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The **GSE** REPORT™

Tracking the Government's Role in the Financial Services Industry

“In the end, I’d argue, what must happen is an effective default on a significant part of [the United States’] debt, one way or another. The default could be implicit, via a period of moderate inflation that reduces the real burden of debt; that’s how World War II cured the depression. Or, if not, we could see a gradual, painful process of individual defaults and bankruptcies, which ends up reducing overall debt. And that’s what is happening now: ...the main force behind the gratifying decline in consumer debt appears to be default rather than thrift. So basically, we can do this cleanly or we can do this ugly. And ugly is the way we’re going.”

Paul Krugman, “scholar of Depression economics”
September 25, 2010

Professor of Economics at Princeton University and the London School of Economics,
op-ed columnist for *The New York Times* and recipient of the 2008 Nobel Memorial Prize
in Economics

<http://krugman.blogs.nytimes.com/2010/09/25/default-is-in-our-stars/?pagemode=print>

“A key aspect of the current situation that concerns me is the growing evidence that we are in what economists call a “liquidity trap.” In a liquidity trap, the supply of savings continually outstrips the demand for investment, but interest rates near zero can’t fall to equate supply and demand. Liquidity traps are exceedingly rare. The last time the U.S. economy was in a liquidity trap was during the Great Depression, some 80 years ago.”

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago
Evanston Civic Leaders Breakfast
Evanston, Ill.
October 19, 2010

Table of Contents

Major Events	5
• The foreclosure crisis takes center stage:.....	5
• The Obama administration’s response to the foreclosure crisis	7
• Legal status of MERS is questioned	9
• Setting the stage for massive loan buybacks from investors?.....	12
• The cost of the foreclosure clean-up—anybody’s guess	13
• And the longer term impact... ..	15
• President signs a one-year extension of conforming loan limits	16
• President Obama selects Elizabeth Warren to serve as an advisor, responsible for setting up the Bureau of Consumer Financial Protection Bureau.....	16
• The President appoints Senator Ted Kaufman to serve as chairman of the Congressional Oversight Panel for TARP	19
• NCUA bails out wholesale credit unions with a \$30 billion federal guarantee.....	19
• Countrywide Financial’s former CEO Mozilo agrees to pay fines and restitutions totaling \$67.5 million to settle SEC charges of insider trading and fraud.....	20
TARP.....	21
• Treasury estimates cost of TARP of approximately \$50 billion---excluding the bailout costs of Fannie Mae and Freddie Mac	21
• The Congressional Oversight Panel concludes that TARP leaves behind an implicit federal government guarantee that “is proving difficult to unwind”	22
• AIG and Treasury announce agreement for repayment of the insurer’s bailout funds.....	25
• Auto industry sector: \$67.1 billion of TARP funds outstanding	28
• The question now is how successful will GM’s turnaround be in Dan Akerson’s hands, says former car czar Steve Rattner	28
• Effort fails to save 650 GM jobs at the Indianapolis stamping plant.....	30
• The Chrysler bailout was the administration’s “most debated decision,” according to former car czar Steve Rattner	30
• Citigroup reports \$2.15 billion earnings for the third quarter.....	31
• Treasury completes its third round of sales of Citi shares	32
• As TARP winds down, SIG-TARP plans to expand his staff and open four regional offices.....	32
• Small business lending fund created.....	33
• FDIC’s roundup: 132 bank failures in 2010 and 876 problem institutions	34
• FDIC may seek \$1 billion from failed-bank executives	35
• The next Armageddon.....	35
• QE2, magic bullets and economic realities.....	36
Fannie Mae and Freddie Mac.....	42
•	42
• Update on mortgage relief initiatives.....	43
• Despite mortgage modification efforts the housing market remains weak.....	46
• Blanket mortgage modification bill re-introduced by Representative Dennis Cardoza	49

• Congressional Oversight Panel criticizes Fannie Mae and Freddie Mac’s performance as TARP contractors	51
• Senate confirms new inspector general for FHFA after two year vacancy	53
• Chairman Frank to introduce GSE reform legislation during the lame-duck session	54
• Republicans’ Pledge with America proposes to privatize Fannie Mae and Freddie Mac	56
• Senator Johnson to move cautiously with housing finance reform	58
• “Cheap” talk for Fannie and Freddie	60
• GSEs’ government guarantee estimated to cost \$53 billion over the next decade	60
• Municipalities and businesses are seeking lawmakers’ help in fight to save the PACE program.....	60
Fannie Mae	61
• Fannie Mae’s retained mortgage portfolio declines at an annualized rate of 4.1% in August, as its mortgage delinquencies decline	61
• Fannie Mae adopts Appraiser Independence Requirements to replace HVCC	61
• Fannie Mae announces new incentives for HomePath properties	62
• Fannie Mae announces new assistance program for military homeowners.....	62
• Fannie Mae computer contractor convicted of computer sabotage and hacking offenses	62
• Fannie Mae alumni news	63
Freddie Mac	64
• Freddie Mac continues its “low growth mode”	64
• Forbearance is preferable to foreclosure, says Freddie Mac CEO Haldeman	64
• Harvard business professor Clayton Rose joins Freddie Mac’s board of directors....	65
• Freddie Mac to form Giant Mortgage Participation Certificates from PCs held in its retained mortgage portfolio.....	65
Federal Home Loan Banks	66
• Federal Home Loan Bank of Atlanta changes the valuation of single-family mortgages from unpaid principal balance to current market value.....	66
Ginnie Mae.....	66
• Lawmakers pressure FHA to raise its reserves quickly	66
• Fannie Mae discontinues its purchase of reverse mortgages	67
Farm Credit System / Farmer Mac	68
• Farm Credit System “mega-mergers in the works”	68
• Ag industry lobbies the CFTC for an exemption for FCS members from swaps clearing.....	69
• FCA amends the definition of “rural area” for Rural America Bonds and Agriculture and Rural Community Pilot Investment Programs	69
• Obama administration approves a 50% increase in ethanol blends.....	70

Postal Service	72
• Postal Regulatory Commission denies Postal Service’s rate increase request	72
• Rate hikes won’t help the Postal Service.....	73
• GOP lawmakers block Democrats move to postpone the payment of retirement benefits by the USPS	75
• Inspector General’s reports highlight “extremely troubling problems” at the USPS .	76
• The USPS is in crisis.....	77
• A sign of the times	78
• Election delayed after ballots are lost in the mail.....	78
TVA	79
• TVA’s four new board members are sworn in.....	79
• TVA receives “fair” rating on its environmental record from its IG.....	79
• Senator Bingaman calls for creation of a “green bank” to finance the development of clean energy technology	79
• Proposed Cap and Trade bill could “wreak havoc on the Tennessee economy” warns the Tennessee Center for Policy Research.....	80

Major Events

The foreclosure crisis takes center stage:

The Obama administration's response to the foreclosure crisis

Legal status of MERs is questioned

Setting the stage for massive loan buybacks from investors?

The cost of the foreclosure clean-up is anybody's guess

And the longer term impact...

The foreclosure crisis takes center stage:

- On September 17, GMAC Mortgage, the lending subsidiary of Ally Financial, announced it had suspended all foreclosures in the 23 states in which foreclosures must be approved by judges (judicial states). On September 20, GMAC confirmed that the reason for the foreclosure suspension was a “technical difficulty”—related to the use of “robo-signing” of court filed notices in which employees attested to information that they did not know to be true and improper notary signings (without a notary present). GMAC said these difficulties may result in the company needing “to take corrective action in connection with some foreclosures.” The company’s foreclosure suspension not only stopped pending foreclosures in the 23 states, but also stopped REO sales and eviction proceedings on eligible loans.
- Chase Mortgage and PNC announced that they faced similar issues and announced a suspension of foreclosure in the 23 judicial states. Bank of America followed suit, but announced a nationwide moratorium on foreclosures until the technical issues could be resolved. On October 18, Bank of America said it had completed a review of the Bank’s foreclosure procedures in the 23 judicial states and is restarting the process on 102,000 cases. According to a BofA spokeswoman, the Bank found no errors in their review and fewer than 30,000 foreclosure sales across all 50 states will be delayed as a result of the investigation.
- An estimated 1 million homeowners, who are behind on their mortgage payments, will benefit from the four banks’ foreclosure moratorium.
- On September 30, the OCC instructed the top 7 bank owned servicers—JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, HSBC, PNC, and US Bank—to examine their foreclosure processes and fix any problems that are identified. Subsequently, the OCC and FDIC have asked all banks to review their processes and resolve any issues, but have not requested their regulated institutions to suspend the

foreclosure process. Fannie Mae, Freddie Mac and the Federal Housing Finance Agency have asked mortgage servicers to perform similar reviews and resolve all problems promptly—or face financial penalties. Specifically, the GSEs notified servicers that they would be on the hook for any losses the enterprises suffer as a result of flaws in the foreclosure process. Neil Barofsky, special inspector general of TARP, has also launched an investigation into GMAC’s improper foreclosure procedures.

- Old Republic National Title Insurance said it would not write policies on foreclosed properties by GMAC or Chase until “the objectionable issues [related to the titles] have been resolved.” Separately, Fidelity National issued a statement saying it doesn’t believe that the problems with the foreclosure process would have a “material adverse impact.”
- Subsequently, attorneys general from all 50 states along with 39 state banking regulators have joined forces to conduct an investigation of mortgage servicers. In a joint statement, the group said they believe that the robo-signing of court documents in foreclosure cases “may constitute a deceptive act and/or unfair practice or otherwise violate state laws.” John Ryan, EVP of the Conference of State Bank Supervisors, said, “The foreclosure process in the various states is designed to ensure a basic level of due diligence and accountability occurs before taking an action that has dramatic implications for homeowners and communities. Our priority is to ascertain if violations of state law occurred, to reestablish confidence in the integrity of the foreclosure process and take appropriate action to protect the rights of consumers and homeowners affected.”
- Separately, Ohio and Maine have requested foreclosure moratoriums by all servicers, while Connecticut has requested that GMAC and Chase cease foreclosure actions. The California Attorney General, gubernatorial candidate Jerry Brown, has demanded that GMAC and Chase suspend their legal actions until they prove that they have complied with state law, requiring that lenders first attempt to contact borrowers and offer a loan modification, if they qualify, before proceeding with foreclosure proceedings. The Texas State Attorney General sent a demand letter to 30 servicers, requesting that all foreclosure actions be halted until at least October 15. On October 5, North Carolina and Massachusetts asked servicers to halt foreclosure actions. The State of Ohio has filed a civil fraud suit against GMAC, alleging the servicer misled the courts in foreclosure proceedings. On October 5, a group of Kentucky borrowers facing foreclosure filed a RICO class action suit against Citigroup Inc., Ally Financial Inc., and MERS for allegedly conspiring with MERS to falsely foreclose on loans even when they don’t hold titles to the properties.
- The Senate Banking Committee has scheduled two hearings on November 16 to investigate allegations that the nation’s largest lenders have improperly foreclosed on struggling borrowers. “American families should not have to worry about losing their homes to sloppy bureaucratic mismanagement or fraud,” said outgoing Chairman Christopher Dodd (D-CT). “I am deeply troubled by recent revelations and

allegations of practices by some of the nation's largest lenders." Minority leader Richard Shelby (R-AL) added, "Because it appears that the regulators have failed yet again to properly supervise the entities under their jurisdiction, the committee should immediately commence a separate, independent investigation into these allegations."

- "We fear this is only the beginning," wrote Laurie Goodman, Senior Managing Director of Amherst Securities, in an October 12 report. "We expect more state attorneys general to call for foreclosure moratoriums; more state Attorney General lawsuits; and more noise at the federal level. While more servicers may extend their moratoriums to non-judicial states, we expect those moratoriums to be shorter lived." Goodman concluded, "This issue could become so political that it can potentially have three further detrimental effects of investors in private label securitizations: (1) additional foreclosure moratoriums, (2) a re-examination of the title transfer process and (3) litigation of homes that have already been foreclosed on and sold. While such effects cannot be quantified at this time, they certainly cannot be ignored." (*The Affidavit Fiasco—Implications for Investors in Private Label Securities*, Laurie Goodman, 10/12/10; *CNBC*, John Carney, 10/11/10; *American Banker*, Kate Berry and Sara Lepro, 10/14/10; *Real Estate Channel*, Alex Finkelstein, 10/04/10; *New York Times*, David Streitfeld, 10/02/10; *Associated Press*, Daniel Wagner, 10/12/10; *CQ Today*, Steven Sloan, 10/06/10; *Washington Post*, Zachary A. Goldfarb, 10/11/10; *CNNMoney.com*, Charles Riley, 10/18/10)

The Obama administration's response to the foreclosure crisis

- On October 7, the White House announced that President Barack Obama would pocket veto the Interstate Recognition of Notarizations (H.R. 3808) that would have made it easier for states to recognize out-of-state notarizations. "The Interstate Recognition of Notarizations Act of 2010 was designed to remove impediments to interstate commerce," said White House Communication Director Dan Pfeiffer. "While we share this goal, we believe it is necessary to have further deliberations about the intended and unintended impact of this bill on consumer protections, including those for mortgages, before this bill can be finalized." (*Bureau of National Affairs*, 10/08/10)
- The Obama administration said it supports the joint investigation that the attorneys general and state supervisors are conducting regarding improperly processed home foreclosure documents—but continues to reject calls for a national moratorium on foreclosures, concerned such a move would damage the economic recovery. White House spokesman Robert Gibbs said, "[If banks haven't followed the legal foreclosure process] that can and should be rectified. We also have pointed out...the idea of a national moratorium would impact the recovery in the housing sector, as anybody that wished to enter into a contract or execute a contract or purchase a home that had been previously foreclosed on, that process stops." (*Wall Street Journal*, Damian Paletta, 10/13/10)

- In an October 17 commentary in *Huffington Post*, HUD Secretary Shaun Donovan wrote, “The recent revelations about foreclosure processing—that some banks may be repossessing the homes of families improperly—has rightly outraged the American people. The notion that many of the very same institutions that helped cause this housing crisis may well be making it worse is not only frustrating -- it’s shameful.”
- “No one should lose their home as a result of a bank mistake. No one. That is why the Obama Administration has a comprehensive review of the situation underway and will respond with the full force of the law where problems are found. The Financial Fraud Enforcement Task Force that President Obama established last November has made this issue priority number one. Bringing together more than 20 federal agencies, 94 US Attorney’s Offices and dozens of state and local partners to ...combat fraud, the Task Force is examining this issue and the Attorney General has said publicly that if it finds any wrongdoing the members of the task force will take the appropriate action. The [FHA] and [FHFA] have launched reviews to make sure servicers are in full compliance with the law. The [OCC] has directed seven of the nation’s largest servicers to review their foreclosure processes, fix the processing problems and determine whether there is specific harm that has been caused in individual cases.”
- “The message all these institutions are sending is the same: banks must follow the law—and those that haven’t should immediately fix what is wrong. Given the problems that have already been found and admitted to by some servicers, the Obama Administration fully supports the voluntary moratoria that are already in place and others should they be deemed necessary. Some have suggested, however, that all foreclosures in every state, under every servicer, should be stopped. But a national, blanket moratorium on all foreclosure sales would do far more harm than good—hurting homeowners and home-buyers alike at a time when foreclosed homes make up 25 percent of home sales.”
- ...”Right now, families who have watched their home values decline over the last few years want nothing more than homebuyers ...to buy the vacant homes in their neighborhoods. These homeowners are at risk, too—and the best hope they have is for the ‘Foreclosed’ signs in front of the vacant, abandoned properties on their block to come down, so that the value of their homes can start rising again....[It is] only when those foreclosed homes started to sell again that home prices in that neighborhood began to stabilize—and even increase in some instances.”
- “Another unintended consequence of a blanket moratorium on foreclosure sales, even where problems haven’t yet been found, is that it could cause servicers to take their eyes off the ball when it comes to helping at-risk homeowners stay in their homes well before their problems reach the crisis of a foreclosure. By the time the home gets to foreclosure, it’s often too late to help families stay in their homes -- they may be too far behind or in some cases, they’ve already left the home. Banks need to provide more help, more people, more resources to those families facing a crisis long before they ever get to a foreclosure -- so more families can keep their homes. And

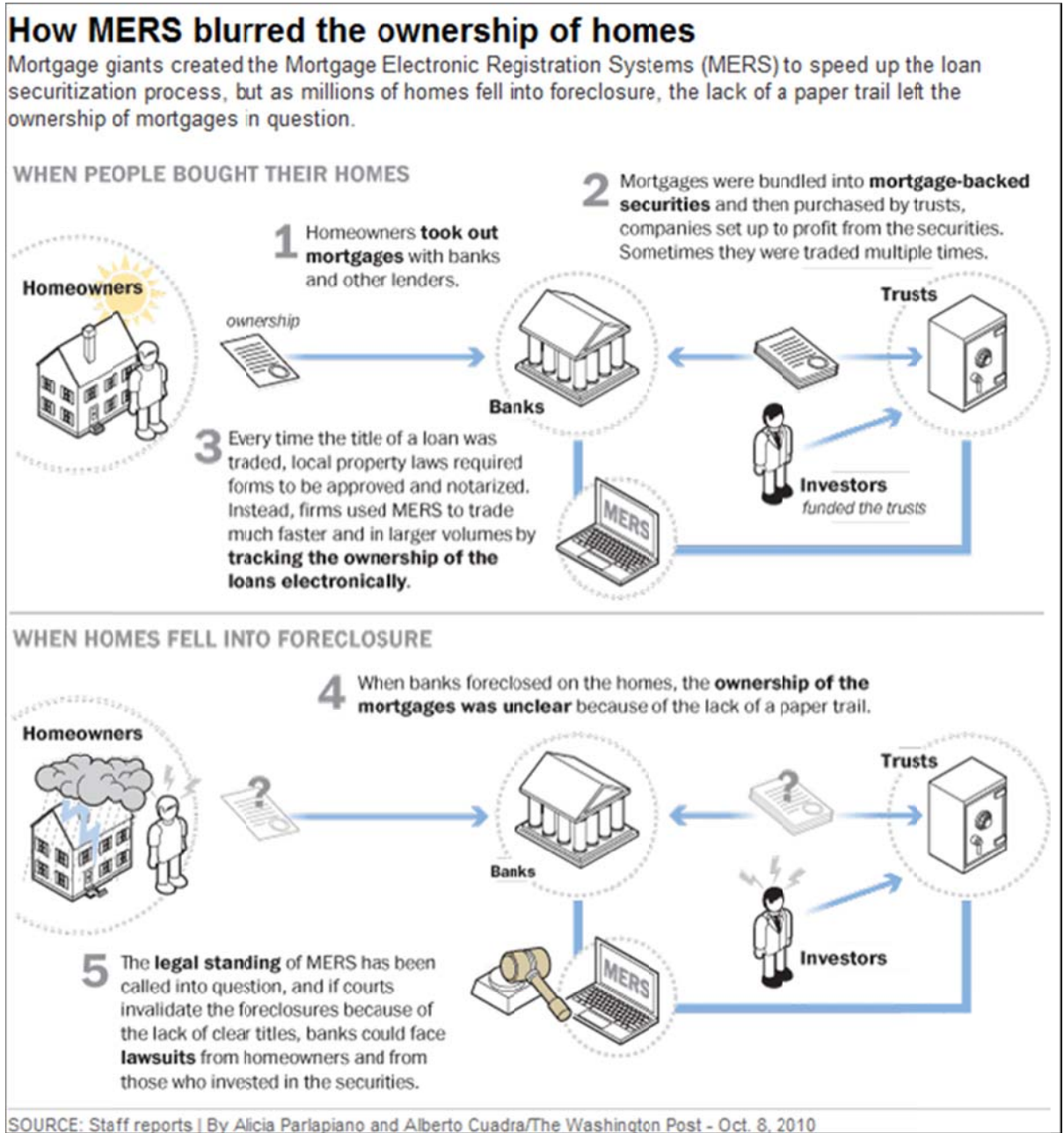
where foreclosure is not avoidable, having been processed legally and appropriately, banks should help families transition to sustainable housing situations with dignity.”

- “We’ve seen real progress in the housing market. Foreclosure starts are down by 30 percent from a year ago. In the last 18 months, 3.3 million families have received restructured mortgages with more affordable monthly payments, which is more than twice as many foreclosures that have been completed during that time. With vacant and abandoned homes more than three times as destructive to the values of neighboring homes as occupied homes that are just beginning the foreclosure process, a blanket moratorium would only slow down that progress. ...[T]he more quickly we provide help to families—whether it’s to stay in their homes, to ensure they can buy new homes, or to help them to transition to affordable rental housing—the sooner our neighborhoods will stabilize—and the sooner our economy will recover.”
(*Huffington Post*, Shaun Donovan, 10/17/10)

Legal status of MERS is questioned

- While the loan underwriting technicalities can be taken care of through added resources and time, this crisis has brought the spotlight back to the title transfer process conducted by the Mortgage Electronic Registration System (MERS), opening another window to litigation, added expense and further delay to the foreclosure process.
- In the *Cincinnati Law Journal*, Christopher L. Peterson wrote, “...MERS maintains a central national database tracking mortgage servicing rights for loans registered on its system. In addition to its database, MERS has taken on two related but distinct roles in the American home mortgage market. First, mortgage finance companies use MERS’ name as a proxy in county land title records in order to avoid paying taxes to local governments for recording assignments during the life of a loan. Second, where local courts have allowed it, MERS creates something of a foreclosure doppelganger by allowing the actual parties in interest to bring residential foreclosures under MERS’ corporate identity instead of their own. Recording loans in the name MERS, rather than the actual parties in interest, has generally not been explicitly authorized under the state title recording acts that trace their lineage back to the earliest years of the American republic. By adopting such a radical shift in how mortgages are recorded and foreclosed without legislative change, the mortgage finance companies have rebuilt their industry on a legal foundation of sand. MERS’ claim to own legal title to a mortgage loan’s security interest, divorced from the promissory note and entitlement to receive loan payments, is in direct tension with precedent that has been well settled for over a hundred years. MERS’ role in prosecuting home mortgage foreclosures should bring it within the scope of the federal Fair Debt Collection Act—a statute that MERS has generally made little attempt to comply with. And it is unclear whether recording a mortgage or mortgage assignment in the name of someone other than that actual mortgagee and assignee should be sufficient to protect those actual parties in interest from subsequent purchasers. Indeed there is a

compelling argument that loans where MERS is recorded as the original mortgagee should be avoidable by bankruptcy trustees in many states.”



- “The shift away from recording loans in the name of actual mortgagees and assignees represents an important policy change that erodes not only the tax base of local governments, but also the usefulness of the public land title information infrastructure. MERS did not, by itself, cause the mortgage finance crisis and its ensuing aftermath. However, it was an important cog in the machine that churned out the millions of unsuitable, poorly underwritten, and incompletely documented mortgages that were destined for foreclosure. In the aftermath of the mortgage

finance crisis that has crippled the American economy, necessitated massive taxpayer bailouts of financial institutions, and left millions of American families ejected from their homes, the judiciary has an obligation to aggressively reexamine our financiers' cut corners, false assumptions, and jaundiced legal theory." The full article is available http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1469749. (*Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, Christopher L. Peterson, 10/05/09)

- When Oppenheimer analyst Chris Kotowski asked if JPMorgan Chase is comfortable with "the robustness of the MERS system," Jamie Dimon, the Bank's chairman and CEO, responded "We stopped a while back using [MERS] for that purpose. And we're not going to comment on all the underlying things. One of the things you've got to remember ... we've known there are issues in the mortgage business. And for the most part, by the time you get to the end of the process ... we're not evicting people who deserve to stay in the house." JPMorgan Chase stopped foreclosing in the name of MERS in 2008 and doesn't register any retail-originated loans with MERS, added Bank spokesman Tom Kelly. "We take the title out of the MERS name before we start foreclosure proceedings because some state courts don't accept foreclosures in the MERS name."
- Earlier this year, Fannie Mae instructed servicers that foreclosures filed after May 1 could no longer name MERS as plaintiff on mortgage loans that are owned or securitized by the enterprise. (*American Banker*, Kate Berry and Sara Lepro, 10/14/10)
- Arnold Kling, former economist for the Federal Reserve (1980-1986) and Freddie Mac (1986-1994) and currently an adjunct scholar with the Cato Institute and member of the Financial Markets Working Group at the Mercatus Center at George Mason University, wrote:
 - "The real foreclosure scandal is that it is taking so long to get people who have stopped making payments out of their homes. Those costs are shifted to the rest of us. Moreover, from now on, any mortgage lender has to raise the interest rate on a mortgage loan in order to take into account the fact that the lender's losses in the event of a default are going to be much higher. There may be individuals who are facing foreclosure for whom I would feel sorry. But, in my opinion, anyone who is fighting for delinquent borrowers as a class is doing damage to the economy and, furthermore, is on the wrong side of justice." (www.econolog.com, Arnold Kling, 10/08/10)
- In *The Atlantic*, Megan McArdle wrote, "...We are witnessing the confluence of two problems: our antiquated titling system, and a massive move to securitization without adequate systems for tracking the chain of custody on these mortgages. The result is that it is now unclear who has title to these houses. I know some of my readers will be tempted to cheer at the thought of the little guy getting one over on the bank, but

what about the people who bought foreclosed houses? They just bought into a whole world of legal problems.”

- “As Hernando de Soto has chronicled, good land titling is important. It is also emergent. When there are changes in the marketplace, we need new legal mechanisms for dealing with any resulting irregularities. I don’t know if the bill that Obama just pocket vetoed would have done more good than harm. But I sure hope he isn’t planning to just let this mess continue for fear of being seen to do anything that ‘helps the banks’—or in hopes that some lucky voters will get to default and keep the house. (*The Atlantic*, Megan McArdle, 10/08/10)

Setting the stage for massive loan buybacks from investors?

- In the October 18 issue of *The Institutional Risk Investor*, Chris Walen wrote, “[T]he threat which faces us all in the real estate and banking system is more akin to metastatic cancer, a slow wasting destruction of the American political economy which our leaders neither see nor understand. Witness the little love note from our friend Josh Rosner, heralding the unwinding of the RMBS market into unsecured debt[:]”

“The reading of our prior note, without an understanding of the importance of ‘blank name’ to the mortgage origination to securitization process, has led to a series of stories suggesting that we are of the view that issuers are at risk and that we will have a Lehman weekend crisis, this is not our view. It is our belief that, given the black box nature of the process and the former white-hot origination market, that documentation of transfer may not have been properly effected. If not properly effected, the ‘true sale’ of mortgages to the trusts that issued mortgage backed securities would be in question. If this proves to be the case then, as we stated in the October 12 note: ‘the Trustee, who has responsibility to make sure all loans were properly assigned to the trust, may have liability.’” (Josh Rosner, *Why “In Blank Name” Matters and Trustee Obligations*, Graham, Fisher & Co., October 14, 2010)

- “The fiber going into most securities law firms is literally melting down from the inquiries from risk averse investors, trustees and custodians who now know that the emperor has no clothes.”
- Joseph Mason, professor of finance at Louisiana State University, believes this “crisis” may result only in a delay on foreclosures. Mason acknowledges that the turmoil will create added “policy risk” that could be disruptive to lending and ultimately to economic growth. Mason said, “The all-in cost of dealing with problem foreclosures is going to be fairly small. In a nutshell, the delays from fixing the documentation will not affect the disposition cycle very much because the REO was not moving anyway. Overall, if you are a bank, your REO is probably going to sell around the same price. The real problem is the REO liquidation cycle and how this

impacts the economy [<http://tiny.cc/rvxcb>], inserting an additional layer of policy risk into the foreclosure mess by interfering in private contracts runs the risk of substantially disrupting lending, overall, and therefore economic growth.”

- “[The foreclosure mess will lead to vast retribution against ‘the banks’ as a group] ...only if the media seeks to whip up popular unrest unjustifiably. Remember, the note is still a valid document: people borrowed money and they legally are obligated to repay that money. The mortgage, however, may be defective, creating difficulties seizing the property as collateral. Nobody really thinks the documentation mess will result in people getting free homes. ...[W]hile the incremental cost may not be large the foreclosure crisis may shift existing losses on defaulted loans and foreclosed properties from investors to banks.”
- “...Trustees now universally require the note holders to organize themselves, hold a vote and then and only then will the trustee hire a diligence firm, lawyers, etc... This effectively shut down investor claims and/or litigation against the issuers of MBS. For a while now, it has been a chicken and egg problem: I would like to open up the deal to show systematic shortcomings that may justify repurchase, but I cannot justify that investigation to note holders until I can show at least some evidence to support my claim and gather the vote, but I cannot get that evidence without access to the deal. Around and around we go.” (*Institutional Risk Analyst*, Chris Whalen, 10/18/10)

The cost of the foreclosure clean-up—anybody’s guess

- Concerns that the rising costs of faulty foreclosures would erode banks’ profits triggered a selloff of U.S. bank stocks, triggering a \$49.3 billion loss in market value for Citigroup, Bank of America Corp, Wells Fargo & Co., and JPMorgan Chase for the three days ended October 15. The selloff was triggered in part by JPMorgan’s October 13 announcement that the bank had set aside an additional \$2.3 billion of reserves to cover mortgage repurchases or litigation expenses, including some for “mortgage-related matters.” (*Bloomberg News*, Dakin Campbell, 10/18/10)
- “We’ve had two banks [JPMorgan and First Horizon National Corp] report good earnings in terms of credit-quality costs coming down,” said Erik Oja, an equity analyst at Standard & Poor’s. “But people don’t care. They say ‘Well, how many foreclosures do you have in the pipeline? And what are you seeing?’ And they answer that we’re looking at each one. And people say ‘All right, sell.’” In October 15, Oja cut his recommendation on Bank of America to “hold” from “strong buy” due to uncertainty about the Bank’s mortgage costs.
- “While the legal details are murky, our initial take is that the bigger risk to banks remains mortgage putbacks...and that the issues raised ...will most likely end up delaying the foreclosure process, but will not present a systemic issue for the mortgage industry and the banks,” wrote Citi Smith Barney analyst Keith Horowitz in

an October 13 note to investors. (*Mortgage Foreclosures: Understanding “Robo-Signers,” Documentation Req’s & MERS*, Keith Horowitz, 10/13/10)

- Analysts’ cost estimates for the cost of the foreclosure crisis vary widely. In August, Chris Gamaitoni, an analyst with Compass Point Research and Trading, estimated that lenders may lose as much as \$179.2 billion related to mortgages they will be forced to repurchase from mortgage-bond insurers and investors. Mike Mayo, an analyst at Credit Agricole Securities USA in New York, estimates a cost of \$20 billion for repurchases when including government-sponsored entities Fannie Mae and Freddie Mac. Goldman Sachs Group Inc.’s Richard Ramsden said a worst-case scenario would be \$84 billion, while Paul Miller, an analyst at FBR



Capital Markets in Arlington, Virginia, said it could cost the banks as much as \$91 billion. (*Wall Street Journal*, Carrick Mollenkamp, 09/23/10)

- In an October 15 report [<http://tiny.cc/lpnqn>], JPMorgan Chase analysts Ed Reardon and John Sim estimated that future losses from repurchases of “putback” home loans will likely total \$55 billion to \$120 billion—or approximately \$10 billion to \$25 billion a year over the next five years. By mortgage category, the JPMorgan analysts estimated the put-back risk to be approximately \$23 billion to \$35 billion for agency mortgages; \$40 billion to \$80 billion in non-agency; and roughly \$20 billion to \$30 billion for second liens and HELOCs. “However, there are a number of reasons why these estimates are on the high end, including losses already taken and loss reserves established,” wrote Reardon and Sim. “Furthermore, these costs will be spread out over years owing to the complexity and cost of implementing putbacks, especially in non-agency securitizations.” (*JPMorgan Chase Securitized Products Weekly*, Ed Reardon and John Sim, 10/15/10; Bloomberg News, Jody Shenn, 10/18/10)
- In an October 18 analyst report, Morgan Stanley estimated large and midcap banks’ exposure to putbacks totals approximately \$55 billion with \$38 billion yet to be

booked. The analysts wrote, “We expect banks will recognize remaining reps and warranties and foreclosure costs over the next 2-4 years, not the next 12 months.” (*Morgan Stanley Industry Review*, Betsy L. Graseck, Ken A. Zerbe, and Michael J. Cyprys, 10/18/10)

- FBR Capital Market analyst Paul J. Miller estimated that lenders could have a hit to earnings, ranging from \$6 billion to \$10 billion to resolve the foreclosure crisis—a large sum, but one the industry “could comfortably absorb.” Richard X. Bove, an analyst with Rochdale Securities, said “I don’t see how [the crisis] can be cleared up in a short time. The moratorium won’t last that long, but the problem will last at least four or five years, maybe a decade. [Over the short term,] it could easily cost \$1.5 billion.” (*Bloomberg News*, Dakin Campbell, 10/18/10; *Washington Post*, David Hilzenrath, 10/15/10; *New York Times*, Nelson D. Schwartz, 10/15/10)

And the longer term impact...

- “Instead of having a ton of mortgage borrowers who haven’t made any payments in at least a year, we would have a ton who haven’t made a payment in a year-and-half,” said Guy Cecala, publisher of *Inside Mortgage Finance*. “Keep in mind we will have new problem loans entering the system throughout any moratorium whether we acknowledge them or not. Do we seriously believe that a foreclosure moratorium can change the outcome of potentially 5 million or more homeowners losing their homes over the next two years? Ultimately, if we don’t do something to handle distressed properties more efficiently (and faster), the housing market is going to remain stuck in limbo with no recovery in sight.”
- In an October 9 editorial, the *Wall Street Journal* wrote, “...The bigger damage here is to the housing market, which desperately needs to find a bottom by clearing excess inventory and working through foreclosures as rapidly as possible. The moratoriums further politicize the housing market and further delay a housing recovery. In an economy and a financial system engulfed in Washington-created uncertainty, the political class has decided to create still more.” (*Wall Street Journal*, 10/09/10)
- In the October 15 *Frontline Weekly Newsletter*, John Mauldin wrote, “...All those subprime and Alt-A mortgages written in the middle of the last decade? They were packaged and sold in securities. They have had huge losses. But those securities had representations and warranties about what was in them. And guess what, the investment banks may have stretched credibility about those warranties. There is the real probability that the investment banks that sold them are going to have to buy them back. We are talking the potential for multiple hundreds of billions of dollars in losses that will have to be eaten by the large investment banks. We will get into details, but it could create the potential for some banks to have real problems. And all this coming as European banks are going to have to sort out their own sovereign debt

problems. Shades of 2008. I hope I am wrong, but it's all connected. (*Frontline Weekly Newsletter*, John Mauldin, 10/15/10)

President signs a one-year extension of conforming loan limits

- On September 30, the President signed H.R. 3081, which included a provision extending the current conforming loan limits of \$417,000 for most areas in the U.S., and \$729,750 for high-cost areas, through September 30, 2011 for loans backed by Fannie Mae, Freddie Mac and FHA. (*Mercury News*, Rose Meily, 10/11/2010)

President Obama selects Elizabeth Warren to serve as an advisor, responsible for setting up the Bureau of Consumer Financial Protection Bureau

The President appoints Senator Ted Kaufman to serve as chairman of the Congressional Oversight Panel for TARP

President Obama selects Elizabeth Warren to serve as an advisor, responsible for setting up the Bureau of Consumer Financial Protection Bureau

- On September 17, President Barack Obama tapped Harvard law professor and Congressional Oversight Panel chairman Elizabeth Warren to serve as the de facto head of the Consumer Financial Protection Bureau (CFPB). As the CFPB czar, Warren will be responsible for “getting this agency off the ground” through an advisory role with the White House and Treasury that does not require Senate approval.
- Obama said, “...Secretary Geithner and I both agree that Elizabeth is the best person to stand this agency up. She was the architect behind the idea for a consumer watchdog, so it only makes sense that she'd be the—she should be the architect working with Secretary of Treasury Geithner in standing up the agency. She will help oversee all aspects of the bureau's creation, from staff recruitment to designing policy initiatives to future decisions about the agency. She will have direct access to me and to Secretary Geithner, and she will oversee a staff at the Treasury Department that has already begun to work on this task. She will also play a pivotal role in helping me determine who the best choice is for director of the bureau. And given the importance of these economic issues, I also want Elizabeth to have a role as a White House advisor as well as advisor to Secretary Geithner on consumer issues.” (www.realclearpolitics, 09/17/10)
- During a Senate Budget Committee hearing, Senator Judd Gregg (R-NH) called Obama's appointment of Warren a “transgression of the constitutional process,” which avoided Senate confirmation of her role. Judd predicted that Warren would be “one of the most powerful people in Washington.” He added, “This agency shall—I

project and predict—be an agency not for the purposes of protecting consumer credit but for pursuing an agenda of social justice as defined by [Warren].” (*Wall Street Journal’s “Washington Wire” Blog*, 09/28/10)

At the September 30 hearing, Republican members of the Senate Banking Committee closely questioned deputy Treasury secretary Neal S. Wolin about the rule writing authority of the CFPB before a permanent director is in place. Lawmakers from both parties said such actions would likely be illegal, arguing the Dodd-Frank Act would not allow the Bureau to write rules with Warren as the temporary leader.

- Wolin conceded to lawmakers that regulators would not have substantive power to write CFPB rules until its permanent director of the bureau is approved by the Senate and until July 21, 2011, when consumer protection responsibilities from seven other federal agencies are transferred to the new bureau. Wolin told lawmakers that “there is limited rule-writing authority, but it is constrained until such time as there is a confirmed director.” Under follow-up questioning by Senator Bob Corker (R-TN), Wolin said Treasury can solicit ideas from the public and prepare the CFPB prior its inception on July 21, 2011. (*American Banker*, Stacy Kaper, 10/01/10; *New York Times*, Sewell Chan, 10/01/10)
- At a private leadership dinner sponsored by the Financial Services Roundtable, Warren struck a conciliatory tone with the 400 bankers attending the event. “First, in the weeks and months ahead, I’m going to listen more than I’m going to talk, and I’m going to keep my door open,” said Warren “And second, I am committed to helping build a consumer credit structure that works — works for families, works for the financial services industry, and works for the American economy.” Warren said the purpose of the new bureau was to not only create new regulations, “but also to get rid of old regulations that are dated, expensive or just plain don’t work.” She added, “We have a chance to take a step back to ask: What vision should drive this agency? What test should be used to determine when the agency should act, when it should not, and which tools it should use when it does take action? What is the central aim of financial services regulation?” (*New York Times*, Sewell Chan, 09/30/10)
- Senate Banking Committee Chairman Christopher Dodd (D-CT) said the Obama administration is likely to nominate a director for the Consumer Financial Protection Agency “in coming days,” but said he doubted if the CFPB director would be approved during the lame-duck session. In a speech at New York University Law School’s Global Economic Forum, Dodd said “If it is Elizabeth Warren [who is nominated], I am delighted to step up and try to help her be confirmed by the Senate, but I want someone who is confirmable. I worry that if we end up nominating someone that ends up in a protracted debate over too many weeks and months spilling over into next year and spilling over into spring, you are going to get people who are trying to get rid of this bureau.” (*New York Times “Dealbook” Blog*, Cyrus Sanati, 10/12/10; *Dow Jones Newswires*, Marshall Eckblad, 10/12/10)

- In a September 30 *Wall Street Journal* commentary, Todd Zywicki wrote, “The Obama administration has promised that the Federal Reserve’s new Consumer Financial Protection Bureau will be independent from politics, a model of regulatory expertise grounded in sound data and economics. Naming Harvard Law Prof. Elizabeth Warren as de facto agency head undermines both goals. By appointing another White House czar to avoid Senate confirmation, the administration politicized the powerful new bureaucracy from its birth. And by appointing an individual with a track record of using questionable research to advance policy ends, it has jeopardized the second goal as well.” (*Wall Street Journal*, Todd Zywicki, 09/30/10)
- In a September 19 editorial, the *Washington Post* wrote, “We have qualms about Elizabeth Warren, the Harvard law professor President Obama has put in charge of setting up the Bureau of Consumer Financial Protection. The new body, which will have a half-billion-dollar budget and wide regulatory power over mortgages, credit cards and the like, was her brainchild. It emerged from Warren’s zealous campaign against what she called the ‘tricks and traps’ of the banking industry, which has made her a hero to the progressive wing of the Democratic Party. Like many such activists, however, Ms. Warren can be simplistic and hyperbolic.”
- “Certainly, her dim view of the banking industry is fully reciprocated—and, egged on by Wall Street, Republicans probably would have filibustered her nomination to be the bureau’s first director. That, in our view, would have been unjustified. Ideologically contentious as she may be, Ms. Warren is qualified for the job. In an ideal world, as opposed to the polarized Washington in which we actually live, she would have received at least a prompt hearing and a floor vote.”
- “Still, Republicans would have been within their rights. Can the same be said for Mr. Obama’s end run of the Senate confirmation process? Senate confirmation of the bureau’s director was one of the few checks Congress built into an office that otherwise will be very powerful and independent. Nevertheless, the statute establishing the bureau gives Treasury Secretary Timothy F. Geithner interim authority in the absence of a permanent director, at least until July 21—when the bureau officially absorbs and consolidates various federal agencies’ consumer-protection functions. And, under the arrangement the president outlined, Ms. Warren will work for Mr. Geithner. Of course, she’ll also be on the White House staff, reporting to the president—as Mr. Geithner does. That gives her a free hand, indeed, and as Mr. Obama said..., she’ll be advising on everything from policy to personnel to a nominee for director, which might yet be Elizabeth Warren. Only actual rule-making will have to wait, for now.”
- “Mr. Obama would have been better off picking a more confirmable candidate, as some senators from his own party had urged. Even a recess appointment for Ms. Warren—which would have lasted through 2011—would have been preferable in terms of sticking to constitutionally prescribed processes for filling federal offices. But either move would have infuriated progressives, who still dream of a full five-year term for Ms. Warren—and whose support Mr. Obama needs in November. For

all intents and purposes, the president has created, and filled, a de facto directorship. This might have been in keeping with the letter of the laws, but not with their spirit. (*Washington Post*, 09/19/10)

The President appoints Senator Ted Kaufman to serve as chairman of the Congressional Oversight Panel for TARP

- President Barack Obama appointed Senator Ted Kaufman (D-DE) to serve as a member of the Congressional Oversight Panel for TARP, succeeding Elizabeth Warren as chairman of the Panel. Although TARP expired on October 3, the panel will retain its oversight responsibilities until April 2011. (*HousingWire*, Christine Ricciardi, 10/04/10)

NCUA bails out wholesale credit unions with a \$30 billion federal guarantee

- The National Credit Union Administration (NCUA) announced a federal rescue program for the industry’s wholesale credit unions, underpinned by a federal guarantee valued at \$30 billion (or more). As part of the rescue, NCUA seized three wholesale credit unions—Members United Corporate Federal Credit Union, Southwest Corporate Federal Credit Union and Constitution

Battered Five failed wholesale credit unions	
Seized Sept. 24, 2010	Assets (billions)
Members United Corporate Federal Credit Union (Warrenville, Ill.)	\$8.93
Southwest Corporate Federal Credit Union (Plano, Texas)	9.52
Constitution Corporate Federal Credit Union (Wallingford, Conn.)	1.22
Seized March 20, 2009	
U.S. Central Corporate Federal Credit Union (Lenexa, Kan.)	\$34
Western Corporate Federal Credit Union (San Dimas, Calif.)	23
Sources: National Credit Union Administration; the credit unions	

Federal Credit Union. In March 2009, NCUA seized the two largest wholesale credit unions, U.S. Central Federal Credit Union and Western Corporate Federal Credit Union—bringing to five the number of wholesale credit union failures of the 29 wholesale institutions.

- To minimize losses, the regulators will transfer the failed wholesale institutions’ assets into a good bank/bad bank structure with NCUA managing their troubled \$50 billion MBS portfolio, which are worth roughly half of their face value based upon current market values. NCUA estimates that losses on the \$50 billion MBS portfolio will total \$15 billion, which will be partially offset by the institutions’ capital. The remaining \$7 billion to \$9.2 billion in losses will eventually be borne by the credit union industry through future NCUA insurance premium assessments. NCUA will issue \$30 to \$35 billion in NCUA Guaranteed Notes, secured by the MBS portfolio,

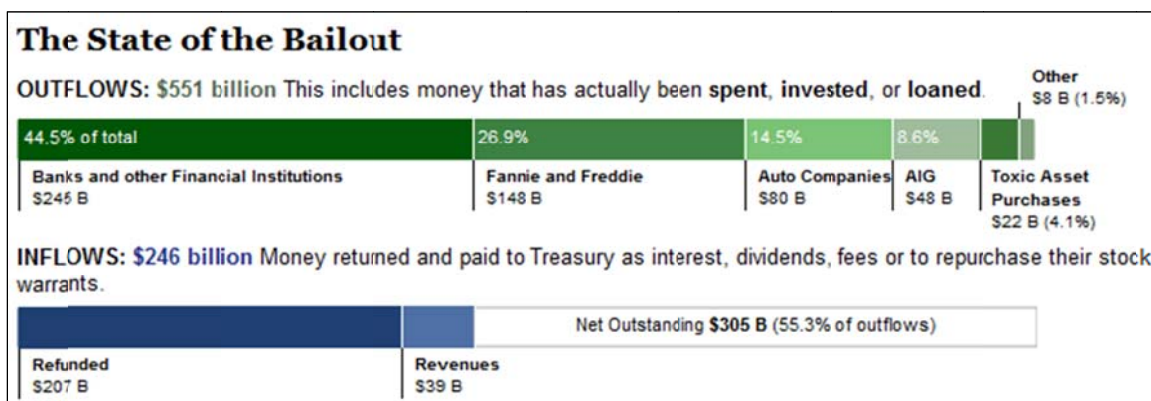
to fund the bad bank. NCUA officials said the plan “won’t cost taxpayers any money.”

- NCUA will allow the “good bank” operations of the credit unions to continue for about two years to allow their retail credit union customers to wind down their relationships with the failed institutions. (*Wall Street Journal*, Mark Maremont and Victoria McGrane, 09/25/10; *Bureau of National Affairs*, Thecla Fabian, 10/07/10)

Countrywide Financial’s former CEO Mozilo agrees to pay fines and restitutions totaling \$67.5 million to settle SEC charges of insider trading and fraud

- Countrywide Financial co-founder and former chairman Angelo Mozilo and two former executives have reached a financial settlement with SEC, agreeing to pay millions of dollars to settle civil fraud and insider trading charges. Mozillo agreed to repay \$45 million in ill-gotten profits and a \$22.5 million fine in civil penalties, while former CEO David Sambol agreed to pay \$5 million in ill-gotten profits and \$520,000 in civil penalties and former CFO Eric P. Sieracki will pay \$130,000 in civil penalties. Under the agreement, the three executives did not admit wrongdoing during their tenure at Countrywide. (*Associated Press*, 10/15/10)
- *Salon’s* Andrew Leonard viewed Mozilo’s \$67.5 million settlement with the SEC a mere slap on the wrist—noting he earned about \$140 million in 2007 alone, while laying off 12,000 Countrywide employees. ... Angelo Mozilo should be behind bars. And maybe someday he will be. His legal woes are hardly over. The U.S. Attorney’s office in Los Angeles is conducting a federal criminal probe, and a \$67.5 million fine seems to me a fairly strong sign of vulnerability.” (*Salon*, Andrew Leonard, 10/15/10)
- *Huffington Post’s* David Callahan concurs, writing: “Let’s say a business leader makes hundreds of millions of dollars through criminal practices that end up wiping out the wealth of myriad homeowners and contributing to the biggest economic crisis in 70 years. Then, as punishment, he is forced to fork over \$67.5 million—and yet faces no prison time. Has justice been done? Well, if you listen to the SEC—and plenty of media commentators, too—the settlement just reached with former Countrywide CEO Angelo Mozilo was tough stuff. ... It is hard to see how the Mozilo settlement—coming on the heels of another weak SEC settlement with financier Steve Rattner—will deter future wrongdoing. ...Indeed, it could have the contrary effect. If you can make a great fortune behaving badly, get busted, and still end up with most of that fortune, then you’ve come out way ahead. At least in financial terms. ...Mozilo’s story is yet more testimony to the seductive power of big money in an age of soaring inequality and lax regulation. It would be nice to think that this age has come to a close. But Mozilo’s light punishment, with the clear message that crime pays, will help ensure that is not the case.” (*Huffington Post*, David Callahan, 10/17/10)

TARP



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

Treasury estimates cost of TARP of approximately \$50 billion---excluding the bailout costs of Fannie Mae and Freddie Mac

- In Treasury's *Troubled Asset Relief Program: Two Year Retrospective*, Timothy G. Massad, Acting Assistant Secretary for Financial Security, outlined five key accomplishments of TARP:
 - "TARP was remarkably effective in helping unfreeze markets for credit and capital, bring down the cost of borrowing restore confidence in the financial system, and restart economic growth."
 - "The projected costs of TARP have fallen by about \$300 billion [to "about \$50 billion"—excluding taxpayers' equity injections of \$150 billion into Fannie Mae and Freddie Mac; Treasury expects most of the residuals losses on TARP will be incurred on the program's investments in the automotive industry and expenditures for foreclosure mitigation initiatives.]"
 - "We are moving quickly to recover the government's investments and to withdraw from the financial system."
 - "Two critical elements of the Obama Administration's strategy were 'stress test' to force banks to raise private capital and a series of innovative programs to jumpstart credit markets and financing for consumers, businesses, and homeowners."
 - "The U.S. financial system is much stronger today, and in a strong position to support economic recovery."

- Massad concluded, “When TARP was created, the world around us was falling apart. And in that moment, when families and businesses were worried like never before about their economic security, leaders from both parties stood up, stood together, and as Americans, did what was best for the country. They did something unpopular, but necessary. And we are much better off for the result.” (*Troubled Asset Relief Program: Two Year Retrospective*, Timothy G. Massad, October 2010; *October Oversight Report to Congress*, Congressional Oversight Panel, 10/14/10)
- In an October 10 *Washington Post* commentary, Treasury Secretary Timothy Geithner wrote, “[T]he cost of the TARP, which succeeded in reducing the overall economic damage, will be considerably lower than once feared. ...Even looking beyond the TARP to the losses associated with Fannie Mae and Freddie Mac’s pre-crisis mistakes, the direct costs of the government’s overall rescue strategy are likely to be less than 1 percent of GDP. By comparison, the much less severe savings and loan crisis of the late 1980s and early 1990s cost 2.5 times that as a share of our economy.” (*Washington Post*, Timothy Geithner, 10/10/10)
- On October 3, the Troubled Asset Relief Program officially “expired.” In a town hall event, Secretary Geithner said, “I know across the country Americans will rejoice in its demise. TARP was something our country should never have had to do... But for all the baggage, there is something to embrace about TARP.” (*Washington Post*, Brady Dennis, 09/30/10)
- In an October 3 editorial, the *Washington Post* wrote, “... [T]he costs of TARP—tangible and intangible—have to be considered in the context of the unprecedented emergency that faced the policymakers who adopted it. They must be weighed against the costs of not intervening. Financial stability is a public good, but it isn’t free. TARP helped save the United States from an economic collapse and bought time to get America’s house in order under calmer circumstances. Goodbye, TARP. Good riddance—and thanks.” (*Washington Post*, 10/03/10)

The Congressional Oversight Panel concludes that TARP leaves behind an implicit federal government guarantee that “is proving difficult to unwind”

- In the *September Oversight Report*, the Congressional Oversight Committee (COP) concluded that the TARP program “will likely leave behind after its formal expiration [a legacy of] Treasury’s holding billions of dollars’ worth of private-company securities and an implicit government guarantee that certain private financial institutions too systemically important to be allowed to fail.” COP concedes that while Congress attempted to address the TBTF problem in the Dodd-Frank Act, “the implicit guarantee of TARP is proving difficult to unwind.”
- The Panel points to market’s perception the four TBTF institutions—Bank of America, Citigroup, Morgan Stanley and Goldman Sachs—as reflected in long-term credit ratings to illustrate the government’s perceived on-going guarantee of these

“new” GSES. In a May 2010 report, Standard & Poor’s noted that the credit ratings for Bank of America, Citigroup, and Morgan Stanley were three notches higher and Goldman Sachs was two notches higher, than these institutions would have been without government support. According to the report, these four TBTF institutions were the only ones that S&P believes “have the potential for government support above and beyond system-wide programs.

- As of the report date, COP reported that Treasury had disbursed \$394.6 billion of TARP funds [below the statutory ceiling of \$475 billion] and \$204.1 billion of TARP funds had been repaid. The majority of outstanding TARP funds are concentrated in four programs—the Capital Purchase Program (\$55.1 billion); the Public-Private Investment Program (\$12.7 billion); the AIG Investment Program (\$49.1 billion); and the Auto Industry Finance Program (\$67.1 billion).
- The cost to taxpayers of TARP is now projected to range between \$66 billion (CBO as of August 20) and \$105.4 billion (Treasury on March 31; the agency subsequently has lowered its estimate to \$50 billion on September 5). COP noted that while the Capital Purchase Program is expected to be a net gain for Treasury and PPIP is expected to lose no more than \$500 million, that losses on the administration’s housing programs cannot be determined. “[W]hile less than \$5 billion has been distributed on housing programs, Treasury could disburse as much as \$45.6 billion in funds that are not intended to be recovered by the federal government in HAMP, the Hardest Hit Fund, and the FHA Refinance Program.”
- The panel concluded that while TARP was needed to stabilize the financial system, it has failed to fulfill its statutory responsibilities to help reduce home foreclosures and “maximize overall returns to the taxpayers.” The panel also found that “[TARP] was mismanaged and could post significant costs far into the future.” While COP chairman Elizabeth Warren recused herself from the panel’s critical assessment of TARP, a panel source confirmed that she worked extensively on the report and agreed wholeheartedly with its findings. “She agreed with it 100 percent,” the source added.
- In the *September Oversight Report*, panelists A.J. Mark McWatters and Professor Kenneth R. Troske argued that Treasury advocates an inappropriate metric for assessing TARP. Specifically, McWatters and Troske argue that:
 - “Repayment by TARP recipients of advances received under the program is a misleading measure of the effectiveness of the TARP and therefore should not serve as the standard by which the TARP is judged.”
 - “The unlimited bailout of Fannie Mae and Freddie Mac by Treasury and the purchase of \$1.25 trillion of GSE-guaranteed MBS in the secondary market by the Federal Reserve benefitted TARP recipients and other financial institutions.”
 - “According to the Congressional Budget Office, the bailout of Fannie Mae and Freddie Mac is projected to cost more than five times the projected cost of the

- TARP, including the Capital Purchase Program employed by Treasury to bail out over 700 financial institutions. TARP recipients and other holders of GSE-guaranteed MBS who benefitted from the bailout of the two GSEs are not required, however, to share any of the costs incurred in the bailout.”
- “The bailout of Fannie Mae and Freddie Mac permitted TARP recipients to monetize their GSE-guaranteed MBS at prices above what they would have received without the GSE guarantee and use the proceeds to repay their obligations outstanding under the TARP, thereby arguably shifting a greater portion of the cost of the TARP from the TARP recipients themselves to the taxpayers. Costs such as this should be included when evaluating the TARP.”
 - Additionally, McWatters and Troske argue that “TARP created significant moral hazard risks and all but enshrined the concept that some financial institutions and other business enterprises are too big or too interconnected to fail.” (*September Oversight Report to Congress*, Congressional Oversight Panel, 09/16/10; *Evaluating the Impact of Far-Reaching U.S. Financial Regulatory Reform Legislation on U.S. Banking Ratings*, Standard & Poor’s, 05/25/10; *CQ Today*, Joseph J. Schatz, 10/05/10; *Politico*, John Maggs, 10/04/10)
 - In an October 1 *Investor’s Business Daily* editorial, Representative Jeb Hensarling (R-TX), a former member of the Congressional Oversight Panel, wrote, “...And make no mistake — TARP hasn’t really ended. While it’s true Treasury can’t make any new commitments, outlays under existing contracts will continue for years to come. Currently, Treasury has committed \$460 billion in signed contracts and only \$199 billion of the \$386 billion actually paid out has been repaid. There’s no obligation that the outstanding money be repaid to taxpayers in a timely manner.”
 - “Aside from the \$66 billion price tag [estimate by CBO], what’s truly harmful is that TARP has elevated political interests over the rule of law, representing crony capitalism at its worst. By institutionalizing the notion of ‘Too Big To Fail,’ TARP introduced an unprecedented level of government involvement into the market, paving the way for passage of the Dodd-Frank permanent bailout bill. The moral hazard created by TARP may well set the stage for a larger crisis down the road. We will be living with the consequences of this bailout program for years after it has ‘ended.’” (*Investor’s Business Daily*, Jeb Hensarling, 10/01/10)
 - In *City Journal*, Nicole Gelinas, Searle Trust Fellow at Manhattan Institute, wrote, “...TARP’s role in Washington’s near-total guarantee of large financial firms and debt markets protected the economy from the full force of the financial meltdown, which would have caused hundreds of thousands, if not millions, more jobs to vaporize for lack of financing. But just as 23 percent of potential voters told pollsters, it’s ‘too soon to tell’ whether TARP, in the end, made things better or not. If the public allows the political and financial classes to view TARP as a success, the program will levy a steep long-term price. When future crises arrive, pols will think that the right fix is to shore up Wall Street via more TARPs, thus ensuring that

creditors and counterparties to financial firms don't suffer consequences for their risk-taking. As this lesson congeals, investors will again become comfortable with lending too much money, too freely, to banks, insurers, and investment firms. Eventually, they will help create a crisis so big that the American government can't save the nation from its full economic effects, just as has happened in Iceland and is now happening in Ireland.”

- “The best hope we currently have against that outcome is the American populace’s still-incandescent rage. The unwashed masses aren’t demonstrating their financial illiteracy; they’re serving as an inchoate substitute for what their government should be providing: the prospect of market discipline through rules that allow any firm to fail without laying waste to the economy at the same time. Unless government lays down those rules, the 45 percent of Americans who think that Washington’s rescues of Wall Street ‘made things worse’ instead of better may be proven right.”
http://www.youtube.com/watch?v=vF_cftQJvM&feature=player_embedded (*City Journal*, Nicole Gelinas, 10/1510)

AIG and Treasury announce agreement for repayment of the insurer’s bailout funds

- On September 30, AIG entered an agreement-in-principle with Treasury, the Federal Reserve Bank of New York (FRBNY), and the AIG Credit Facility Trust to allow the company to repay its outstanding obligations to the federal government. AIG’s repayment plan consists of three elements:
 - AIG will repay its outstanding \$18.9 billion revolving credit facility as of September 20 with FRBNY, using proceeds from the initial public offering for American International Assurance Company Ltd. (AIA) and the pending sale of American Life Insurance Company (ALICO) to MetLife, Inc. AIG will also use funds from the parent company to pay down and, ultimately, liquidate the credit facility.
 - AIG will draw down up to \$22.3 billion in Series F funds available through the TARP to help purchase FRBNY’s \$25.7 billion preferred equity interests in the AIA Aurora LLC and ALICO Holdings LLC special purpose vehicles (SPV). AIG will also use proceeds from two future asset sales—AIG Star Life Insurance Co. and AIG Edison Life Insurance—to purchase the remaining shares held in the SPVs. In turn, AIG will transfer its preferred interests to Treasury as part of its consideration for the Series F preferred shares. In order to repay Treasury for the equity interest in the SPVs, AIG will use proceeds from future sales of AIA and MetLife equity, which AIG will own upon completion of the ALICO sale.
 - Upon full repayment of the FRBNY’s revolving credit facility, AIG will issue approximately 1.655 billion shares of common stock to Treasury in exchange for \$49.1 billion of Series E and Series F preferred equity issued under the TARP and Series C preferred convertible stock held by the AIG Credit Facility Trust. AIG

will also issue up to 75 million warrants for common equity to all existing common shareholders. Once the exchange is complete, Treasury will have a 92.1 percent common equity stake in AIG.

- AIG's plan to exit U.S. ownership includes a *new* \$2 billion backstop from Treasury to address concerns from credit rating agencies that the insurer may need emergency capital to support its efforts to regain its independence. In a September 30 filing with the SEC, AIG disclosed that Treasury's funds will be available when the government converts its preferred stake into common stock and can be drawn through March 2012 or until AIG sells at least \$2 billion in shares. To secure these funds, AIG must maintain investment-grade ratings to execute its privatization plan, calling for the sale of bonds and stock to private investors as the government withdraws support. AIG will pay Treasury a 5% dividend on the new backstop funds, which are carved out from the company's existing bailout lines of credit. [Initially, AIG paid Treasury 10% dividends on the agency's preferred stock investment in the firm, but was later permitted to skip dividends when the bailout terms were restructured.]
- "What do you do if something adverse were to happen in between the time the government winds down its support and the company fully completes its restructuring plan?" asked Julie Burke, managing director at Fitch. "[Treasury's commitment] is a step to provide liquidity coverage during this interim period." While AIG's plan is a sign of progress, Moody's said the plan raises the risk that Treasury exits before AIG is ready. "[AIG] could become vulnerable if it does not fully revitalize its core operations and substantially exit non-core businesses before parting ways with the government," wrote Moody's analyst Bruce Ballentine in an October 4 note.
- The four main insurance rating firms, including A.M. Best Co., affirmed their grades of AIG in September after AIG announced its restructuring plan. Standard & Poor's rates AIG's debt at A-, a grade that is five levels higher than it would be without federal support, said the agency.
- In a June Oversight Report to Congress, Elizabeth Warren, then chairman of the Congressional Oversight Panel, wrote, "Concerns about rating downgrades drove government policy in regard to AIG. That this small group of private firms was able to command such deference from the federal government raises questions about their role within the marketplace and how effectively and accountably they have wielded their power."
- "By doing things like demanding more capital, rating firms have become the de facto regulator of AIG," said Jonathan Hatcher, an analyst with Jefferies Group Inc. "This is very much a negotiation between AIG, the government and the rating agencies, and no one in that room wants egg on their face."
- At *The Big Picture* [blog], Barry Ritholtz took a closer look at AIG's repayment plan and financial condition, discovering (i) the government has provided the insurer \$182.3 billion of bailout funds of which \$132.1 billion was owed on June 30; and (ii)

AIG's current market capitalization is approximately \$27 billion, based upon roughly 700 million shares outstanding and a current market price of \$39.10 on October 1. Ritholtz concluded, "Today's transaction was the converting of Preferred Stock that had a nominal value of \$49.1 billion—but that was privately held stock that did not trade. Its true value is actually not known. For valuation purposes, let's imagine a hypothetical company that has a myriad value parts worth about \$30 billion... But the company also owes over \$130 billion... to creditors. We would describe that firm as insolvent and heading towards bankruptcy."

- In an interview with *MarketWatch*, AIG's CEO Robert Benmosche said the federal government will make a profit from its bailout of his company. "My personal view is that there's no chance of a loss," added Benmosche. (*Marketwatch*, 10/01/10; *Bloomberg News*, Hugh Son, 10/14/10; *October Oversight Report to Congress*, Congressional Oversight Panel, 10/14/10)

Government Assistance to AIG as of September 1, 2010 (millions of dollars)

	Amount Allocated	Assistance Amount Outstanding as of 9/1/2010
FRBNY¹⁰¹		
Revolving Credit Facility ¹⁰²	\$30,000	\$20,057
Maiden Lane II: Outstanding principal amount of loan from FRBNY	22,500	13,873
Accrued interest payable to FRBNY	–	387
Maiden Lane III: Outstanding principal amount of loan from FRBNY	30,000	15,107
Accrued interest payable to FRBNY	–	477
Preferred interest in AIA Aurora LLC	16,000	16,469
Accrued dividends on preferred interests in AIA Aurora LLC		111
Preferred interest in ALICO SPV	9,000	9,264
Accrued dividends on preferred interests in ALICO Holdings LLC ¹⁰³		<u>62</u>
Total FRBNY	107,500	75,807
TARP		
Series E Non-cumulative Preferred stock	40,000	40,000
Unpaid dividends on Series D Preferred stock ¹⁰⁴		1,605
Series F Non-cumulative Preferred stock ¹⁰⁵	<u>29,835</u>	<u>7,544</u>
Total TARP	69,835	49,149
Total FRBNY + TARP		
Net borrowings	181,035	122,314
Accrued interest payable and unpaid dividends		<u>2,642</u>
Total Balance Outstanding on All Government Investments	\$177,335	\$127,598

(Source: *September Oversight Report*, Congressional Oversight Panel, 09/16/10)

- According to the Congressional Oversight Panel's *September Oversight Report to Congress*, "The latest estimates by CBO, OMB and Treasury project losses in the amount of \$36 billion, \$50 billion and \$45 billion, respectively [on TARP's investments in AIG], although the estimated losses have steadily decreased since the

inception of the credit facility.” COP notes that the timing of Treasury’s exit from AIG is complicated by the fact that AIG is not permitted to repay Treasury until it has fully repaid the Federal Reserve Bank of New York. COP notes, “[O]ver recent months, Treasury, the Federal Reserve, and AIG have stated that they are confident that AIG will fully repay FRBNY in the near future without jeopardizing its financial stability...” (*September Oversight Report to Congress*, Congressional Oversight Panel, 09/16/10)

Auto industry sector: \$67.1 billion of TARP funds outstanding

The question now is how successful will GM’s turnaround be in Dan Akerson’s hands, says former car czar Steve Rattner

Effort fails to save 650 GM jobs at the Indianapolis stamping plant

The Chrysler bailout was the administration’s “most debated decision, according to former car czar Steve Rattner

Auto industry sector: \$67.1 billion of TARP funds outstanding

- Treasury has invested \$67.1 billion of TARP funds in the Automotive Industry Financing Program [AIFP]—of which CBO, OMB and Treasury are projecting losses of \$34 billion, \$28.2 billion and \$24.6 billion, respectively, according to the COP’s September Report to Congress. COP concludes, “Whether Treasury will incur losses from its investment in the AIFP depends on the ability of G.M. and Chrysler to achieve strong operating results and establish themselves as competitive auto manufacturers, and the ability of GMAC, now Ally Financial, to rebuild itself as a healthy standalone company. [GMAC’s recent difficulties with its foreclosure processes may further complicate the company’s ability to turnaround its operations.]”

The question now is how successful will GM’s turnaround be in Dan Akerson’s hands, says former car czar Steve Rattner

- In a *New York Times* interview, Steve Rattner, said, “[During my role as car czar,] I found that the culture in Detroit, and at General Motors in particular, was even more bureaucratic and more stultified than what I would have guessed before I got there. The financial controls were far weaker than anything I would’ve imagined before I got there. On the positive side, G.M. had better projects than I would’ve imagined and it had also brought its manufacturing efficiency to a much higher level than I would’ve predicted. ...G.M. has succeeded in implementing our restructuring plan that we developed with them and bringing its break-even point way, way down from needing 16 million cars a year to be sold in the U.S. to needing 10 to 11 million cars

to be sold. So as we sit here at the moment with car sales running between 11 and a half and 12, G.M. is making significant net income in an environment where it never could have made that money before.

- I think we should all feel that the restructuring has been very successful, the liabilities were reduced from about \$120 billion to about \$55 billion and about \$8 billion of structural costs were taken out of the company. So there's no question that G.M. is a viable, successful company. The only question is how successful and that is in the hands of Dan Akerson." (*New York Times Dealbook Blog*, Micheline Maynard, 09/20/10)
- In October, Standard & Poor's assigned G.M. a BB- rating with stable outlook, three investment levels below investment grade, while it assigned Ford Motors a B+ rating with a positive outlook. "There are a lot of similarities, but there are a lot of differences," said S&P analyst Robert Schultze, who pointed to GM's prospect for generating cash from its China and Brazil operations, along with its improved balance sheet post-bankruptcy. "We expect Ford's credit measures to be improving because of the improvement in the earnings, whereas G.M., some of the balance sheet metrics are strong or relatively better because of the debt reduction." The S&P rating was published a day after Fitch Ratings issued a BB- rating for G.M.—the same rating it assigned to Ford. G.M and Ford have underfunded pensions of \$27 billion and \$6.1 billion, respectively, said Fitch. (*Bloomberg News*, Tim Higgins, 10/07/10)
- Many industry observers question the timing and size of the upcoming G.M. offering, now rumored to be smaller, ranging from \$8 billion to \$10 billion, than previous internal targets of up to \$19 billion, in an effort to achieve the highest price possible for the government shares. Officials hope that subsequent sales of G.M. stock at higher prices over the next three years will increase Treasury's average exit price. Treasury would have to sell the government's 304 million shares in G.M at an average price of \$133.78 a share, before splits, to recover its investment in the automaker, said Neil M. Barofsky, special inspector of TARP. According to press reports, G.M. is negotiating with SAIC, China's top auto manufacturer, which has expressed an interest in investing in stock offering planned for mid-November. (*Washington Post*, Peter Whoriskey, 09/22/10; *New York Times*, Nick Bunkley and Michael J. de la Merced, 09/24/10; *Financial Times*, Bernard Simon, Helen Thomas, and Tom Braithwaite, 10/04/10; *Detroit Free Press*, Chrissie Thompson, 09/19/10)
- G.M. has resumed its contributions to political campaigns, lifting its self-imposed ban on political spending that the company had established during its bankruptcy in the spring of 2009. According to FEC records, G.M. contributed \$90,500 to candidates running for election in 2010, including Senator Debbie Stabenow (D-MI), Senator Sherrod Brown (D-OH), Representative John Dingall (D-MI), and Representative Eric Cantor (R-VA). (In addition, G.M. has spent \$7 million over the past four quarters since exiting bankruptcy for lobbying Capitol Hill, according to *The Hill*.)

- GM spokesman Greg Martin said, “As we’ve emerged as a new company, we’re not going to sit on the sidelines as our competitors and other industries who have PACs are participating in the electoral process. [GM’s political action committee is] an effective means for our employees to pool their resources and have their collective voices heard.” Martin added that the company supports members of both parties who “approach issues thoughtfully [and] support a strong auto industry.” (*Wall Street Journal*, Josh Mitchell, 09/22/10; *Wall Street Journal*, 09/24/10)
- As part of the company’s turnaround, GM has begun retooling its cars’ interior designs to reflect the international market’s needs. In its latest Buick LaCrosse, GM designed the interior with an eye to serving the Chinese market, where the automaker sells four times as many Buicks as in North America. While a car’s rear passenger compartment is usually designed for children in North America, Buick is marketing the LaCrosse as a chauffeur-driven vehicle in China with an “unusual” amount of backseat legroom for a typical North American car. The back window of the LaCrosse is equipped with an anti-glare screen operated with the touch of a button to make it easier for Chinese businessmen to use their laptops and for American children to watch DVDS. “We both benefited,” said a GM spokeswoman. (*Financial Times*, Bernard Simon, 10/04/10)

Effort fails to save 650 GM jobs at the Indianapolis stamping plant

- G.M. autoworkers rejected—by 457 “no” and 96 “yes” votes—the contract offer from JD Norman Industries that proposed to continue operations of the 2.1 million square foot Indianapolis stamping plant. Under the proposal, autoworkers would have to accept new contracts that would include a lower base wage of \$15.50, down from \$29 an hour, and trim back skilled trader workers’ wages to \$24 per hour from \$33.
- Three years ago, G.M. scheduled the shut-down of the plant if no buyer was found for the factory. JD Norman Industries agreed to take over the plant if UAW Local 23 would accept a new contract. The workers’ rejection of the contract will result in the closure of the plant in 2011 and the loss of 650 jobs. [According to the Bureau of Labor Statistics, the unemployment rate in the Indianapolis, IN MSA was 9.1% in August.] (*IndyStar.com*, Ted Evanoff, 08/29/10; *IndyStar.com*, Ted Evanoff, 09/27/10; <http://data.bls.gov/cgi-bin/surveymost>)

The Chrysler bailout was the administration’s “most debated decision,” according to former car czar Steve Rattner

- In a *New York Times* interview, Steve Rattner, said, “Chrysler was the most debated decision we made [about bailing out the auto maker]. It was a very collegial, professional debate and there were very strong arguments on both sides and it was an exceedingly close call. In most other economic environments I think the consensus would’ve been to let Chrysler go. I don’t think it is the government’s job to save companies that are laggards in their industry, but we were facing an extraordinary set

of economic circumstances and in the end the president decided— and I agreed with that decision—to go ahead and save Chrysler.”

- “I have no regrets about that decision and, given where we were in March 2009, if I were part of deciding that all over again I wouldn’t want to do anything differently. And I am encouraged by the progress Chrysler has made. Sergio Marchionne has taken a firm hand on the steering wheel—no pun intended—and moved the company significantly forward. We always knew that the test for Chrysler would be new products that were coming along starting with the Grand Cherokee that just came out, and moving on to the Fiat 500 and then revamped Chrysler projects in the fall of this year and early next year. And of course we don’t know the results of that yet.” (*New York Times Dealbook Blog*, Micheline Maynard, 09/20/10)
- Officials have put on hold a federal agreement to settle allegations that former car czar, Steve Rattner, participated in a pay-for-play scheme with pension funds while running the private equity firm, Quadrangle Group. [Quadrangle agreed to settle related SEC and state allegations in April.] Sources say that Rattner’s settlement has been put on hold to coordinate a deal with Attorney General Andrew Cuomo on state charges. Rattner has agreed to pay a \$6 million fine and be barred from the financial industry for two years to settle the SEC’s allegations that he bribed a political consultant to win business from New York’s pension fund for his former firm, according to sources. (*Washington Post*, Zachary A. Goldfarb, 10/14/10)
- On a brighter note, “Here’s a couple of things America got *right*: cars and freedom” www.youtube.com/watch?v=Ezk0e1VL80o

Citigroup reports \$2.15 billion earnings for the third quarter

Treasury completes its third round of sales of Citi shares
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- Citigroup reported third-quarter earnings of \$2.15 billion, (7 cents a share), beating analysts’ estimates of 5 cents a share. The Bank’s profits benefited from the company’s reduced loan-loss reserves (\$1.99 billion). Citigroup reported total assets of \$1.98 trillion on September 30, up 2% from the second quarter, while bank deposits increased 4% to \$850 billion, driven largely by growth in international deposits. On September 30, Citigroup reported a Tier 1 Capital Ratio of 12.5% and Tier 1 Common Ratio of 10.3% (\$103.7 billion).
- Citi Holdings, the division created to hold businesses tagged for liquidation, reported loan losses of \$4.64 billion during the third quarter, down 37% from a year earlier (\$7.37 billion). Citi Holdings’ assets have declined 24.3% to \$421 billion from a year earlier (\$556 billion). Citigroup CEO Vikram Pandit said he expects

Citi Holdings' total assets to comprise less than 20% of the Bank's balance sheet by yearend.

- “The risk, of course, is that market conditions really dry up, we get that double-dip, and [Citigroup is] unable to sell those assets or they have to do so at distressed prices,” said William Fitzpatrick, a financial analyst with Optique Capital Management. “That for me remains the wild card for Citigroup.” (*Bloomberg News*, Donald Griffin and Bradley Keoun, 10/18/10; *New York Times*, Eric Dash, 10/18/10)

Treasury completes its third round of sales of Citi shares

- The Treasury Department completed its third round of sales of Citigroup common shares on September 30, generating gross proceeds from the three sales of \$16.4 billion from the sale of 1.5 billion shares at an average price of \$3.91 per share. The sales generated a \$3 billion profit to Treasury, along with repayment of \$13.4 billion of Citi's CPP funding. Treasury still holds 3.1 billion of Citi's common shares, representing a 12.4% stake in the Bank.
- Treasury also completed a \$2.2 billion public offering of trust preferred securities (TruPS), issued under the Asset Guarantee Program. According to the *October Report Oversight Report*, “These securities were a premium for Treasury's \$5 billion guarantee on a \$301 billion pool of Citigroup ring-fenced assets. Treasury initially received a \$4 billion premium; however, \$1.8 billion was cancelled upon the December 2009 termination of the guarantee. All proceeds from the TruPS sale constitute further profits for taxpayers since Treasury did not make any payments associated with the loss share agreement during the life of the program. Treasury also plans to sell \$800 million in AGP TruPS currently held by FDIC. The FDIC will transfer these securities to Treasury upon Citigroup's exit from the Temporary Liquidity Guarantee Program (TLGP), provided that there are no losses from the company's participation in the TLGP.” (*October Report Oversight Report*, Congressional Oversight Panel, 10/14/10)

As TARP winds down, SIG-TARP plans to expand his staff and open four regional offices

- Neil Barofsky, the special inspector general for TARP, has requested permission to expand his current staff of 140 to 192 to serve the four branch offices he plans to open in New York, Atlanta, Los Angeles, and San Francisco. “Most of the ramp-up in our numbers, the expansion in our hiring, is due to our criminal investigations,” said Barofsky. “The reason why we're ramping up is that the amount of fraud out there, the amount of case work that we're doing, has in some cases exceeded our expectations. The cases are very complex ...sophisticated white collar cases.” However, Barofsky's budget request for FY2012 will be slightly less than his \$54.6

million request for FY2011. (www.moneycontrol.com. 09/20/10; *Wall Street Journal*, 09/23/10)

- Charles J. Antonucci, the former CEO of Park Avenue Bank, pleaded guilty in the U.S. District Court for the Southern District of New York to securities fraud and other charges, stemming from his failed attempt to steal more than \$11 million of TARP funds. Antonucci, who was the first person charged with trying to steal TARP funds, faces a maximum of 135 years in jail at his sentencing hearing to be held on April 8. (*Bureau of National Affairs*, 10/12/10)

Small business lending fund created

- On September 29, President Barack Obama signed into law the Small Business Jobs and Credit Act of 2010 that will create a \$30 billion small-business lending fund in hopes of stimulating small business growth and job creation across the country. The legislation allows small banks (with assets under \$10 billion) that participated in TARP's Capital Purchase Program to refinance into the Small Business Lending (SBL) fund in order to pay lower dividends on the TARP funds. Currently, CPP participants pay 5% dividends on TARP funds that will increase to 9% in 2013. In contrast, institutions participating in the SBL fund will pay an initial dividend of 5%, which could drop to as low as 1% for a few years, as participants increase their business lending. However, if the banks fail to increase their business lending, the dividend rate will increase to 7%. Unlike TARP, the SBL program has no restrictions on executive pay and is free of warrants.
- Interest among some bankers for the SBL program appears to be lackluster at best, saying they aren't able to get past their bitter experience with TARP and have no interest in doing business again with the federal government. "It's like all their programs, said Thomas O'Brian, president and CEO of State Bank (Jericho, NY). "They're just subject to change and revision, and someday they'll turn around and attack or revile their participants, and I don't think any of us want to go through that anymore."
- Senator Olympia Snow (R-ME) called on Treasury Secretary Timothy Geithner and the Senate Banking Committee to monitor the implementation of the SBL program and exercise strict oversight of its initiative. In a letter to Geithner and Committee Chairman Christopher Dodd (D-CT), Snow outlined three concerns about the loan fund's provisions, which included (i) the possible cost of the program to taxpayers, estimated at \$6.2 billion on a comprehensive fair-value basis by CBO; (ii) the risk that the program's structure "could encourage unnecessarily risky behavior by banks" to achieve lower dividend rate on SBL funds; and (iii) the fear that the program will do very little to promote healthy lending to small businesses.
- Gene Sperling, counselor to Treasury Secretary Geithner, said the administration hopes to publish guidelines for banks to participate in the SBL program within a few

weeks, which will allow the agency to begin receiving and processing banks' applications this calendar year. "That's ambitious, but that's our hope, said Sperling. "We're moving expeditiously." (*Bureau of National Affairs*, Thecla Fabian, 09/29/10; *American Banker*, Kate Davidson, 10/13/10; *Bureau of National Affairs*, 10/15/10)

FDIC's roundup: 132 bank failures in 2010 and 876 problem institutions

FDIC may seek \$1 billion from failed-bank executives

FDIC's roundup: 132 bank failures in 2010 and 876 problem institutions

- On October 15, regulators closed two banks in Missouri, bringing the number of bank failures to 132 in 2010. (*New York Times Dealbook*, Andrew Ross Sorkin, 10/18/10)
- At the end of the third quarter, 876 banks with total assets of \$416.1 billion were identified as problem institutions, operating under some of form regulatory agreement. (<http://calculatedriskimages.blogspot.com/2010/10/unofficial>)

Top 15 States by Total Problem Bank Assets						
State	% Total	Tot. Assets (\$000)	Number Institutions	Special Purpose Institutions		MEMO- BOTH
				CDFIs	MDIs*	
MI	8.59%	33,357,263	22			
FL	8.28%	32,164,757	63		4,698,125	
CA	7.95%	30,899,499	61	1,069,298	8,533,916	1,069,298
UT	5.79%	22,477,008	16			
MO	5.22%	20,274,007	27			
SC	4.67%	18,132,383	17	91,895	91,895	91,895
PR	4.66%	18,102,301	1		18,102,301	
GA	4.45%	17,276,806	65	312,941	518,035	312,941
IL	4.42%	17,150,669	58	438,517	1,576,849	220,996
CO	4.07%	15,791,416	34	91,519	161,800	91,519
WI	3.80%	14,748,811	34	216,237	216,237	216,237
TX	3.61%	14,005,288	42	2,140,508	2,569,715	
WA	3.14%	12,183,759	26	196,292	115,387	
KS	2.74%	10,648,306	36		119,763	
MN	2.71%	10,533,605	60			
Top 15	74.08%	287,745,878	562	4,557,207	36,704,023	2,002,886
Others	25.92%	100,695,161	314	1,738,567	2,732,872	1,329,940
Totals	100.00%	388,441,039	876	6,295,774	39,436,895	3,332,826

Sources: <http://calculatedriskimages.blogspot.com/2010/10/unofficial->

The CDFI Banking Sector: 2009 Annual Report on Financial and Social Performance

*Minority depository institutions; www.fdic.gov/regulations/resources/minority/minority2q2010.html

- More than 120 banks, nearly all of them smaller institutions, have missed their scheduled quarterly dividend payments to TARP. Five banks have failed to make *any* dividend payments to TARP, making it very unlikely that taxpayers will recover the nearly \$3 billion of Treasury funds that they received. (*Washington Post*, Brady Dennis, 09/13/10)
- In an October 5 editorial, the *Washington Post* wrote, "...A minority-owned institution with close ties to Representative Maxine Waters (D-CA) of the House Financial Services Committee, OneUnited got \$12 million from ...[TARP] in December 2008, thanks in part to a provision inserted in the TARP bill by the committee's chairman, Rep. Barney Frank (D-MA). OneUnited has since failed to pay the government the \$900,000 it owes—not surprising, given its history of mismanagement... So a dodgy bank with little going for it except access to powerful members of Congress gets \$12 million for no evident public purpose and with little chance taxpayers will ever see that money again. Those responsible insist that, according to prevailing norms in the nation's capital, they did nothing wrong. Worst of all, they might be telling the truth." (*Washington Post*, 10/05/10)

FDIC may seek \$1 billion from failed-bank executives

- FDIC has authorized lawsuits against more than 50 officers and directors of failed institutions in hopes of recouping more than \$1 billion in losses stemming from the banks' failures. "We're ready to go," said Richard Osterman, FDIC's acting general counsel. "We could walk to court tomorrow and file the lawsuits." To date, FDIC has brought only one lawsuit against officers and directors related to recent bank failures—a July filing, seeking \$300 million in damages from former executives of IndyMac Bancorp Inc.
- FDIC spokesman David Barr said, "It's in both our interest and theirs to try and settle this matter before it gets to court and we get into expensive litigation." (*Bloomberg News*, Phil Mattingly, 10/08/10)

The next Armageddon

- At an American Enterprise conference, Chris Whalen presented strong arguments illustrating how policymakers have simply "kicked the can" down the road in dealing with the financial services industry's problems and even

bigger problems loom on the horizon. If Whalen is correct, Congress may face new rounds of government interventions and takeovers that are likely to lead to nationalization of parts of the U.S. banking sector.

- Whalen said the U.S. banking sector is entering a new period of crisis in which operating costs are rising dramatically due to foreclosures and defaults. The U.S. is less than 25% the way through the foreclosure process with an estimated 1 in 5 mortgages likely to go into foreclosure without radical action, according to Laurie Goodman with Amherst Securities
- Rising operating costs in banks will be more significant than in past recessions and could force the U.S. government to restructure some large lenders, as expenses overwhelm their revenue. The current foreclosure moratoriums by some of the largest servicers is only the start of the crisis that will threaten the financial foundations of the entire U.S. political economy, according to Whalen.
- The largest U.S. banks remain insolvent and must continue to shrink, argued Whalen. The administration's failure to restructure the largest banks over the past two years has only delayed the process—something that is likely to occur over next three to five years, whether we like it or not. The key issue the banks will face is recognizing existing losses on their balance sheets.
- Whalen said that the impending operational collapse of some of the largest U.S. banks will serve as the catalyst for re-creation of RFC-type liquidation vehicle(s) to handle the operational task of finally deflating the subprime bubble, which will occur over a four to five year period. (<http://pragcap.com/chris-whalen-describes-why-2011-could-make-2008-look-like-a-cakewalk>)
- A video of the American Enterprise Institute Event can be viewed at http://www.ustream.tv/recorded/10034228#utm_campaign=synclinkback&source=http://www.wealthdaily.com/articles/americas-next-crisis-is-already-here/2764&medium=10034228 and his slide presentation is available at <http://www.scribd.com/doc/39634096/Pictures-of-Deflation-Whalen-AEI-Presentation-October-6-2010>.

QE2, magic bullets and economic realities

- *Fortune Magazine's* Allan Sloan, Tory Newmyer and Doris Burke, wrote, “Let us tell you an Ugly Truth about the economy.... It's this: There is nothing that the U.S. government or the Federal Reserve or tax cutters can do to make our economic pain vanish overnight. There are no all-powerful, all-knowing superheroes or super villains who can rescue or tank the economy all by themselves.”

- “...[I]f you look at things rationally rather than politically, you’ll see that Washington has far less power over the economy, and far less maneuvering room, than people think. ... [W]e could use such a wondrous fix. ... The fact is that our nation has suffered a huge financial trauma, and it’s going to take years to get well again. This isn’t exactly unknown in Washington, but it’s not something people in power go out of their way to emphasize.”
- “... [T]he Great Recession, whose aftermath we’re living through, was different from the 10 previous post-World War II recessions. Those slowdowns were caused by the Fed’s increase of short-term interest rates to combat inflation. Recessions caused by the Fed’s rate-raising could be cured by the Fed’s rate-lowering. If things looked especially dicey, the federal government would send people checks to generate economic activity and spur confidence.”
- [This recession] “was triggered by a financial meltdown brought on by excessive lending, reckless risk-taking, the implosion of an unregulated shadow banking system that assumed that short-term money would always be available—and ignorant and careless borrowing by people and institutions. The recession’s genesis is why things are still sluggish even though the Fed has cut short-term rates, which it controls, to virtually zero and has forced down long-term rates, which it doesn’t control, by buying more than \$1 trillion of securities in the open market and letting it be known that it and other central banks will buy more.”
- “Yet although such ‘quantitative easing’—econo-speak for ‘printing money’—helped allay financial panic in 2009 by providing cash to institutions that needed it badly, it’s less effective and more risky to use it to stimulate the economy. Hence the knife fight at the Fed Board of Governors between the fans of quantitative easing and those opposing it.”
- “Let us explain. Even though the Fed is very powerful, it’s not all-powerful, just as the United States is not all-powerful when it comes to its own financial affairs. The Fed has to worry not only about the U.S. economy and money supply but also about debasing the dollar too much too quickly, lest it spook the foreigners who finance our trade and federal budget deficits. If foreigners lose faith in the dollar’s value, it could run our interest rates up sharply and abort any recovery.”
- “To its credit, the Fed—the one institution that because of its independence can actually act quickly without making a political show—sort of admits that its power is limited. ‘Central bankers alone cannot solve the world’s economic problems,’ Chairman Ben S. Bernanke said in a speech at the Fed’s conclave in Jackson Hole, Wyo., in August. [F]ormer Fed vice chairman Donald Kohn, a 40-year Fed veteran,[said,] ‘The Federal Reserve can make a difference, but it doesn’t have a magic bullet, it can’t take a weak economy facing a lot of major challenges and rapidly turn it into a strong economy.’ Kohn isn’t alone in that view.”

- “Douglas Holtz-Eakin, president of the American Action Forum, a conservative think tank, was Senator John McCain’s economic adviser in the 2008 campaign. He and his Democratic counterparts know the dirty little secret: that the huge financial trauma suffered by the economy won’t disappear overnight. ‘The public has been sold this notion that somehow we can control the economy - that we can fine-tune it so we don’t get inflation on the upside, we don’t get recessions on the downside, [that] when something happens, they can step in and offset it. The economics profession is painfully aware that this is just not true, and [that it] has a terrible impact on politicians, presidents in particular,’ says ... Holtz-Eakin.”
- “The biggest single source of wealth for many people—their home equity— has fallen almost 50 percent from its peak in 2006, according to Federal Reserve statistics. Loss: \$6.5 trillion. U.S. stocks are still down 25 percent from their peak in 2007, their 75 percent gain in the past 19 months notwithstanding. Cost: \$4.8 trillion. Then there are the 7.7 million lost jobs with their associated lost income, lost wealth and lost consumer spending. Loss: untold trillions of dollars. This wealth-reducing trauma, combined with consumers becoming afraid to spend and lenders changing from being ultra-lax to ultra-strict, has sucked huge amounts of money from the economy. Don’t let occasional upticks in consumer spending, the stock market or home equity fool you into thinking that things are okay, because they aren’t.”
- “‘The economy suffered a really deep wound—it’s healing, and it’s a little bit uneven,’ says Alan Krueger, assistant Treasury secretary for economic policy. ‘But that is what you’d expect given the loss of wealth from the financial crisis.’”
- “People used to collectively spend more than they took home—hence, our negative national savings rate, which was covered by borrowing. Now we’re spending 6 percent or so less than we’re taking home. That’s a big head wind to fight. ... Compared with all the losses we’ve talked about, the \$814 billion in stimulus spending - the effectiveness of which we won’t get into today - is small beer.”
- “So what do you do? One proposed solution is to jump-start the economy with deep and permanent tax cuts. That’s more than a little problematic, given that the Great Recession began in 2007, when tax rates, especially on investment income, were about the lowest in modern times and there were no ‘Obama tax increases’ on the horizon.”
- “What about having the Treasury engage in a massive stimulus program to put money in people’s pockets and have them spend it, ginning up economic activity and restoring confidence? But stimulus money has to come from somewhere—and it doesn’t seem possible for the Treasury to raise a few trillion more stimulus bucks without dire consequences to interest rates and the dollar’s value.”
- “Our final little secret is that the United States is now being forced to live within its means, and that’s not fun. For years our country could spend and spend because two bubbles showered companies, consumers and governments with free money. Who

needed to save when stocks were producing returns of almost 20 percent a year, which they did from August 1982 through the spring of 2000? Or when house prices rose at double-digit rates and you could get cash easily and quickly through refinancing, a second mortgage or a home equity loan? Homeowners raising and spending cash propped the economy for years.”

- “The closest we’re likely to come to free money is the Fed’s proposed quantitative-easing moves to buy Treasury securities. Let us show you how it works - and the problems with it. Let’s say the Fed buys \$1 trillion of Treasury securities in the secondary market. Out of thin air, it creates \$1 trillion in credit balances in the sellers’ accounts. The sellers have \$1 trillion more cash than they did, increasing the money supply. There is now \$1 trillion less in publicly traded Treasuries, which props up their price.”
- “By contrast, if Goldman Sachs wanted to buy \$1 trillion of Treasury securities, it would have to find \$1 trillion of cash to pay for them. Sellers would have \$1 trillion more cash than before. Goldman would have \$1 trillion less. There would be no increase in the money supply or decrease in the Treasury supply.”
- “If the Fed could buy endless amounts of Treasury securities without any side effects, it would be almost like free money. The securities would cost the Treasury little or nothing in the way of interest, because the Fed turns over its profits - \$53 billion last year, \$40 billion in the first half of 2010 - to the Treasury.”
- “So if the Fed buys \$1 trillion of 2.5 percent, 10-year Treasury notes, Treasury’s \$25 billion annual interest expense is offset by the \$25 billion of extra profit the Fed would make, all (or almost all) of which would be turned over to the Treasury. See? Isn’t that grand?”
- “There is, however, a problem. The Fed can’t do that indefinitely without touching off inflation, debasing the dollar, or both. Markets are bigger and more powerful than the Fed.”
- “Consider the reaction of people like veteran Wall Street value investor Hugh Lamle of M.D. Sass to quantitative easing. ‘It’s one thing to do \$800 billion once,’ he says. ‘But if the federal government is going to print \$1 trillion a year for five years, maybe I don’t want to be in dollars.’”
- “A second factor is that long-term rates are already so low that it’s not clear how much stimulus you get from cutting them more. It’s a big deal to cut interest rates to 5 percent from 8 percent. But at lower levels, the result is less dramatic.”
- “Do you think the difference between 3 percent and 2.5 percent is going to matter? Meanwhile, these ultra-low rates are penalizing American savers - especially retirees relying on CD income to supplement Social Security. They tend to spend all their income, and it’s down sharply. That’s one reason the economy is weak.”

- “Don’t get us wrong, there are plenty of winners in this game - just not the ones who need help. Cash-rich corporations are issuing billions of dollars of cheap debt for purposes such as buying back stock rather than expanding and creating new jobs. Corporations have record cash on hand but aren’t using it to expand in the United States.”
- “Banks, too, are profiting mightily from quantitative easing. They can borrow short-term money for essentially nothing, then buy Treasury securities, knowing that the Fed will support the securities’ prices by buying them in the market. Playing the yield curve is easier, less risky and more lucrative than what the government wants the banks to do, which is to make loans.”
- “Perhaps the biggest problem we have standing in the way of having good times return is housing - which is an example of how deep-rooted our problems are and how resistant they are to government programs.”
- “Housing was a major source of national wealth for decades, and home equity, however sadly diminished, is still the biggest single piece of wealth many Americans have. That’s especially true of lower-income people.”
- “For the first half of the year, 89 percent of mortgages came from the government-run Fannie Mae, Freddie Mac, Federal Housing Administration and Department of Veterans Affairs, according to *Inside Mortgage Finance*. That’s almost triple the levels of housing’s peak years: 31 percent in 2005 and 30 percent in 2006.”
- “Even with all that effort, though, housing prices may be stabilizing at levels far below their peak four years ago rather than recovering broadly.”
- “When will house prices get back to where they were? John Burns of John Burns Real Estate Consulting, one of the nation’s savviest real estate analysts, invokes the seven-and-seven rule. In previous local-market bubbles, Burns says, ‘the rule of thumb is seven years down and seven years up’ after the bubble pops. Apply that rule to the national market, where the bubble popped in 2006, and we’re talking about a sustained recovery starting in 2013, and taking until 2020. That’s pretty grim, but probably realistic.”
- “So when are we going to know when things are getting better? They may, in fact, be getting better now, but it’s going to take a long time for the wound to heal completely. We need to take care of people who have lost their jobs and lost their hope.”
- “But after the midterm elections, when there’s going to be immense pressure to adopt everyone’s programs, we can’t just throw money at everything, searching for magic cures and magic sound bites. If we do, it will take us that much longer to climb out of the hole.” (*Fortune*, Allan Sloan, Tory Newmyer, and Doris Burke, 10/17/10)

- In the October 15 *Weekly Economic & Financial Commentary*, Wells Fargo Economic Group wrote, “When a new person enters the Economics department at Wells Fargo Securities, LLC, we suggest several books to read—one of those books is Thomas Sowell’s “A Conflict of Visions.” Why? Sowell’s book helps the reader understand the “other” side. Sowell helps explain why Democrats have a set of beliefs that is different from Republicans.”
- “So it is for monetary policy. Why does President Tom Hoenig have a consistent, dissenting view on monetary policy going into next week’s FOMC meeting? From President’s Hoenig’s speech earlier this week at the National Association for Business Economics conference, we drew the following views: first, while the public may have a sense that the Fed must ‘do something,’ President Hoenig is asking why. Second, there is no shortage of liquidity in the financial system right now. Banks and non-financial firms have lots of extra cash right now so liquidity is not the issue. Third, how well can the Fed fine tune the market response to quantitative easing? The lags in monetary policy are long and variable and the impacts on inflation are not evenly spread over many product areas. For example, farmland, metals and corn prices are rising, while the estimated impact of \$500 billion of Fed easing is estimated to have a modest 20 bps-30 bps impact on interest rates. So why all this effort for so little return? Why take all these risks if the benefit is so small?”
- “Two final points. First, the lesson of the 1960s was that over time inflation pressures build up and continued increases in reserves (high powered money) today will generate rising inflation pressures down the road, and it is not clear that the Fed will be able to rein in such pressures so easily. Finally, what does this episode indicate for the risks of the Fed’s independence? Is the Fed the new first lender of first resort to address the unemployment problem? How independent can the Fed be in an environment when it is also a major buyer of public (Treasury) and private debt? The Fed as a marginal buyer would set the price—a politically risky scenario for an independent Federal Reserve” (*Weekly Economic & Financial Commentary*, Wells Fargo Economic Group, 10/15/10)

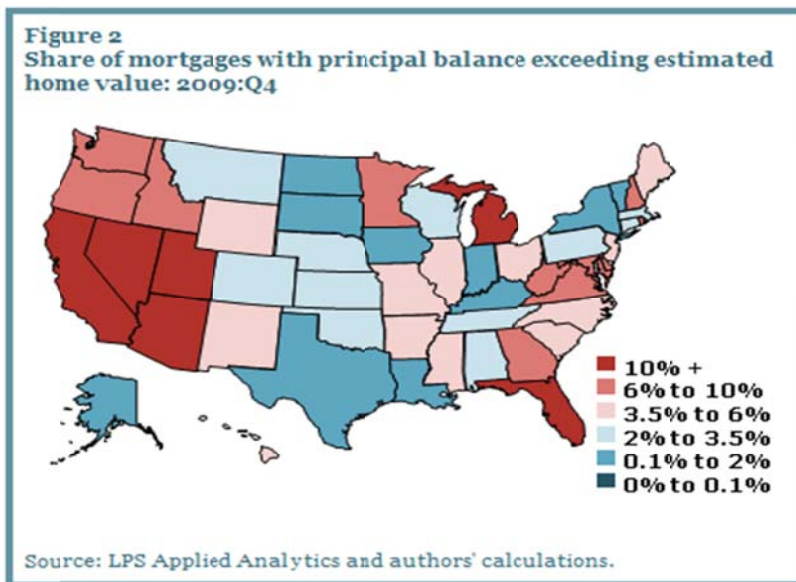
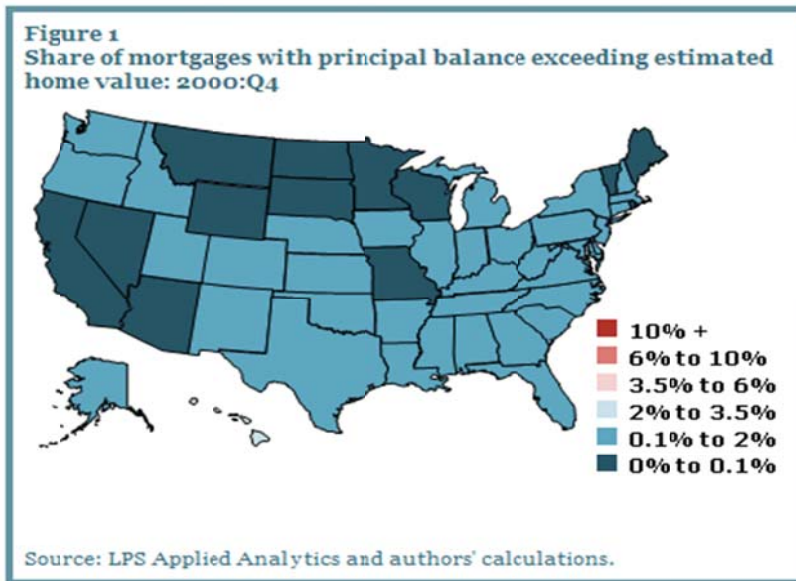
[Editor’s Note: John E. Silvia, Wells Fargo’s chief economist said his department’s reading list also includes: *Team of Rivals* by Doris Kearns Goodwin (“a great management lesson based upon Lincoln’s Presidency”); *Nothing Like it in the World* by Steven Ambrose (“how making decisions on the fly as the transcontinental railroad was built”); *Thinking in Time* by Neustadt & May (“how to use precedent/analogies properly in making executive decisions”); and *Against the Gods* by Peter L. Bernstein (“a historical review of risk”).]

Fannie Mae and Freddie Mac

Update on mortgage relief initiatives

Despite mortgage modification efforts the housing market remains weak

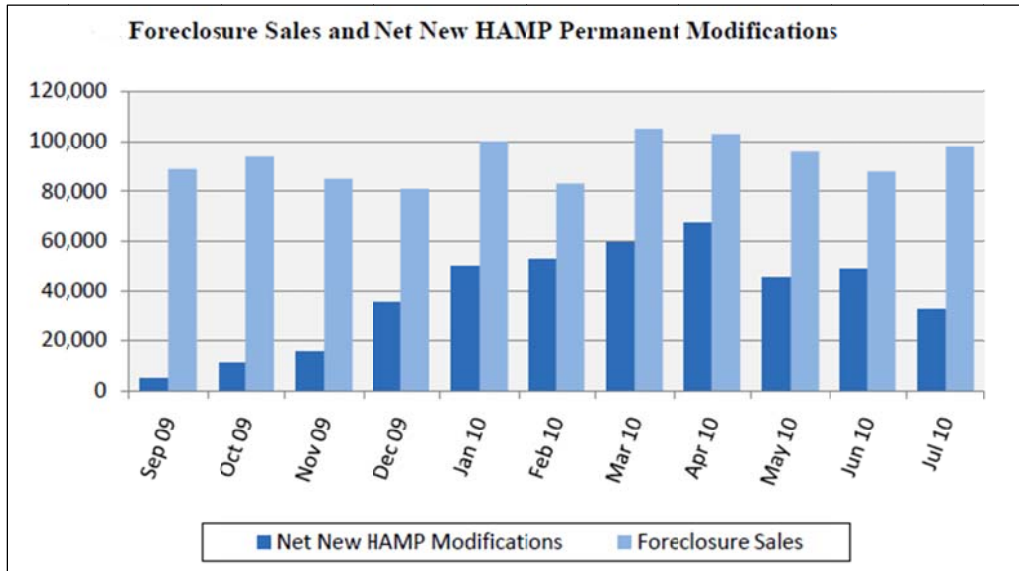
And housing markets continue their downward trend



Source: <http://www.frbsf.org/publications/economics/letter/2010/el2010-31.html>

Update on mortgage relief initiatives

- Treasury estimates that its foreclosure mitigation programs will cost taxpayers \$48.8 billion, which includes \$11 billion for FHA, \$4.2 billion for the Hardest Hit Fund, and \$30.5 billion for other programs under HAMP, according to the *July TARP Monthly 105(a) Report*. Under the current HAMP guidelines, servicers will continue to offer loan modifications through December 31, 2012 and conversions to permanent mortgages through May 2, 2013. Since HAMP payments occur in installments over a period of up to five years, Treasury has distributed only \$395 million—or 1.3%—of the \$30.5 billion currently committed to HAMP.
- **HAMP.** Treasury’s cornerstone program for foreclosure mitigation is HAMP, which has helped 434,716 homeowners enter permanent mortgage modifications between September 2009 and July 2010 with approximately 3% (12,912) borrowers either re-defaulting on their mortgage or leaving the program for other reasons, according to the Congressional Oversight Panel. Over this period, approximately 572,000 trial modifications failed to convert to permanent mods due to (i) incomplete requests (28%); (ii) trial plan default (21%); (iii) ineligible borrowers based upon their debt to income ratio (14%); (iv) denial code missing (12%); (v) ineligible mortgage (8%); (vi) negative present value (7%); (vii) offer not accepted by the borrower or withdrawn (3%); and other reasons, including excessive forbearance, property not owner-occupied, etc. (6%). Over the 11 month period, approximately 1 million foreclosure sales occurred nationwide, while 421,804 permanent modifications, net of re-defaults, were successfully implemented.
- As of August, only 449,000 borrowers have received permanent modifications through HAMP—34% of the 1.3 million borrowers who have enrolled in the program, while 680,000 borrowers have fallen out of the program (51%). (*Washington Post*, Alan Zibel, 09/25/10; *September Oversight Report to Congress*, Congressional Oversight Panel, 09/16/10)



Source: *September Oversight Report to Congress*, 09/16/10

- In an October 3 editorial, the *Washington Post* wrote, “...Of all the uses of TARP, the only one that has clearly failed is the attempt to channel mortgage relief funds to troubled homeowners. But even in that case, there’s a silver lining: So few people ended up qualifying that TARP has hardly spent any of the \$41 billion it set aside for the job.”
- **Hardest Hit Fund (HHF).** Treasury has committed \$4.1 billion of TARP funds to 18 states and the District of Columbia to support a variety of foreclosure mitigation and other housing assistance programs.
- Treasury is encouraging [but not requiring] states that participate in the HHF to leverage their TARP allocations with matching contributions with “affected” financial institutions (e.g., the lender or servicer of the mortgage) on a dollar-for-dollar basis. In cases in which funds are matched, the TARP payments are in effect grants with no possibility of the funds being repaid to the state. Where grants are not obtained, the TARP payments must be structured as forgivable loans that do not have to be repaid as long as certain conditions are met. To date, Treasury has not publicly disclosed their conditions for forgiveness of indebtedness.

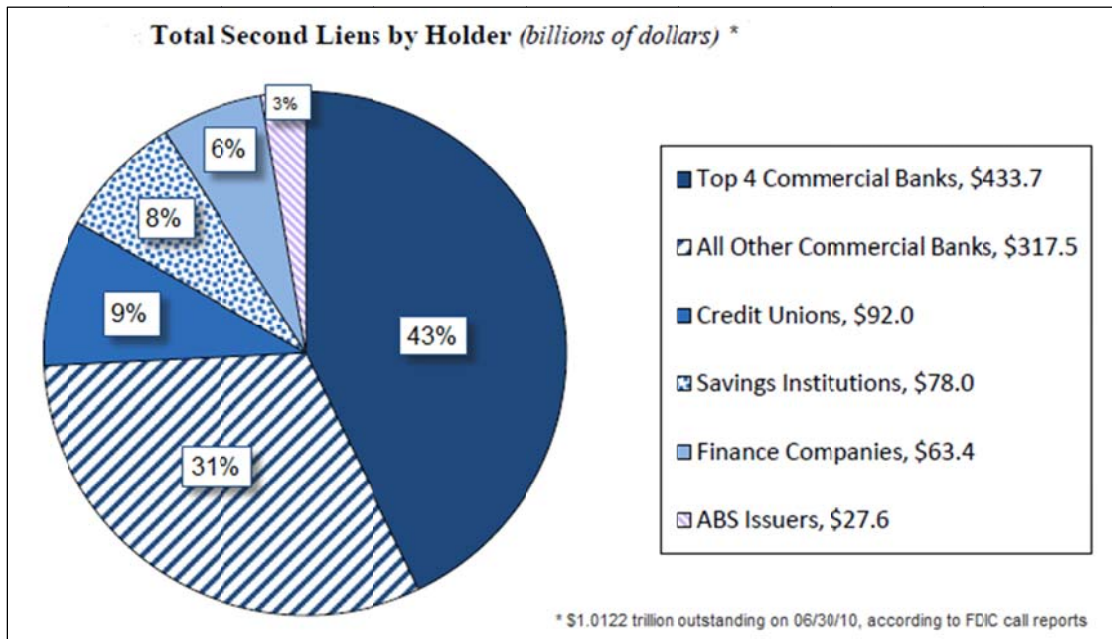
<u>State</u>	<u>Total Allocation</u>	<u>% Allocation</u>
California	1,175,857,070	28.68%
Florida	656,864,755	16.02%
Ohio	320,728,864	7.82%
Michigan	282,961,559	6.90%
North Carolina	279,874,221	6.83%
South Carolina	196,772,347	4.80%
Illinois	166,352,726	4.06%
Oregon	137,294,215	3.35%
Nevada	136,856,581	3.34%
Georgia	126,650,987	3.09%
Arizona	125,100,000	3.05%
New Jersey	112,200,638	2.74%
Indiana	82,762,859	2.02%
Tennessee	81,128,260	1.98%
Alabama	60,672,471	1.48%
Rhode Island	56,570,770	1.38%
Kentucky	55,588,050	1.36%
Mississippi	38,036,950	0.93%
District of Columbia	<u>7,726,678</u>	<u>0.19%</u>
Total	\$4,100,000,000	100.00%

(Source: *September Oversight Report to Congress*, 09/16/10)

- **FHA Refinance Program (FHA Refi).** In March 2010, Treasury announced an \$11 billion refinance program with FHA for homeowners whose mortgage balance exceeds the market value of their home. Treasury earmarked approximately \$3 billion of program funds for use as incentive payments to re-subordinate and to pay for write-down and extinguishment of second liens with the remaining \$8 billion used to share losses on these refinanced mortgages with FHA until August 2020. This voluntary program would require first lien holders to write-down 10% of the mortgage balance. According to a HUD study, the FHA Refi program would result in \$23.5 billion in net benefits to society, \$20.4 billion of which would take the form of benefits to owners of first and second liens. HUD estimates that each refinanced mortgage would cost Treasury on average \$4,083—or approximately \$4 billion of the \$8 billion in TARP funds that Treasury has set aside for loss sharing. The Congressional Oversight Panel questions if this program will “be able to make any significant headway against the problem of ‘underwater’ borrowers.”
- On September 3, Treasury purchased an \$8 billion, 10-year letter of credit facility from Citibank to cover losses on new FHA loans. Over a 2.5 year period, Treasury plans to incrementally increase the Citibank facility over time in proportion to the dollar value of mortgages refinanced under the FHA Short Refinance Program.

Treasury will pay Citibank \$117 million in fees for the availability and usage of the credit facility.

- In its *September Oversight Report to Congress*, the Panel wrote, “Although the program shifts most of a loan’s risk from the lender to the government, it is unclear whether this will be sufficient incentive to persuade a large number of lenders to participate, in light of the significant principal write-downs participating lenders must offer to borrowers. ...The Panel is also concerned about the precedent set by a government program that pays holders of a second lien while asking first lien holders to take a loss. ...The Panel is [also] concerned that in many instances, the financial institutions that own second liens also service first liens on the same homes, which presents a conflict of interest and gives the second lien holder the ability to allocate losses to the first-lien holder. The nation’s four largest commercial banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo—hold 43 percent [of the \$1 trillion] of second liens [outstanding on June 30]. Those same four banks are also the four largest servicers of residential mortgages. Unlike second liens, first liens are usually securitized, and are more broadly distributed among investors. It is possible that this program may benefit the large banks that hold second liens at the expense of first lien investors.” (*September Oversight Report to Congress*, Congressional Oversight Panel, 09/16/10) *Washington Post*, 10/03/10)



(Source: *September Oversight Report to Congress*, 09/16/10)

Despite mortgage modification efforts the housing market remains weak

- Three million foreclosures have occurred since the first quarter of 2007, as mortgage delinquencies have soared more than 90% to 9.85% on June 30. Approximately

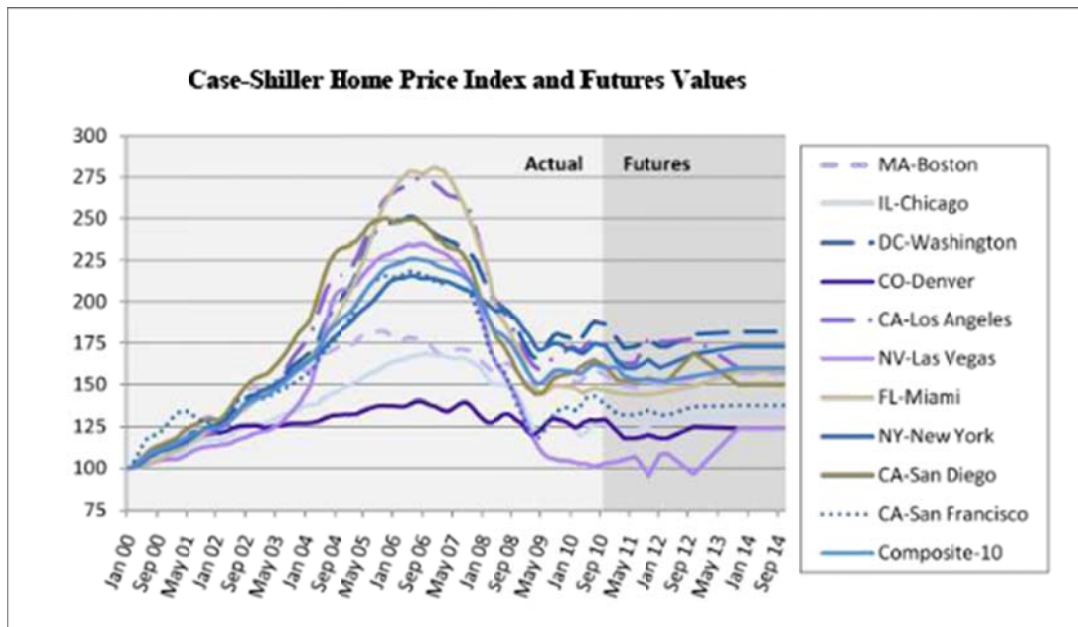
4.57% of all residential mortgages were in foreclosure at the end of the second quarter. Housing prices will continue to be adversely impacted by foreclosure and default rates that lead to growing inventory of homes. In August, foreclosure actions increased 4% to 338,836 with five states accounting for more than 50% of the national total and California alone accounting for 20%.



Source: *September Oversight Report to Congress*, 09/16/10

- Residential mortgages in foreclosure are at near all-time highs—nearly 1 in 21, up from 1 in 100 four years ago. Overall, foreclosures topped 930,437 during the third quarter, a 4% increase from the previous quarter. In September, foreclosures totaled 102,134, the first single month ever to reach the 100,000 milestone, according to RealtyTrac. Foreclosures are expected to decline in the fourth quarter, as banks halt foreclosure sales to review irregularities in their foreclosure procedures. (*Frontline Weekly Newsletter*, John Mauldin, 10/15/10; *September Oversight Report to Congress*, Congressional Oversight Panel. 09/16/10; *Mortgage Bankers Association Press Release*, 08/26/10; *Reuters*, Corbett B. Daily, 10/14/10)
- In the *Shadow Inventory Report*, Standard & Poor's estimates that the principal balance of distressed homes is approximately \$460 billion, representing nearly 33% of the non-agency residential mortgage-backed securities currently outstanding. S&P's estimate of the number of months to clear the shadow inventory increased 18% during the first six months of 2010 to 41. (*Mortgage Servicing News*, 09/28/10)
- The Case-Shiller 20-City Composite as well as the FHFA Housing Price Index increased slightly in July with both indices respectively 6% and 5% below their levels in October 2008. Case-Shiller futures prices reflect that the major MSAs are

expected by the market to decrease through the end of 2010 and beginning of 2011. (*October Oversight Report to Congress*, Congressional Oversight Panel, 10/14/10)



Source: October Oversight Report to Congress, 10/14/10

- In the October 8 *Lunch with Dave*, Dave Rosenberg, chief economist and strategist for Guluskin Sheff, wrote, “...There is a wave of new supply [foreclosed single-family homes] that is going to be hitting the market in the future because only 20% of the 1.2 million homes in the foreclosure process are on the market... Of the 900,000 homes that banks have repossessed, just 30% are for sale at the current time. So tack 600,000 units onto the ‘shadow inventory’ and we are talking about a total backlog of up to 3.5 million (tack that on to the 4 million homes that are officially listed for sale right now).”
- “And, the foreclosure process has picked up pace of late—282,000 homes entered it in August compared with 225,800 in June, and a growing share are now in ‘prime’ mortgages. While there is glee whenever the home sales numbers come in above expectations, keep in mind how dysfunctional the market is — 24% of all homes sold in Q2 were foreclosed units (according to RealtyTrac) and in turn, these units are selling at a 26% discount to the rest of the sales universe and hence the renewed downward pressure on house prices of late. It will very likely take between 3 to 5 years to clean up the excess supply in the housing market and until it reaches some balance, expect more deflation—perhaps exceeding 10% before the bottom is reached.” (*Lunch with Dave*, Dave Rosenberg, 10/08/10)
- In an October 1 analysis of the housing crisis, Laurie Goodman, Senior Managing Director of Amherst Securities, noted that out of the roughly 80 million homes in the

U.S., 55 million have mortgages. Goodman concluded that 20% of all residential mortgages are already impaired, including borrowers who are seriously behind in their mortgages (9%); those who have been behind and are “dirty current,” but are now re-defaulting at an alarming rate (6%); and severely underwater borrowers (by more than 20% of current value) and now re-defaulting at a 20% per annum pace (5%). On balance, Goodman estimates that the number of homes that are now in jeopardy of foreclosure total 11.57 million.

- Goodman concludes, “The housing market is quite fragile. This is underscored by the two latest existing home sales numbers—3.85 million units in July, 4.13 million units in August, the lowest prints on record since the National Association of Realtors (NAR) began the series in 1999. If governmental policy does not change, over 11 million borrowers are in danger of losing his or her home (1 borrower out of every 5). ...Politically, this cannot happen. Successive modification plans will be attempted until something works. The success rate on mortgage modifications can be raised by making greater use of principal reductions. The moral hazard (strategic default issue) must be addressed by first recognizing it as an economic issue, not a moral one. The costs of default must be made explicit. The 2nd lien issue must also be addressed. However, supply side actions alone will be insufficient to address the housing crisis. Demand side actions are needed: providing leverage for investors to buy real estate, and increasing credit availability on prudent terms to borrowers with less than pristine credit.” (*Amherst Mortgage Insight*, Laurie Goodman, 10/01/10)

Blanket mortgage modification bill re-introduced by Representative Dennis Cardoza

- Representative Dennis Cardoza (D-CA) reintroduced the “Housing Opportunity and Mortgage Equity (HOME) Act” that would “help stabilize housing values and reduce foreclosures by ensuring Americans have access to an affordable mortgage.” This bill would use the conservatorship of Fannie Mae and Freddie Mac to refinance mortgages owned by the GSEs into new 30 year fixed rate mortgages at record low interest rates, regardless of the borrower’s income, credit history or loan-to-value ratio. To fund the new mortgages, Fannie and Freddie would issue new mortgage-backed securities and use the proceeds to pay off existing MBS. “As long as Fannie and Freddie remain under conservatorship, we have a unique opportunity to move this program forward,” said Cardoza. “Our path ahead is clear and The HOME Act can help pave the way to a stronger economy.” (*Huffington Post*, Representative Dennis Cardoza, 09/28/10; *Reuters*, 09/28/10)
- In a September 18 editorial in the *New York Times*, Glenn Hubbard, the former chairman of the Council of Economic Advisers under President George W. Bush and dean of the Columbia Business School, and Chris Mayer, Columbia Business School’s senior vice dean, endorsed Cardoza’s proposed HOME Act. Hubbard and Mayer argued that by refinancing the roughly 37 million outstanding mortgages now guaranteed by the federal government could save homeowners an estimated \$50 billion a year in mortgage payments. They wrote, “In fact, we believe a well-

designed program could produce even bigger reductions in mortgage payments. While households tend to save an appreciable percentage of any temporary stimulus like a one-time tax rebate, this reduction in mortgage payments would be permanent, likely leading to a substantial increase in spending for households that have been hurt by the recession. Lower mortgage payments would also allow many struggling families to stay in their homes and stave off foreclosure. This program would have the substantial added benefit of reducing the endless stream of fire sales of previously foreclosed houses. Stabilizing house prices reduces the incentive for other underwater homeowners to walk away from their homes, and gives all homeowners increased confidence in the economic value of their house. ... To open things up, the government—which is already financing nearly 19 out of every 20 new mortgages—needs to help struggling homeowners get more manageable monthly payments. Is there a better approach to help bring the economy back?” (*New York Times*, Glenn Hubbard and Chris Mayer, 09/18/10)

- In an October 10 editorial, the *New York Times* wrote, “Mortgage rates are averaging 4.3 percent for a 30-year fixed-rate loan... In theory, those low rates should unleash a wave of refinancings, giving homeowners and the economy a boost. Here is the catch: Millions of people who are current in their payments cannot qualify for low rate refinancing because their home values or credit scores have declined during the recession.”
- “That is bad news for everyone. But there is a way out. Many of the disqualified mortgages are owned or backed by Fannie Mae and Freddie Mac, the government-controlled mortgage companies. The Obama administration could direct the companies to refinance the loans of anyone who is current. That could pave the way for up to eight million refinancings, for a savings to borrowers of roughly \$24 billion a year.”
- “Loosening loan standards may seem like a replay of what caused the mortgage mess, including the costly failure of Fannie and Freddie. But both companies and taxpayers are on the hook if borrowers default. Refinancing would lessen the likelihood of more failures. So far, the administration says it is not pursuing any refinancing options beyond the ones it currently has on offer. Its main program — the Home Affordable Refinance Program (HARP) — has been a flop. It calls for Fannie and Freddie to refinance loans for underwater borrowers with good payment records. But for many of them, the rates of Fannie and Freddie are too high to make a refinancing worthwhile. For HARP to work, the government has to tell Fannie and Freddie to ease up.”
- “The main reason not to do that would be to shield investors in mortgage-backed securities from losses. Those securities pay a higher rate than many other bonds precisely because of the risk the loans will be refinanced. The economic benefits from lower monthly payments would be quick and concentrated, while investor losses would be dispersed over a global market.”

- “The nation needs a serious debate about the future of Fannie and Freddie. The administration started that discussion in August at a meeting of experts from the public and private sectors. For now, however, the government owns the companies and should be doing more with them to help homeowners. (*New York Times*, 10/10/10)

Congressional Oversight Panel criticizes Fannie Mae and Freddie Mac’s performance as TARP contractors

Senate confirms new inspector general for FHFA after two year vacancy

Congressional Oversight Panel criticizes Fannie Mae and Freddie Mac’s performance as TARP contractors

- The Congressional Oversight Panel criticized the Treasury Department’s use of 96 private contractors under the TARP, concluding that Treasury has exceeded the “notoriously nontransparent” standards of government contracting and that significant

Largest Contractors and Financial Agents by Obligated Value

Contractor	Type of Arrangement	Obligated Value	Potential Contract Value	Expended Value
Fannie Mae	Financial Agency Agreement	\$126,712,000		\$111,339,451
Freddie Mac	Financial Agency Agreement	88,850,000		79,296,499
The Bank of New York Mellon Corp.	Financial Agency Agreement	28,495,412		23,777,002
PricewaterhouseCoopers LLP	Contract	25,781,474	50,252,231	23,525,631
Morgan Stanley & Co.	Financial Agency Agreement	23,577,000		13,175,423
AllianceBernstein L.P.	Financial Agency Agreement	22,399,943		21,207,253
Cadwalader Wickersham & Taft LLP	Contract	21,939,919	\$147,645,619	19,069,083
Ernst & Young LLP	Contract	11,397,968	33,391,392	10,710,092
FSI Group LLC	Financial Agency Agreement	11,102,500		10,770,000
Simpson Thacher & Bartlett LLP	Contract	10,827,988	21,025,000	5,479,614
Total		\$371,084,204	N/A	\$318,350,048

transparency concerns remain. The COP report also sharply criticized Fannie Mae and Freddie Mac’s performance as TARP contractors, characterizing Treasury’s contracts with the GSEs as particularly rife with potential conflicts of interest. “[Both Fannie Mae and Freddie Mac] have fallen short in aspects of their performance” as overseers of the Making Home Affordable (MHA) foreclosure mitigation program” with Fannie serving in an administrative role and Freddie as a compliance agent, wrote the COP. Collectively, Treasury paid Fannie Mae and Freddie Mac \$240 million for their services, more than half the money it paid to outside contractors to administer TARP.

- The Panel describes Treasury’s selection of the GSEs’ as MHA overseers as a rushed decision, which required the enterprises to perform roles falling outside their core competencies. According to the COP report, “The extent to which the GSEs had the infrastructure, capabilities and resources is not absolutely clear given the amount of subcontracting they engaged in to help fulfill their responsibilities.” COP Chairman Kaufman added, “The largest TARP contracts, provided to Fannie Mae and Freddie Mac, raise particular concerns. Both Fannie Mae and Freddie Mac have a history of

profound corporate mismanagement, and both companies would have collapsed in 2008 were it not for government intervention. Further, both companies have fallen short in aspects of their performance, making errors and missing deadlines.”

- The Panel also noted that according to their financial agency agreements, Fannie Mae and Freddie Mac “are subject to [four] conflicts of interest mitigation and information barriers within their respective agency agreements,” including:
 - “The GSEs’ interests in maximizing the performance and minimizing the costs of their retained and guaranteed mortgage loan portfolios, which could potentially conflict with their responsibilities to administer HAMP uniformly and for all borrowers and investors and enforce servicer compliance with program guidelines, respectively;”
 - “The GSEs’ business relationships with servicers, which could potentially conflict with their duties to administer HAMP uniformly and enforce servicer compliance with program guidelines, respectively;”
 - “The GSEs’ interests in benefitting from HAMP interest rate or principal reduction payments and loan modifications of mortgages in their own portfolios (whether owned or guaranteed), which could potentially conflict with their duties to administer HAMP uniformly for all investors and enforce servicer compliance with program guidelines, respectively; and”
 - “The financial interest of GSE employees in banks or investment funds that could receive or benefit from HAMP interest rate or principal reduction payments, which could potentially conflict with the interests of Treasury.”
- The Panel wrote, “As the list demonstrates, Fannie Mae and Freddie Mac appear to have more obvious conflicts of interest than any other contractor or financial agent.”
- The Oversight Report concluded, “The Panel is very concerned that, over 19 months into its financial agency agreements with Fannie Mae and Freddie Mac, Treasury’s expectations for them in their respective roles of financial agent/HAMP administrator and financial agent/compliance agent remain unclear. The Panel has previously called on Treasury to ‘clearly define and communicate its goals and requirements as well as its measurements for success. Without clear goals and measurements, Treasury and its agents and third parties (for example, oversight bodies, Congress, and the public) will not be able to evaluate the adequacy or success of its programs overall or of individual participants.’ Not only has Treasury failed to articulate specific goals for the program, but the concerns raised in the discussion above suggest that Fannie Mae and Freddie Mac are not performing satisfactorily under their financial agency agreements.”
- “In addition, [the Office of Financial Stability (OFS)] has yet to develop written procedures for the oversight and monitoring of Fannie Mae and Freddie Mac’s

administrative and compliance activities, including internal controls over the existence, completeness and accuracy of data formulation and input. As GAO noted recently, '[w]ithout clearly documented guidance regarding the specific procedures OFS should follow to effectively oversee and monitor Fannie Mae and Freddie Mac, OFS faces an increased risk that the financial information related to HAMP may not be complete or correct, and OFS management's ability to identify key risks in this area may also be impaired.' It is exactly requirements such as these that Treasury should explicitly include in all procurements and financial agency agreements. Accordingly, GAO has recommended that OFS develop and implement written procedures detailing steps to be performed in overseeing and monitoring Fannie Mae and Freddie Mac."

- In an October 14 editorial, the *Washington Examiner* wrote, "Because Fannie and Freddie are contractors, they are immune from public disclosure of documents critical to the ability of Congress and taxpayers to evaluate their performance. Fannie Mae alone has more than 600 people working on TARP, which is more than twice as many as Treasury does. No wonder the Treasury Department's special inspector general reported earlier this year that TARP is rife with conflicts of interest, tax law violations, securities fraud, and mortgage fraud. Congress should revise TARP's authorization to require public disclosure of all documents, and convene an investigative panel with subpoena power to force this dark program into the sunlight." (*Washington Examiner*, 10/14/10; *MortgageOrb.com*, 10/15/10; *The Hill*, Silla Brush, 10/14/10; *October Oversight Report to Congress*, Congressional Oversight Panel, 10/14/10)

Senate confirms new inspector general for FHFA after two year vacancy

- Two years after the creation of the Federal Housing Finance Agency, the Senate confirmed Steve Linick, a longtime federal prosecutor, to serve as the agency's inspector general. Linick was nominated to the IG post twice, first by President George W. Bush in 2008, which expired at the end of his presidential term, and later by President Barack Obama. Linick is a career federal prosecutor for the Department of Justice, where he recently served as the executive director of the National Procurement Task Force and deputy chief of the fraud section, criminal division, at Justice.
- As a result of a Department of Justice ruling made on "complicated" technical grounds (see <http://www.scribd.com/doc/39530483/DOJ-Opinion-on-FHFA-Inspector-General-Authority-Under-HERA>), FHFA has operated without an inspector general since the agency was established in September 2008. In a 2009 opinion, the Justice Department concluded that "Congress did not intend for FHFA to have an Acting IG or an interim IG pending the confirmation of [FHFA's] ...IG." (*HousingWire*, Sarah Mueller, 09/30/10; *American Banker*, Stacy Kaper and Joe Adler, 10/04/10; *Memorandum to Alfred M. Pollard*, 06/23/09)

Chairman Frank to introduce GSE reform legislation during the lame-duck session

Republicans' Pledge with America proposes to privatize Fannie Mae and Freddie Mac

Senator Johnson to move cautiously with housing finance reform

“Cheap” talk for Fannie and Freddie

GSEs' government guarantee estimated to cost \$53 billion over the next decade

Chairman Frank to introduce GSE reform legislation during the lame-duck session

- House Financial Services Committee Chairman Barney Frank (D-MA) will unveil legislation to revamp the housing finance system and reform Fannie Mae and Freddie Mac during the lame-duck session. “There is no point in rushing,” said Frank during a hearing on GSE reform. “I do think it is important for there to be pieces of legislation embodying somewhat different views—although there is common core of agreement in some areas. But that is not going to be possible until November.”
- Frank’s staff has been working on a housing finance reform bill for some time, according to a source. In media appearances, Frank has said Fannie Mae and Freddie Mac should be abolished. The Chairman’s new goals are to devise a housing system that replaces Fannie and Freddie, preserves existing affordable housing (particularly multi-family housing), and sets up a trust fund to help pay for more affordable housing. While there appears to be agreement among the Obama administration and lawmakers that the GSEs should not exist in their current form in the future, the concept of a continued government guarantee remains prevalent among Democrats in framing the housing reform debate. The Chairman’s “marker” bills will have less impact, however, if Republicans regain control of the House in the 112th Congress.
- During the GSE hearing, ranking member Spencer Bachus (R-AL) chastised the six housing industry witnesses, who favored a new finance system based upon government backstop for mortgages. “I know the industry is here and they are saying we need a government guarantee,” said Bachus. “If I were the industry, I would be doing the same thing because I would love to make loans and if they failed, let the taxpayers make up the loss. That’s a pretty sweet deal.” Bachus argued that such a backstop would place taxpayer funds at risk, likening it to the Treasury’s guarantee of Fannie Mae and Freddie Mac that has cost taxpayers \$150 billion to date.
- Housing representatives offered lawmakers their vision of a reformed housing system, cautioning that mortgage liquidity would likely dry up without some form of government guarantee. Michael Heid, co-president of Wells Fargo Home

Mortgage, presented a reform plan on behalf of the Housing Policy Council (HPC) of the Financial Services Roundtable, calling for the creation of privately capitalized mortgage securities insurance companies (MSICs) that would perform the credit enhancement and guarantee functions of Fannie Mae and Freddie Mac. Specifically, a MSIC would purchase conventional mortgages from mortgage originators; guarantee the payment and interest on the securities; and charge mortgage originators a fee for the guarantee. Under the HPC's plan, the privately capitalized MSICs would be chartered and supervised by the federal government, which provides an explicit—but limited—federal guarantee on mortgage-backed securities issued by these new entities. The MSICs would pay a fee to the government for the guarantee. The government guarantee is essential to ensure a steady flow of reasonably priced mortgages, said Heid. He argued that the taxpayers' risk would be minimized in this framework by layers of private capital ahead of the guarantee, including the homeowner's down payment; private mortgage insurance or other credit enhancement; shareholders' equity in the MSIC; and reserve fees paid by MSICs for the federal guarantee. In lieu of specific housing goals, the HPC Plan supports the transfer payments established as set forth by the Housing and Economic Recovery Act for the GSEs—specifically, 4 basis points charged for new mortgage originations, which are paid to the Housing Trust Fund (65%) and Capital Magnet Fund (35%). (For further details, see <http://www.scribd.com/doc/39493540/HFSC-Michael-Heid-Testimony-Wells-on-Behalf-of-Housing-Policy-Council-092910>.)

- Ken Bentsen, EVP of the Securities Industry and Financial Markets Association, told the Committee that some form of government guarantee is needed to maintain liquidity in the \$11 trillion residential mortgage market and to keep home prices stable. Tom Deutsch, executive director of the American Securitization Forum, called for a limited government role in backing certain mortgage-backed securities. “[A]s a conceptual matter, the role of any guarantee should be a ‘catastrophic’ or ‘100-year flood’ structure that allows maximum use of private capital to limit the government’s potential liability, while providing a tail risk backstop for other unforeseen risks,” said Deutsch.
- Michael Farrell, representing the National Association of Real Estate Investment Trusts’ Mortgage Council, likened the current guarantee structure “to an electric power grid that delivers power to those parts of the country that have the demand.” There would not be enough private capital to meet the needs of all types of mortgage borrowers if the government withdrew entirely from its role of guaranteeing more than half of the U.S. residential market, said Farrell. “Is the guarantee necessary for housing finance in the U.S.?” asked Farrell. “No, it is not necessary, but the economics of the non-agency mortgage market are considerably different, both primary and secondary, and those economics equate to higher primary mortgage rates for borrowers and, depending on risk appetite within the private market, a smaller mortgage securitization market overall and thus less homogeneity and fungibility of housing credit.” He suggested that the government guarantees be administered in a similar manner to the backing that Ginnie Mae

provides for mortgage-backed securities, collateralized by FHA- and VA-insured loans. By using this structure, the government could enforce underwriting standards for mortgages, Farrell added.

- Edward Pinto, a former chief credit officer at Fannie Mae and financial services consultant, was the only witness, who opposed federal support of mortgages in any form. “Numerous proposals have been put forth today and over the past year that call for ongoing government support of private mortgages. Most say it is inevitable,” said Pinto. “The bottom line is: A government guarantee always ends up with the privatization of profits and socialization of losses, period.” Government guarantees create distortions in the market price for mortgage credit risk, interfere with sound underwriting practices, and create incentives for “bad business decisions” by those who benefit from such guarantees, argued Pinto. The federal government could wind down their participation in the U.S. mortgage market in a “reasonable, responsible way” over the next 10 to 15 years by liquidating their existing GSE holdings, eliminating affordable housing goals, and requiring higher down payments and other more stringent loan underwriting standards.
- To attract private capital back to the mortgage market, Pinto said lenders should be allowed to offer a wider array of products, including those with unpopular features such as prepayment penalties, “I know people hate prepayment penalties, but there’s a marketplace for them,” said Pinto. “If you start with a 30-year mortgage and no prepayment penalty, well, yes, you probably need to have a government guarantee and the FHA insuring many of the loans. But if you start backing away from that and looking at what other countries have done, and how they have some variety in things, you don’t end up in that spot.” He also countered arguments that mortgage interest rates would rise dramatically if federal government guarantee were eliminated. “Rates go up and down all the time,” said Pinto. “Over my career mortgage rates have gone from 9 percent in 1974 to 18 percent in 1981 to 4 percent today. This has had much less impact than the congressionally mandated abandonment of underwriting standards that took place starting in 1992.” (*Bureau of National Affairs*, Mike Ferullo, 09/30/10; *CongressDaily*, Bill Swindell, 09/29/10; *Washington Post*, Zachary A. Goldfarb, 10/12/10)

Republicans’ Pledge with America proposes to privatize Fannie Mae and Freddie Mac

- In the Pledge with America, House Republicans propose to unwind Fannie Mae and Freddie Mac and spin them off to the private market by “ending their government takeover, shrinking their portfolios and establishing minimum capital standards.” The plan also calls for reducing over a two year period the maximum amount for conforming loans that the GSEs can purchase, which currently reaches \$729,750 in the most expensive markets. “Frankly, the Republican position today is no more bailouts,” said Representative Scott Garrett (R-NJ), the ranking member on the Financial Services Capital Markets Subcommittee. “That is what you are doing when providing a subsidy to various segments of the market. Should those who

make over \$250,000 be looking towards other taxpayers? Some of whom may not have been able to afford their first house?"

- However, some Republican House members, representing high cost markets, object to reducing conforming loan limits. "The housing market has to come back for this economy to start to turn," said Representative Gary Miller (R-CA), who represents the high cost market of Orange County and serves on the Financial Services Committee. "The last thing we should do is limit loan availability by doing this. It's just a huge mistake. ... "Campaign speeches are nice. But we really need to stop and think this one through. To say we are not going to have anything like a Freddie and Fannie, I think we need to debate that."
- "I understand they don't want to do [reduce loan limits] now," said Garrett. "But you need a set a date, or that date never comes."
- "It will be a fight within the Republican ranks," said Mark Calabria, director of Cato's financial regulation studies. "The loan limit [extension], if it happens at all, is going to be a precursor to how that all falls out."
- Diana Farrell, deputy director of the White House National Economic Council, said Republicans calls to end the government's control of Fannie Mae and Freddie Mac are "irresponsible," given the critical role the GSEs are playing in today's housing market. "The view that we have to go and irresponsibly do something overnight just doesn't hold up," said Farrell said. "We have a terrible legacy problem but we don't have a current operational issue." (*CongressDaily*, Bill Swindell, 09/29/10; *Dow Jones Newswires*, Tom Barkley, 10/08/10)
- In the September 2010 *Financial Services Outlook*, AEI fellow Peter J. Wallison wrote, "...If we are prepared to face facts, recent experience should tell us that there is no way to avoid the moral hazard arising from the government's involvement in housing finance. Housing risks will always gravitate to the place where they are covered by the government guarantee. If they do not start there, over time Congress will move them there, if only to benefit constituents."
- "A good example is the increase in the conforming-loan limit that Congress adopted in 2008. There was then what seemed to be a quarter-point difference between the interest rates on mortgages within the conforming-loan limit and the interest rate on the jumbo mortgages outside it. This was unacceptable to Congress, even though the higher rates were applicable in communities where homes could cost upward of a million dollars. So as the GSE reform legislation moved through Congress, a higher conforming-loan limit was legislated for those areas where houses were expensive. That moved these higher cost mortgages under the GSE guarantee that was ultimately backed by taxpayers. This process will never stop unless politics is taken out of housing finance, and that can only happen if the government's role is eliminated. ...If we are serious about preventing another round of government induced losses in the housing-finance system, we should begin to look seriously at

wholly private-sector solutions.” (*Financial Services Outlook*, Peter J. Wallison, September 2010)

Senator Johnson to move cautiously with housing finance reform

- Senator Tim Johnson (D-SD), who is expected to serve as chairman of the Senate Banking Committee next year if his party retains control of the chamber, said he will move cautiously, rather than quickly, to reform the housing finance system by conducting a thoughtful and exhaustive examination of mortgage finance models. “Because the housing markets have seen such volatility and they are so fragile, we must be deliberate about their performance,” said Johnson. “I would rather take time to explore the options and their consequences than push through legislation that could further destabilize house markets or make homeownership unaffordable for the majority of Americans.”
- Although the Obama administration has promised a housing finance plan by early next year, Johnson refused to be pinned down by any kind of timetable. “I do not think an arbitrary time line would be helpful because this reform will greatly impact the availability of mortgages,” said Johnson. “I would rather get it right than just get it done. A fresh set of recommendations [from the administration] will be released early next year and that will generate discussions that will help move the debate along.”
- Johnson plans to hold a series of hearings to examine different housing finance models in other countries with a goal of perhaps adopting some of the best practices elsewhere. However, he acknowledged that any legislation would need wide consensus to pass, which could take time to build. “It will be difficult. ... I will work hard to find consensus where it exists, recognizing it will be more difficult to find it in some areas than others,” said Johnson. “The U.S. and Denmark are the only countries with a 30-year fixed mortgage rate product and there may be lessons we can take from other countries’ housing markets. At this point, I haven’t seen a compelling argument for eliminating the long-term fixed-rate mortgage product that also maintains access to mortgages. That would be an example of one thing I think we should take up.”
- Johnson is expected to take a more moderate approach than his predecessor, Senator Chris Dodd (D-CT), in part because he hails from South Dakota, a state that is home to Citigroup’s credit card operations and a large number of community banks. In his home state, financial services matters and banking jobs are crucial. “South Dakota is unique in that it has large banks, community banks, credit unions and other types of financial services,” said Johnson. “It also has the largest percentage of working moms in the country and a large underserved community including Native Americans that gives me a wide perspective on a range of issues that I think has and will continue to be helpful to me on the committee.”

- In December 2006, Johnson suffered a brain aneurysm that impaired his speech. Since his return to the Senate in September 2007, his speech and maneuverability have steadily improved. “I’m feeling great. I have driven my car in and out of the office all year, so I feel great,” he said.
- In addition to housing finance reform, Johnson said his panel will focus on oversight of the implementation of the Dodd-Frank Act during the 112th Congress. “As we continue to come out of the worst recession since the Great Depression, continuing our nation’s economic recovery will be a top priority,” he said. “From the perspective of the Banking Committee this will include overseeing implementation of the Dodd-Frank Wall Street reform and continuing mortgage reform, also key to a stable economy. ...There are several issues that will have to be addressed. We haven’t even seen the rules in many areas yet. It is probably too early to tell which specifics in the bill may need to be revisited.”
- Johnson noted that the committee will need to oversee the Consumer Financial Protection Bureau’s rulemaking process. “It is very important that the CFPB is set up well and that Congress exercises its oversight role on the rules of the bureau,” he said. “Elizabeth Warren is setting up the framework. ... She’s doing a good job of reaching out to a lot of the interested stakeholders as she sets up the CFPB. I don’t know if she will be the president’s nominee as director of the agency but I think it’s critically important that this agency has a strong start with a good director with bipartisan support to allow this agency to achieve its objective as a strong consumer watchdog.” When asked if Warren had the authority to begin rulemaking without Senate confirmation as the CFPB director, Johnson replied, “I think it would be wise to hold off on the implementation until the structure is established.”
- No matter what the outcome of the November elections, Johnson said he plans to seek bipartisan consensus, adding he enjoys a strong relationship with Senator Richard Shelby (R-AL). “My relationship with ranking member Shelby is a good one,” said Johnson. “We have worked well together in the past and I anticipate we will work together well on the Banking Committee. I think the Senate operates best with consensus. I anticipate closer margins next year in the Senate, which will make it even more important. ...Regardless of what happens in the House, it will take strong bipartisan consensus to get banking legislation out of the Senate. Without the willingness to compromise, both within the Senate and between the House and Senate, there will be gridlock.” (*American Banker*, Stacy Kaper, 10/08/10)

“Cheap” talk for Fannie and Freddie

- In the September 27 issue of the *Wall Street Journal*, David Reilly wrote, “When it comes to Fannie Mae and Freddie Mac, the most likely course of action over the coming year might end up being inaction. ... For all the talk, paralysis may be more likely, especially if elections change control in Congress. And secretly, this may be just what politicians from both parties prefer.”
- “Necessary changes to the mortgage-finance system will be disruptive. Consider that Fannie and Freddie between them guarantee or own \$5.4 trillion in mortgages. It would be a tall order for the banking system suddenly to step up and take on the risk on all new mortgages. Scrapping guarantees would likely send mortgage rates up and house prices down. That would ultimately help set a clearing price for housing. But it would hardly score political points, given that housing accounts for 25% of U.S. households’ assets, according to the Federal Reserve. Granting full government backing to mortgages, on the other hand, would add to already excessive U.S. debt and result in even greater distortion of housing markets, possibly paving the way for worse crises. Given those unpalatable outcomes, odds are any electoral upheaval will entrench the housing status quo—to politicians’ relief.” (*Wall Street Journal*, David Reilly, 09/27/10)

GSEs’ government guarantee estimated to cost \$53 billion over the next decade

- The Congressional Budget Office expects Fannie Mae and Freddie Mac to guarantee approximately \$10 trillion of new mortgages over the 2011-2020 period with a subsidy cost of approximately \$53 billion, using fair-value estimate—the “most comprehensive measure of cost because it recognizes ...[that] the government assumes financial risk.” (<http://cboblog.cbo.gov/?p=1422>)

Municipalities and businesses are seeking lawmakers’ help in fight to save the PACE program

- The U.S. Green Building Council (<http://www.usgbc.org/>) is leading municipalities and nearly 350 businesses in a campaign to save the Property-Assessed Clean Energy (PACE) Program, which has been stalled by the Federal Housing Finance Agency’s “significant safety and soundness concerns” that PACE loans could take precedence over mortgage debt. The Council lobbied lawmakers, arguing that the PACE program would provide thousands of jobs in 22 states. Municipal groups and businesses are expected to weigh in with Congress in a letter writing campaign to express their support of the PACE program and plead for passage of H.R. 5766 [and its companion bill, S.3642], sponsored by Representative Mike Thompson (D-CA) (and 48 co-sponsors), which would direct regulators to adopt new underwriting standards that would support the program and bar discrimination against communities participating in PACE. “This could be a quick, easy legislative fix that gets these programs up and running,” said PACE supporter. Advocates are also

considering all possible legislative vehicles for the “fix,” including the Senate’s lame-duck debate on energy legislation.

- California Attorney General Jerry Brown (D) and the Natural Resources Defense Council have filed lawsuits against the FHFA and OCC, claiming the agencies illegally halted the PACE program. (*CQ Today*, Geof Koss, 10/20/10; *HousingWire*, Jason Philyaw, 10/07/10; *Huffington Post*, Mike Stark, 10/21/10)

Fannie Mae

Fannie Mae’s retained mortgage portfolio declines at an annualized rate of 4.1% in August, as its mortgage delinquencies decline

- Fannie Mae’s retained mortgage portfolio fell at a compound annualized rate of 4.1% in August to \$809.1 billion, while its total book of business [including mortgage-backed securities and other guarantees] declined at a compound annual rate of 1.3% to \$3.2 trillion. Fannie’s conventional single-family serious delinquency rate fell 17 basis points to a ten month low of 4.82% in July—marking the fifth straight month of decline. Further, the GSE’s serious delinquency rate for multifamily properties declined 6 basis points to 0.74% in July. (*Fannie Mae Monthly Volume Summary*, August 2010; *Wall Street Journal*, Nathan Becker, 09/29/10)

Fannie Mae adopts Appraiser Independence Requirements to replace HVCC

- In conjunction with the Federal Housing Finance Agency, Freddie Mac, and key industry participants, Fannie Mae has developed Appraiser Independence Requirements to replace the Home Valuation Code of Conduct (HVCC). Fannie’s Appraiser Independence Requirements were designed to (i) maintain the spirit and intent of the HVCC; (ii) continue to provide important protections for mortgage investors, home buyers, and the housing market; (iii) pose no significant changes to core principles of the HVCC; and (iv) incorporate language to clarify questions that arose in the implementation of the HVCC. Fannie Mae removed certain provisions from the updated requirements that already exist elsewhere in the Selling Guide, such as the need for lender quality control testing for appraisals.
- The new requirements continue to prohibit use of appraisals ordered by mortgage brokers or real estate agents. They permit use of an appraisal prepared for a different seller if the seller that delivers the loan to Fannie Mae makes representations and warranties, including a representation that the appraisal is

obtained in a manner consistent with the appraiser independence requirements.
(*Fannie Mae Selling Guide Announcement SEL-2010-14*, 10/14/10)

- In the latest edition of *Insight*, Gary Shilling wrote, "...[F]alse appraisals rose 50% in 2009 from 2008. The tax credit for first-time homebuyers cost taxpayers about \$15 billion, twice the official forecast, in part due to fraud. Over 19,000 tax filers claimed the credit but didn't buy houses, while 74,000 who claimed \$500 million in refunds already owned homes." (*Frontline Weekly Newsletter*, John Mauldin, 10/15/10)

Fannie Mae announces new incentives for HomePath properties

- Fannie Mae announced seller incentives for purchasers of Fannie Mae-owned properties listed on the company's REO website, www.HomePath.com. Qualified home buyers, who will be owner-occupants of the REO, can receive up to 3.5% of the final sales price to be used toward closing costs, including a home warranty (if desired and available). Under the program, the purchaser's selling agent will receive a \$1,500 bonus for purchase offers submitted on or after September 23 and closed by December 31. Sales must close within 60 days of the offer's acceptance. (*MortgageOrb.com*, 09/24/10)

Fannie Mae announces new assistance program for military homeowners

- Fannie Mae announced new initiatives to assist members of the armed service and their families, who are struggling to make their mortgage payments. Fannie Mae's military initiative will provide mortgage payment forbearance of up to six months where the death or injury of a service member on active duty causes a hardship for their families with a mortgage obligation. Service members or surviving spouses may be eligible for special forbearance under Fannie Mae's Unique Hardship guidelines. Mortgage servicers should contact Fannie Mae for approval for the reduction or suspension of the borrower's monthly payments for a specified period of time. (*Fannie Mae Press Release*, 09/27/10)

Fannie Mae computer contractor convicted of computer sabotage and hacking offenses

- A jury has convicted Rajendrasinh Babubhai Makwana, a computer contractor for Fannie Mae, for planting a logic bomb on the company's servers. After being terminated by Fannie Mae, Makwana, 36, planted malicious script designed to wipe all the data from its network on January 31, 2009. Fannie Mae's system administrators discovered the malware weeks before the logic bomb was set to "explode," avoiding costly damage to the company's 5,000 servers. Makwana faces a maximum of 10 years imprisonment for computer sabotage and hacking offenses, which will be determined at a sentencing hearing on December 8. (*The Register*, John Leyden, 10/08/10)

- President Barack Obama has named former Fannie Mae executive Tom Donilon to serve as his national security advisor. According to ABC News reporter Matthew Mosk, “President Obama’s new National Security Advisor spent the decade prior to joining the White House as a legal advisor to powerful interests, including Goldman Sachs and Citigroup, and as a lobbyist for Fannie Mae, where he oversaw the mortgage giant’s aggressive campaign to undermine the creditability of a probe of [Fannie’s] accounting irregularities...” From 2000 to 2005, Donilon worked full-time for Fannie Mae as executive vice president for law and policy, where he served as the GSE’s registered lobbyist.
- “He was in charge of the lobbyists,” said Stephen Blumenthal, former acting director of OFHEO. “That process involved using the Hill to rein in the regulators. That was always Fannie Mae’s approach. And, there’s no question that Congress played a major role in enabling Fannie Mae to escape regulation and avoid increasing their capital, which is eventually what killed the company. ...I don’t think [Donilon] was part of the problem, but he wasn’t part of the solution. Mr. Donilon was not a target of the [OFHEO] investigation. ...Was he an enabler? Absolutely.” (*ABC News*, Matthew Mosk, 10/10/10; *Politico*, Josh Gerstein and Abby Phillip, 10/08/10)
- President Obama has nominated Thomas Nides, a former senior vice president for human resources for Fannie Mae, to serve as deputy secretary of State for management and resources. Nides, who previously served as Morgan Stanley’s chief operating officer, would be the latest Wall Street executive to join Secretary of State Hillary Clinton’s team, following the hiring of Goldman Sachs executive Robert Hormats in 2009. (*Reuters*, 09/29/10)
- The Collingwood Group has named Mary Lou Christy to serve as senior vice president. Christy, the former senior vice president of Fannie Mae’s investor relations, will join Joseph Murin, the former president of Ginnie Mae, and Brian Montgomery, the former FHA commissioner, at Collingwood Group, an advisory services firm formed in Washington, DC in 2009. (*HousingWire*, Jason Philyaw, 09/23/10)

Freddie Mac

Freddie Mac continues its “low growth mode”

- In August, Freddie Mac’s retained total mortgage portfolio declined by an annualized 17.0% to \$715.7 billion, while its total mortgage portfolio fell at an annualized 5.2% to \$2.2 trillion. The GSE’s single-family serious delinquency rate declined 6 basis points to 3.83% in July, but was 59 basis points higher than the year ago rate of 3.24%. Freddie Mac’s multi-family delinquency rate increased 2 basis points to 0.32% in July and more than double the year-ago rate of 0.12%. (*Freddie Mac Monthly Volume Summary*, August 2010; *Reuters*, 09/24/10)

Forbearance is preferable to foreclosure, says Freddie Mac CEO Haldeman

- In an interview with *HousingWire*, Freddie Mac CEO Charles E. Haldeman Jr. said forbearance, as an option in loss mitigation, is not as popular as mortgage modifications or short sales, but still one that his company considers highly useful. “Forbearance is not a new idea. It is not a new government-imposed program like HAMP,” said Haldeman. “It is a tool that Freddie has used for a long period of time.”
- If a borrower gets ill or loses their job, Freddie will traditionally use forbearance for six months and then the payments that are forborne are restructured into a new monthly payment going forward once the borrower recovers or gets a new job. “That has been helpful for many families who got in trouble over the past decade,” said Haldeman. “Keeping them in their homes and keeping their kids in the same schools helps keep a sense of normalcy until people get themselves back together.”
- Forbearance is just one tool Freddie will use to protect its investors, Haldeman added. “The thought process is that foreclosure is a very expensive proposition for the investor. Therefore, if we can make a modification or adjustment that is significant but that keeps the homeowner in the home, then often the investor is better off economically.”
- Over the past 18 months, Freddie Mac has helped 350,000 borrowers avoid foreclosure, said Haldeman. “We have done that by implementing many of our traditional foreclosure prevention activities, such as forbearance and what we consider to be our traditional modification program.” (*HousingWire*, Jacob Gaffney, 09/27/10)

Harvard business professor Clayton Rose joins Freddie Mac's board of directors

- Freddie Mac announced that Clayton S. Rose, Harvard Business School professor of Management Practice and veteran executive in the financial services and investment industries, was elected to serve as a director on the company's board. Rose, 52, has been a member of the faculty at Harvard Business School since July 2007. In 2001, Rose served as vice chairman and chief operating officer of JP Morgan, the investment bank of J.P. Morgan Chase & Co. From 1981 to 2000, Rose was head of J.P Morgan's Global Investment Banking and the Global Equities Divisions and served as a member of the firm's executive committee.
- Rose currently serves as a member of the board of directors of XL Group plc; a trustee of the Howard Hughes Medical Institute and the National Opinion Research Center at the University of Chicago; and a director of Public/Private Ventures. Previously, he served as chairman of the board of Highbridge Capital Management, an alternative investment management firm owned by JP Morgan Chase & Co. (November 2007 to March 2010) and as a member of the board of directors of Mercantile Bankshares Corporation, (September 2003 to April 2007) and Lexicon Pharmaceuticals, Inc. (September 2003 through October 2007).
- "Clayton Rose brings to Freddie Mac's board of directors a wealth of financial and management experience," said John A. Koskinen, Freddie Mac's non-executive chairman. "His years of managing large and complex financial organizations, and his practical insight into the workings of global markets, are particularly valuable to our board as Freddie Mac continues to serve its vital mission of providing liquidity, stability and affordability to the nation's housing finance system." (*Freddie Mac Press Release*, 10/14/10)

Freddie Mac to form Giant Mortgage Participation Certificates from PCs held in its retained mortgage portfolio

- Freddie Mac announced that its retained mortgage portfolio will form Giant Mortgage Participation Certificates (Giant PCs) from its holdings of Mortgage Participation Certificates (PCs). Giant PCs, which the company first began issuing in 1988, are single-class pass-through securities created by consolidating Freddie Mac PCs into larger Giant PCs. Traditionally, Giant PCs have been formed by third parties. By forming Giant PCs from PCs in the company's retained portfolio, Freddie Mac can simplify its internal administration of PC securities and ultimately help lower the company's management costs (*Freddie Mac Press Release*, 10/15/10)

Federal Home Loan Banks

Federal Home Loan Bank of Atlanta changes the valuation of single-family mortgages from unpaid principal balance to current market value

- The Federal Home Loan Bank of Atlanta will change the way mortgages are valued for use as pledged collateral effective November 1. Under the Bank's new guidelines, residential first mortgages will no longer be assessed on the Lendable Collateral Value (LCV) standards on unpaid principal balance; instead, first mortgages will be assessed on current market value. "By shifting to a market-based valuation methodology, the Bank can measure the current market value of collateral and then adjust for uncertainties with respect to the price and costs associated with liquidation or servicing," said the FHLB-Atlanta. "This allows the Bank to establish its collateral discounts with greater precision." (*HousingWire*, Jacob Gaffney, 10/11/10)

Ginnie Mae

Lawmakers pressure FHA to raise its reserves quickly

- During a Senate Banking Committee hearing on the agency's future, lawmakers expressed concern about FHA's ability to get back on its feet given its growing share of the mortgage market. "We want you to survive," said Senator Richard Shelby (R-AL), the ranking Republican on the panel. "What's it going to take financially ... not to be concerned about FHA? What's it going to take to allay these concerns?"
- FHA Commissioner David Stevens offered the panel some good news on his agency's progress in restoring its depleted capital reserves, noting that during the third quarter FHA's Mutual Mortgage Insurance fund grew by \$450 million, a significant boost from a projected decline of \$2.6 billion during the first three quarters of the year. FHA expects its new mortgage insurance premium structure that went into effect on October 4 will increase the agency's revenues by \$4.1 billion annually, he said. "We are confident this new premium structure is sound policy, more in line with private mortgage insurers' pricing and will facilitate the return of private capital to the mortgage market." However, Stevens cautioned lawmakers that FHA remains vulnerable if housing prices drop. "We should all be concerned about FHA," said Stevens. "I'm concerned about FHA. If home prices recover, the strength of the fund will grow quicker. If home prices recede and worsen depending on that pace, that will make the recovery much slower. ... We remain cautious... the job is not yet done."

- At the hearing, Chairman Chris Dodd questioned if Congress should require a FHA time line to restore the capital ratio to 2%. Matthew Scire, GAO's director of financial markets and community investments, said such a directive was an opportunity for Congress to weigh in on "what balance there should be between financial soundness and its role supporting the mortgage market." Scire added, "It's important to consider what the role of FHA is in the next few years, in however many years makes sense to get back to that 2% ratio." Dodd continued to press the question of establishing a deadline. "I'm concerned a time line might tie the department's hands to do its job exactly at the time when we may want them to be aggressive," Dodd said.
- Stevens objected to Dodd's proposal. "A time line would be the wrong way of approaching FHA reform," said Stevens. "Putting a time line in place could force action that could have a broader adverse impact on the market." The two factors that impact FHA's capital reserves are home prices and premiums paid on mortgage insurance, said Stevens, who estimated that it will take three to four years for FHA to achieve "normal" capital levels. Stevens said that factors such as the home price index, discount rates in the market, and recovery of defaulted loans would need to be taken into account before determining how quickly the agency could reach that goal. "These are complex answers because obviously there are economic variables," Stevens added.
- Stevens' reassurances were not adequate to ease concerns by Shelby or Scire. "How are you going to grow to at least have that 2%?" asked Shelby. "I don't think we have any way of knowing when FHA gets to 2%," said Scire. "FHA is actually in the best position to do that estimate, and I would expect they would be able to say with the policy changes enacted ... and assumptions about future economic activities. They should be able to tell us what their expectations are of reaching a 2% ratio."
- GAO also recommended that FHA shift its reliance on deterministic models, using a single economic forecast, to stochastic simulation, which runs simulations of hundreds of different economic scenarios and results that offer the prospect of better estimates of the agency's reserve fund value. Stevens agreed with GAO's recommendations and told lawmakers that his agency plans to begin implementing stochastic simulations in FY2011. (*American Banker*, Donna Borak, 09/24/10; *Bureau of National Affairs*, Thecla Fabian, 09/27/10; *National Mortgage News*, 09/22/10)

Fannie Mae discontinues its purchase of reverse mortgages

- Fannie Mae announced it is no longer purchasing reverse mortgages due to its internal systems lack of ability to handle the new HECM Standard and Saver products

for case numbers dated on or after October 4, 2010. Lenders have 90 days to deliver any loans that were obtained prior to the start of HUD's FY 2011.

- Since 2009, Fannie Mae's presence in the reverse mortgage market has diminished, while Ginnie Mae has stepped in to provide the market liquidity. During the past year, Fannie Mae's HECM market share has fallen from 68% (second quarter of 2009) to approximately 2% (second quarter of 2010), while its HECM portfolio has stabilized at \$50.7 billion.
- Ginnie Mae's HMBS program serves as the primary source of liquidity for its nine active reverse mortgage issuers. In 2009, Ginnie Mae's HMBS issuances increased more than five-fold to \$8.538 billion. The agency's HMBS FY2010 issuances—totaling \$7.244 billion for the 11 months ended August 31—will easily pass the record levels of 2009. (*Reverse Mortgage Daily*, 10/11/10)

Farm Credit System / Farmer Mac

Farm Credit System “mega-mergers in the works”
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- In the September issue of *Farm Credit Watch*, Bert Ely wrote, “U.S. AgBank, one of the five FCS banks, announced in its second-quarter financial report that its board had ‘approved a plan related to AgBank’s long-term strategic direction.’ That type of language usually signals that serious merger talks are underway. CoBank, the second-largest FCS bank, separately stated that ‘U.S. AgBank chose to evaluate CoBank as a potential merger partner.’ As the last two *FCW*’s have reported, the Farm Credit Administration (FCA) has been preparing the ground for mergers among the FCS banks. According to the FCA’s Fall 2010 Regulatory Performance Plan..., the FCA intends to issue a final notice in October of a Joint and Several Liability Allocation Agreement among the five banks. Last month’s *FCW* reported that the FCA was seeking public comment on this proposed agreement. No comments were filed by the close of the comment period on September 17, presumably because the five banks are comfortable with the agreement and no one else cares. Expect a CoBank/AgBank merger announcement around the end of the year.”
- “According to a September 8 news release, the FCA granted preliminary approval to the merger of Louisiana Ag Credit, ACA, into Southern Ag Credit, ACA, which serves south Mississippi. Since August of last year, Louisiana Ag Credit has been managed by Southern Ag Credit in preparation for this merger. Southern’s management role was due to ‘material weaknesses in [Louisiana Ag Credit’s] risk profile as well as an overall continuing concern with the Association’s safety and soundness.’ It will be interesting to see what problems arise in the merged association after the merger is closed.”

- “Although not officially announced, a possible merger of American AgCredit, ACA, headquartered in Santa Rosa, California, with Mountain Plains, ACA, which serves western Colorado, is in the works. The merged institution would have about \$6 billion in assets. American AgCredit, which last year merged with an FCS association serving portions of Kansas and Oklahoma, would then serve portions of five states with a highly disjointed and unmanageable lending franchise. Does this merger make any sense, especially so soon after American AgCredit’s merger last year?” (*Farm Credit Watch*, Bert Ely, September 2010)

Ag industry lobbies the CFTC for an exemption for FCS members from swaps clearing

- Over a dozen groups representing the agriculture industry wrote the Commodity Futures Trading Commission, urging the agency to exempt Farm Credit System members from a mandatory swaps clearing requirement, currently under consideration. The groups told CFTC chairman Gary Gensler that they believe the FCS could be exempted from the requirement without compromising the safety and soundness of the financial system—in part because the FCS institutions are closely regulated by the FCA. While the members undertake interest rate swap activities to support their lending operations, none of these actions pose a systemic risk to the U.S. financial system, they argued. House Agriculture Committee chairman Collin Peterson (D-MN) and Representative Tim Holden (D-PA), chairman of the subcommittee with jurisdiction over FCA, have indicated that not all of the provisions of the Dodd-Frank Act are appropriate for FCA members. (*US Ag Net*, 10-11-10)

FCA amends the definition of “rural area” for Rural America Bonds and Agriculture and Rural Community Pilot Investment Programs

- The Farm Credit Administration board of directors has amended the “Definition of Rural Area” condition of approval for the Rural America Bond (RAB) and Agriculture and Rural Community (ARC) bonds or securities pilot investment programs, effective September 2. The amended definition reads as follows: “Rural area” or “Rural” means an area that is: (1) Outside a standard metropolitan statistical area (MSA), or (2) Within a community that has a population of 50,000 or less inhabitants. As used in this definition, “community” means any area outside of a MSA or any territory within an MSA that is not within an urbanized area, all as defined by the United States Census Bureau at the last decennial census, or (3) Defined as “rural” under the criteria established by either the United States Department of Agriculture (USDA) or other Federal agency pursuant to a congressionally approved program to serve rural areas and the securities are guaranteed, issued, or approved under such congressionally approved program.
- The FCA Board adopted the amended condition of approval to better accommodate the definition of rural area for the RAB and ARC pilot programs with the definitions

of “rural area” that the USDA currently applies to various programs it administers. Farm Credit System institutions participating in the RAB and ARC pilot programs may now purchase securities in connection with a RAB and ARC project in which (1) the rural area meets the definition of “rural” under the criteria established by either USDA or any other Federal agency pursuant to a congressionally approved program to serve rural areas; (2) the securities are guaranteed, issued, or approved under such congressionally approved program; and (3) the project meets the criteria, objectives and requirements of the RAB and ARC pilot programs. The FCA has determined that amending the definition of “rural area” in the Conditions of Approval for the RAB and ARC programs will better facilitate the ability of FCS institutions to participate in federally administered rural development programs, which often require significant investments from multiple sources. (*FCA Informational Memorandum*, 09/24/10)

Obama administration approves a 50% increase in ethanol blends
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- The Obama administration has approved a 50% increase in the amount of ethanol used in fuel blends, which should be used only for newer vehicles. The EPA announced it will allow blends to include as much as 15% ethanol (E15), up from the current 10% (E10). The agency said the E15 blend should not be used for cars and trucks made before 2007 because they were not designed for higher ethanol blends, but can be used in 2007 models (and later). EPA is reviewing data on vehicles made from 2001 to 2006 and expects to report their findings in November.
- To mitigate the impact of its decision, EPA said it will not mandate that gas stations offer the E15 blend, but will require stations to label E15 pumps clearly to prevent customers from buying the wrong blend. “Ultimately it will be up to fuel suppliers and retailers to make it available,” said Gina McCarthy, a senior EPA administrator. “It’s by no means assured the market will develop quickly.”
- Supporters of higher ethanol blends argue that it will reduce the nation’s dependency on foreign suppliers of oil, helping the American economy. Under federal law, the U.S. is supposed to double the amount of alternative fuels by 2022.
- However, a number of automakers, boat builders and refiners opposed the EPA’s approval of E15, concerned by the risk of consumer confusion and potential legal liabilities arising from the new blend. “The large majority of today’s vehicle warranties only cover gasoline with up to 10 percent ethanol,” said spokesman Bob Greco of the American Petroleum Institute. “More ethanol in gasoline could result in the voiding of customer warranties.” Livestock ranchers and environmentalists also fought EPA’s approval of E15, arguing that the new blend will drive up corn prices, leading farmers to shift away from growing corn for feed and clearing more land for corn production. “The corn lobby has been pushing this idea for many months and this decision appears to be a concession to corn-state politics,” said Frank O’Donnell, president of Clean Air Watch. “As we all know, the party in power has been under fire in many such states for alleged environmental zealotry.”

- *Politico* reporter Robin Bravender noted that the “administration’s decision ...to allow more ethanol in gasoline was met with fury from environmentalists and Big Oil, but it could help Democrats in the nation’s Corn Belt. ...The timing of the announcement seems aimed at shoring up Democratic support in Midwestern states that President Obama carried in 2008, such as Iowa, Illinois and Wisconsin, but where some of his fellow Democrats are now scrambling.” Barry Rabe, a professor of public policy at the University of Michigan, said, “This can be seen as one of a series of steps leading up to an important election that could have some benefit for the administration or administration-supported candidates in a few key states or districts.”
- “EPA’s unwise and premature decision to allow the sale of gasoline with higher levels of ethanol may be good politics in Corn Belt states on the eve of the midterm elections, but it is bad news for every American who owns a car, truck, motorcycle, boat, snowmobile, lawnmower, chainsaw or anything else powered by gasoline,” said Gregory Scott, EVP and general counsel of the National Petrochemical & Refiners Association.
- EPA chief Gina McCarthy deflected suggestions that the timing of the E15 decision was political, saying the decision was reached as soon as the agency had enough information about the safety and environmental effects. (*MarketWatch*, Jeffrey Bartash, 10/14/10; *Politico*, Robin Bravender, 10/13/10)

Postal Service

Postal Regulatory Commission denies Postal Service's rate increase request

Rate hikes won't help the Postal Service

GOP lawmakers block Democrat's move to postpone the payment of retirement benefits by the USPS

Inspector General's reports highlight "extremely troubling problems" at the USPS

The USPS is in crisis

Postal Regulatory Commission denies Postal Service's rate increase request

- On September 30, the Postal Regulatory Commission (PRC) voted unanimously to deny the Postal Service's request for an average 5.6% rate increase, based upon the agency's failure to justify rate increases in excess of its statutory CPI price cap. "The Commission finds that the Postal Service has shown the recent recession to be an exigent circumstance but it has failed both to quantify the impact of the recession on its finances and to show how its rate request relates to the resulting loss of mail volume; therefore, we unanimously deny its exigent rate request," said Chairman Ruth Y. Goldway. Under the statutes, the Postal Service is required to demonstrate that any exigent rate adjustments are due to the identified exceptional circumstances. This requirement prevents the USPS from using a bona fide extraordinary or exceptional circumstance as a general rate increase mechanism that would circumvent the price cap system.
- While the PRC recognized Service's recent volume losses and multi-billion dollar shortfalls, the Commission's analysis confirmed that the Postal Service's cash flow problem is not a result of the recession and would have occurred whether or not the recession took place. Instead, the Commission concluded that the agency's financial hardships are the result of other, unrelated structural problems, which would neither be solved nor delayed by the proposed exigent rate adjustments.
- The Commission concluded, "The Postal Service may be unable to continue to meet a statutory 10-year payment schedule—averaging roughly \$5.5 billion per year—to create a fund to pay future retiree health benefit premiums. It has been unable to fund this obligation from operations, and has instead used up all of its retained earnings and drawn down from its \$15 billion borrowing authority. Even with the requested increase, the Postal Service would be unable to meet this annual obligation either in 2011, or in succeeding years. The Postal Service achieved over \$6 billion in cost reductions in 2009. While volume declines outstripped cost reductions during the

actual recession, Postal Service cost containment programs are producing results and work hours have declined faster than volumes in 2010.” (*Postal Regulatory Commission Press Release, 09/30/10*)

- The Postal Service’s current projections show the agency won’t have enough cash to make the payment next September 30, said Postmaster General Potter. He was “encouraged” that the PRC acknowledged the financial threat posed by the need to prepay retiree health benefits. “We will need to take a much closer look at the ruling from the PRC in order to make an informed decision about what options we have and what may be the best course of action for our customers, our employees, our stakeholders and the American public,” he added.
- Fredric Rolando, president of the National Association of Letter Carriers, said, “The Postmaster General and his top executives wasted the entire year seeking unpopular measures to eliminate Saturday delivery and stack the deck against employees in collective bargaining rather than focusing on the prefunding reform backed by mailers and the entire postal community.”
- “The PRC today has helped countless businesses stay competitive and saved tens of thousands of jobs,” said Tony Conway, a spokesman for the Affordable Mail Alliance. “The commissioners recognized that imposing an additional tax on Postal Service customers is not the way to address its financial troubles. Our members look forward to working with the Postal Service on the long-term restructuring needed to restore the Postal Service to competitiveness.” (*Associated Press, 09/30/10*)

Rate hikes won’t help the Postal Service

- In a September 23 editorial, Senator Susan Collins (R-ME), ranking member on the Homeland Security and Governmental Affairs Committee, wrote, “There is a financial truism that every American family knows instinctively and every economist knows by rote: When goods are priced too high or services lose value, people cut back on spending. That can be counted on—like clockwork. And sometimes, when customers cut back, they also turn away. Customer sensitivities to pricing and service are known market responses. Successful entrepreneurs find the right balance and work to keep it—using innovation to draw new customers, maintain current ones and increase the franchise.”
- “Not so with the U.S. Postal Service, which is grappling with declining revenues and volumes — most recently, a \$5.4 billion loss for the first three quarters of fiscal year 2010. Now the Postal Service, stalled in a lackluster business model, is again seeking rate hikes. The proposed increases, averaging 4 percent to 6 percent, would far exceed the rate of inflation.”
- “...This postal rate hike, far beyond the inflation rate, is inconsistent with the law. ...The language is explicit. We could not have been clearer about the legislative

intent of exigent rate cases. Citing my 2007 letter and the legislative history, I emphasized to the PRC this year that the exigent rate authority is reserved for national emergencies—like Sept. 11 or the series of anthrax attacks—which had a profound effect on the Postal Service well outside normal business.”

- “So what is the Postal Service now using as justification for the proposed increases? It is citing the ‘continued movement toward electronic alternatives’ and a weak economy — neither unexpected nor extraordinary reasons. When it comes to the Postal Service’s proposals for rate increases or service cutbacks, you might have the same response that I do: Haven’t we seen this movie before? It is a lot like watching ‘Groundhog Day,’ in which the same day repeats over and over again. Each time, when seeking rate increases, service reductions or relief from financial obligations, the Postal Service has assured Congress that financial stability and a return to profitability will result. But, here again, the Postal Service is billions of dollars in the red, pleading for help.”
- “These rate hikes are likely to drive away customers, hurt a wide array of businesses and cause customers to seek cheaper digital alternatives, like e-mail. What the Postal Service is proposing is not a remedy; it may be its eulogy. ...Instead of forcing customers to explore other options, the Postal Service needs to find ways to cut expenses and entice customers. It should take cues from its private-sector competitors, like United Parcel Service and FedEx, which trimmed expenses by 9 percent and 14 percent, respectively, from 2008 to 2009. In comparison, the Postal Service cut expenses by only 3 percent in that time.”
- “The Postal Service must take a broader approach to cutting work-force-related expenses. For example, it could increase cross-craft training and bring its significant contributions toward employee health care and life insurance in line with the smaller amounts paid by federal agencies for their employees. It also needs to push the Office of Personnel Management to calculate more accurately the amount it pays into the Civil Service Retirement System pension fund. Independent actuaries now estimate an overpayment of between \$50 billion and \$55 billion—which must be corrected.”
- “The Postal Service should also collaborate with its high-volume customers to find ways to increase mail volume and better serve them. Initiatives like its Summer Sale, held over the past two summers, can increase volume, give customers a price break and increase revenue. This is a win-win situation. According to the Postal Service, last year’s Summer Sale led to a \$24 million boost in revenues. These sorts of innovative initiatives work. The Postal Service needs to devote energy to developing similar customer-focused programs that can enhance revenue and increase volume, rather than making changes that are certain to alienate customers. And make no mistake: Increasing postal rates and cutting services will lead to dwindling numbers of customers and plummeting mail volume...” (*Politico*, Senator Susan Collins, 09/23/10)

GOP lawmakers block Democrats move to postpone the payment of retirement benefits by the USPS

- GOP blocked passage of a provision to a temporary spending bill, which would have permitted the Postal Service to postpone paying \$3 billion (out of the \$5.5 billion required by law) for pre-funded retiree health benefits. “The Postal Service does not want to make the tough decisions, which include cuts in personnel, pay and benefits. Instead, they are relying on a generous taxpayer bailout that will not solve any of their mid- or long-term problems,” said Representative Darrell Issa (R-CA), who opposed the provision. “Taxpayers should not be made to bail out a business-as-usual Postal Service.”
- “While it appears that the continuing resolution will not include USPS funding, service will not be compromised while the administration works with Congress and USPS to ensure that they have the tools and authorities necessary to remain viable well into the future,” said the Office of Management and Budget in a statement. The administration and Postal Service met to determine what portion, if not all, of the payment can be made by the close of the fiscal year (September 30), added OMB.
- Senator Susan Collins (R-ME) and other Republican lawmakers argue that Postmaster General Potter should find deeper spending cuts before Congress approves new revenue streams. “The problem is that every three years it seems the Postal Service has been in financial crisis,” said Collins, who plans to introduce new postal reform legislation and is urging Potter to review spending cuts, including consolidation of regional offices.
- Senate Democrats hope to introduce a bill during the lame-duck session that would give the USPS additional flexibility for determining delivery schedule and deciding the need for closing thousands of branches. The legislation, introduced by Senator Thomas R. Carper (D-DL), also addresses how the Postal Service could make the \$5.5 billion annual payments for retiree benefits in the future.
- “I think this entire situation puts more pressure on the Postal Service and pressure on the legislators to address the issue comprehensively,” said Tony Conway, executive director of the Alliance of Nonprofit Mailers.
- “It’s been a tough few months for the Postal Service in terms of its management and relations with Congress,” said Ruth Y. Goldway, chairman of the Postal Regulatory Commission. “But on the other hand, it appears from what we can see on the street that things are improving. They don’t have all their problems solved, but volume is going back up, and they have their costs under control.”
- In an April interview with the *Washington Post*, Postmaster General Potter said, “We are perilously close to running out of cash in October or November. Ideally what you’d like to do in the Postal Service is have access to about \$5 to \$6 billion in cash, whether that’s borrowing ability or cash on the books. And that’s basically two

payrolls. That's not a lot of breathing room." The USPS could also tap its \$15 billion from the U.S. Treasury, but it's used much of that money already and the credit runs out next year.

- The Postal Service doesn't face a strong penalty, if it's unable to make the \$5.5 billion retiree benefit payment—other than facing embarrassing questions from Capitol Hill. Creditors and other contractors might get nervous and could stop doing business with agency.
- The Postal Service is in the midst of a 10-year plan to trim \$120 billion in costs, said Potter. The agency employs about 584,000 full-time workers, a drop of about 100,000 career positions in three years, he added. Facing declining revenue and congressional gridlock, Potter, the longest-serving postmaster in U.S. history, has not ruled out leaving the Postal Service as some aides and observers have suggested. "I'm going back to my office," he responded after being asked twice by reporters if he plans to retire. (*Washington Post*, Ed O'Keefe, 09/29/10; *Washington Post's Federal Eye Blog*, Ed O'Keefe, 09/29/10)

Inspector General's reports highlight "extremely troubling problems" at the USPS

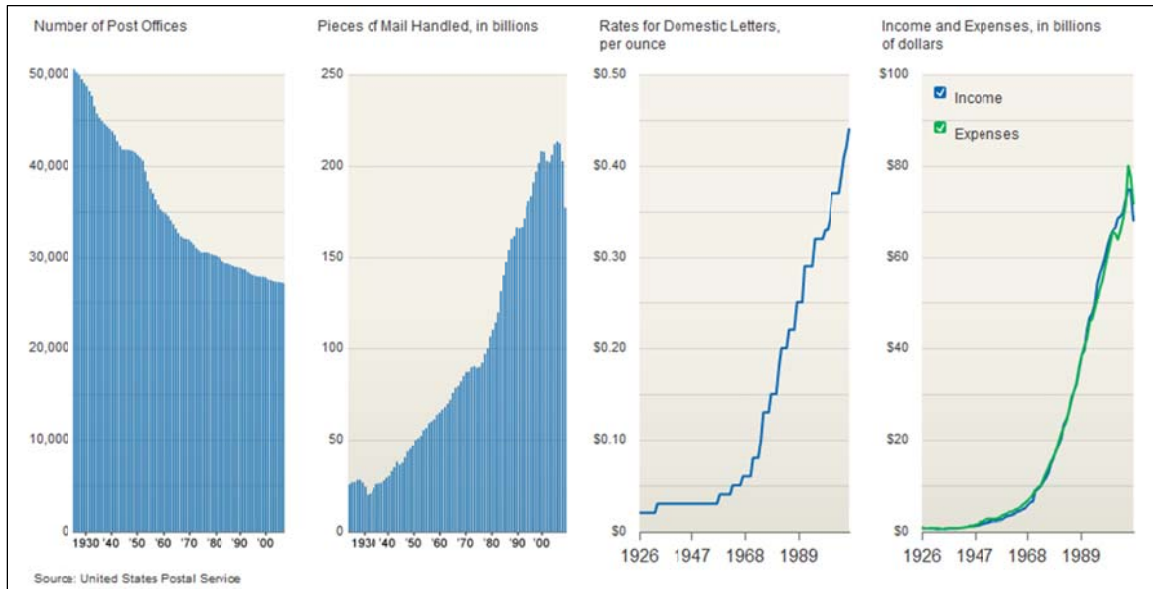
- More than 800 Postal Services executives receive health care coverage at no cost—a perk not available to other federal workers. According to an inspector general report, 835 Postal Career Executive Service employees, OIG directors and Senior Executive Service members receive free health care from the USPS. The IG report found that the USPS contributes 79% of Federal Employees Health Benefits Program (FEHBP) premiums, versus the government's 72% contribution for other federal workers. The USPS also covers the entire basic Federal Employees' Group Life Insurance (FEGLI) rate, while the federal government contributes only 33.33% for other federal workers. The IG concluded that in FY2011, the USPS could save \$133 million if the agency matched the lower FEGLI rate and an additional \$567 million, if it decreased its FEHBP payments. The Postal Service's contribution rates were set during its collective bargaining process with its four major unions.
- "It is unbelievable to me that the Postal Service—awash in red ink and asking for huge postal rate hikes, service reductions and relief from its financial obligations—is paying the full health care premiums for its top executives," said Senator Susan Collins (R-ME), ranking member of the Homeland Security and Governmental Affairs Committee.
- In a separate IG report, auditors reported that the Postal Service has awarded more than 2,700 contracts to former employees since 1991 and awarded 17 no-bid deals to former executives between 2006 and 2009. One unnamed executive received a \$260,000 no-bid [July 2009] contract to train his successor just two months after retiring. "It appears unethical to hire back former executives at nearly twice their former pay to advise new executives who were placed in their position based on their

expertise and year of Postal Service experience,” wrote the IG’s auditors. “There is also employee morale and public image issues management must consider when the Postal Service is closing post offices and seeking a reduced delivery schedule.” The auditors also reported that the agency improperly classified the status of 5%—some \$910 million—of its \$18 billion annual contracting costs.

- The inspector general reported that between \$289 million and \$894 million can be saved by the USPS over the next decade by merging and closing dozens of the agency’s administrative offices. The IG recommended that the USPS consider merging several offices into a central location, closing district offices with low mail volume and limited work hours, or moving regional offices to its Washington headquarters to reduce operating costs.
- “These IG reports raise extremely troubling questions about management abilities and core decisions by the Postal Service,” said Collins. “[USPS] is at a crossroads in its history. The survival of this institution, which is vital to our country, depends on its regaining its financial footing.” (*Washington Post*, Ed O’Keefe, 09/26/10; *Government Executive*, Emily Long, 09/27/10)

The USPS is in crisis

- The Postal Service is effectively bankrupt with losses for FY2010 estimated to range between \$6 billion and \$7 billion. The agency has already borrowed approximately \$13 billion from Treasury, leaving only \$2 billion available for operating needs. At the end of 2009, the USPS had \$33.5 billion in outstanding liabilities and an additional \$54.8 billion in unfunded retiree health and pension liabilities.



Source: <http://s.wsj.net/public/resources/documents/info-POSTOFFICE100706.html>

- In the *American Spectator*, Doug Bandow wrote, “The USPS is in crisis. It is locked in a declining market. It can only survive with indirect taxpayer subsidies and a ban on private competition. Instead of forcing Americans to pay more for less service, Congress should open mail delivery to all comers. ...Whatever the theoretical arguments for a public mail monopoly in the past, they have been superseded by a rapidly changing marketplace. ...[Bankrupt] Uncle Sam has no money for a postal bailout. Only privatization is a realistic option. We need real change that we can believe in.” (*American Spectator*, Doug Bandow, 10/05/10)

A sign of the times

- The Internal Revenue Service plans to stop mailing instructions and paper forms for annual income tax return filings, a move that will save the agency \$10 million. Taxpayers, who want to file paper returns, can obtain printed forms on-line at www.irs.gov or at local IRS office, and participating libraries and post offices.
- In 2009, approximately 11.5 million taxpayers received tax information in the mail. More than 96 million individuals filed their tax returns in 2009 via IRS e-File—up nearly 7% from 2008. (Washington Post, Ed O’Keefe, 09/27/10)

Election delayed after ballots are lost in the mail

- The American Postal Workers Union (APWU) extended its internal election to October 14 after the union announced that only about 39,000 ballots were turned in and “a large number of union members had not received their ballots.” Apparently, thousands of were lost in the mail. According to Fox News, “It’s unclear whether the mail mix-up will become an eleventh-hour campaign issue.” (*Fox News*, 10/07/10)

TVA

TVA's four new board members are sworn in

- The Obama administration's four new appointees to the TVA board were sworn in on October 7, 2010. The new directors include three Democrats nominated by the President—Middle Tennessee State University professor Barbara Haskew; Georgia Tech professor Marilyn Brown; and Oak Ridge lawyer Neil McBride. In addition, Obama re-nominated former TVA chairman and Republican businessman Bill Sansom. Obama has yet to nominate a replacement for outgoing TVA Director Howard Thraikill, whose term expired in May, but has stayed on until the current Congress adjourns. (*Times Free Press*, Dave Flessner, 10/05/10; *Tennessean.com*, 09/08/10)

TVA receives "fair" rating on its environmental record from its IG

- TVA's inspector general said the utility has a "mixed" environmental record, earning the utility only a fair rating despite its efforts to improve air quality and improve coal ash disposal. TVA IG Richard Moore said the utility's Kingston coal ash spill nearly two years ago "represented one of the largest environmental disasters in U.S. history and demonstrated poor performance in managing coal ash, ...[reflecting] a culture that coal was unimportant and relegated to the status of garbage at a landfill." In addition, TVA has one of the highest concentrations of transformers with toxic polychlorinated biphenyls [PCBS] which new environmental rules may require be replaced and TVA trails other utilities in promoting power generation through renewable sources, said Moore. "We deem that taken as a whole, TVA's overall environmental performance was fair," wrote the IG in a 56-page performance report. (*Times Free Press*, Dave Flessner, 09/28/10)

Senator Bingaman calls for creation of a "green bank" to finance the development of clean energy technology

- Senator Jeff Bingaman (D-NM), chairman of the Senate Energy and Natural Resources Committee, called for the creation of the Clean Energy Deployment Administration (CEDA)—a federally owned, not for profit "green bank" to finance the development of clean energy technology. In 2009, Bingaman's committee approved a bill that would use the federal government's ability to make focused, "patient" investments to leverage and unlock private capital markets necessary to fund the country's clean energy future. According to the Center for American Progress, the "newly established public CEDA—a financial entity with sufficient initial capitalization to invest in and accelerate the deployment of clean energy technologies across the United States in partnership with the private sector—will

lead to the steady and reliable creation of clean-energy jobs and will be a crucial element in the U.S. transition to an energy efficient, clean energy economy.” [See www.americanprogress.org/issues/2010/06/ceda_june_2010.html/print.html for additional information on CEDA).

- “CEDA would help move a wide range of clean energy technologies from laboratory to marketplace, combining the technological expertise of the Department of Energy with a new, independently overseen cadre of business professionals who can craft the financial support that entrepreneurs need to negotiate the ‘valley of death’ where new technologies languish for lack of investment support,” wrote Bingaman in a September 20 editorial in *Politico*. “CEDA would have a broad mandate to identify, on a continuing basis, technologies with the best potential to deliver sustainable energy with the most efficient use of federal dollars. A broad comprehensive energy bill may not be possible in this Congress. But action on common-sense bipartisan proposals like CEDA should not be put off. If we want to realize the energy security, environmental security and economic benefits of the clean energy revolution, then the investments we need in clean energy technology deployment cannot wait. ..As senators contemplate their final “must do” lists for this Congress, I hope they give priority to America’s leadership of the clean energy revolution and conclude that the bipartisan proposal to establish CEDA is a timely initiative that deserves to be enacted this year.” (*Politico*, Senator Jeff Bingaman, 09/20/10; *Washington Independent*, Andrew Restuccia, 09/20/10; *Center for American Progress*, Jake Caldwell and Richard W. Caperton. 06/16/10)

Proposed Cap and Trade bill could “wreak havoc on the Tennessee economy” warns the Tennessee Center for Policy Research

- The Tennessee Center for Policy Research (TCRR) conducted an analysis of the “cap and trade” legislation passed by the House, which the Senate is expected to consider during the lame duck session after the November election.
- According to TCRR, “The current cap and trade proposal sets targets to reduce greenhouse gas emissions 17 percent below 2005 levels by 2020, 42 percent below 2005 levels by 2030, and 83 percent below 2005 levels by 2050. It is estimated that the price companies must pay to emit CO₂ above the threshold could reach \$48 to \$61 per metric ton of CO₂ by 2020 and could increase to between \$123 and \$159 per metric ton of CO₂ by 2030. To put this into perspective, Tennessee Valley Authority’s (TVA) Cumberland fuel plant in Cumberland City, Tennessee, released 15.88 million tons of CO₂ in 2009.⁷ Assuming the plant still releases the same amount of CO₂ in 2020, the plant would release 2.7 million tons over threshold and would owe between \$129 million and \$165 million in fines. By 2030, the same plant (still assuming it was producing 15.88 million tons of CO₂) would be 7.15 million tons over threshold and would owe \$879 million to \$1.14 billion in fines, an enormous cost that would surely be passed along to TVA’s consumers.”

- If the cap and trade bill were passed, TCRR projects that by 2030 gas prices could increase by up to 27%, while electricity and natural gas prices could increase as much as 64% and 73%, respectively. TCRR estimates that the bill could cost the state \$9.8 billion annually and result in the loss of up to 52,000 jobs. On average, Tennessee households' disposable income could decline by more than \$1,100 a year as a result of this legislation. (*Tennessee Center for Policy Research Policy Report*, Allyn K. Milojevich, 10/04/10)

“...We cannot afford regulatory capture nor can we afford consensus regulation, not in any government agency, but especially at the SEC, which oversees such a systemic, and fundamental, aspect of our entire economy. For our markets to remain credible—and it is essential that they do so—it is vital that regulators be proactive, rather than reactive, when future developments arise ...[I]f we fail, if we do not act boldly, if the status quo prevails, I genuinely fear we will be passing on to my grandchildren a substantially diminished America—one where saving and investing for retirement is no longer widely practiced by a generation of Americans and where companies no longer spring forth from the well of capital flows that our markets used to provide.”

Senator Ted Kaufman (D-DE)
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Canfield Press, LLC
600 Cameron Street
Alexandria, VA 22314

Phone: (202) 617-2110
Fax: (202) 403-3926

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