said Brian Deese, a member of the administration's auto task force. "The companies are position now to move forward in an environment of 11 to 12 million in sales."
- While the GM and Chrysler bankruptcies slashed debt, jobs and labor costs, this realignment of costs will be tested when the Detroit manufacturers negotiate new contacts with U.A.W. next year. Bob King, president of the union, has vowed to set aside some of the concession made in the bankruptcies in the new contracts. [The average GM production worker—under the current U.A.W. contract—earns \$57 an hour in wages and benefits versus \$51 at Toyota, according to the Center for Automotive Research.]
- Some economist contend that for the recovery in the U.S. auto sector to be sustainable that a number of things need to happen, including continued improvements in quality, a relentless focus on cost cutting and some luck that the national economy will improve. "Their recovery is not sustainable yet," said Morici. "They need to reduce their costs more if they're going to be competitive in the long term with the Japanese, the Koreans, and ultimately the Chinese." (*New York Times*, Bill Vlasic, 08/13/10)

TARP's Special Inspector General criticizes Treasury's role in closing auto dealerships
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- In a July 19 report, the Special Inspector General was sharply critical of the Obama administration's handling of the closure of auto dealerships that were pushed through last year to expedite the bankruptcy proceedings of Chrysler and General Motors. SIG- TARP concluded that Treasury's auto task force's decision to reject the company's plans for gradual closings of dealerships in favor of an accelerated process may have exacerbated job losses in the midst of a recession. "Treasury made a series of decisions that may have substantially contributed to the accelerated shuttering of thousands of small businesses and thereby potentially adding tens of thousands of workers to the already lengthy unemployment rolls--all based on a theory and without sufficient consideration of the decisions' broader economic

impact,” wrote the Special Inspector General in a 45-page report. “[Treasury didn’t show why the cuts were] either necessary for the sake of the company’s economic survival or prudent for the sake of the nation’s economic recovery.”

- Obama administration officials said they strongly disagreed with SIG-TARP’s findings, arguing that the analysis focused solely on one element of the painful restructuring plan, which required shared sacrifices from auto workers, dealerships, retirees, suppliers and creditors to enable GM and Chrysler to rebound. (*Associated Press*, Ken Thomas, 07/18/10; *Dow Jones Newswires*, Tom Barkley, 07/18/10)

#### Ally Financial posts \$565 million profit for the second quarter

- For the second quarter, Ally Financial reported a \$565 million profit compared with a \$3.9 million for the year-ago period. Ally continued to build upon its re-entry in to the leasing market with second quarter leases totaling \$800 million, up 14% from the first quarter. For GM, Ally financed 84.4% of inventory for the auto maker’s U.S. dealerships in the second quarter versus 87.7% in the first quarter. The lender also funded 74.9% of new vehicles for Chrysler’s dealers as of June 30, compared to 76.4% in the first quarter. Ally’s 30 day delinquencies for auto loans increased 6 basis points to 2.93% on June 30.
- “[An] IPO is very clearly in our sights,” said Ally’s CEO Michael A. Carpenter. “We’re very confident of our ability to repay the U.S. Treasury.” Ally, formerly known as GMAC, is majority-owned by the federal government and owes taxpayers \$16.3 billion. (*Wall Street Journal*, Aparajita Saha-Bubna, 08/04/10)

#### 17 TARP participants overpaid their executives, according to pay czar

- Seventeen of the companies that participated in TARP paid out \$1.6 billion in “ill advised” compensation at the height of the financial crisis, said Kenneth Feinberg, the administration’s pay czar. Citigroup was the worst offender, handing out \$400 million in excess pay, said Feinberg. Other offending companies included JPMorgan Chase, Morgan Stanley, AIG, Capital One, Boston Private Holdings, CIT, M&T Bank, Sun Trust, Bank of New York Mellon, Regions, PNC Financial and U.S. Bancorp.
- In this final report as pay czar, Feinberg concedes that the companies did not do anything illegal and that 90% of these executive payments were made by firms that have fully repaid their TARP funds. “This is an eleventh hour, arm chair, ‘look back’ quarterbacking,” said Feinberg, who recommended that companies adopt emergency provisions, allowing them to break pay contracts when a financial crisis occurs. Having relinquished his role as pay czar, Feinberg is transitioning into his new job as the government-appointed administrator of the BP PLC’s \$20 billion

fund for oil-spill damage. (*Wall Street Journal*, Aaron Lucchetti, Victoria McGrane and Randall Smith, 07/24/10; *Washington Post*, Jia Lynn Yang, 07/23/10)

#### Obama administration knocks down “August surprise” rumors

- Obama administration officials moved to squelch rumors swirling around Wall Street and the mortgage industry that a new program, dubbed the “August Surprise” would reduce mortgage balances for underwater mortgages, was in the works. Speculation intensified after Morgan Stanley published a July 23 Trading Commentary, entitled [The Best Laid Plans of Mice and Men](#) [live link], and a July 23 Economics Team report, entitled [US Economics Slam Dunk Stimulus](#) [live link]. In turn, *Reuters*’ James Pethokoukis triggered a firestorm on the Street with his commentary on Wall Street rumors that the administration would “order ...Fannie Mae and Freddie Mac to forgive a portion of the mortgage debt of millions of American who owe more than what their homes are worth.” As a result of these rumors, Pethokouskis noted that Wall Street banks, were alerting their clients to the possibility of this political risk, which was driving market prices down.
- In a note to investors, Mizuho Securities wrote, “As policy makers ponder their next move, the data suggests that they face not only a stalling recovery but a growing risk of deflation taking root in the economy. As a result, the Administration has turned back to industrial policies by approving the purchase of a subprime auto lender by GM as a means of pumping up domestic sales, especially since the auto sales data indicates that consumers are still responsive to incentives. This precedent increases the risk that the government will use its control of Fannie and Freddie to increase consumer cash flow and juice the economy once again.”
- Administration officials dismissed the idea that such a plan was in the works. “The Administration is not considering a policy change in this area,” said a Treasury Department spokesman. Instead, Treasury announced on August 11 that an additional \$4 billion of the \$50 billion Making Homes Affordable funds would be allocated to Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (\$3 billion) and HUD’s Emergency Home Ownership Loan Program (\$1 billion), as previously discussed. (*Wall Street Journal*, 08/05/10; *Reuters*, James Pethokoukis, 08/05/10)

#### Government taking equity stakes in new home purchases could spur real estate demand

- In the August issue of *FRBNY Economic Policy Review*, Yale University professor John Geanakoplos proposed that the federal government take equity stakes in new home purchases to stimulate demand for real estate. Specifically, Geanakoplos argued that the government’s 20% equity stake could stimulate market demand, lower borrowers’ margins, raise lenders’ margin of safety and stimulate more lending by banks. He suggests that this program be restricted to first-time home

buyers. This program could be gradually phased out, perhaps in a year or, at most, two after adoption. Geanakoplos estimates that such a program could generate the sale of 7 million homes for a cost of \$280 billion, assuming an average sales price of \$200,000. The discussion of this proposal can be found on pages 117-113 in his full article at [www.scribd.com/doc/35894808/Solving-The-Present-Crisis-and-Managing-the-Leverage-Cycle-Geanakoplos](http://www.scribd.com/doc/35894808/Solving-The-Present-Crisis-and-Managing-the-Leverage-Cycle-Geanakoplos). (*FRBNY Economic Policy Review*, John Geanakoplos, August 2010; *Bureau of National Affairs*, Aaron Lorenzo, 08/13/10)

The Fed reaches agreement with Treasury to reduce its credit protection for TALF

Appointment of Peter Diamond to serve on the Fed board is blocked by the Senate

Columbia University president Lee Bollinger to serve as New York Fed's chairman

#### The Fed reaches agreement with Treasury to reduce its credit protection for TALF

- On July 20, the Federal Reserve announced that it had agreed with Treasury to reduce from \$20 billion to \$4.3 billion the credit protection provided for the Term Asset-Backed Securities Loan Facility under TARP. The Fed had authorized up to \$200 billion in TALF loans, but only \$43 billion were outstanding when the program closed on June 30. (*Federal Reserve Press Release*, 07/20/10)

#### Appointment of Peter Diamond to serve on the Fed board is blocked by the Senate

- The Senate approved President Obama's nominations of Sarah Bloom Raskin and Janet Yellen to serve as members of the Federal Reserve Board of Governors, but sent back to the White House the nomination of Peter Diamond, a MIT economist, who was criticized by Republican lawmakers for not having the macroeconomic policy background necessary to sit on the Fed. "I don't believe he is ready to be a member of the Federal Reserve," said Senator Richard Shelby, minority leader of the Senate Banking Committee last month. "I do not believe that the current environment of uncertainty would benefit from policy decisions made by board members who are learning on the job."
- Under Senate rules, a returned nomination such as Diamond's dies, unless the president resubmits it. Senate Banking Committee chairman Christopher Dodd (D-CT) said, "While it is unfortunate that Mr. Diamond's name has been sent back to the president, I am confident that we will be able to act swiftly on his nomination when it is [resubmitted and] received in the Senate."

- Michael Feroli, a former Federal Reserve and U.S. chief economist for JPMorgan Stanley, said, “Whether or not you are thrilled at his appointment, this doesn’t look good, it looks like a mess.” (*Wall Street Journal*, Michael R. Crittenden and Luca Di Leo, 08/07/10; *Reuters*, Pedro da Costa and Rick Cowan, 08/05/10; *CQ Politics*, 08/06/10)

Columbia University president Lee Bollinger to serve as New York Fed’s chairman

- The Federal Reserve Board of Governors has named Lee Bollinger, president of Columbia University, to serve as chairman of the Federal Reserve Bank of New York. Bollinger, who has served on the NY Fed board since 2007, has served as deputy chairman since August 2009. On January 1, 2011, Bollinger will replace the board’s current chairman, Dennis Hughes, president of the New York State AFL-CIO. The Board of Governors also appointed Kathryn Wylde, president & CEO of the nonprofit Partnership for New York City, to serve as the NY Fed’s vice chair effective the first of the year. (*Wall Street Journal*, Michael S. Derby, 07/20/10)

FDIC completes its pilot securitization of single-family mortgages

110 bank failures in 2010 and counting...

Americans’ confidence in U.S. banks is not improving

FDIC completes its pilot securitization of single-family mortgages

- On July 30, the FDIC announced the completion of a \$471.3 million securitization of performing single-family mortgages from 16 failed banks, marking the first securitization sale completed by the agency during the current financial crisis. The securitization consisted of three tranches of securities, including approximately \$400 million senior certificates that represent 85% of the capital structure and were guaranteed by FDIC. The senior notes were sold at a coupon of 2.184% and are expected to have an average life of 3.66 years. The subordinated certificates, which were retained by failed bank receiverships, “comprised a mezzanine and an over collateralization class representing 15% of the capital structure,” according to FDIC. This pilot program was generally structured to comply with FDIC’s proposed Safe Harbor Rule with the exception of “certain limited differences necessitated by the origin of the collateral and the absence of information available from the failed banks,” said the agency.
- Some view the FDIC securitization program as a vehicle to avoid going to Congress for appropriations. “They aren’t really selling the bad assets,” said William Black, a former thrift regulator. “They’re selling the equivalent of a Treasury bond without congressional approval. It hides the economic substance of what’s really

happening—an unlimited taxpayer bailout.” The FDIC objects to this argument, saying it doesn’t expect a claim on the guarantee because of an equity cushion to absorb the losses, and securities are collateralized by only performing loans. Thus, a lot of resources stand between the FDIC guarantee and the U.S. taxpayer, FDIC argues. (*Alston & Bird, LLP, Tara Castillo, 07/30/10; Barron’s, Jack Willoughby, 07/24/10*)

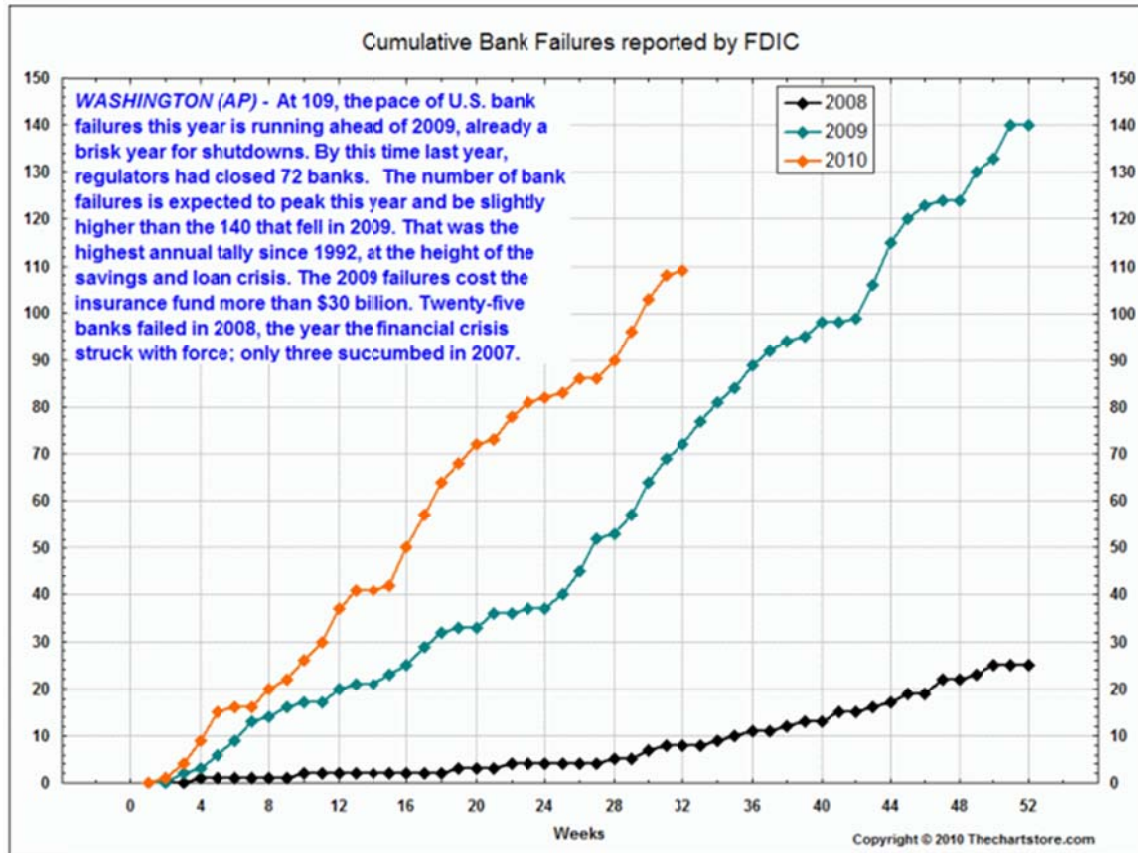
### 110 bank failures in 2010 and counting...

- Since 2008, nearly 1,200 banks have been hit with an enforcement action made public by federal regulators—a number which is expected to climb at an accelerating rate. “By the end of this year, there will be in excess of 2,000 banks under an order,” said Michael Ross, the president and chief executive of Dearborn Bancorp Inc., which is operating under a written agreement with the Federal Reserve Bank of Chicago. If so, the number of banks operating under regulatory agreements would increase from approximately 15% of the country’s 8,200 banks to as much as 24%. With



enforcement actions on pace to increase 64% in 2010, bankers are increasingly wary about their ability to raise capital, making them reluctant to lend which, in turn, impedes the economic recovery. (*American Banker, Rachel Witkowski, 08/13/10*)

- On August 8, 109 banks had been placed into receivership for the year, roughly 51% higher than the number of bank failures that had occurred a year ago. The following chart, depicting cumulative bank failures in 2008, 2009 and 2010 is provided courtesy of *Thechartstore.com*. (<http://www.ritholtz.com/blog/2010/08/fdic-bank-failures-4/>)



Source: <http://www.ritholtz.com/blog/2010/08/fdic-bank-failures-4/>

- On August 13, FDIC closed Palos Bank and Trust Company, headquartered in Palos Heights, IL—marking the 110<sup>th</sup> bank failure of 2010. (*FDIC Press Release*, 08/13/10)
- “There are a lot homes caught up in mortgage modifications,” said Richard Suttmeier, chief market strategist for *ValuEngine.com*, which he says results in a temporary stability in home prices. “There’s waves of more foreclosures coming in the housing market because very few of the HAMP modifications are becoming permanent.” Meanwhile, the backdoor bailout of the housing market continues through continued taxpayer funding of Fannie Mae’s and Freddie Mac’s operations, which Suttmeier estimates will wind up costing taxpayers at least \$400 billion and “probably more than that.” These problems in the housing sector creates a vicious cycle for the economy, jobs and the fragile banking system, said Suttmeier, who predicts another 30% drop in home prices by 2014, as measured by the Case-Shiller Index. “If you’re not building homes, you’re not creating jobs,” he said. “Construction is the biggest component of job creation on Main Street USA. Community banks can’t lend because they’re stuffed with loans they wrote 2003-2007. They are going bad.”

- This “negative feedback loop” is going to lead to more bank failures, which leads to another problem—a lack of money in the FDIC Insurance Fund, said Suttmeier. “The FDIC Deposit Insurance fund has now been drained by just \$1.33 billion so far this quarter bringing the year-to-date total to \$18.93 billion well above the \$15.33 billion prepaid assessments for all of 2010,” wrote Suttmeier recently in a note to clients.
- Ironically, filling FDIC’s coffers will fall on the shoulders of the Too Big To Fail Banks he said, “because they can afford it.” The big banks can afford it thanks to TARP and other taxpayer subsidies. However, the rising cost of replenishing the FDIC fund will result in lower profits for the big banks, which means they’ll be even less inclined to lend money, further curtailing economic activity. (*Yahoo Finance*, Peter Gorenstein, 08/11/10)

#### Americans’ confidence in U.S. banks is not improving

- For the second consecutive year, the percentage of Americans expressing very little or no confidence in U.S. banks (30%) exceeds those who have a great deal or quite a lot of confidence (23%) with the degree of confidence in banks falling in all regions of the country compared to 2007 (before the onset of the financial crisis), according to a Gallop poll. (*Gallop Press Release*, Dennis Jacobe, 07/23/10)
- In a *Forbes* commentary, William M. Isaac, former chairman of the FDIC, wrote, “...The damage to our institutions will be very difficult to repair. People have lost faith in the American Dream: to get an education, work hard, save and invest, and build a better life for your children and their children. We trusted that the system would be fair and just for those who played by the rules.” (*Forbes*, William M. Isaac, 07/21/10)

Representative Maxine Waters is charged with three ethics violations relates to her actions to garner special treatment for OneUnited Bank to receive TARP funds

- On August 2, the House Ethics Committee released formal charges against Representative Maxine Waters (D-CA) , accusing her of three counts of violating the letter and spirit of House rules and federal regulations by assisting OneUnited, a bank in which her husband owned stock, to obtain \$12 million of TARP funds. The Committee’s 10-page “Statement of Alleged Violation” focuses on the actions of Waters and her chief of staff [and grandson], Mikael Moore, and tracks the year-old findings of the Independent Office of Congressional Ethics. The Committee accuses Waters of improperly intervening on behalf of the minority-owned OneUnited, in which her husband held stock valued at roughly \$350,000. Waters, who chairs the Housing and Community Opportunity Subcommittee of the House Committee on Financial Services, has denied any wrongdoing and has asked that her adjudicatory hearing be held before the November election.

- On August 14, Waters publicly fought back against the ethics charges, arguing that the Ethics Committee overlooked key facts during their investigation. “Neither my staff nor I engaged in any improper behavior,” said Waters, who argued that the Committee “ignored or disregarded key pieces of exculpatory evidence crucial to my case, and that is extremely puzzling.” Specifically, Waters said the charges ignored the purpose of the Treasury meeting in which two of the OneUnited bank officials were attending on behalf of the National Bankers Association [a trade group for smaller banks owned by minorities and women], rather than the bank. To buttress her defense, Waters and her chief of staff produced a stack of documents, seeking help on behalf of the National Bankers Association rather than OneUnited. “The question at this point should not be why I called [Treasury] Secretary [Hank] Paulson, but why I had to,” she said. “The question at this point should be why a trade association representing over 100 minority banks could not get a meeting at the height of the crisis.”
- Waters acknowledged that it is rare for the Ethics Committee to conduct what amounts to the public trial of a colleague. Instead, the Committee typically resolves cases through negotiated settlements—a script that Waters is not following. “I’m teetering on the border here,” said Waters. “I won’t go behind closed doors.” (*Politico*, Jonathan Allen and John Bresnahan, 08/09/10; *Wall Street Journal*, Billy House, 08/05/10; *Wall Street Journal*, Devlin Barrett, 08/14/10; *Fox News*, Chad Pergram, 08/13/10)

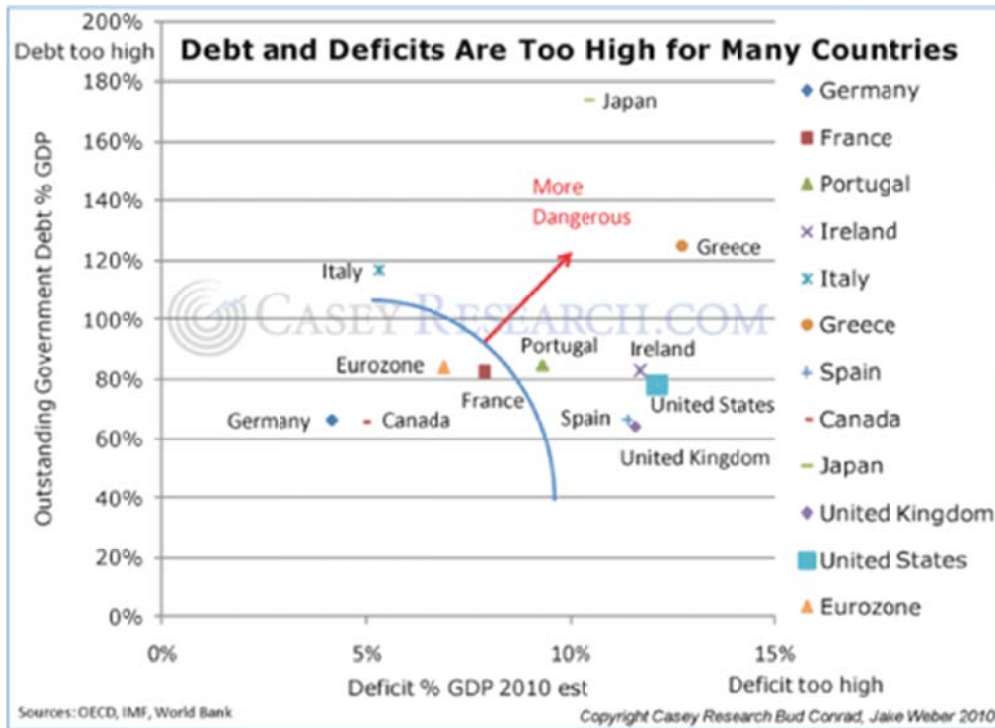
The cycle continues --bailouts, moral hazard, TBTF
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- In *The Rise and Fall of Bear Stearns*, Alan C. Greenberg and co-author Mark Singer, wrote, “...[W]ithin hours of the announcement of our sale to JPMorgan, the Federal Reserve had declared that from then on it would open its ‘discount window’ to investment banks, access previously reserved exclusively for commercial banks. ...Bear’s failure and the apprehension that it provoked—how panicked might the panic become, and with what consequences? What would a global bank run look like?—had forced this policy shift. All of this amounted to a rewriting of the rules regarding moral hazard. As applied to banking and credit crisis, any institution treated by the government as if it were ‘too big to fail’ by definition enjoyed an inherently unfair advantage over any banks not regarded as such. As the opposing fates of Lehman Brothers and AIG illustrated, the definition of too big to fail was quite flexible. In addition to the deterioration of its assets and capital, Lehman had been undone by its clients’ lack of confidence. The failure of Fannie and Freddie only made Lehman look worse. Too big to fail was hardly a new concept. Under the extreme stress of the credit crisis, they became populist fighting words.” (*The Rise and Fall of Bear Stearns*, Alan C. Greenberg and Mark Singer, June 2010)
- In the summer issue of *City Journal*, Nicole Gelinas wrote, “...Over the two decades leading up to 2008, financial markets were anything but free. The nuts-and-bolts government infrastructure that free markets require to thrive—healthy fear of failure,

respect for the rule of law, and fair rules for everyone—was crumbling.  
...Washington’s extraordinary rescues of Wall Street have eroded much of what’s left of free-market infrastructure in finance. Worse, Congress’s efforts to reform the industry will do yet more damage. The next time the financial world implodes, it will hurt the economy even more severely.

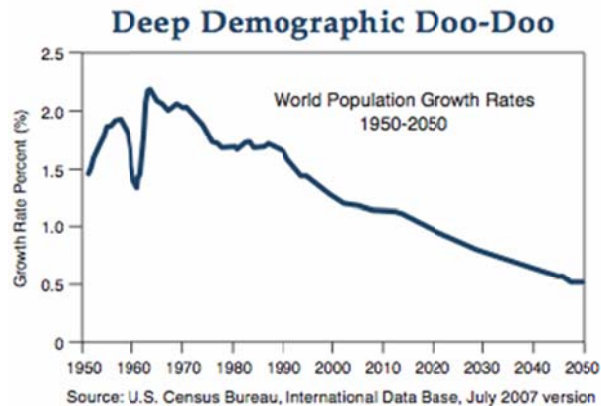
- “... United States government’s quarter-century-old policy toward the financial sector [was] to subsidize its growth at all costs. The delirious 1980s party on Wall Street lasted until 2008—and has even started up again—because a bailout-happy Washington hasn’t allowed finance to benefit from the market discipline of self-correction. This policy has been particularly damaging because the financial industry underpins the rest of the economy. Financiers determine which industries, which companies, and which individuals get investment capital, and on what terms. A distorting government hand in finance reaches past Wall Street into every industry and community in America and beyond...”
- “...Washington’s extraordinary actions are now precedent... What was once a ‘vague expectation’ that government would rescue financial firms in a crisis is now ‘a virtual certainty...’ The financial fixes [in the Dodd Frank Act] that Congress [passed] would further entrench this oligarchy and institutionalize Washington’s 2008 powers. Consider the creation of a ‘financial stability oversight council,’ a centerpiece of the new financial-regulatory reform bill. The council would supposedly end ‘too big to fail’ by preventing failure in the first place. But markets will know that this is impossible. A stability overseer can’t predict the future any better than other Washington bureaucracies could. ...Congress also seems oblivious to the fact that, throughout history, financial crises have come about because of two factors: too much debt and too much hidden risk.”
- “...[T]he too-big-to-fail financial firms, thanks to mergers encouraged by the government, are bigger and more powerful than ever, with just five banks controlling nearly all of the credit-derivatives market, meaning that they can delay the results of their future mistakes for longer. Investors can’t analyze just markets and companies anymore; they also have to figure out what arbitrary moves the government will make. And as Wall Street and Washington both depend increasingly on the issuance of cheap government debt, the two partners have an even bigger incentive to warp the free-market infrastructure so that dissenting voices have a harder time getting vital information across to the economy.”
- “...[T]o some degree, we’ve already been following this path for decades: deficit spending and willfully ‘orientating’ growth toward the housing and financial sectors, expanding on John Maynard Keynes’s suggestions that government control demand. America’s pols should be honest about what their fixes and non-fixes amount to: yet more central planning, which jeopardizes our sovereign credit, endangers the Western world’s ability to grow its way out of a crippling recession, and makes it even harder for free markets to fight government mistakes.” (*City Journal*, Nicole Gelinas, Summer 2010)

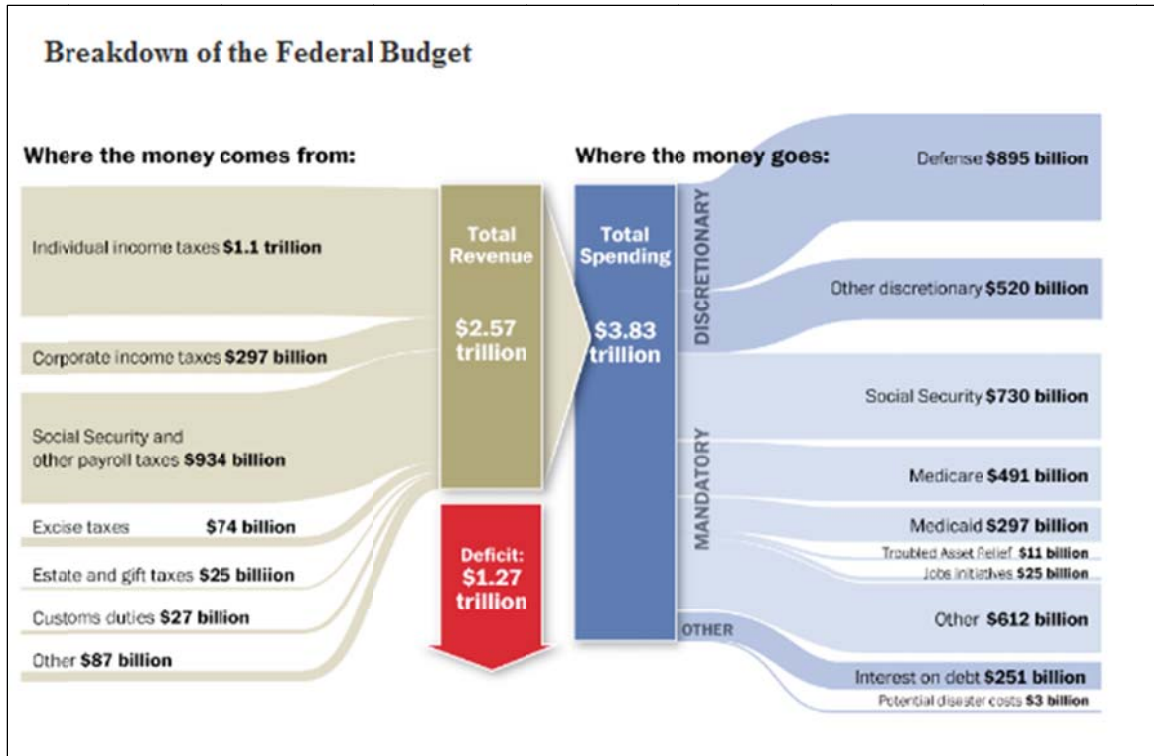
- In the August 11 *Monthly Outlook*, Wells Fargo Securities wrote, “Our outlook has no double-dip, no V-shaped recovery, no hyper-inflation in response to the Fed’s enlarged balance sheet, and no deflation in response to the Fed’s failure to increase the balance sheet even more. Instead, our outlook is for moderate, subpar growth during the second half of this year, low inflation and steady short-term interest rates. Such an outlook remains a challenge to public and private decision-makers. There is no ‘easy button’ to push to deal with the complex, interrelated problems of slow job growth, the ongoing housing correction, low inflation/lack of pricing power and concerns about federal and state deficits.”
- “Moderate growth in the second half of this year reflects the positive influence of consumer, business equipment and government purchases. Non-residential construction spending continues to detract from growth. What does look different is a turnaround for residential investment, which we expect to add to growth in the fourth quarter. In contrast to the first half of this year, inventories do not contribute much to economic growth. In addition, we see cutbacks in state and local government which also suggest slower second half gains. Inflation, measured by the core PCE deflator, remains low at 1.0 to 1.5 percent for the second half of this year.” (*Monthly Outlook*, Wells Fargo Securities, 08/11/10)
- In the July 19 *Outside the Box*, Louis Gave wrote, “[T]he credit crunch, bank bailouts and recession only account for 9% of the increase in long-term public debt burdens in major advanced economies. The remaining 91% of the long-term fiscal pressure is due to the growth of public spending on pensions, health and long-term care. In other words, the credit crunch and recession did not create the present pressures on public borrowing and spending. They merely brought forward an age-related fiscal crisis that would have become inevitable once a majority of the baby boomers retired around 2020.” (*Outside the Box*, Louis Gave, 07/19/10)
- In *RGE EconoMonitor*, Nouriel Roubini wrote, “The global economy, artificially boosted since the recession of 2008-09 by massive monetary and fiscal stimulus and financial bailouts, is headed toward a sharp slowdown this year as the effect of these measures wane. Worse yet, the fundamental excesses that fueled the crisis—too much debt and leverage in the private sector (households, banks and other financial institutions and even much of the corporate sector)—have not been addressed. Private-sector deleveraging has barely begun. Moreover, there is now massive re-leveraging of the public sector in advanced economies, with huge budget deficits and public-debt accumulation driven by automatic stabilizers, countercyclical Keynesian fiscal stimulus and the immense costs of socializing the financial system’s losses.” (*RGE EconoMonitor*, Nouriel Roubini. 07/20/10)



(Source: Casey's Daily Dispatch, 07/27/10)

- In the August *Investment Outlook*, PIMCO's Managing Director Bill Gross wrote, "PIMCO's ...New Normal thesis of deleveraging, reregulation and deglobalization produces structural headwinds that lead to lower economic growth as well as half-sized asset returns when compared to historical averages. The New Normal will not be aided nor abetted by a slower-growing population nor by cyclical policy errors that thrust Keynesian consumption remedies on a declining consumer base. Current deficit spending that seeks to maintain an artificially high percentage of consumer spending can be compared to flushing money down an economic toilet. Far better to create and mimic other government industrial policies aimed at infrastructure, clean energy, more relevant education and less costly healthcare services. Until we do, policymakers will continue to wave their hands in front of the electronic eye—waiting for the flush, waiting for the flush, waiting for the flush, with very little success. Try another way, Washington..." (*Investment Outlook*, Bill Gross, August 2010)





Source: <http://www.ritholtz.com/blog/2010/07/do-deficits-matter-not-to-us/>

- Federal grants to states have increased almost three times as fast as overall spending, according to data compiled by the Commerce Department. Specifically, grants were provided at a \$525 billion annual rate in the second quarter, a 33% jump from two years ago. Most of the federal funds went to pay health-care expenses under the Medicaid insurance program and to cover educational costs. *Bloomberg News* wrote, “The federal government provided \$131.25 of state and local aid last quarter for every dollar spent 50 years ago.” (*Bloomberg News*, David Wilson, 08/11/10)

## ***Fannie Mae and Freddie Mac***

HAMP program “drop-outs” exceed the number of permanent modifications

Housing market remains in a period of “extend and pretend”

And housing markets continue their downward trend

### HAMP program “drop-outs” exceed the number of permanent modifications

- On July 20, Treasury said that the number of borrowers dropping out of the program grew in June at almost twice the pace of those getting a permanent modification, signaling a potential rise in foreclosures in the second half of the year. More than 40% of the roughly 1.3 million borrowers (520,000), who have started in the trial loan modifications under HAMP since its March 2009 inception have since dropped out, while just over 30% (nearly 390,000) have received permanent new terms for their loans.
- The Obama administration has issued a revision to the June HAMP report, disclosing that the re-default rate for permanent loan modifications was incorrect due to an “inconsistent” reporting of cancelled loans. “These omissions have impacted our previous analysis ...with respect to the performance of HAMP permanent modifications,” said Treasury. “...Fannie Mae is now revising the data and Treasury has retained a third-party consultant to provide additional review and validation.” Treasury’s revised re-default rate for loans 90 day or more past-due is approximately 15%, as opposed to the 2%, originally reported.
- A number of analysts had noted that the originally reported re-default rate was too low, particularly in light of the high median debt-to-income ratios (63.7%) for the permanent loan modifications. Most analysts expect the majority of HAMP modifications will eventually re-default. In June, Fitch’s Ratings projected as many as 75% of HAMP modifications will re-default, despite their reduced monthly payments. In their last investor note, Barclays analysts re-iterated their forecast of a 60% re-default rate. (*Making Home Affordable Program Servicer Performance Report*, June 2010; Reuters, Corbett B. Daly and Christopher Doering, 08/06/10; *Calculated Risk*, 07/28/10; *Huffington Post*, 07/28/10; *National Mortgage News*, 08/09/10; *Wall Street Journal*, 08/10/10)
- “While the HAMP program will show relative low re-default rates, the real success rate (32% or so) will be lower than what was historically experienced for modifications with a similar payment reduction,” wrote Laurie Goodman in a recent Amherst Securities report. “Why slightly lower? HAMP considers only front-end [Debt to Income] DTI (1st mortgage payment + taxes + insurance). Most servicers

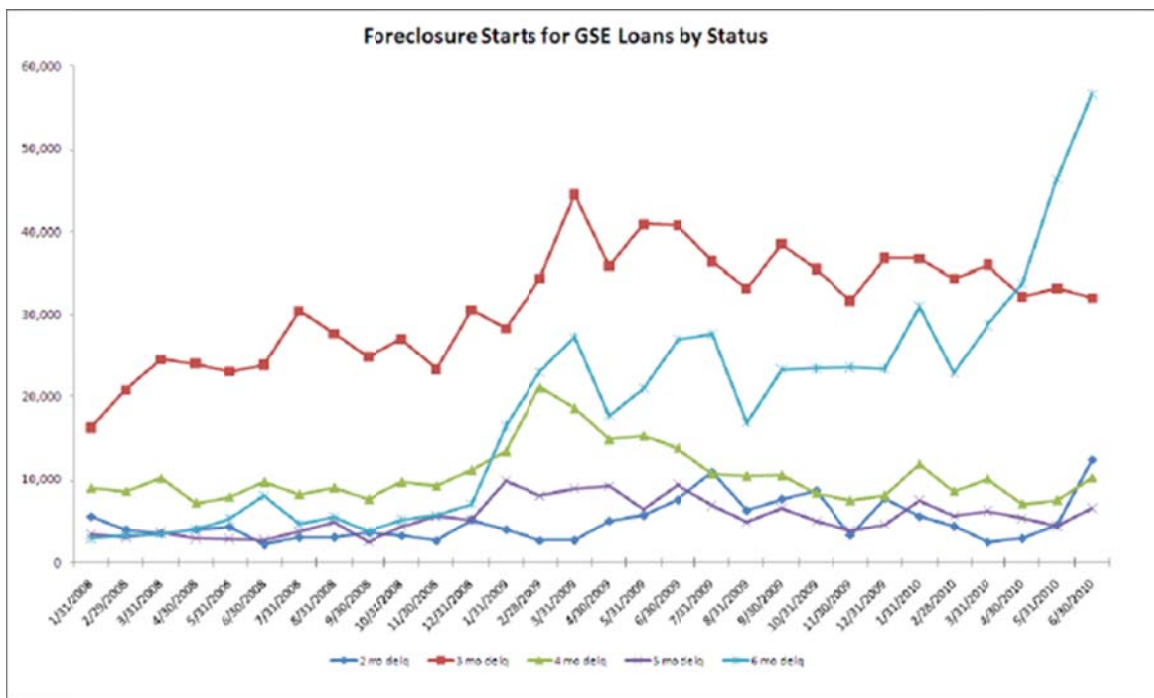
in their proprietary modification programs have attempted to work with borrowers to reduce their back-end DTI (1st + 2nd mortgage, taxes, insurance, credit card payments, auto loans, etc.). Others have declined to modify borrowers where backend DTI is an impossible obstacle. HAMP does not use back-end DTI as an input; HAMP encourages borrowers who have back-end DTIs >55% to seek credit counseling, but it is not clear this is enforced. We know that of the HAMP modifications that have become permanent, the borrower's back-end DTI went from 80% before the modification to 65% afterwards (a still unsustainable level!).”

- On *Financial Times' Alphaville* (blog), Tracey Alloway observed, “The implication being that while HAMP has helped stabilize house prices in recent months, it's done so by building up shadow inventory and delaying additional defaults. In other words, once its initial impact starts to fade, we may well be looking at a summer (and autumn) of double-dip house prices. But never fear — this is only HAMP 1.0 we're talking about. ...HAMP 2.0 [introduced in March], if you like, includes things like a principal reduction scheme —which was something lacking in the original program. But even these, Goodman says won't be enough to derail the double-dip.”
- Goodman wrote, “...Unfortunately, we fear that the enhancements announced in March [2010], when fully implemented, will be less successful than hoped. In particular, we are concerned that:”
  - **“The FHA short refi program** is clearly intended as a ‘take-out’ for modified loans. We believe few will qualify due to the back-end DTI constraint. Moreover, for loans in private label securitizations, we don't think that servicers will have the incentive to go the FHA short refi route, unless it helps the value of the 2nd lien. And this program leaves room for the 2nd lien investor to game the 1st.”
  - **“The Principal Reduction Alternative**, a voluntary program, will not receive the servicer support it deserves. A number of servicers have said they will not adopt it unless Fannie and Freddie adopt it. We don't think the GSEs will, as it is inconsistent with the concept of conservatorship.”
  - **“The 2nd Lien Modification Program** has been adopted by the largest 2nd lien servicers/investors. However, the modification will be less effective than it could be, as it occurs after the 1st lien modification, not simultaneously, and needs borrower consent.”
  - **“The implications for non-agency MBS investors:** We do not expect considerable write-offs in the near term as a result of principal forgiveness. We anticipate both the FHA short refi program and the principal reduction alternative will gain limited traction.”
  - **“The implications for the housing market:** If the modification programs do not

succeed, the huge amount of shadow inventory will produce an inevitable double dip in home prices. Our concern is that the programs announced so far will be less successful than hoped, and home prices will begin to fall. At some point, the Administration is going to have to make the principal reduction alternative more mandatory, and find a way to make the first and second lien modifications simultaneous.” (*Financial Times’ Alphaville*, Tracey Allowaym 08/11/10)

Housing market remains in a period of “extend and pretend”

- In an August 2 *Weekly Market Commentary*, John P. Hussman, Ph.D. wrote, “...[T]he housing market remains in a fascinating period of ‘extend and pretend,’ where it is clear that mortgage conditions are worsening, but we have not yet seen an explosion in foreclosures, or a movement of the growing inventory of foreclosed homes onto the open market. The main exception is Fannie Mae and Freddie Mac, which have been accelerating foreclosures in recent months [which may reflect the recent increase in HAMP cancellations], accompanied by a regular influx of funds from the U.S. Treasury (which already exceeds \$145 billion) to bail out losses on what would otherwise be insolvent GSE debt.”



Source: <http://www.housingwire.com/2010/07/27/gse-foreclosure-starts-start-coming-faster-in-2010>

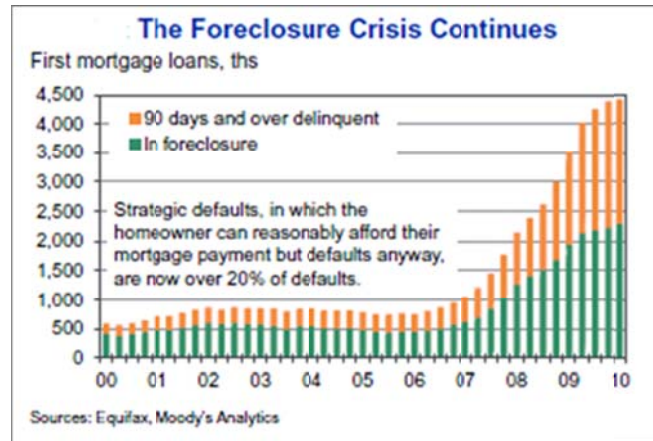
- “The Lender Processing Services (LPS) June Mortgage Monitor provided the most recent report last week, noting that ‘foreclosure starts for loans owned by the Government Sponsored Entities (GSEs) are at an all-time high. The largest percentage of GSE foreclosure starts are coming from loans that are six or more months behind on payment. This finding is consistent with the reports of increased Home Affordable Modification Program (HAMP) trial period cancellations. Total

delinquent and foreclosure inventories remain at historically elevated levels, with Jumbo and Agency prime product experiencing the greatest percentage increase since January 2008. The report also shows that two loans are deteriorating in status for every one loan that improved.”

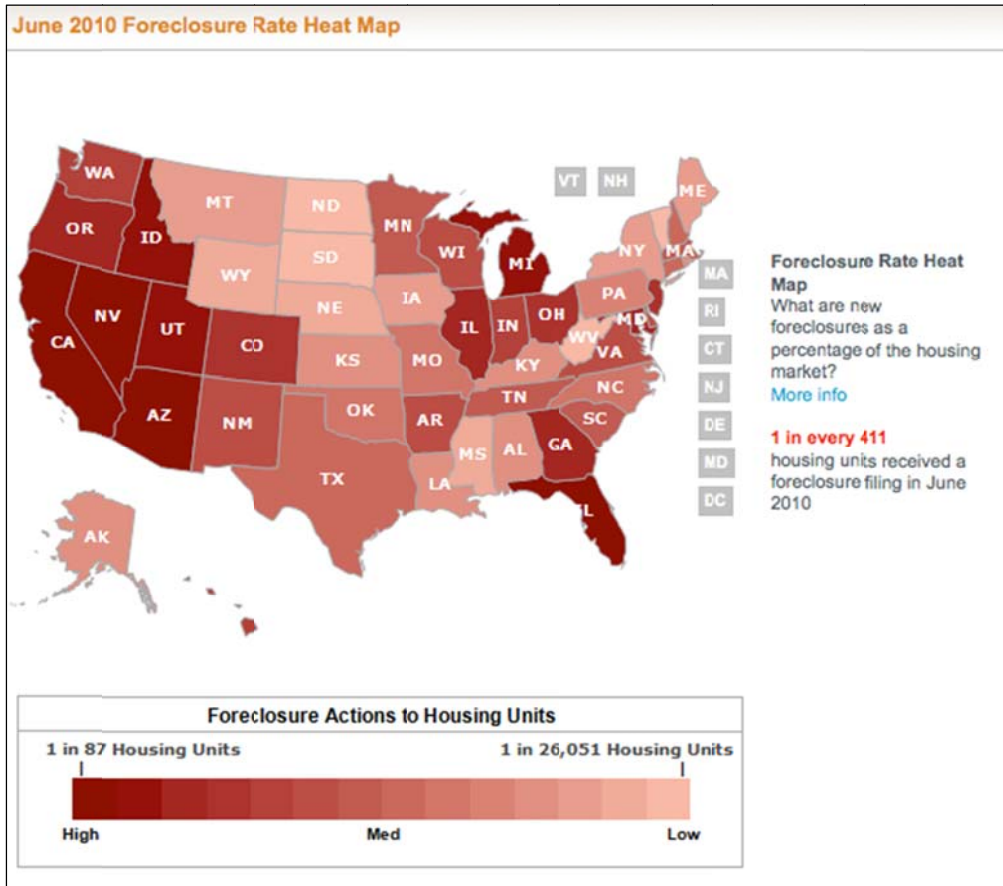
- The “big four” banks—Bank of America, Wells Fargo, JPMorgan Chase, and Citigroup—reported an increase in nonperforming or foreclosed property of \$9.5 billion from the same period last year for a total of \$51.34 billion of NPAs. Bank of America’s NPAs comprised the largest share of the group’s total (69.5%), followed by JPMorgan Chase (18.2%), Wells Fargo (9.5%) and Citigroup (2.7%). (*HousingWire*, Jon Prior, 07/27/10)
- On June 30, the government—Fannie Mae (129,310), Freddie Mac (62,178) and FHA (44,850)—owned 236,338 properties as real estate owned, a 13% increase from the first quarter and 74% from the year-ago period. According to economist Thomas Lawler, the country’s four largest banks had an estimated \$14.5 billion of real estate owned or roughly 97,000 properties (assuming a median price of \$150,000). Moody’s estimates that private label MBS reposessions stand at 203,665. [To these figures, REO for other smaller banks also needs to be added.] “My best guess right now is that REO held by Fannie, Freddie, and FHA, and other government entities, and banks and thrifts is just under 600,000, but unfortunately that is on the rise,” said Lawler.
- As James Saccacio, the CEO of RealtyTrac observed..., “The roller coaster pattern of foreclosure activity over the past 12 months demonstrates that while the foreclosure problem is being managed on the surface, a massive number of distressed properties and underwater loans continues to sit just below the surface, threatening the fragile stability of the housing market.”
- “On [the August 1] edition of *Meet the Press*, Alan Greenspan remarked that there is a huge number of homes that would go ‘underwater’ if home prices were to slip by another 5-7%, and that such an event could potentially trigger a large wave of additional foreclosures. I am not familiar enough with the price distribution of existing mortgages to contribute much insight here, but the remark does help to explain why banks appear so reluctant to bring the massive inventory of delinquent and foreclosed properties onto the market.”
- “It is not clear precisely at what point the burgeoning inventory of foreclosures and delinquent mortgages will impact the markets, but it is clear that conditions are not improving, and that fresh economic weakness would tend to destabilize an already fragile situation. At the same time, it is not out of the question that we may be quietly allowing U.S. banks to go insolvent without disclosure, covering the losses over time out of wide interest spreads on existing loans, and that we may be able to avoid outward evidence of mortgage deterioration simply by allowing the Treasury to go further and further into deficit on behalf of the GSEs. Undoubtedly, all of this will produce future strains in the form of inflation risk, longer-term commodity price

pressures, fiscal instability, stagnant lending activity, continued failure of smaller institutions, further loan writedowns, and other events.”

- “The losses are inevitable, and to some extent even quantifiable. The real question is who will actually bear those losses and when. The official policy is clearly for the public to do so, massively, preferably quietly, and over a very long period of time. Still, my impression is that fresh economic weakness could prove to be a tipping point, and that both investors and the public should understand that they are likely to pay terribly for the current abundance of apparently free lunches.” (*Weekly Market Commentary*, John P. Hussman, 08/02/10; *HousingWire*, Jacob Gaffney, 07/27/10)



- Foreclosures climbed in 75% of U.S. metropolitan areas in the first half of 2010 with the number of bankruptcy filings more than doubling from a year earlier in Baltimore, MD, Oklahoma City, OK and Albuquerque, NM. In addition, notices of default, auction or bank seizures rose by more than 50% in Salt Lake City, UT, Savannah, GA and Atlantic City, NJ. Continued weakness in employment and government’s efforts to delay foreclosures may “delay the inevitable” and depress house prices, said RealtyTrac CEO James J. Saccacio. “There is a pretty direct correlation between job loss and foreclosure,” said Saccacio. “Until employment rates start to go down, and until we actually see net job creation, and importantly until consumer confidence comes back, the housing market has really slim chances of recovery. That coupled with the huge overhang of distressed property, really suggests the housing market is not going to turn around for the next few years.”
- In June, one in every 411 housing units received a foreclosure filing, according to RealtyTrac. (*CNNMoney.com*, Nin-Hai Tseng, 07/28/10; *Bloomberg News*, Dan Levy, 07/29/10)



Sources: RealtyTrac; image from Wikimedia Commons, CC 2.0

- High levels of mortgage delinquencies and foreclosures are taking their toll on borrowers' credit scores, which decline 135 points once they fall three months behind on their mortgage. As a result, 25% of Americans had a credit score below 600 [below the definition of subprime at 620] in June, while the score averaged 688. Regulators and some lawmakers contend that borrowers participation in loan modifications should end their delinquent status; however, these loan mods are hurting these borrowers' credit scores. At the urging of Treasury, the Consumer Data Industry Association, a trade group representing Equifax, Experian PLC and TransUnion LLC, created a special status code for credit files that had been modified under the HAMP program, which banks began using in November 2009. Craig Watts, spokesman for FAIR Issac, the maker of FICO scores, said a borrower's credit score is not hit if the servicer uses the new codes for permanent mod payments. Representative Jackie Speirer (D-CA) has proposed legislation that would prevent banks and servicers from reporting modified mortgage payments as delinquent. (*Prescott News.com*, Dan Shaw, 08/07/10; *American Banker*, Kate Berry, 08/09/10)

## And housing markets continue to their downward trend

- On July 22, the National Association of Realtors reported that existing home sales fell 5.1% (month over month) in June, following a 2.2% decline in May. Home sales were up 9.8% year over year to an annualized rate of 5.37 million units. Although a positive effect of the first-time homebuyer tax credit on existing homes sales had been expected to continue into June, sales fell as a result of weak demand. Total housing inventories for the end of May rose by 2.5% to 3.99 million units, an 8.9 month supply of housing at the current sales rate, up from an 8.3 month supply. Distressed sales accounted for 32% of all sales in June 2010, while the national median existing-home price rose by 1.0% year over year. Resales of single-family homes fell 5.6% month over month to an annual rate of 4.70 million, while sales of condos and co-ops fell 1.5% month over month. (*CNNMoney.com*, Ben Rooney, 07/26/10)
- During the second quarter, U.S. house values fell 3.2% from the same period last year, and were down 0.6% from the first quarter to \$182,500, according to the Zillow Real Estate Market Reports. However, the level of homeowners with negative equity in their homes—the so-called underwater mortgages—fell to 21.5% in the second quarter versus 23.3% in the first quarter, as reported by Zillow Real Estate Market Reports. (*National Mortgage News*, 08/09/10)
- Moody's Investors Service analysts estimate that U.S. home prices will fall—along with house sales—an estimated 20% before stabilizing in early 2012. (*HousingWire*, Christine Ricciardi, 08/09/10)
- Robert Shiller, professor of economics at Yale University and co-developer of the Standard & Poor's S&P/Case-Shiller home price indexes, said, "For me a double-dip is another recession before we've healed from this recession ... The probability of that kind of double-dip is more than 50 percent. I actually expect it" When asked about his forecast for home prices, Shiller responded, "I don't know. I am taking a 'wait-and-see' attitude." (*Reuters*, 07/27/10)

Metro Area	Change in Housing Inventory	Months Supply	Price Change	Jobless Rate	Loan Payments Overdue
Detroit	-20.6%	n.a.	-18.2%	15.5%	141%
Las Vegas	2.2%	6.3	-22.1%	14.2%	22.9%
Tampa, Fla.	-6.9%	9.3	-8.7%	13.1%	20.3%
Sacramento, Calif.	11.6%	3.0	-2.0%	12.9%	13.2%
Jacksonville, Fla.	12%	14.0	-11.0%	12.6%	17.5%
Orlando, Fla.	-21.1%	6.7	-14.0%	12.6%	22.8%
Charlotte, N.C.	-6.6%	17.7	-4.2%	12.3%	12.2%
Miami	-14.4%	11.6	-15.4%	11.9%	26.7%
Los Angeles	19.0%	6.0	5.5%	11.8%	12.2%
Chicago	-7.6%	10.9	-4.5%	11.0%	13.7%
San Francisco	16.7%	6.0	5.8%	11.0%	9.0%
San Diego	33.1%	5.4	7.4%	10.8%	11.0%
Portland, Ore.	1.9%	8.7	-7.1%	10.7%	7.9%
Atlanta	-10.3%	9.9	-5.7%	10.6%	15.7%
St. Louis	8.5%	8.6	-3.2%	10.5%	9.9%
Orange County, Calif.	15.1%	4.8	6.2%	9.9%	n.a.
Nashville, Tenn.	-4.1%	12.4	-6.1%	9.4%	10.7%
Philadelphia	7.4%	n.a.	0.1%	9.4%	10.9%
Seattle	3.3%	8.2	-5.9%	9.2%	8.9%
Raleigh, N.C.	6.9%	11.5	-6.7%	9.1%	8.3%
New York	n.a.	n.a.	-2.6%	9.1%	121%
Phoenix	9.2%	4.9	-11.7%	8.9%	15.4%
Houston	16.0%	7.0	n.a.	8.6%	10.3%
Boston	4.1%	6.1	3.3%	8.3%	8.7%
Denver	9.2%	6.6	2.6%	8.1%	7.7%
Dallas	-4.6%	6.5	n.a.	8.1%	10.0%
Minneapolis	4.4%	7.4	-2.7%	7.2%	7.7%
Washington, D.C.	0.6%	6.3	12%	6.8%	9.8%
L. Island/Queens	0.6%	13.6	n.a.	n.a.	n.a.
NJ Suburbs	6.0%	10.8	n.a.	n.a.	n.a.
Manhattan	-13.0%	8.9	n.a.	n.a.	n.a.

Source: <http://online.wsj.com/public/resources/documents/HagertyQuarterly.html>, 07/20/10

FHFA subpoenas 64 Wall Street firms for information on private-label MBS purchased by Fannie Mae and Freddie Mac

Federal Reserve Bank of New York is exercising its buyback rights for faulty mortgages and other assets acquired in the Bear Stearns and AIG rescues

Losses from loan buybacks from Fannie and Freddie may exceed \$27 billion over the next three or four years

FHFA subpoenas 64 Wall Street firms for information on private-label MBS purchased by Fannie Mae and Freddie Mac

- The Federal Housing Finance Agency, as Conservator of Fannie Mae and Freddie Mac, has issued 64 subpoenas to various entities that act as trustees for mortgage pools or that service the loans in them, seeking information related to private-label mortgage-backed securities (PLS) in which the two GSEs invested. The documents will enable the FHFA to determine whether PLS issuers and others are liable to the GSEs for certain losses they have suffered on PLS. Collectively, Fannie Mae and Freddie Mac purchased \$294 billion of PLS MBS in 2006 and 2007. Not all of these purchases are under scrutiny, said FHFA. If so, the Conservator expects to recoup funds through loan buybacks, which would be used to offset payments made to the GSEs by the U.S. Treasury. In turn, Wall Street firms may force the mortgage originators to buyback the underlying loans.
- “FHFA is taking this action consistent with our responsibilities as Conservator of each Enterprise,” said FHFA Acting Director Edward J. DeMarco. “By obtaining these documents we can assess whether contractual violations or other breaches have taken place leading to losses for the Enterprises and thus taxpayers. If so, we will then make decisions regarding appropriate actions.”
- *New York Times* reporter Gretchen Morgenson wrote, “...[I]n the topsy-turvy world of Washington, the housing finance agency’s move is unusually aggressive. ...Demarco, [FHA’s] acting director, seems to be that rarity—a regulator who not only talks about looking out for the taxpayer, but actually does something about it.” FHFA’s move is clearly turning up the heat on major players in the mortgage servicing and securitization market, particularly the biggest trustees in the business—Deutsche Bank and Bank of New York—and the biggest loan servicers—Bank of America, Wells Fargo and JPMorgan Chase.
- Justin Vedder, managing director of PBIS Insurance Services, Inc., said, “The subpoenas could trigger further due diligence and review of prospectus language and the reps and warranties contained in these contracts. It very well could cause more buybacks.” In general, undisclosed debt by the borrower has become the single biggest reason for buyback requests, said Vedder. Brian Coester, president of

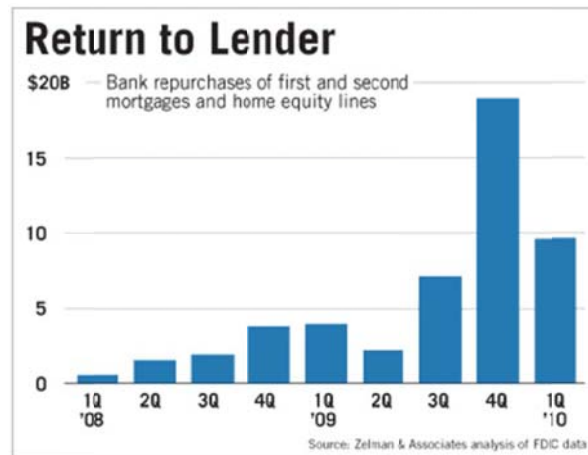
Coester Appraisal Group, said at least 15% of loan buybacks are attributable to appraisal problems, ranging from outright fraud on the comparable sales used to picking the highest possible value during the peak years of the market. Increasingly, more loans are being pushed back to the appraiser because the mortgage lender has gone out of business, Coester added.

- In the company’s second quarter earnings release, Freddie Mac said it has “begun to require certain seller/servicers to commit to plans for completing repurchases with financial consequences or with stated remedies for non-compliance, as part of the annual renewals of our contracts.” On June 30, Freddie had \$5.6 billion in buyback requests outstanding with 24% of these requests more than 120 days old.

Federal Reserve Bank of New York is exercising its buyback rights for faulty mortgages and other assets acquired in the Bear Stearns and AIG rescues

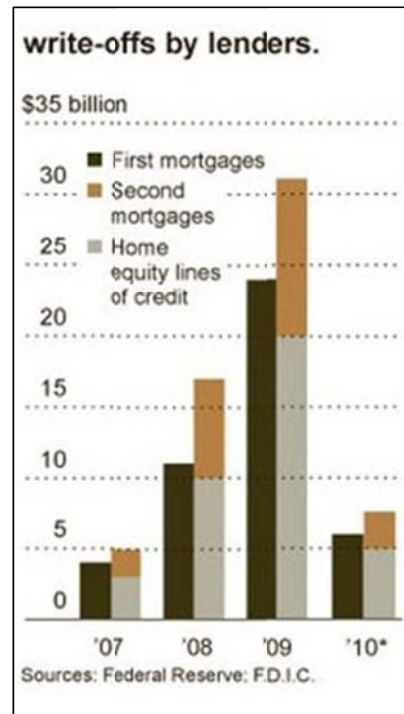
- The Federal Reserve Bank of New York may require banks to buy back its holdings of faulty mortgages and other assets acquired through the bailout of Bear Stearns and AIG, said Fed spokesman Jack Gutt. “We are involved in multiple efforts related to exercising our rights as investors in non-agency RMBS or CDO securities [which include requiring] originators to repurchase ineligible loans.” The New York Fed holds \$69.1 billion of assets through its rescue of AIG and \$30 billion of assets from its Bear Stearns bailout. Issuers of the AIG assets include Countrywide Financial, now owned by Bank of America, Bear Stearns, Goldman Sachs Group, and UBS AG, along with defunct lenders, such as New Century Financial. The Fed’s Bear Stearns portfolio includes some 9,000 residential loans, 50 commercial real estate loans 75 CDOs, 1,600 credit default swaps and 1,500 federal agency securities.

- The New York Fed is facing the prospect of foreclosing on a number of residential and commercial properties in coming months. “For the Fed to come in and foreclose on properties puts it at some reputational and political risk, said Vincent Reinhart, a former Fed staffer and economist with American Enterprise Institute. “If the Fed can’t figure out how to recast terms of these mortgage and work with these borrowers, it’s emblematic of the problems the government has with other programs over the last year and a half.”



- In the second quarter, the four largest U.S. banks booked \$2.5 billion in charges for mortgage-repurchase requests, more than double that booked during the same period

last year. Specifically, Bank of America's charge-offs for repurchases totaled \$1.2 billion in the second quarter, up nearly three-fold from a year ago. J.P. Morgan Chase & Co. reported that its second-quarter mortgage-repurchase provision more than doubled over last year's second quarter to \$667 million. Citigroup's total second-quarter costs for taking back loans were \$347 million, up from \$103 million a year ago. And, Wells Fargo reported second-quarter costs of \$346 million to offset current and future losses from loan repurchases (but did not disclose a year ago comparison).



- In its 10Q filing with the SEC, BofA said it had \$11.2 billion of “unresolved” mortgage buyback requests on June 30, a 50% spike since the beginning of the year. These buyback disputes include disputes with Fannie Mae and Freddie Mac (\$5.6 billion) and mortgage insurance firms, particularly monoline insurers (\$4 billion). According to the SEC filing, BofA acknowledged that “disputes have increased with buyers and insurers regarding representations and warranties.” (*American Banker*, Kate Berry, 07/20/10; *National Mortgage News*, 07/16/10; *New York Times*, Gretchen Morgenson, 07/16/10; *American Banker*, 08/1/10; *National Mortgage News*, 08/09/10; *Bloomberg News*, David Henry, 08/10/10; *National Mortgage News*, 08/16/10; *Wall Street Journal*, Serena Ng and Carrick Mollenkamp, 08/03/10; *Bloomberg News*, Dawn Kopecki, 08/04/10; *Wall Street Journal*, Marshall Eckblad, 08/11/10)

Losses from loan buybacks from Fannie and Freddie may exceed \$27 billion over the next three or four years

- Chris Gamaitoni, Vice President, Equity Research at Compass Point Research and Trading LLC, estimates that banks will have to absorb roughly \$27.2 billion in losses from loan buybacks from Fannie Mae and Freddie Mac—well in excess of the loss reserves that the banks have been setting aside. In a recent research note, Gamaitoni wrote that the GSEs have only “just become operationally efficient” by increasing their staffs for loan reviews. In coming months, the enterprises will be forced to resolve a larger percentage of their mortgage delinquencies by pushing more back to their loan servicers—particularly those borrowers who failed to qualify for permanent HAMP loan modifications,” Gamaitoni wrote. “There is a material risk relating to mortgage losses in the banking sector due to representations and warranties made to the GSEs and other private-label buyers.” He estimates potential losses from the buybacks could range from \$11.9 billion to \$64.8 billion. (*American*

*Banker*, Kate Berry and Sara Lepro, 07/22/10)

- Bank credit may come under pressure and profits could suffer for years as the Federal Reserve, Fannie Mae and insurers step up demands on lenders to buy back mortgages, wrote Moody's Investors Service in an August 11 report. "The need to build reserves against this potential exposure is likely to continue, and will continue to be a drag on bank earnings for another year or longer," wrote Moody's. Repurchase reserves at the four largest U.S. banks totaled more than \$8 billion as of June 30, said the ratings agency. (*Bloomberg News*, Dawn Kopecki, 08/04/10)

The battle over the Property Assessed Clean Energy Program moves to the courts
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- On July 7, the Federal Housing Finance Agency reiterated its concerns about the safety and soundness of "green energy" loan programs [Property Assessed Clean Energy Program or PACE] and advised Fannie Mae, Freddie Mac and the FHLBs to adopt new guidelines to protect the GSEs' lien positions. FHFA also instructed the GSEs to make exceptions for homeowners who have already obtained PACE financing.
- In many of the PACE programs around the country, municipalities lend money to homeowners to pay for energy-efficient improvements, such as solar panels or other energy devices or improvements. These loans are typically repaid over 20 years through an annual assessment included in the borrower's property tax bill. If the home is sold, the new owner is responsible for paying the PACE loan. For repayment purposes, the PACE lien has priority ahead of existing first and subordinate mortgage liens.
- In May, Fannie Mae and Freddie Mac had informed their lenders that PACE's subordination feature violated the GSEs' guidelines for first mortgages, causing confusion among lenders and borrowers about whether homes with PACE liens could be financed. In response to these concerns, FHFA later instructed the GSEs to waive prohibitions against such senior liens for any homeowner who had obtained a PACE loan prior to July 6.
- FHFA warned that PACE programs can be harmful to consumers with "collateral-based lending rather than lending based upon ability-to-pay, the absence of Truth-in-Lending Act and other consumer protections, and uncertainty as to whether the home improvements actually produce meaningful reductions in energy consumption." The GSE's new guidelines should adjust loan-to-value ratios to reflect the maximum PACE loan amount available to borrowers and tighten debt-to-income ratios to account for additional obligations under possible future PACE loans, said FHFA. The regulator reached these conclusions after spending a year reviewing the PACE program in cooperation with federal agencies that helped develop the initiative, an inter-agency working group that included the Department of Energy, HUD and the Council on Environmental Quality.

- "We now have so many states [18] that are signed up for this thing that there was a feeling we just have to say, after all the reviews, we feel this presents an unsafe and unsound situation and for [the GSEs] to take action to protect themselves," said Alfred Pollard, FHFA's general counsel.
- The Office of the Comptroller of the Currency has also advised national banks to take steps to mitigate risks from exposure to PACE loans, pursuant to an July 6 OCC Bulletin (<http://www.occ.gov/ftp/bulletin/2010-25.html>).
- On July 14, California Attorney General Jerry Brown filed a law suit in the U.S. District Court for the North District of California against Fannie Mae, Freddie Mac, and FHFA, for effectively killing PACE program and urged the court to issue an order restraining or enjoining the agencies for refusing to participate in these programs that the AG insists is permitted under state law. Brown contends that FHFA and GSEs are violating state law and the National Environmental Policy Act and Administrative Procedures Act by failing to prepare an appropriate environmental review before making their PACE decisions. In addition, the AG has asked the court to declare the PACE funding as "assessments," as permitted under state law, rather than "loans." Brown argues that GSEs actions "are severely hampering California's efforts to assist thousands of California homeowners to reduce their energy and water use, help drive the state's green economy, and create significant numbers of skilled, stable and well-paying jobs." California stands to lose more than \$100 million in federal stimulus money that is available for PACE participants, argued Brown. "Fannie Mae and Freddie Mac received enormous federal bailouts, but now they're throwing up impermeable barriers to bank lending that creates jobs, stimulates the economy and boosts clean energy," he added.
- FHFA said it will launch a strong defense against the California lawsuit. In a July 14 statement, FHFA director Demarco said, "In keeping with our safety and soundness obligations, the Federal Housing Finance Agency will defend vigorously its actions that aim to protect taxpayers, lenders, Fannie Mae and Freddie Mac. Homeowners should not be placed at risk by programs that alter lien priorities and fail to operate with sound underwriting guidelines and consumer protections. Mortgage holders should not be forced to absorb new credit risks after they have already purchased or guaranteed a mortgage."
- On July 14, PACENow, a nonprofit group supporting PACE initiative, launched a campaign to push Congress to pass a legislative fix to restore the programs. More than 600 individuals and groups participated in a conference call sponsored by PACENow to discuss how to fight the federal regulator's resistance to the PACE program. "Federal regulators ...let's be clear, are trying to kill PACE, said Cisco DeVries, president of Renewable Funding, participated in a conference call sponsored by PACENow, to discuss how to fight the federal regulators' resistance.
- According to a May 3 [white paper](#) published by The National Resources Defense

Council, PACENow, Renewable Funding, LLC, and The Vote Solar Initiative, 17 states and the District of Columbia have enacted PACE legislation and 15 states are considering bills to allow municipalities to enact PACE programs. [In August, Massachusetts became the eighteenth state to pass enabling legislation for PACE programs.] The authors contend that PACE liens meet the three prong test of qualifying as special assessments set forth by the Supreme Court. Specifically, the authors argue (i) the PACE impairment “does not substantially impair the contractual relationship between a pre-existing mortgage lender and the property owner;” (ii) the states’ enabling legislation determines that energy conservation efforts, such as the PACE program, are necessary to address climate change; and (iii) PACE programs are a reasonable use of government power to achieve a public purpose. (*FHFA Press Release*, 07/14/10; *OCC Bulletin*, 07/06/10; *Property Assessed Clean Energy (“PACE”) Programs White Paper: Helping Achieve Environmental Sustainability and Energy Independence, Improving Homeowner Cash Flow and Credit Profile, Protecting Mortgage Lenders, and Creating Jobs*, 05/03/10; *National Mortgage News*, Peter Schroeder, 07/15/10; *HousingWire*, Kerry Curry, 07/14/10; *American Banker*, Sara Lepro, 07/07/10; *Cape News*, Michael C. Bailey, 08/13/10)

Senators urge Obama administration to name a permanent director for FHFA

- In a letter to the president, Senate Banking Committee Chris Dodd (D-CT) and ranking minority member Richard Shelby (R-AL) urged the administration to name a permanent director for the Federal Housing Finance Agency. Edward DeMarco, a career civil servant, has been the acting director for FHFA since September 1, 2009. The Senators also urged the Obama to choose someone to run the newly created Consumer Financial Protection Bureau and name a vice chairman for supervision at the Federal Reserve. (*Reuters*, 07/29/10)

The FHFA proposes rule to restrict the GSEs from investing in mortgages with private transfer fees

The agency also proposes rule to establish an Office of Ombudsman

The FHFA proposes rule to restrict the GSEs from investing in mortgages with private transfer fees

- The Federal Housing Finance Agency is seeking a comment on a proposed rule to restrict Fannie Mae, Freddie Mac and the FHLBs from investing in mortgages that contain private transfer fee covenants. “The private transfer fee covenants appear to run counter to the important mission of the housing GSEs to increase liquidity, affordability and stability,” said Edward DeMarco, FHFA’s acting director. “Encumbering housing transactions with fees that may not be properly disclosed may impede the marketability and the valuation of properties.” FHFA has submitted the proposal to the Federal Register, which is open for public comment for 60 days.

(*Associated Press*, Alan Zibel, 08/12/10; *Bloomberg News*, Gregory Mott, 08/12/10)

### The agency also proposes rule to establish an Office of Ombudsman

- On August 5, the Federal Housing Finance Agency issued a proposed rule to establish an Office of Ombudsman to handle complaints about Fannie Mae, Freddie Mac, the FHLBs, and the GSEs' business partners. Under the proposed rule, the ombudsman would serve as an independent intermediary and arbitrator in conflicts that would have the authority to conduct investigations and make nonbinding recommendations to the FHFA director regarding complaints. The ombudsman's office would be funded by FHFA. Under the Housing Recovery Act of 2008 (HERA), FHFA was required to establish the Office of Ombudsman.
- HERA also granted the FHFA director enhanced enforcement powers, including higher civil money penalties and the power to remove or suspend individuals at Fannie Mae, Freddie Mac or the FHLBs. On August 4, FHFA issued a proposed rule, establishing notice and hearing procedures. In each case, FHFA must provide the regulated entity or individual with notice and an opportunity for a hearing that is presided over by an impartial presiding officer, typically an administrative law judge. (*Bureau of National Affairs*, 08/10/10)

Stripdowns and bankruptcy
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- In August 3 economic commentary, Thomas J. Fitzpatrick, IV and James B. Thomson, economists with the Federal Reserve Bank of Cleveland, examine the lessons learned in the 1980s from agricultural bankruptcy reform that authorized the use of stripdowns, and applies these observations to today's debate over the use of stripdowns to help reduce mortgage foreclosures. From a review of data for bankruptcies in the 1980s, the authors found that the actual impact of the farm stripdown legislation was "minor." They wrote, "Although the legislation created a special chapter in the Bankruptcy Code for farmers and allowed stripdowns on primary residences, it did not change the cost and availability of farm credit dramatically. In fact, a [GAO] (1989) survey of a small group of bankers found that none of them raised interest rates to farmers more than 50 basis points. While this rate change may have been a response to the [new] Chapter 12, it is also consistent with increasing premiums due to the economic environment. This suggests that the changes in the cost and availability of farm credit after the bankruptcy reform differed little from what would be expected in that economic environment, absent reform."
- "What was most interesting about Chapter 12 is that it worked without working. According to studies by Robert Collender (1993) and Jerome Stam and Bruce Dixon (2004), instead of flooding bankruptcy courts, Chapter 12 drove the parties to make private loan modifications. In fact, although the [GAO] reports that more than 30,000 bankruptcy filings were expected the year Chapter 12 went into effect, only

8,500 were filed in the first two years. Since then, Chapter 12 bankruptcy filings have continued to fall.”

- The authors conclude, “Allowing bankruptcy judges to modify mortgages secured by primary residences remains one of the most contentious proposed responses to the ongoing home mortgage foreclosure crisis. After all, any legislative reform that allows bankruptcy judges to strip down debt secured by primary residences can potentially alter the terms of financial contracts, a change that could have unintended consequences”.
- “The debate is not a new one. The 1980s farm foreclosure crisis sparked similar proposals and concerns. Congress’s response was to include a stripdown provision in a newly created chapter in the bankruptcy code specifically intended for family farms. The effects of that stripdown provision, in place for more than two decades, on the availability and terms of agricultural credit suggest that there has been little if any economically significant impact on the cost and availability of that credit.”
- “In applying the lessons of Chapter 12 reform to the current debate one needs to recognize some important differences between the agricultural foreclosure crisis of the 1980s and the current home foreclosure crisis. First, the structure of the underlying loan markets is different. Unlike mortgages today, few if any of the farm loans in the 1980s were sold or securitized. Moreover, there was more direct government involvement in agricultural loan markets in the 1980s than there was in the mortgage markets leading up to the current housing crisis. Finally, the scale of the current foreclosure crisis is several times larger than the 1980s agricultural crisis, which was limited geographically to the Midwest and Great Plains states. Yet, despite these differences, the response to the farm foreclosure crisis and the impact of bankruptcy reform on agricultural credit markets is still informative for the current debate.” (*Stripdowns and Bankruptcy: Lessons from Agricultural Bankruptcy Reform*, Thomas J. Fitzpatrick, IV and James B. Thomson, 08/03/10)

IMF advocates “psychic insurance” to reduce asset demand... <i>ok</i>
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- In a March 2009 white paper published by the International Money Fund, Christopher W. Crowe, wrote, “The recent housing bust has reignited interest in psychological theories of speculative excess (Shiller, 2007). I investigate this issue by identifying a segment of the U.S. population—evangelical protestants—that may be less prone to speculative motives, and uncover a significant negative relationship between their population share and house price volatility. Evangelicals’ focus on Biblical prophecy could account for this difference, since it may enable them to interpret otherwise negative events as containing positive news, dampening the response of house prices to shocks. I provide evidence for this channel using a popular internet measure of ‘prophetic activity’ and a 9/11 event study. I also analyze survey data covering religious beliefs and asset holding, and find that ‘end times’ beliefs are associated with a one-third decline in net worth, consistent with

these beliefs providing a form of psychic insurance (Scheve and Stasavage, 2006a and 2006b) that reduces asset demand.” ([Irrational Exuberance in the U.S. Housing Market: Were Evangelicals Left Behind?](#), Christopher W. Crowe, 03/01/09)

#### FGIC Corp files for Chapter 11 protection

- On August 3, FGIC Corp filed for bankruptcy protection, saying it had not been paid dividends by its troubled bond insurance unit, Financial Guaranty Insurance Company (FGIC) since January 2008. The parent company relies upon its bond insurance unit’s dividend payments for sustaining its operations. FGIC Corp listed estimated unsecured debt of \$391.5 million and estimated assets, ranging from \$10 million to \$50 million, according to court documents. Continuing losses on FGIC-insured mortgages resulted in FGIC’s surplus falling to negative \$1.640 billion. (*Reuters*, 08/04/10)

#### Countrywide Financial enters \$624 million settlement in subprime loan class action lawsuit

- Bank of America’s Countrywide Financial subsidiary has agreed to pay \$600 million to settle several class action lawsuits from Countrywide shareholders, led by a group of New York pension funds, over the lender’s subprime mortgage program. Separately, Countrywide’s independent auditor, KPMG LLP, agreed to pay an additional \$24 million as part of the settlement. Under the settlement, the defendants—Countrywide, its management team and board members—did not admit any wrong-doing. The company’s former executives and board members did not have to help fund the settlement payment. The Countrywide settlement comes days after New Century officers and directors agreed to pay \$90 million to settle claims in their subprime lawsuit. [In addition, a group of New Century shareholders has reached a \$125 million class action settlement over misstatements and omissions with the company’s officers and directors, auditor KPMG LLP and underwriters J.P. Morgan Securities Inc., Deutsche Bank Securities Inc. and Morgan Stanley & Co. Inc.] Countrywide’s former CEO Angelo Mozilo and two other former executives still face a fraud lawsuit, filed by the SEC, alleging the company duped shareholders by failing to disclose growing risk of its subprime lending business. (*CNNMoney.com*, 08/03/10; *Dow Jones*, 08/03/10; )
- The list of participants in Countrywide’s VIP mortgage program continues to grow. According to more than 44,000 Countrywide documents subpoenaed by Representative Darrell Issa (R-CA), 153 VIP mortgages were extended to Fannie Mae employees and 20 were extended to Freddie Mac executives. Moreover, it appears that Countrywide processed 30 VIP mortgages for Senate staff or senators themselves, including 12 loans processed by borrowers, who identified the office of Senator Bob Bennett (R-UT), as their place of employment. Issa, ranking member of the House Committee on Oversight and Governmental Reform, is demanding a

panel review of Countrywide's VIP mortgage program. Issa also said he was sending the information to the Senate Ethics panel, because his House committee doesn't investigate ethics matters involving the Senate. (*New York Post*, Stephen B. Meister, 07/27/10; *Politico*, Manu Raju, 07/15/10; *Wall Street Journal*, John R. Emshwiller, 07/15/10)

#### E-mortgage penetration expected to hit 50% in two years

- According to Xerox Mortgage Services' (XMS) survey, members of the mortgage industry expect e-Mortgages to comprise 50% of the market in two years. "The industry does see us getting closer," said XMS vice president Greg Smith. "The population is clearly seeing progress toward e-mortgage adoption or believing that it's going to happen." (*National Mortgage News*, Bonnie Sinnock, 08/05/10)
- Genpact Ltd of Bermuda has been awarded a seven-year contract to provide business process services to Merscorp, Inc., which runs the mortgage industry's electronic loan registry system. Today, Mers currently registers 60% of all newly originated mortgages. Beginning in December, Genpact will be responsible for managing the receipt, identification and delivery of mortgage-related correspondence on behalf of Mers' 2,500 members. It will be responsible for improving the quality and accuracy of the registry's processes and will manage the Mers help desk. (*American Banker*, Brian Collins, 08/06/10)

## ***Fannie Mae***

Fannie Mae's mortgage holdings grow at an annualized rate of 43.6% in May, as its mortgage delinquencies decline

- In June, Fannie Mae's Book of Business, Gross Mortgage Portfolio, Commitments to Purchase, Net and New Business Acquisitions include approximately \$19 billion in loans purchased from MBS trusts that were not reflected as liquidated from MBS until July 2010. Excluding these loan repurchases and the impact of May repurchases on the May book of business, the Total Book of Business compound annualized growth rate would have been (0.3%) for June 2010.
- Fannie Mae's serious delinquency rate fell 15 basis points to 5.15% in May, marking the year's low after rising to an all-time high of 5.59% in February. Analysts attribute the company's decline in delinquencies to (i) an increase in Fannie Mae's permanent loan modifications and (ii) the company's more aggressive pursuit of foreclosures. The company's serious delinquency rate for multi-family properties fell two basis points to 0.76% in May. Fannie Mae's effective duration gap was zero

months in June compared to -2 months in May. (*Reuters*, 07/30/10; *Monthly Volume Summary*, Fannie Mae, June 2010; *Calculated Risk*, 06/30/10)

Fannie Mae whistleblower alleges Fannie Mae focused on short-term incentive HAMP payments
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- Fannie Mae executives bungled their stewardship of Treasury’s massive foreclosure-prevention campaign, creating a bureaucratic muddle characterized by mismanagement and gross waste of public funds,” claimed Caroline Herron, a former Fannie Mae executive and consultant in a whistleblower lawsuit filed in June. Herron, who served as vice president for the company from 2000 to 2007, returned to Fannie Mae in 2009 as a high-level consultant, responsible for helping the GSE coordinate with Treasury the Home Affordable Modification Program. Herron claims that Fannie Mae’s HAMP effort was marred by delays, missteps and executives preoccupied with their institution’s short-term financial interests. “It appeared that Fannie Mae officers were focused on maximizing incentive payments available to Fannie Mae under various federal programs – even if this meant wasting taxpayer money and delaying the implementation of high-priority Treasury programs,” said Herron in her lawsuit.
- Herron alleges that Fannie Mae officials terminated her \$200-an-hour consulting work in January because she raised questions about how it was administering the HAMP. Herron contends that she raised concerns about how Fannie was administering HAMP with her immediate managers, but was roundly ignored. In retaliation, Herron claims her superiors sabotaged her pending position at Treasury and fired her in January, according to the lawsuit. Fannie never explained to Herron why she was being dismissed and barred her managers and other Fannie employees from divulging details regarding her firing, she claims.
- Representative Spencer Bachus (R-AL), minority leader of the House Financial Services Committee, asked Chairman Barney Frank (D-MA) to hold a hearing to investigate Herron’s allegations. “If true, it would help explain why HAMP has been such a failure,” said Bachus. “It would mean that thanks to Fannie Mae’s executives’ misfeasance, particularly a preoccupation with short-term financial gain, HAMP was only able to permanently modify about 230,000 mortgages, instead of the 3 million modifications that the Obama Administration promised.” .
- Fannie Mae spokeswoman Janis Smith said the company was notified in early March of Herron’s allegations and subsequently had an independent investigation conducted by Michael Bromwich, a former inspector general at the Justice Department. Bromwich “found no merit to her allegations,” said Smith.
- Treasury spokesman Mark Paustenbach said his agency “remains confident in Fannie Mae” as HAMP’s administrator. (*Reuters*, Corbett B. Daly and Christopher Doering, 08/06/10; *Center for Public Integrity*, Michael Hudson, 08/06/10)

## Fannie Mae to prohibit lenders from changing appraisals

- Effective September 1, Fannie Mae is prohibiting its lenders from changing appraisers' numbers. According to a June 30 guidance, Fannie Mae said lenders must contact appraisers to resolve any disagreements about the appraisal. If an agreement can't be reached, the lender must order a second appraisal, rather than reduce the value, based upon an electronic model, to support the real estate contract. (*Los Angeles Times*, Kenneth R. Harney, 07/18/10)
- Separately, Fannie Mae announced new policies that will provide struggling borrowers who face "unique hardships" more flexibility in making their payments effective August 1. Under the guidance, Fannie Mae will allow borrowers to skip up to six months of payments if a spouse is injured or killed in military duty or if they're forced to vacate a home to replace defective dry wall. Borrowers must obtain written permission from the servicer to skip their mortgage payments, by offering details on their hardships and providing supporting documentation or bills. The GSE has also instructed the loan servicer to inform the credit rating agencies that the borrower is not delinquent. (*New York Times*, Bob Tedeschi, 07/31/10)

There's a "new realism" in today's housing market, says Fannie Mae CEO Michael J. Williams

- In a July 28 speech at the Women in Housing and Finance Luncheon, Fannie Mae CEO Michael J. Williams expressed cautious optimism about Fannie Mae and the mortgage industry, noting that he's seeing a "new realism" in today's U.S. housing market—among borrowers, lenders and everyone with a stake in the future. Fannie Mae is putting together a new foundation for the industry, based upon the right lending standards and a broad re-examination of what constitutes sensible risk. To support a healthy housing market, Fannie Mae has strengthened its lending standards. Fannie Mae is demanding better credit quality, better and more complete documentation and more accurate appraisals. As a result, Fannie Mae's new book of business has some of the highest quality loans it's seen in the last decade with loan-to-value ratios of nearly 70% and average credit scores of 760 (and a median score of about 712) with more than 90% of the book "plain, old-school" fixed rate mortgages and *zero* subprime loans. In addition, Fannie Mae provided financing to more than 1.7 million low- and moderate-income families and more than 1 million families living in underserved communities last year. "New realism doesn't mean turning our backs on the families who need us," said Williams.
- Today, Fannie Mae is the number-one supplier of housing funds for the U.S., having supplied more than \$1 trillion in liquidity to the mortgage market through purchases and loan guarantees of both single-family and multifamily loans over the past two years, said Williams. "I believe the greatest contribution that Fannie Mae can make

is to stay focused on the job we have to do—and do it well [while policymakers determine the future of the housing market and Fannie’s role in it], he added.  
(*Prepared remarks at the Women in Housing and Finance Luncheon*, Michael J. Williams, 07/28/10)

Fannie Mae’s “Affordable Advantage” mortgage pilot with the \$1,000 down payment

- Through a pilot program called Affordable Advantage, Fannie Mae is offering affordable mortgages with minimum down payments of \$1,000 and no private mortgage insurance required. Thus far, state housing finance agencies (HFAs) in Massachusetts, Wisconsin and Idaho have adopted the program, which was designed to replace the HFAs’ tax free bonds, whose market demand collapsed during the financial crisis. Under this program, Fannie Mae has agreed to purchase these small down payment mortgages for homebuyers who have excellent employment history and credit, but merely lack a down payment. Participating HFAs have agreed to buy back delinquent loans made through the Affordable Advantage Program, in lieu of Fannie requiring traditional mortgage insurance. “[The program] was created to support state HFAs and their efforts to provide qualified first-time homebuyers with financing in the wake of the housing and economic downturn,” said Fannie Mae spokeswoman Janis Smith.
- However, some industry experts voice concerns about the problems intrinsic with buying a home with almost no money down. “Haven’t they noticed what’s happened to the country in the past five years?” asked Dean Baker, co-director of the Center for Economic and Policy Research. “You’re not necessarily helping if you’re helping them buy a home where they’re in the position they won’t be able to afford it. I don’t understand the logic of this. House prices are still going to fall. And when they do, we haven’t helped these people who are going to have to work like crazy to pay their mortgage off, or they’re going to default. If you’re in a situation where this is the only mortgage you can get, you shouldn’t be buying a house.”  
(*Washington Independent*, Annie Lowrey, 08/05/10)

Fannie Mae launches a new on-line education website for distressed borrowers

- On August 3, Fannie Mae launched a borrower outreach website, designed to educate distressed borrowers on potential retention strategies and foreclosure alternatives. The KnowYourOwnOptions.com website, available in English and Spanish, provides the borrower financial checklists, a contact log for loan servicers and calculators to demonstrate the mechanics of refinance, repayment and forbearance and modification options. (*HousingWire*, Diana Golobay, 08/03/10)

## Fannie Mae opens Mortgage Help Centers in Chicago and Atlanta

- Fannie Mae has opened new mortgage help centers in Chicago and Atlanta to provide counseling and other services for struggling homeowners with loans owned by the enterprise. In a partnership with Neighborhood Housing Services of Chicago, major mortgage servicers, and civic and community leaders from across the region, Fannie Mae has opened the Chicago help center to facilitate borrowers meeting directly with dedicated, on-site English- and Spanish-speaking staff and experienced housing counselors to discuss their mortgage situation. Similarly, Fannie is partnering with The D&E Group, A Financial Education and Training Institute, major mortgage servicers, and community and civic leaders from across the Atlanta metropolitan area to operate Atlanta's new mortgage help center.
- "Struggling homeowners should know that free help is available to them and experienced housing counselors are on-hand to help them navigate through the process," said Jeff Hayward, Fannie Mae's SVP, National Servicing Organization. "Fannie Mae's help center in Chicago [and Atlanta are] part of our broad effort to reach distressed borrowers, connect them with the resources they need to find alternatives to foreclosure and find the best resolution for their particular circumstances." (*Fannie Mae Press Release*, 08/10/10; *Fannie Mae Press Release*, 07/29/10)

## **Freddie Mac**

### Freddie Mac's continues its "low growth mode"

- In June, Freddie Mac's mortgage portfolio shrank by an annualized 13.8 % to \$739.5 billion, while its serious delinquencies declined slightly. "We have been in a low-growth mode in our retained portfolio for much of this year, with most of the growth in portfolio related to purchase of seriously delinquent loans from pools backing our PC securities," said Freddie Mac spokesman Michael Cosgrove.
- In June, Freddie's single-family delinquencies have eased from its peak of 4.20% to 3.96%, while the company's serious delinquencies for multifamily properties decreased 4 basis points in June to 0.28%. "Since we include loans in the HAMP trail period as delinquent in our statistical reporting, this results in a temporary rise in our delinquency rate until the modifications become effective and are removed from delinquent status," added Cosgrove. (*Monthly Volume Summary*, Freddie Mac, May 2010; *Reuters*, Lynn Adler, 07/23/10)

Freddie Mac names Jerry Weis to serve as its chief administrative officer and Deborah Jenkins to as its national head of multifamily underwriting and credit

- Freddie Mac has named a company insider, Jerry Weiss, to its newly created position of chief administrative officer. Weiss, who currently manages the company's regulatory affairs and serves as the company's liaison to FHFA and Treasury, will take on the tasks of managing external relations and human resources and be responsible for overseeing the company's activities in relation to and compliance with the federal Making Home Affordable Program. (*Freddie Mac Press Release, 08/02/10*)
- On July 23, Freddie Mac named Deborah Jenkins to serve as vice president and national head of the company's multifamily underwriting and credit. Prior to this promotion, Jenkins served as national underwriting and quality control director of Freddie Mac's multifamily underwriting and credit department. Before joining Freddie Mac in March 2008, she was senior vice president and senior underwriter with Wells Fargo. (*LoanSafe.org, 07/23/10*)

## ***Federal Home Loan Banks***

FHLB System reports 71% decline in earnings for the second quarter relative to same period last year

- The FHLB System reported net income of \$326 million for the second quarter, a 71% decline from the same period last year. The System's lower profitability was attributable to a decline in net interest income after provision for credit losses, net losses on derivatives and hedging activities, and an increase in credit-related OTTI charges. Two of the 12 FHLBs reported losses in the second quarter—the FHLB-Indianapolis (\$13 million loss) and FHLB-Pittsburgh (\$68 million loss)—which were primarily due to credit-related OTTI charges for PLS securities. During the second quarter, the FHLBs recognized \$495 million of credit related OTTI charges on certain private-label mortgage-backed securities. (*FHLBanks Office of Finance Press Release, 07/30/10*)

Self-Help Ventures Fund is first CDFI loan fund member to join a FHLB

- FHLB-Atlanta announced that Self-Help Ventures Fund, a financing affiliate of the Center for Community Self-Help, has become the Bank's first Community Development Financial Institution (CDFI) loan fund member, and the first CDFI-affiliated organization to join a FHLB.

- In January 2010, the FHFA implemented provisions of the Housing and Economic Recovery Act of 2008 (HERA) that permitted qualifying CDFIs to become members of a FHLB.
- “FHLBank Atlanta is pleased to welcome Self-Help Ventures Fund as a new member under the recently-implemented provisions of HERA,” said Jill Spencer, interim president and CEO of the FHLB-Atlanta. “This is an important milestone for FHLB-Atlanta and the FHLBs, and will allow us to broaden our community and economic development support efforts.”
- “It is an honor for Self-Help Ventures Fund to become the first CDFI loan fund member of the Federal Home Loan Bank System,” said Martin D. Eakes, CEO of the Center for Community Self-Help. “We have worked for more than ten years to make this partnership possible, and together with the FHLB-Atlanta, we believe we can provide the financing that will enable thousands of well-qualified homeowners to buy their first homes.” (*FHLB-Atlanta Press Release, 08/05/10*)

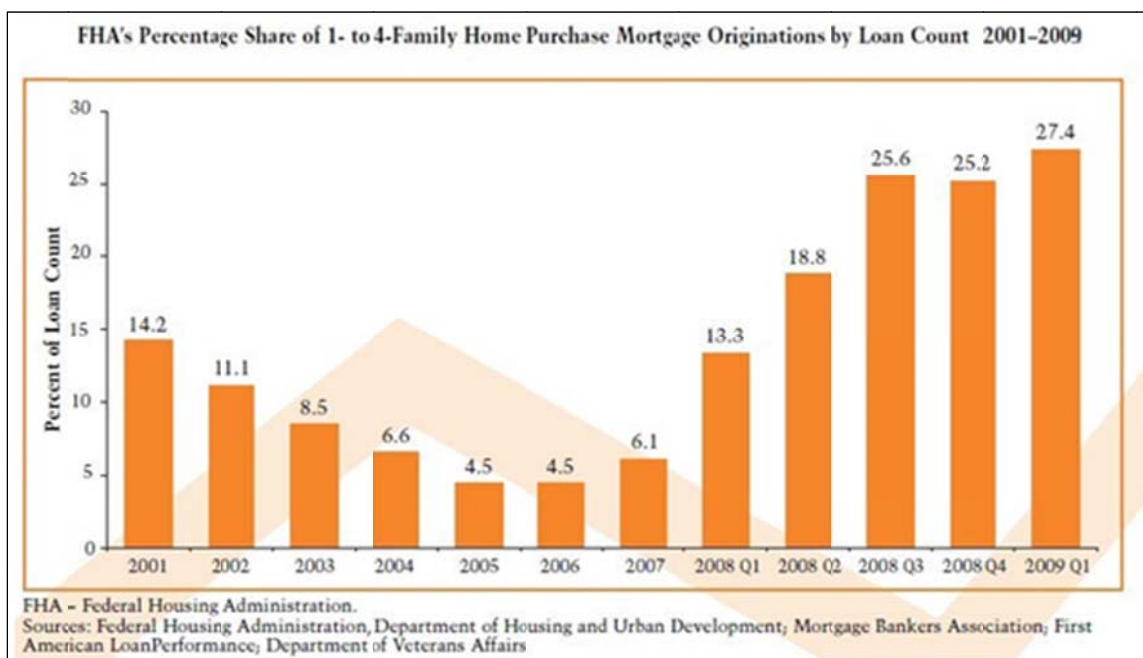
## ***Ginnie Mae***

FHA’s financial health improved in 2010, says HUD Secretary Donovan
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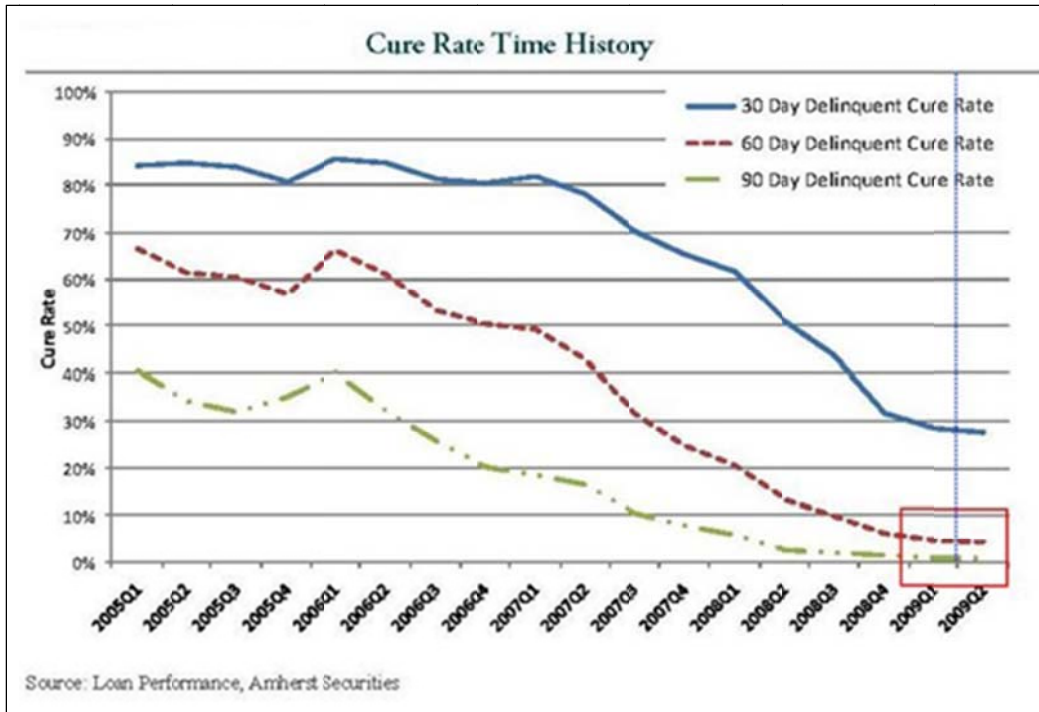
- The Senate approved bills to raise the FHA’s multifamily commitment authority (H.R. 5872) and allow the agency to increase its annual premiums for its single-family program (H.R. 5981). Specifically, H.R. 5981 would raise FHA’s statutory cap rate to 1.55% from 0.55%, providing the agency the ability to generate an estimated \$300 million of additional insurance premiums per month for FHA’s Mutual Mortgage Insurance Fund, according to FHA Commissioner David Stevens.
- “While premium increases are never ideal, this bill was necessary to help improve the strength and stability of FHA’s single family programs,” said MBA chairman Robert Story Jr. “We are encouraged that FHA Commissioner Stevens has indicated he may not need to raise premiums to the maximum, and we believe that that a small increase in the annual premium, coupled with a decrease in FHA’s upfront premium [calculated in below chart from the FHA], will help stabilize FHA while lowering closing costs for many borrowers.”
- “I thank Congress for giving FHA the flexibility to adjust its annual premium at a time when our reserves are perilously low,” said Stevens. “With this authority, FHA is in a better position to address the increased demands of the marketplace and return the MMI fund to its congressionally mandated level without disruption to the

housing market.” Stevens concluded, “While we appreciate and applaud this recent action, there is still work to be done. HUD remains steadfast in its commitment to comprehensive FHA reform legislation, similar to the FHA Reform Act passed earlier this year by the House, which would further enhance FHA’s lender enforcement capabilities and risk management efforts.” (*HousingWire*, Diana Golobay, 08/05/10)

- As of June 2010, the FHA had 6.4 million insured loans in force, totaling \$865 billion. During FY2008-2009, FHA insured 3.5 million loans, representing approximately 55% of its insured portfolio on June 30. At the agency’s current rate of insured loan originations, FHA’s total of insured loans in force will exceed \$1 trillion within six months.



- According to Loan Performance, the cure rate for delinquent mortgages (in its massive loan database) has plunged to roughly 1%--meaning 99% of seriously delinquent mortgages are headed for default and then either foreclosure or short sale.



- According to FHA Commissioner Steven’s March 11 testimony before the House Financial Services Committee, 6.2% of the FHA’s insured loan portfolio (approximately 360,000 loans) had been issued to homebuyers with FICO scores below 500. In February 2010, 31.1% of the FHA-insured loans with FICO scores below 500 were seriously delinquent 90 days or more.
- Currently, FHA has 555,000 FHA-insured homes that are delinquent 90 days or more—a figure has been rising steadily for three years. Considering the rate at which FHA mortgages are now becoming delinquent, it’s likely that more than 700,000 FHA-insured mortgages will be seriously delinquent within 12 months. Moreover, a large percentage of these seriously delinquent loans will be headed to default and added to the agency’s current REO inventory of 44,000 homes. (*SeekingAlpha.com*, Keith Jurow, Ph.D., 08/09/10)

HUD introduces the FHA Short Refinance program to help underwater borrowers

- On August 6, HUD has announced changes to its refinance program that will provide refinancing options for homeowners who owe more than their home is worth. Starting September 7, 2010, FHA will offer certain “underwater” non-FHA borrowers, who are current on their existing mortgage and whose lenders agree to write off at least 10% of the unpaid principal balance of the first mortgage, the opportunity to qualify for a new FHA-insured mortgage through the “FHA Short Refinance” program. This new program, along with FHA’s other loan options, will help the Administration meet its goal of stabilizing housing markets by offering a

second chance to up to 3 to 4 million struggling homeowners through the end of 2012.

- Participation in the FHA Short Refinance program is voluntary and requires the consent of all lien holders. To be eligible for this program, the homeowner must owe more on their mortgage than their home is worth and be current on their existing mortgage. The homeowner must qualify for the new loan under standard FHA underwriting requirements and have a credit score equal to or greater than 500. The property must be the homeowner's primary residence. And the borrower's existing first lien holder must agree to write off at least 10% of their unpaid principal balance, bringing that borrower's combined loan-to-value ratio to no greater than 115%. In addition, the existing loan to be refinanced must not be an FHA-insured loan, and the refinanced FHA-insured first mortgage must have a loan-to-value ratio of no more than 97.75 percent. To facilitate the refinancing under this program, Treasury will provide incentives to existing second lien holders who agree to full or partial extinguishment of the liens.
- "We're throwing a life line out to those families who are current on their mortgage and are experiencing financial hardships because property values in their community have declined," said FHA Commissioner David H. Stevens. "This is another tool to help overcome the negative equity problem facing many responsible homeowners who are looking to refinance into a safer, more secure mortgage product." (*HUD Press Release*, 08/07/10)

FHA begins the process to tighten its loan underwriting requirements
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- FHA has begun the rule making process to address tightening its loan underwriting requirements with an eye toward reducing mortgage defaults and losses to its insurance fund. Specifically, the agency published in July a notice in the Federal Register, seeking public comments on cutting sellers concessions in half—from 6% to 3%-and increasing the borrower's down payment requirement from 3.5% to 10% for borrowers with less than a 580 credit score. FHA also plans to tighten its loan underwriting standards for manually written mortgages. "These are the latest in a series of changes to allow FHA to manage its risk better while continuing to support the nation's housing recovery," said FHA commissioner Stevens. (*National Mortgage News*, Brian Collins, 07/23/10)
- Effective September 7, FHA's maximum loan-to-value ratio will fall to 97.85%, eliminating the "unlimited" CLTV ratio that the agency first introduced in 2007 to allow lenders to refinance struggling subprime borrowers. To help underwater borrowers, the new policy exempts conventional borrowers, who refinance under the FHA Short Refinance program with a maximum CLTV of 115%, and FHA borrowers, who refinance under the streamline refinance program with a maximum CLTV of 125%. (*National Mortgage News*, 08/09/10)

## FHA's financial health appears to have improved in 2010

- A new report from FHA indicates that the financial condition of its mutual mortgage insurance fund (MMI) may not be as dire as originally estimated due to “less severe” delinquency rates and proactive actions taken by the agency to minimize claims. On June 30, the total capital resources of FHA’s MMI rose to \$33.1 billion from \$32.2 billion at the end of March, reflecting a lower dollar amount and number of mortgage claims so far in fiscal year 2010 relative to the last independent actuarial study. FHA received 13,310 fewer insurance claims and paid \$3.7 billion less so far in FY2010 than was projected by the actuarial review. FHA chief risk officer Bob Ryan attributed the lower claims to (i) stability in housing prices, (ii) a decline in the number of new 90-day delinquencies; (iii) an attempt by FHA servicers to pursue loss mitigation efforts; and (iv) delays in processing foreclosures in states that have large numbers of foreclosures. The report did not, however, update FHA’s excess cash reserve, which on September 30 was approximately \$3.6 billion or approximately 0.53% of all FHA-insured mortgages.
- Ryan noted that the quality of the FHA portfolio has improved, as a result of credit restrictions in the conventional market and FHA’s new underwriting standards. As a result, the average credit score of new FHA endorsements has risen from 634 in 2007 to nearly 700 in 2010. However, the FHA report cautioned that the improvements in FHA’s MMI could be reversed if housing prices continue to decline. (*HousingWire*, Diana Golobay, 08/02/10; *Bureau of National Affairs*, Mike Ferullo, 08/05/10; *Washington Post*, Dina ElBoghdady, 08/04/10)

## ***Farm Credit System / Farmer Mac***

### Farm Credit System survives untouched by the Dodd Frank Act

- The Dodd Frank Act, the sweeping financial services reform package that won final congressional approval, will reshape the way banks conduct business—*unless* your institution is a part of the Farm Credit System. Buried deep in the 2,000+ page legislation is a provision written by the Senate Agriculture Committee which gives special treatment to the FCS and allows the System to keep its own regulator, the Farm Credit Administration.
- In the July *Farm Credit Watch*, Bert Ely wrote, “Perhaps the most important provision for the FCS is a complete exemption from the rules and enforcement powers of the new Bureau of Consumer Financial Protection. ... The FCA/FCS exemption from the regulatory reach of the BCFP certainly applies to the FCS’s \$5 billion in rural residential real estate loans outstanding at the end of 2009. An

inference from a statement of congressional intent appended to the Act is that FCS institutions could be exempt from the Truth in Lending Act (TILA), the Equal Credit Opportunity Act, and the Real Estate Settlement Procedures Act (RESPA). Additionally, the FCS will be exempt from the BCFP's 'authority to regulate unfair, deceptive, and abusive practices and consumer products that it identifies [as such]' and from BCFP regulations 'relating to disclosures about consumer financial products and services.' ...Even though the FCS required a taxpayer bailout in 1987, following its reckless lending in the 1970s and early 1980s, the Act exempts the FCS from systemic risk regulation by the new Financial Stability Oversight Council (FSOC)."

- Ely continued, "...Especially troubling is the potential for an exemption of all FCS institutions from derivatives regulation by the Commodity Futures Trading Commission (CFTC). While the Act authorizes the CFTC to exempt financial institutions with less than \$10 billion of assets from CFTC regulation of derivatives, a discussion on the floor of the House of Representatives strongly suggested that that \$10 billion limit was not binding with regard to FCS institutions. Instead, according to that discussion, that \$10 billion number 'should not in any way be viewed by the [CFTC] as a limit on the size of the institution that should be considered for an exemption.' Translation: The CFTC is encouraged to exempt even the largest FCS institutions from its regulation of derivatives activities, leaving that job to the FCA. At March 31, 2010, all five FCS banks and two FCS associations each had more than \$10 billion of assets, with AgriBank the largest, at \$65 billion."
- Ely said providing carve-outs for the Farm Credit System is popular with lawmakers because, unlike farm subsidies, the federal government doesn't have to pay directly for the benefits. "The ag committees see the Farm Credit System as a way to help farmers without hurting the budget (deficit)," said Ely.
- The *Houston Chronicle* also noted, "But there's something in it for the legislators, too. The PAC for the Farm Credit Council, the lobbying arm of the Farm Credit System, has spent more than \$500,000 on congressional campaigns for the 2010 election cycle, more than any other agricultural services lobby, according to the nonpartisan Center for Responsive Politics. The Farm Credit Council has donated to 14 of the 21 senators who sit on the Senate Agriculture Committee, including its chair, Blanche Lincoln, D-Ark., and its top Republican, Saxby Chambliss of Georgia."
- "The Senate Agriculture Committee prevailed when the Senate and House met to write the final version of the reform bill. Of the 11 senators who sat on the conference committee that wrote the final bill, four were from the Senate panel, including Lincoln and Chambliss. Michael Stokke, director of the Office of Congressional and Public Affairs at the Farm Credit Administration, said the relationship between the Farm Credit System and the agriculture panels was 'positive and appropriate.'" (*Houston Chronicle*, Spencer Gaffney, 07/17/10; *Farm Credit Watch*, Bert Ely, July 2010)

- In a July 12 speech to the AgFirst FCB Annual Meeting, Leland A. Strom, chairman of FCA, said, “...During the past several months, we had productive meetings with Treasury and with key staff on the House and Senate Agriculture Committees to discuss how the proposed [Dodd-Frank] bill would affect the Farm Credit Administration, the System as a whole, and Farmer Mac. I’m glad that Congress addressed this difficult issue, and I believe the final bill resulted in an appropriate framework for the System. It keeps intact the current regulatory structure and ensures that FCA can continue to appropriately oversee the System and keep it safe and sound.”
- Strom cautioned, “However, there are still challenges ahead, as Congress will address the 2012 Farm Bill and take up GSE Reform. As Congress looks to determine the future of Fannie Mae and Freddie Mac, the impact on all GSE’s could be significant. The System should also be prepared for additional scrutiny as that process unfolds.” *(Prepared remarks at the AgFirst FCB Annual Meeting, Leland A. Strom, 07/12/10)*

Farm Credit System reports 29% increase in earnings for the second quarter
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- The Farm Credit System reported second quarter net earnings of \$882 million, up 29% for same period a year ago. The FCS, which holds more than a third of the U.S. farm debt, said its second quarter earnings reflected higher net interest income and decreases in the provision for loan losses and net noninterest expenses. Net interest income increased \$102 million to \$1.429 billion, while loan loss provisions and noninterest expenses declined \$83 million and \$19 million, respectively. According to the FCS, the rise in net interest income “resulted from increases in the system’s net interest spread driven by overall market conditions.”
- FCS’s provisions for loan losses at the end of the quarter totaled \$145 million, down more than 36% from the year ago period (\$228 million). During the second quarter, nonaccrual loans increased \$6 million to \$3.523 billion and nonperforming loans increased \$34 million to \$3.750 billion. On June 20, nonperforming loans represented nearly 2.49% of FCS loans—up 20 basis points from year-end 2009 (2.29%). *(Reuters, Christine Stebbins, 08/02/10)*

At year-end 2009, one FCA member had invested \$1.24 billion in rural housing mortgage securities
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- According to the Farm Credit Administration’s 2009 Annual Report, “During 2009, three Farm Credit banks continued to be authorized to purchase and hold RHMS under a pilot program. RHMS must be fully guaranteed by a Government agency or another GSE. The rural housing loans backing the RHMS must be conforming, first-lien residential mortgage loans originated by non-System lenders in “rural areas” (as defined by the Farm Security and Rural Investment Act of 2002). These pilot programs are expected to provide additional liquidity for rural housing loans by

providing economic incentives to lenders to create RHMS for sale in the secondary market. In turn, these programs should create more cost-effective credit for rural homeowners. As of December 31, 2009, only one of the Farm Credit banks was participating in this program; it had \$1.24 billion in RHMS classified as held to maturity.” (2009 Annual Report, Farm Credit Administration, 06/30/10)

- The Department of Agriculture’s Section 502 Rural Housing Single-Family Housing Guaranteed Loan Program, which was discontinued in May after exhausting its existing funding of \$13.1 billion, received an additional \$40 million of stimulus money from the Department of Agriculture. The Section 502 Program provides 30-year mortgages primarily to low-income families to purchase or renovate homes they already own with no-down payment. (*HousingWire*, Christine Ricciardi, 07/29/10; [www.digtriad.com](http://www.digtriad.com), Matt McKinney, 07/26/10)

#### Downturn in ethanol industry reflected in Farm Credit System’s NPAs and charge-offs

- On December 31, the Farm Credit System’s loan commitments to the biofuel industry—primarily ethanol—totaled \$3.6 billion, down 20% percent from a year earlier. Of the System’s \$4.5 billion of outstanding loan commitments on December 31, 2008, System institutions had funded \$2.5 billion at year-end 2009. The decline in the System’s loan activity reflected the distressed conditions in the sector, as firms filed for bankruptcy or idled their plants during the year.
- The System’s nonperforming loans to the ethanol industry rose significantly before declining in late 2009. System loans not accruing interest totaled \$370 million on December 31, while charge-offs totaled \$142 million for the year, representing 4.8% percent of the loans outstanding to the biofuel industry in January 1, 2009. According to FCA’s 2009 Annual Report, “Biofuel loans outstanding at year end 2009 were less than 9[%] of capital and less than 2[%] of total loan volume, both relatively small numbers when compared to the System’s exposure to other industries or commodities. Furthermore, both losses and nonaccrual assets were concentrated in a few firms. A key risk for the FCS is the dependency of the biofuels industry on Government policy and support, including tax credits, protection from imports, loan guarantees, and Government grants. To reduce its risk exposure, the System has originated and participated out a significant amount of debt to non-System lenders.” (2009 Annual Report, Farm Credit Administration, 06/30/10)

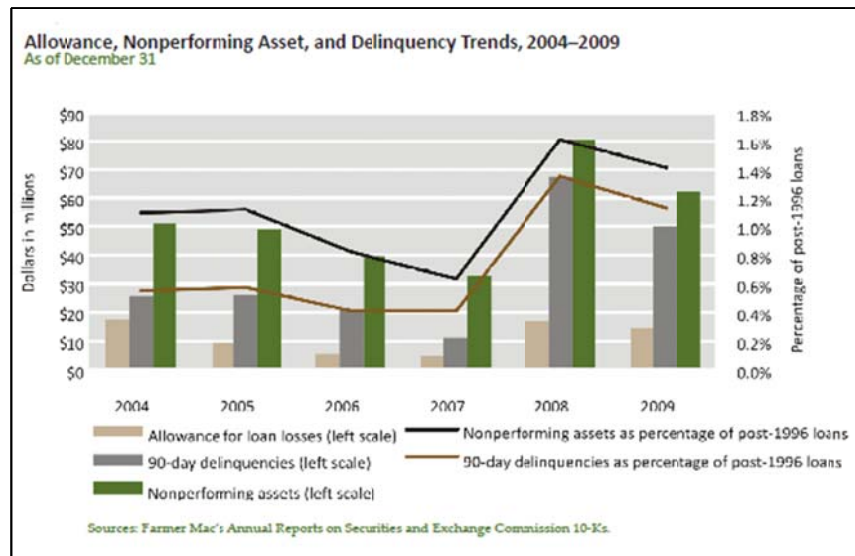
#### Farmer Mac reports 1.5% capital coverage at year-end 2009

- Farmer Mac reported equity capital of \$163.2 million on December 31, 2009, compared to \$15.3 million at year-end 2008. The agency’s increase in capital is attributable primarily to (i) \$80.3 million of retained earnings; (ii) \$50.7 million of other comprehensive income from unrealized gains on investment securities and

Farmer Mac Guaranteed Securities classified as available-for-sale; and (iii) the issuance of \$48.4 million of Farmer Mac’s Series C Preferred Stock during FY2009. The agency’s capital coverage, which includes off-balance program assets, was 1.5% on December 31, 2009. Farmer Mac exceeded its regulatory capital requirement of \$35.9 billion by \$120.2 billion—or 55.4%--at yearend 2009.

- On December 31, 2009, Farmer Mac reported nonperforming loans of \$62.0 million, representing 1.41% of all loans purchased, guaranteed, or committed to be purchased—down 22.5% from NPAs totaling \$80.0 million from year-end 2008. The agency’s NPAs consisted of loans 90 days or more past due (\$49.5 million), in foreclosure, in bankruptcy, or real estate acquired by Farmer Mac through foreclosure (\$739,000). According to FCA’s 2009 Annual Report, “[39%] of the 90-day delinquencies [approximately \$23.2 million] in Farmer Mac’s portfolio were on ethanol loans.” Moreover, Farmer Mac’s \$8.5 million of charge-offs were largely driven by defaults in its ethanol portfolio. During much of 2009, ethanol margins were also under considerable pressure, because of the industry’s excess capacity and uncertainties

associated with pending government actions, driving the sector to struggle with low to negative margins during the year. (2009 Annual Report, Farm Credit Administration, 06/30/10)



“It’s time to end the excessive subsidies for corn ethanol”

- In a July 24 editorial, the *Washington Post* wrote, “When Washington starts handing out cash, it can be hard to stop. See, for example, the decades of subsidies the government has showered on the corn ethanol industry. The fuel was supposed to free America from its dependence on foreign oil and produce fewer carbon emissions in the process. It’s doing some of the former and little of the latter. But corn ethanol certainly doesn’t need the level of taxpayer support it’s been getting. Lawmakers are considering whether to renew these expensive subsidies; they shouldn’t.”

- “The feds give companies that combine corn ethanol with gasoline a 45-cent tax subsidy for every gallon of corn ethanol added to gasoline. That’s on top of a tariff on imported sugar cane ethanol from Brazil and federal mandates requiring that steadily increasing amounts of these biofuels be produced. The Congressional Budget Office this month estimated that, all told, the costs to taxpayers of replacing a gallon of gasoline with one of corn ethanol add up to \$1.78. The tax incentives alone cost the Treasury \$6 billion in 2009.”
- “How about the environmental benefits? The CBO calculates that it costs a huge \$750 to reduce annual carbon dioxide emissions by one ton using corn ethanol. And that figure relies on assumptions extremely favorable to the industry.”
- “Not only are these subsidies expensive, but they are redundant. Since Congress has mandated that the industry furnish a steadily increasing number of gallons of ethanol every year, the stimulative effects of the tax incentives on corn ethanol production will continue to diminish. Numbers from the Food and Agricultural Policy Research Institute at the University of Missouri, on which the CBO relies, show that over the next 10 years, corn ethanol production will still increase—just not quite as quickly—if Congress allows the subsidies to lapse this year and leaves the mandate in place.”
- “At this point, the question should not be whether to allow corn ethanol’s tax incentives and trade protections to expire. The debate should be about why corn ethanol deserves any federal protection at all. There are certainly more effective ways to reduce oil consumption and greenhouse emissions.” (*Washington Post*, 07/24/10)

## *Postal Service*

Postal Service reports \$3.5 billion loss for the third quarter
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- The USPS reported a \$3.5 billion loss in the third quarter of FY2010, caused largely by plummeting mail volume and rising retiree health care costs. During the period, the agency's operating revenue declined 1.8% to \$16 billion relative to same period last year, while operating expenses spiked 4.2% to \$19.5 billion.
- During the third quarter, the Postal Service's mail volume slipped 1.7% to 40.9 billion pieces. "A significant portion of USPS losses in the past few years has been due to an unprecedented decline in mail volume—down more than 20% since 2007," said the USPS in a statement. "The replacement of letter mail and business-transaction mail by electronic alternatives continues to cause downward pressure on mail volume."
- A provision of the 2006 Postal Reform Act, mandating a prepayment of retiree's benefits has exacerbated the USPS losses. USPS chief financial officer Joseph Corbett said the agency's required payment of \$5.5 billion due to the retiree fund on September 30 will threaten the agency's cash flow for the next fiscal year. "Given current trends, we will not be able to pay all 2011 obligations," Corbett said. "Despite ongoing aggressive cost reductions totaling over \$10 billion in the last three years, it is clear that a liquidity problem is looming and must be addressed through fundamental changes requiring legislation and changes to contracts."
- As a part of its cost cutting initiatives, the USPS has reduced total work hours by 63 million, or roughly 36,000 full-time employees, to help offset falling revenues related to declining mail volumes. Despite these efforts, the Postal Service has lost \$5.4 billion year-to-date in FY2010, 13% above the agency's losses for the same period last year.
- Earlier this year, the Postal Service estimated it will lose \$238 billion in the next 10 years if Congress doesn't permit the agency to revamp its outdated business model. "Securing the fiscal stability of the Postal Service will require continued efforts in all of these areas, as well as further review of retiree health benefit prefunding," said postmaster general John Potter. "It also will require that the Postal Service gain flexibility within the law to move toward five-day delivery, to adjust our network as needed, to develop new products the market demands, and to work with our unions to meet the challenges ahead." (*CNNMoney*, Hibah Yousuf, 08/05/10)

## Postal Service seeks 2-cent increase for first-class mail

- USPS has applied to the Postal Regulatory Commission, seeking a 4.6% increase in first-class postage of 2-cents, along with an 8% increase in periodicals, 23% increase for parcels under one pound and 7% increase for heavier parcels. While Express Mail and Priority Mail are excluded from the proposed rate increases, the USPS plans to announce higher rates for these products in October. The Postal Service projects these proposed rate increases would generate \$2.3 billion of revenues during the first nine months of 2011 to help off-set about 33% of the agency's projected \$7 billion deficit.
- In the filing, the Postal Service invoked a legal provision in the federal statutes, which allows for rate increases in excess of inflation in the event of "exceptional extraordinary" circumstances. Under the filing, the USPS' average rate increase would be 5.6%, well above the average inflation rate of 0.6%, said Stephen Kearney, a senior vice president with the agency. "We are doing this because the Postal Service really faces a serious risk of financial insolvency," said Kearney. "[The higher postal rate charges] will remain competitive, which shows you how underpriced they are now," Kearney added.
- The USPS filing is being challenged by a trade group Magazine Publishers of America (MPA) and mail order pharmacy supplier Medco Health Solutions. "The filing is unlawful," said James Cregan, MPA's executive vice president of government affairs. "It's bad economics and it's bad public policy." The USPS is abusing its emergency powers, added Cregan, arguing the agency first needs to cut its costs and improve its procedures.
- Ruth Goldway, chairman of the PRC said her panel will decide whether there is an emergency that would justify rate increases which exceed the rate of inflation. Lacking an emergency, the Commission can't approve the proposed increases, she added. "The mailers have already told us they're going to challenge that concept—that this economic recession is not an emergency," said Goldway. "There is no precedent for deciding that." (*Bloomberg News*, Todd Shields, 07/06/10)

## Giving away the store?

- The Postal Service's Inspector General contends that the USPS may have lost money on its 2009 "Summer Sale initiative, a program designed to encourage customers to increase their mail volumes and (hopefully) the agency's revenue. The IG wrote, "The Postal Service reported both volume and revenue increases resulting from the FY 2009 Summer Sale. However, the processes used to calculate the reported increases may result in misleading reported revenue and volume impacts. Postal Service outsiders — including the Postal Regulatory Commission's public representatives — have also questioned the Postal Service's methods for calculating

reported revenue and volume increases. The public representatives found that using methods more closely aligned with those initially considered by the PRC in approving the Summer Sale suggests the Postal Service may actually have lost money on the FY 2009 program.”

- The IG continued, “The Postal Service’s calculation of ‘loyalty growth’ considered trends in volume, whereas the PRC’s public representatives applied a measure of price sensitivity to volumes actually mailed during the Summer Sale to calculate ‘loyalty growth.’. As a result, the Postal Service provided \$67.8 million in rebates to customers who exceeded the established threshold volumes that may have been inaccurate. We consider the \$67.8 million to be assets at risk.” The IG also argued that the Postal Service may have also spent more than it reported on personnel costs to create the initiative. “The Postal Service attributed \$530,000 to the cost of having six full-time and 10 part-time employees working on the project for four months,” said the IG. “However, the actual amount of time these employees spent on the project far exceeded those estimates.”
- The Postal Service stands by its original numbers, which management believes generated some \$24 million of revenue. Tom Foti, manager of marketing mail at the USPS, argued that the 2009 Summer Sale was “a success for a number of reasons.” Foti added, “There are other people, such as the PRC’s public representative, who looked at other methodologies. We believe ours was the most appropriate for a short-term sale.”
- Given the program’s “success” last year, the USPS has launched its 2010 Summer Sale, scheduled to run from July 1 through September 30. The USPS said it expects to generate between 3.3 million and 1.1 billion new mail pieces through the initiative. In April, the Postal Regulatory Commission approved the 2010 Summer Sale after concluding that “offering new discounts under these circumstances represents a risk.” Even if the initiative were to result in a financial loss, program would be “unlikely to seriously worsen the financial situation of the Postal Service,” concluded the PRC. (*DMNews*, Frank Washkuch, 07/27/10)

“Privatize the post office”
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- In a July 13 editorial, *Appeal Democrat* (Maryville, CA) wrote, “The U.S. Postal Service has increased rates so often in recent years that they came out with the Forever Stamp, which is good for a first-class mailing into the indefinite future. On July 6, the USPS proposed another increase, a two-cent hike, to 46 cents, in 2011. That’s a 4 percent increase. Rates for other types of postage would increase a similar amount. After review by the Postal Regulatory Commission, the rate increases then must be approved by the Postal Service Board of Governors. The proposal comes on the heels of increases in 2006, 2007, 2008 and 2009. As recently as 2005, a first-class stamp cost only 37 cents. So if the 46-cent rate is approved, that would mean a 24 percent increase in just six years.”

- “Meanwhile, the Internet and text messaging on mobile devices continue to demolish the USPS’s mainstays of personal letters and bill-paying. According to a report by the Newspaper Association of America, USPS mail volume has declined 17 percent, or 36 billion pieces, in three years. Its deficit for fiscal 2010, which ends Sept. 20, is projected at \$7 billion. That means Congress would have to bail out the USPS with tax money.”
- “To deal with its problems, the USPS has proposed eliminating Saturday delivery, saving \$3 billion a year; although the PRC says the savings would be \$2 billion. The proposed stamp-rate increase would bring in an estimated \$2.3 billion for the first nine months of 2011.”
- ““Only with a government service would you increase prices and decrease customer service in the face of declining demand for your service,’ says Tad DeHaven, a federal budget analyst at the Cato Institute... What’s needed, he said, is competition—ending the USPS’s monopoly on first-class mail. UPS, FedEx and other services can compete on delivering packages, but not on first-class mail. ‘Other countries, especially in Europe, are starting to liberalize their postal services. In the United Kingdom, they’re selling shares in Royal Mail,’ that country’s postal service.”
- “He said there are two choices. First is subsidization by Congress, meaning taxpayers would be forced to underwrite a bloated government bureaucracy. The other choice is privatization, bringing to bear the efficiencies and innovation of the marketplace.”
- “We would add that USPS workers should not fear privatization. As with other businesses grappling with the information revolution, change will be difficult — but essential, and transforming.” (*Appeal Democrat*, 07/13/10)

USPS cuts its “energy intensity” by 21% through a multi-prong energy strategy
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- The USPS is more than 66% of the way toward reducing energy use by 2015, thanks to its green roofs, green buildings, energy efficient delivery fleet, and an energy management system that has fast tracked the agency to meet its energy reduction goals. According to *Greenbiz.com*, “An impressive component of the agency’s multi-pronged energy strategy is its green roof topping its Morgan mail processing facility ...[that] cover[s] nearly 2.5 acres.” This green facility will (i) reduce polluted storm runoff by 75% in the summer and 40% in the winter; (ii) reduce energy use on average by 15% [which is also attributable to the replacement of 1,600 windows and other energy-saving measures]. Moreover, the green roof will also pay dividends over the long run, since its life expectancy is 50 years—twice that of a traditional roof. On balance, the USPS said it has cut its “energy intensity” some 21% since 2003. (*Greenbiz.com*, 07/22/10)

## New stamp commemorates the Boy Scouts' 100<sup>th</sup> anniversary

- On July 27<sup>th</sup>, the USPS gave the Boy Scouts of America its stamp of approval with the issuance of the Scouting stamp, honoring the organization's 100<sup>th</sup> anniversary. The 44-cent "Celebrate Scouting" stamp, illustrated by Craig Frazier, depicts a backpacking Scout and a silhouette of a Scout overlooking the landscape.



- "I'm very proud to represent the United States Postal Service as we unveil the artwork for the scouting commemorative stamp to be released in 2010 and to recognize what scouting has done for boys and girls alike for more than 100 years," said USPS Sustainability Vice President, Samuel M. Pulcrano. "I learned a great many things from scouting when I was a boy, and many of those lessons came from my father who served as my assistant scoutmaster. The experience made such an impression on me that I now serve as assistant scoutmaster for my sons' troop."
- Robert Mazzuca, chief Scout executive of the Boy Scouts of America, said, "The postal service receives over 50,000 stamp proposals a year [and only 20 to 25 are selected]. Creating the Scouting stamp speaks volumes of the significance of Scouting in America." (*Richmond Times Dispatch*, Althea Fung, 07/28/10; *USPS Press Release*, 11/12/09; *Fox41.com*, 07/23/10)

## TVA

### Fourth Circuit Court of Appeals reverses lower court ruling on TVA's emissions

- A three judge panel of the Fourth Circuit Court of Appeals unanimously reversed a ruling by District Judge Lacy Thornburg, requiring TVA to promptly install upgraded emission controls at four coal-fired power plants. Thornburg had ordered TVA to accelerate the cleanup of its plants (for a cost of \$1 billion), ruling that emissions affecting air quality in North Carolina's scenic western mountains were a "public nuisance." The district judge's ruling concluded a decade long battle by the State of North Carolina, in which Attorney General Roy Cooper (D) spent \$7.7 million to clean up air emission, including pollution that blows in from adjacent states.

- A three-judge panel of the 4th U.S. Circuit Court of Appeals in Richmond overturned the ruling, arguing that allowing the common law claim to stand would undermine the nation’s carefully created regulatory scheme . In the 34-page decision, Judge J. Harvie Wilkinson wrote, “If allowed to stand, the injunction would encourage courts to use vague public nuisance standards to scuttle the nation’s carefully created system for accommodating the need for energy production and the need for clean air. The result would be a balkanization of clean air regulations and a confused patchwork of standards, to the detriment of industry and the environment alike. ...Energy policy cannot be set, and the environment cannot prosper in this way.”
- The TVA case has been closely watched by business groups, environmentalists, states and lawmakers, being viewed by many as a watershed case. Sixteen state attorneys general filed a friend-of-the-court briefs, urging the court to uphold the public nuisance claim, while the state AGs from Tennessee and Alabama filed briefs supporting TVA. The U.S. Chamber of Commerce, the National Association of Manufacturers, the American Petroleum Institute and the Utility Air Regulatory Group argued in another brief that allowing public nuisance claims would undermine the certainty provided by the Clean Air Act and other state regulations. The court’s ruling is a blow to environmentalists, who had hoped that common law would provide another means of battling pollution.
- North Carolina Attorney General Roy Cooper (D) has the option to request a rehearing by the circuit court, appeal the decision to the Supreme Court, or dropping the case. In a statement, Cooper said, “This ruling is disappointing but the fight for clean air is far from over. I’m pleased that the TVA is cleaning up the four plants cited in the order and I trust this will continue during the appeals process.”
- In a July 31 editorial, *The Charlotte Observer* wrote, “The court’s decision embracing an ineffective regulatory framework not only ignores how poorly it works, but also turns a deaf ear and blind eye to North Carolina’s admirable effort to clean the air for more than nine million citizens who live here.”
- “In the early part of this decade, the N.C. General Assembly spent several years fashioning the Clean Smokestacks Act to first clean up power plants here. The theory was that, having expended considerable time, effort and money to put our own house in order, the state would be in a better position to urge other states to clean up their emissions that wind up fouling the lungs of Tar Heel residents. Those who live in Western North Carolina can attest to how the unique topography there traps and worsens the effects of air pollution that moves into North Carolina from TVA’s coal-fired plants that produce harmful emissions. The court ruling ignoring the problem is discouraging. But it is, sadly, the kind of decision one can expect from a 13-member court that has only one judge from North Carolina, the circuit’s largest state.”

- “The Fourth Circuit was not interested in the practicalities of the N.C. fight against having to breathe TVA pollution. Instead it found far too much to like about a federal regulatory system that, from the N.C. point of view, is as inadequate in preventing bad air as the Fourth Circuit Court of Appeals is successful in producing hot air.” ([www.LegalNewsline.com](http://www.LegalNewsline.com), John O’Brien, 07/27/10; *New York Times*, Gabriel, 07/28/10; *Dow Jones Newswires*, 07/26/10; *Charlotte Observer*, 07/31/10; *Carolina Journal*, David N. Bass, 07/28/10)

Judge sets September 2011 trial date for ash spill suits against TVA
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- Lawsuits seeking damages from the TVA’s coal ash spill will go to trial on September 13, 2011 before U.S. District Judge Thomas Varlan in Knoxville, TN. Litigants are seeking restitution for damages related to a breach in TVA’s earthen dam in December 2008 sent 5.4 million cubic yards of toxic muck into the Emory River and onto surrounding landscape at TVA’s’ Kingston Plant in Roane County. Judge Varlan has dismissed lawsuits against TVA that were seeking punitive damages. (*Associated Press*, 07/15/10)

The <i>Knoxville News Sentinel</i> calls on Congress to “stop stalling” the confirmation of TVA’s new board members
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- In a July 25 editorial, the *Knoxville News Sentinel* wrote, “Even in normal times, the nine members of the Tennessee Valley Authority’s board of directors have plenty to keep them busy. The massive fly-ash spill into the Emory River from the Kingston Fossil Plant in December 2008 ensured that normal times for TVA are a thing of the past. The cleanup from that environmental disaster continues, with lawsuits pending and a federal decision on the regulation of fly ash looming.”
- “Thus, it is puzzling—’unconscionable’ might be a better term—that the U.S. Senate would allow the board of a major federal organization to limp along with almost half of its directors unconfirmed for their duties. The four individuals—all well qualified for their positions—have been approved by the Senate Environment and Public Works Committee. The nominees told the panel at their hearing in late February that they are committed to making certain the federal utility provides low cost, clean energy and indicated that will include a renewed emphasis on nuclear power.”
- “That was almost five months ago. Now the utility is heading toward its Aug. 20 meeting with only five of the board’s nine members able to conduct business. Five is the minimum needed for a quorum. One of those five is Howard Thraikill of Huntsville, Ala., whose term expired in May. President Barack Obama has yet to name his replacement, so Thraikill will remain on the board until the end of the year or until his successor is nominated and confirmed.”

- “The four nominees are Oak Ridge lawyer Neil McBride; Marilyn Brown, an energy policy expert from Atlanta who previously worked at Oak Ridge National Laboratory; Barbara Haskew, an economics professor from Chattanooga who managed TVA’s rate staff for eight years; and businessman William Sansom of Knoxville, who already has served one term on the board.”
- “The nominations are being held up by one or more senators under a secret process that allows a single senator to block a vote on a bill or nomination. No one in the Senate has claimed responsibility for what seems a clear misuse of power. More than likely, the hold on the nominations has little to do with TVA or the nominees but with Obama and the Democrats who hold a majority in the Senate.”
- “If Republican senators are responsible for the hold, as sources close to the confirmation process have said, it is more than a jab at Democrats. The idea of a nine member board was pushed by a Republican, Bill Frist of Tennessee, who was Senate majority leader at the time. The concept was to give the agency a board that would function more like a business instead of the three-member board that some claimed was too political. Apparently, removing the politics at the local end didn’t remove politics at the Washington end.”
- “The result at this point is that one or more senators are holding millions of TVA ratepayers over a barrel. Tennessee’s senators—Republicans Lamar Alexander and Bob Corker—should use their positions to move the nominations along to confirmation. (*Knoxville News Sentinel*, 07/25/10)

“Listen carefully, and you may detect a giant sucking sound across the rich world. ...[I]t comes from the tentacles of the state, reaching into more and more areas of business in an effort to get the economy moving. It is the sound of Leviathan Inc. Politicians are reviving the notion that intervening in individual industries and companies can drive growth and create jobs. ...[T]he rich world has a clear choice: learn from the mistakes of the past, or else watch Leviathan Inc. grow into a true monster.

*The Economist*, August 5, 2010  
<http://www.economist.com/node/16743343>

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